A comparative view on reform complementarities

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A comparative view on reform complementarities*

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Policy complementarity matters for a sustainable reform process : a positive interaction with the rate of growth is found in the new members of the European Union. Reform design also helps understand the effects of the change in currency regime implied by monetary union, as suggested by Portugal's experience after the signature of the Maastricht treaty.

Une vue comparative sur la complémentarité des réformes

La soutenabilité d'un processus de réformes dépend da la complémentarité des politiques : une intéraction positive avec le taux de croissance se dégage de l'expérience des nouveaux membres de l'Union Européenne. L'architecture des réformes est également utile pour comprendre les effets du changement de régime suite à l'union monétaire, ce qui est illustré par l'expérience portugaise après la signature du traité de Maastricht.

Classification JEL : P2, E61

This presentation argues that policy complementarity matters for a sustainable reform process. It is divided into two parts. The first one lays down the argument, contained in previous work, that the relationship between the rate of growth and the level of reforms during the transition from central plan-

* Based on Jorge Braga de Macedo and Joaquim Oliveira Martins [2006] Growth, Reform Indicators and Policy Complementarities, *NBER Working Paper* no. 12544, September 2006 forthcoming *Economics of Transition* and e.q. Macedo,, Martins and Bruno Rocha (MMR), *Are complementary reforms a "luxury" in developing countries ?* in progress. An earlier version was presented on *20 February 2007* at a panel on « The political economy of reforms in Europe and France » of the French Economic Association meetings. I am grateful to the participants for comments and to my co-authors for help in the preparation of this text, which has been used in classes given at Institut d'Études Politiques in Paris. The usual caveat applies.

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ning reflects the importance of the terminal condition of membership in the European Union. In other words, given a gradual increase in the level of reforms, as captured by the EBRD transition indicators, countries from central and Eastern Europe experienced a period when complementarity and the rate of growth decreased, which was followed by a period when complementarity and the rate of growth decreased increased.

Reports by Amable and Saint-Paul in previous sessions have not stressed the importance of complementarity enough, but the debate about « French gradualism » cannot be understood without a reference to reform design. The same applies to the change in Portugal's currency regime after the signature of the Maastricht treaty and I use this example in the second part.

1. Policy complementarity during transition

If reforms are conceived to be implemented by stealth, they are more likely to be piece meal and therefore not produce enough gains in terms of economic growth to be sustained. In other words, it will be all pain no gain ! Instead, if the coherence of reform strategies can be measured and comparisons across countries can be made, then best international practices might be emulated and seemingly insurmountable economic (let alone cultural) differences overcome. This is especially true when multilateral surveillance recognizes long term objectives (EU membership) as credible terminal conditions, or when crises occur.

Two examples, from transition countries and emerging markets respectively, are available from earlier work. Macedo and Martins [2006] define a complementarity index across structural reforms (captured by EBRD indicators) and investigate its impact on economic growth for Central and Eastern European countries in transition. This policy experiment is particularly attractive because, allowing for different initial conditions, all transition countries were offered roughly the same liberal policy package designed to make use of market mechanisms to obtain the best possible allocation of resources. Countries have implemented this package in different ways and extent leading to a wide and rich variation of outcomes[1].

1. Also Rocha [2007], At Different Speeds : Recovering from the Asian Crisis, *ABD Institute Working Paper* n° 90, February first presented in the Sciences-Po course mentioned above.

→	Health	Social security	Education and R&D	Fiscal policy	Monetary Policy	Financial sector reform	Product markets	Labour markets
Health	--	Reduce early retirement by disability	Incentives for Human K accumulation	Reduce spending pressures				**Better health status**
Social security	Sustainable retirement incomes	--	Incentives for Human K accumulation	Reduce implicit liabilities		New market segments	Reduce producer tax wedges	**Reduce labour tax wedges**
Education and R&D	Healthy lifestyles; Innovation	Financial literacy	--	More effective spending	Non-price competitiveness	Financial literacy	Higher skills	Higher skills
Fiscal policy	Resources for long-term financing	Resources for long-term financing	Resources for long-term financing	--	Aggregate demand management	Avoid Crowding-out	Reduce producer tax wedges	**Reduce labour tax wedges**
Monetary Policy			Improved individual financing	Impose budget discipline	--	Reduced inflationary pressures	market interest rates	**Reduce need for indexation**
Financial sector reform	Higher activity rates, Innovation	Development of annuities, reverse mortgages	Improved individual financing	Prevents systemic risks	Prevents systemic risks	--	Improved credit conditions	More investment and employment
Product markets	Higher activity rates; Innovation	More employment for older workers	Increases return on education	Improves profitability and tax base	Lower price pressures	Lower level of bad debts	--	More job creation
Labour markets	Higher activity rates	More employment for older workers	Increases return on education	Improves employment and tax base	Lower wage pressures	Lower risks of excess indebtedness	Easier Entry/Exit	--

Using a larger sample, which draws on EBRD and World Bank *Doing Business* indicators, preliminary evidence suggests that complementary reforms are not a « luxury » in developing countries[2].

