Available online at www.sciencedirect.com
ScienceDirect
Journal of Macroeconomics 30 (2008) 179–198
Journal of MACROECONOMICS
www.elsevier.com/locate/jmacro

The political economy of structural reforms under a deficit restriction

Marcos Poplawski Ribeiro [a,*], Roel Beetsma [b,1]

[a] University of Amsterdam, Tinbergen Institute and Department of Economics, Roetersstraat 11, 1018 WB Amsterdam, The Netherlands
[b] University of Amsterdam, Tinbergen Institute and CEPR, The Netherlands

Received 5 July 2005; accepted 11 January 2007
Available online 30 March 2007

Abstract

This paper analyzes the incentives of a government facing electoral uncertainty to implement structural reforms in the presence of a deficit restriction. In designing a reform package, the government faces a trade-off between enhancing its electoral chances by providing compensation to private individuals and the cost of violating the deficit restriction. Ceteris paribus, tighter sanctions, more volatile macroeconomic shocks and lower income inequality worsen the trade-off.

JEL classification: E62; H11; H30; H50

Keywords: Structural reforms; Deficit restriction; Compensation; Elections; Stability; Growth pact

1. Introduction

> "We must recognize that the goal of consolidating public budgets may well conflict in the short term with the goal of enhancing the potential for economic growth. A

* Corresponding author. Tel.: +31 20 5253913; fax: +31 20 5254254.
E-mail addresses: M.P.Ribeiro@uva.nl (M. Poplawski Ribeiro), R.M.W.J.Beetsma@uva.nl (R. Beetsma).
URLs: http://www1.fee.uva.nl/toe/content/people/poplawski.shtm (M. Poplawski Ribeiro), http://www1.fee.uva.nl/toe/content/people/beetsma.shtm (R. Beetsma).
[1] Present address: Department of Economics, University of Amsterdam, Roetersstraat 11, 1018 WB Amsterdam, The Netherlands; Tel.: +31 20 5255280; fax: +31 20 5254254.

0164-0704/$ - see front matter
doi:10.1016/j.jmacro.2007.01.003

reformed pact must take this conflict into account, as well as the need to bring improved growth and employment opportunities into line in the long term with sound public budgets."

Gerhard Schröder

"A framework for a stable Europe," Financial Times, January 16, 2005

Many countries are now confronted with the simultaneous need to pursue fiscal discipline and to implement structural reforms, such as making their labor and product markets more flexible and reform of their welfare and pension systems. This is, for example, the case for Germany and France, but also for other countries. The needs for structural reform and fiscal discipline should not be seen in isolation. In fact, the two are tightly related to each other, as structural reforms are conducive to maintaining the long-term sustainability of the public finances.[2] Most directly this is probably the case for pension reform. However, also the supposedly larger growth potential and the greater shock-resilience of an economy with better functioning markets should reduce pressures for fiscal profligacy. Nevertheless, it has been argued that fiscal restrictions, while in principle beneficial for fiscal discipline, may in the short run conflict with the abovementioned structural reform measures.[3] In particular, implementing the necessary structural reforms may require substantial up-front spending, such as compensation for those who stand to lose from the reform.[4] In fact, the conflict between short-run and long-run economic objectives has been an important argument for the recent reform of Europe's stability and growth pact (SGP) (see ECOFIN, 2005; European Commission, 2005b).[5]

This paper analyses this conflict in the context of a model that combines the presence of a short-run deficit restriction with the possibility of carrying out structural reforms that yield long-run benefits, but impose upfront costs on private agents. Of course, not all structural reforms fit this description. However, a number of important reforms in, for instance, labor and product markets do. Examples are the relaxation of firing restrictions or sectoral re-allocations leading to temporary unemployment and a loss in income. To enhance the support for structural reform and therefore its chance to be re-elected, the incumbent government can provide compensation to the voting population. However, such handouts come at the cost of a higher deficit and may thus lead to a violation of the fiscal restriction intended to restrain politically-motivated overspending. We build a political-economy framework for analyzing the feedback effects between fiscal restrictions and the incentives for structural reform in a setting where the policymaker is accountable to the voting population. Eventually, the desirability of a deficit restriction depends on the severity of the political distortion leading to the excessive deficit and the long-run benefit from the structural reform.

[2] This is also recognized by the European Commission (2005a) in its three-pronged strategy for ensuring long-term sustainability and the quality of the public finances. The Commission evaluates what has been done and what is further required in terms of structural reforms. For most countries in the European Union, large parts of the necessary reforms still need to be completed.

[3] An early paper in this vein is Razin and Sadka (2002). They explore the political viability of a pay-as-you-go social security-system in an aging scenario and compare it to a funded system. Their work supports the idea that a deficit ceiling hampers the transition to a funded pension system.

[4] Beetsma and Debrun (2004, 2007) provide examples of such compensation costs (see also Saint-Paul, 2002 and Grüner, 2002).

[5] A large number of reform proposals have been made by academic researchers (see, for instance, Buiter, 2003; Buti et al., 2003; Blanchard and Giavazzi, 2004; Fatás et al., 2004; Mathieu and Sterdyniak, 2003).