



**EUROPEAN COMMISSION**  
DIRECTORATE  
GENERAL ECONOMIC  
AND FINANCIAL  
AFFAIRS

Brussels, 1<sup>st</sup> September 2020

## **UNDERSTANDING THE POLITICAL ECONOMY OF REFORMS: EVIDENCE FROM THE EU**

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Technical note for the Eurogroup<sup>1</sup>

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<sup>1</sup> This is a technical background paper prepared by the Commission services. It does not represent the Commission position and does not bind the Commission in any way.

## **1. Introduction: the impact of Covid-19 on the conditions for advancing structural reforms**

**Alongside its formidable health and social dimensions, the Covid-19 crisis is having drastic consequences for our economies.** Moreover, the economic impact of the pandemic comes on top of the subdued potential growth that the European economies have been experiencing over last several decades<sup>2</sup>. Reforms and investment promoting inclusive and sustainable growth are thus needed more than ever.

**However, implementation of such reforms is notoriously difficult.** Addressing the obstacles to fundamental drivers and enablers of growth and productivity has often economic, social and political costs in the short-term, typically falling on specific groups, while benefits are diffused across the economy and may only arise over time. Reforms thus produce winners and losers, and the opposition of potential losers makes them difficult to implement. Moreover, the distribution of gains from a reform may in some cases be perceived as unfair by the population at large. The resulting lack of domestic reform ownership and commitment becomes a serious hurdle for planning, adopting and implementing complex reforms that enhance potential growth.

**Progressing with structural policies that promote inclusive and sustainable growth is particularly important for the euro area.** In the absence of a flexible exchange rate and with strong spillover effects, euro area countries need to find adequate adjustment mechanisms to absorb shocks. Implementing adequate reforms is therefore crucial for addressing macroeconomic imbalances. Enhancing Member States' reform efforts to address underlying social and economic weaknesses that could lead to increased divergences in the event of shocks, and potentially disturb the good functioning of the Economic and Monetary Union, is all the more important.

**The Covid-19 crisis is both a daunting challenge and a stark reminder for policymakers to generate momentum behind ambitious reform agendas, including those serving the green and digital transition.** The decisive role of governments in times of emergency came more to the fore during the crisis. The pandemic and the crisis that has followed have highlighted the capacity of governments in responding to the alarming health situation and supporting the economy. Financial support programmes for businesses and deferral of interest and tax payments, as well as the activation of short term work schemes, have contributed to limiting the economic damage. In addition, the forceful response at EU level has confirmed Member States' capacity to coordinate within the Union. Experience suggests that it will be a challenge to maintain momentum in the policy actions following a crisis. Indeed, the strong impact that the crisis has on people's lives could erode popular support for further action. Governments will need to pay particular attention to the design of their recovery strategy to make reforms perennial, through generating economic growth and living-up to citizen's expectations. The need to sustain the recovery and ensure that the policy action supports the longer-term challenges, such as the green and digital transition, makes it clear that reform fatigue or reform reversals cannot be afforded.

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<sup>2</sup> The reasons behind slower potential economic growth were analysed in a background note "Drivers of the low interest rate environment" presented by the Commission to the Economic Financial Committee in March 2020.

**The role of the EU in supporting structural reforms is also evolving as result of policy responses to Covid-19.** Traditionally, the European Semester has supported structural reforms at national level through benchmarking, the development of best practices and guidance in the form of Country-Specific Recommendations. Long-term investment has *inter alia* been supported by the Cohesion Funds. In recent years, technical assistance through DG REFORM (formerly Structural Reform Support Service) has provided a new tool to support reforms. The Recovery and Resilience Facility (RRF) offers a new and powerful instrument for the EU to support reform efforts at Member State level, combined in coherent packages of investments and reforms in policy areas where there are pronounced barriers to growth. By providing direct financial support linked to the implementation of investment and reforms, the RRF will provide positive incentives for Member States to make their economies more resilient and better prepared for the future.

**The remainder of this note provides lessons on how a combination of political economy factors can affect reform implementation, based on recent experiences of Member States.** It draws on a non-exhaustive list of reform episodes observed across the EU over the past decade<sup>3</sup>. The analysis covers factors that have facilitated implementation of reforms, as well as reforms that were not implemented as planned due to various political economy constraints. It concludes by indicating how the design of the Recovery and Resilience Facility potentially addresses some of these lessons.

## **2. A closer look at structural reforms experiences in the EU**

### ***Strong political mandate facilitates reform adoption***

**The overall democratic support often plays a decisive role in the capacity to pass reforms.** Evidence shows that governments with strong support from the parliament have better managed to implement substantial reform measures. Moreover, reform momentum can also be affected by the election cycle<sup>4</sup>. With general elections approaching, governments may refrain from implementing reforms bearing short-term costs, whereas newly-elected governments tend to be more open to reforms whose benefits will materialise over a longer time-span.