The attached table reports the matrix of policy complementarities in Macedo and Martins [2006], showing the positive spillover of policy row on policy column. Examples drawn from the EU experience can be provided.

2. MMR define certain policy complementarities that are more important than others at certain stages of economic development to see how complementarity affects the catching-up process, and thus make a link with sequencing. Another idea is to deal with policy priorities through the weighting scheme of the reform indicators.

First, international competitiveness and human capital policies : the EU Lisbon strategy focus on becoming the most competitive economy in 2010 mentions policy coherence and provides many structural indicators to be monitored, but the complementarity between real exchange rate, relative prices and human capital policies needs more attention.

When real exchange rate adjustment is constrained by EMU, relative prices between tradable and non-tradable goods & services may hinder the development of the tradable sector. Moreover, strong upward price pressures in the non-tradable sector (e.g. services) require an appropriate framework for competition policy and regulatory reform.

A second example is pension reform and labour market performance : many OECD countries, including France, increase the retirement age but this will not produce results if the labour market is not creating jobs for older workers. Taking this complementarity into account will increase the benefits to both reforms, making them more visible to public opinion and broadening the political support they need in order to be fully carried out.

A third example is tertiary education reform with introduction of tuition fees and individual financing systems. Higher cost of education may decrease private incentives to invest in human capital when students are liquidity constrained.

2. Regime change in Portugal

The matrix illustrates the importance of product market competition, as a signal that policy design being broad based rather than a succession of individual sectoral reforms. This is something that is well accepted, and which is evident in the advice currently provided to Portugal, for example by Dani Rodrik, who places a lot of emphasis on technological changes, and on getting things to work better or improve the productivity. This is of course the message from Daniel Cohen's model of industrial productivity[3]. Instead of just talking about economic institutions, which is almost as broad as social capital, Causa and Cohen [2006] distinguish, aside from the usual factors of production, the role of infrastructure and of integration with the international trading system. It turns out that, with respect to those two dimensions, Portugal is on par with many other of the European Union countries, or countries outside of that. But with respect to human capital, this has been mentioned, and the ratio of human to physical capital, it really is far behind. Even though it is restricted to industry, Cohen's approach is

3. See my *Economic advice and regime change in Portugal* presented at the conference Challenges Ahead for the Portuguese Economy, where the references to follow in the text can be found.

relevant to present a view about aggregate productivity in the future, because those are traded goods and they are most important for investment[4].

Talking about creative destruction at the technological frontier is also very fitting in this context, and I want to go back to the Krugman [1991] « history versus expectations » model, which I use in the development course mentioned at the outset. When there are multiple equilibrium development paths, a country can escape being the prisoner of history, of past policies and achievements by following an expectations-driven path depending on three observable parameters. One parameter, which has to do with intertemporal trade, is the interest rate. It must be lower than the combined effect of increasing returns to scale and speed of adjustment. Aside from technology, then, we find flexibility as a guide for institutional change.

Flexibility includes the ability to exploit the complementarity between macroeconomic and structural reforms[5]. Yet there is relatively little attention to the design of reform packages and its effects on economic growth, suggesting that, when there are many distortions, eliminating only few of them may threaten the sustainability of the reform process. Reforms are more likely to fall prey to the second-best argument under ready-made policy packages with scant knowledge about local conditions. A more systemic approach to national economies will include the concept of complementarity as an input into economic advice. When starting a reform strategy that deliberately results, in its initial stages, in a reduction of economic coherence, countries incur a risk. While it may be rational to bear that risk, it cannot be systematically ignored without facing long-lasting negative consequences.

4. What Cohen likes to call the Baumol curse (the differential rise in the productivity of traded and non traded goods) is not only relevant for short-run adjustement but also for growth and development. More detailed factors of production suggest immediately that we need more competition and we need a better policy design.

5. Examples from Portugal's recent changes in currency regime are provided in the paper cited in note 3, where the communiqué of the Monetary Commitee listing a series of structural reforms as conditions for entry of the Greek drachma into ERM on 18 March 1998 to be successful is quoted.