Summary for non-specialists
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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.