Why Are Structural Reforms So Difficult?

The benefits of structural reforms aren't always as obvious as the smaller, short-term costs

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MANY economic problems are due to problems in the working of markets, rather than, say, to resource shortages or an excess or deficiency of overall demand. To most economists, the need for structural reforms—measures that change the institutional and regulatory framework governing market behavior—then seems obvious. Such reforms can impose costs on a few in the short run but will potentially make many more better off in the long run. Economists believe that the opposition of these few can be overcome through compensation from the government. But this rarely happens. Why?

Reforms are hard to sell

The first problem is that the gains from reform are never as clear to the wider public as they are to economists, often because they are indirect. Consider the removal of interest rate ceilings on loans. The public is likely to view such a reform as a license for lenders to charge extortionate rates.

In truth, if interest rate ceilings are removed in a competitive financial system, the prices of loans will reflect risk accurately, and loans will be allocated more efficiently. The kind of distortion that ceilings introduce depends on the kind of lenders present in the system. If the lenders are private banks that aim to maximize profits, they will simply not lend to projects requiring a break-even rate above the ceiling. So risky projects will be shut out, even if they are worthwhile.

But if lenders don't care about profits or can't evaluate risks, they will be inundated with loan applications from high-risk borrowers with financially unviable projects. Because lenders can't charge a rate that exceeds the ceiling, they may use some other way of choosing among applicants willing to pay a higher rate—for example, the ones who pay the largest bribe. Applicants who have the most to gain from bribing will be those with the most unviable projects because they will get the largest interest subsidy. Thus, lenders (often state-owned) will not only succumb to corruption but will also make very risky loans.

When interest rate ceilings *are* in place, regardless of whether lenders maximize profits, loan allocations aren't optimal: the economy assumes either too little or too much risk. Moreover, lenders can't make a large enough return from lending to pay savers a high enough rate to generate savings in the economy.

The trouble is that it requires a high-minded and articulate politician to appreciate these arguments and compress them into the persuasive sound bites that would probably be needed to sell interest rate liberalization to the public. Far easier to attack the Shylocks and retain ceilings!

Another problem with selling structural reforms is the possibility of short-run costs to some. For example, a reform that makes it easier to fire employees enhances a firm's ability to shape its workforce to its needs and makes it more willing to hire. In the short run, firms will use the newfound freedom to prune deadwood. And workers, concerned about the increased job uncertainty the reform implies, may consume less, thereby reducing growth. But in the long run, although it may strike the noneconomist as paradoxical, greater freedom for firms to fire should boost employment and incomes.

The costs and benefits of reform may also accrue to different people. Economists believe that if a reform is beneficial overall, those who benefit could, in principle, compensate those who are hurt by it. If the compensation actually took place, the losers would be more likely to drop their opposition, and everyone would benefit. Unfortunately, such compensation may be hard to implement: the labor reform described above helps firms and the unemployed who now find jobs, but it hurts the workers who would be fired. How, for instance, should one compensate a steelworker who loves his job and knows he will never again find work that pays anything remotely near his current salary? And how will compensation arrangements differentiate between good laid-off workers, who will find new jobs, and bad ones, who won't, without destroying the incentive of the former to remain in the labor force? How does the worker know whether, once he gives his job up, public opinion will support paying his benefits at a future date when he is powerless?

The bottom line is that those who perceive themselves to be potential losers—possibly a majority of workers, given the uncertainty surrounding who will be axed—may oppose reforms, and their cohesiveness will make them a very effective lobbying group.

Timing is all important

Despite these impediments, policymakers *do* implement structural reforms. The IMF's April 2004 *World Economic Outlook* devoted a chapter to analyzing when and how structural reforms take place in industrial countries in financial, labor, and product markets, and in trade and taxation. Here are some of the findings and some possible explanations.

First, a period of weak or negative growth is conducive to reforms: it either causes people to see the need for reforms or weakens opposing interest groups. For example, in New Zealand and the United Kingdom, where deep structural reforms were implemented in the 1980s, persistent, difficult economic conditions had built up support for change.

Second, when there is fiscal room in the budget, reform is more easily accomplished. It helps to have such flexibility if, for example, interest groups need to be paid off. Labor market reforms in the Netherlands in the 1980s and 1990s were aided by sizable budgetary support. While unemployment, sickness, and disability benefits were cut, workers' taxes and social security contributions were also cut, making the reforms more palatable.

Third, some reforms seem to feed off others. For example, product market reforms appear to make labor market reforms easier. A possible explanation is that when competitive pressures are unleashed by product market reforms, organized labor may be forced to worry about the risk to employers if it doesn't accept greater flexibility.

Fourth, external pressure helps. If a country's three main industrial country trading partners implement reforms, its own reform efforts typically increase, too. It may well be that the reforms one country implements make firms in partner countries less competitive, forcing those countries to either change or perish. External policy competition could thus be a strong force for improving the business environment rather than, as is often alleged, leading to a race to the bottom. When a country joins an international economic organization, that organization can be a second source of external pressure. We know that the European Union has fostered trade and product market reforms in its member countries and that monetary union has increased financial market reforms in the euro area. And IMF surveillance is a form of international peer pressure—at the global level—for policy improvements.

Fifth, there are reasons to believe that small interest groups tend to have more power in proportional voting systems. In majoritarian systems, a party needs to cater only to a sizable bloc to achieve a majority or the plurality needed to govern; it doesn't have to pander to every interest group. This implies that reforms should be easier in majoritarian systems and, indeed, they are: witness the greater number of reforms implemented in recent years in the typically majoritarian Anglo-Saxon countries. The most determined reformers in these countries turn out to be those with a strong majority in parliament.

Finally, reforms don't produce benefits all the time. In fact, as argued earlier, labor market reforms seem particularly difficult, not only because they can lead to a short-term dip in growth and employment but also because the costs fall disproportionately on some.

Lessons for reformers

Are there lessons from this analysis? Yes, but one should heed two caveats: every country is unique; and reformers in industrial countries have the luxury of timing their reforms, which may not be available to a country in crisis or a developing country, where the costs of the distortions may be much larger. Nevertheless, some lessons emerge:

- *Start reforms during the recovery from an economic downturn.* It is a good time because the downturn has focused people's minds on the need for reform while the recovery promises a quicker reward.
- *Use budgetary surpluses to buy reform*. Reform is tough even in the best of times. The ability to compensate losers helps, so why not use it well?
- *Start with reforms that have more immediate benefits.* Trade and financial market reforms, for example, produce benefits even in the short run. If these are successful, they not only have a demonstration effect but may also increase competitive pressures, thus making further reform easier.
- *Secure outside support*. Signing an international agreement or joining an international club can provide the external discipline that will force the pace of reforms. For instance, Chinese banks are under tremendous pressure to clean up their act because, under the terms of China's accession to the World Trade Organization, foreign banks will be able to compete on a level playing field in China starting in 2007.
- *Try to change your system of vot* . . . Sorry, scratch that one.

Happy reforming! ■