### ***How can reform design help facilitate implementation?***

**Reform design can make a difference and contribute significantly to the success of a reform.** In particular, it is important to take into account also the distributional impact of overall growth-

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<sup>3</sup> Evidence was collected through a consultation of DG ECFIN's geographical desks in collaboration with the European Semester Officers (ESOs) (for a detailed list of reforms analysed, see annex 1). This was complemented by insights from recent literature on political economy of reforms. For the policy framework, the note has built on the work done by OECD (2018), Høj et al. (2006), Tompson (2009) and Grüner (2013). Further empirical insights have also been drawn from studies related to reform episodes or macroeconomic support programmes in Europe, for example Turrini (2017), European Commission (2016b) and Pinelli et al. (2017).

<sup>4</sup> European Commission (2016) analyses the implementation of the Macroeconomic Imbalance Procedure five years after its introduction. The study shows a significantly lower CRS compliance if an election is forthcoming. However, the actual impact of undertaking reforms on re-election probability is not obvious (see Buti, Turrini and van den Noord (2014)).

enhancing reforms. As such, certain policies are win-win in terms of reinforcing growth and reducing inequality, but others may involve trade-offs.

Member States' experiences point to the following lessons:

- *An effective consultation with stakeholders and constructive negotiation with opposition parties can help build support and long-term sustainability of reforms.* Potential losers from a reform, especially if they are well-defined and organised, can mobilise themselves in order to maintain the *status quo*. An effective and inclusive consultation process can contribute to building consensus for reforms, by helping to set out clearly the long-term objectives pursued and allowing sufficient time for discussion of various policy options available. It can contribute to strengthening general trust and making stakeholders, social partners or opposition parties more willing to arrive at a compromise. In Denmark, for instance, the minority government invited the opposition to discuss its major welfare reform in 2006. It then stepped back on some initial measures related to student grants and unemployment benefits, which were perceived as unfair. This negotiation was important to create broad political support and safeguard the core of the welfare reform, i.e. linking the retirement age to life expectancy. In some cases, however, concertation may also bear the risk of excessively limiting the implementation and the scope of reforms if the multitude of (opposing) interests of different groups are difficult to be properly addressed.
- *Some form of compensation or measures (temporarily) limiting the impact on those who may lose out from a reform may help gain reform acceptability.* Such compensation may take the form of financial compensation, or measures compensating for potential adverse effects from other elements in the package. As compensation measures can come with budgetary costs, they also depend on a country's fiscal situation. Alternative approaches consist in "grandfathering"<sup>5</sup> of existing rights and gradual phasing-in of reforms through longer transition periods. They can help soften opposition and reduce the risk of reform reversals. At the same time, they can water down the objectives of reforms and generate concerns about fairness, for example if incumbents continue benefitting from generous arrangements at the expense of new entrants in the case of certain reforms to the business environment. In practice, compensation played an important role in gaining support for pension and labour market reforms<sup>6</sup>.
- *Reforms that are part of a larger package tend to meet less resistance –and may also be more effective precisely because they are part of a set of mutually reinforcing measures.* For instance, Italy managed to adopt and implement a comprehensive labour market reform package in 2014-2015, which combined an effective relaxation of employment protection legislation, an increased duration and coverage of unemployment benefits, and efforts to enhance the effectiveness of active labour market policies. Another example of a comprehensive package of reforms is the law on economic activity, growth and equal opportunities, the so-called "Macron law", introduced in

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<sup>5</sup> A grandfathering clause is a provision creating an exemption in which an old rule continues to apply to the existing situations while a new rule will apply to all future cases.

<sup>6</sup> See Turrini (2017) and European Commission (2016).

France in 2015. The aim of this law was to improve the French business environment at large, notably by promoting the functioning of the product market. The reform resulted from an intensive preparation and interaction with stakeholders, seeking to simultaneously lift barriers to activities in a wide array of sectors, including transport, professional services and retail, as well as contributing to improve the functioning of the labour market.

- *Appropriate sequencing and pace of reforms also play a role.* Sequencing of measures is often crucial in order to make reforms work. The sequenced approach for reforming the tax revenue administration chosen by Portugal is a good example. This reform (conducted in 2011-14) was a package comprising the reform of the tax revenue administration and measures to prevent tax fraud, evasion and assessment errors. The reform started by laying the foundations of a single revamped tax administration that set the stage for subsequent policy actions, including enhanced IT services and actions that supported tax compliance. Besides, a swift adoption of reforms can ease their implementation by limiting the room for manoeuvre for diluting the reform. Policymakers should nonetheless grant an appropriate time for debating the reform in order to ensure ownership. Next to sequencing and pace, also the timing of reforms matters. This not only refers to the earlier mentioned election cycles, but also to macroeconomic conditions, as for example some reforms would come with higher short-term costs when implemented in a cyclical downturn.
- *Exchange of best practices and peer-reviews can reveal the unsustainability of existing policies and help raise citizens' and politicians' awareness of the need for action.* It can also provide tools for a government that wishes to initiate a reform, helping to better explain the envisaged changes in policies and expected results. The incentive to reform generated by international institutions is helpful, but rarely sufficient in itself to generate political support of the government in office. International pressure might indeed facilitate the domestic decision-making process, especially in times of economic downturn, but its ability to enforce reforms upon governments without ownership is limited.
- *An evidence-based policy design can foster acceptance of reforms and facilitate its overall implementation.* The quality of the preparatory and implementation process can have a positive effect on reform readiness. A culture of *ex-ante* and *ex-post* policy assessment increases transparency, contributes to the effectiveness and efficiency of reforms, and helps to build trust in the decision-making process. Sufficient technical capacity should be made available to support evidence-based policy and to ensure effective implementation<sup>7</sup>.
- *Effective communication backed-up by objective and evidence-based analysis can help gain support for reforms.* Estonia's work ability reform is an example of combining good

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<sup>7</sup> If the specific expertise is not available in-house, governments can resort to external expertise and can get EU technical assistance to support the implementation of national reforms. The Structural Reform Support Program (SRPS) facilitates the implementation of important reforms in different Member States. Building upon the success of the Structural Reform Support Program, the Commission proposed to establish a Technical Support Instrument. With this instrument the Commission can continue to provide tailor-made expertise on the ground, so that the Member States have the necessary institutional and administrative capacity to develop and implement growth-enhancing reforms.

communication with high-quality evidence-based analysis carried out by respected institutions, such as the Bank of Estonia. Moreover, the reform benefitted from the initial trigger of international policy exchanges and peer-reviews, such as the analyses in the European Semester. Both ex ante and ex post communication is important to foster reform acceptance and avoid reform fatigue, as it is also crucial to communicate on the good results achieved.

### **3. The role of EU economic governance in supporting Member States' recovery reform agendas**

#### **EU economic governance can support Member States' efforts to implement their recovery strategies.**

The European Semester's revamped economic governance structure will put a stronger emphasis on delivery of results. The Recovery and Resilience Facility will be closely aligned with the policy guidance provided under the European Semester. In this respect, EU economic governance raises awareness of challenges and provides a framework to prioritise reform action, including in view of supporting the digital and green transitions. Work is being undertaken to provide guidance on the roll out of the Recovery and Resilience Facility in advance of the forthcoming Semester.

**Robust recovery and resilience plans will provide Member States with a framework to address the effects of Covid-19 and help strengthen economic and social resilience.** Structural reforms can play an important role in assisting Member States to deal with the economic and social effects of Covid-19. Setting an appropriate sequencing through relevant milestones and targets can also contribute to the success of the overall recovery and resilience plan. National ownership remains important in underpinning successful reforms. In addition, a number of initiatives and tools can help to increase national ownership and encourage reform adoption, such as the independent analyses from the National Productivity Boards, and a more systematic use of benchmarking exercises.

**The design of the Recovery and Resilience Facility can help overcome some of the political economy constraints.** The strong link between investments and related reforms provides incentives for putting forward comprehensive packages. In this way, the financial incentives through grants or loans are accompanied by improvements in institutional settings, framework conditions or market performance that contribute to an efficient use of the public resources. The comprehensive approach can also broaden the support for the recovery reform agendas in general, including by addressing the distributional impact of a specific reform (within and across generations). Support can also be gained by providing a solid rationale on how the recovery and resilience plans can strengthen the growth potential and economic and social resilience. To that end, Member States could reach out and seek support at national level from the relevant national independent institutions, notably the National Productivity Boards, and at EU level through the newly proposed Technical Support Instrument.

### Questions for discussion

- *What do you think will be the implications of Covid-19 crisis for the political economy of implementing growth-enhancing reforms in the euro area? How can the lessons drawn inform the preparation of the recovery and resilience plans?*
- *What elements of reform design can help to sustain implementation over time?*
- *Do you have specific experiences on how the design of reform processes can contribute to successful implementation? For instance, how to address the distributional aspects of reforms?*
- *How could national independent institutions be involved in the preparation of the recovery and resilience plans under the Recovery and Resilience Facility?*