The Elusive Promise of Structural Reform

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Structural reform – or more accurately talk of structural reform – is everywhere nowadays. Every country struggling for economic growth, it seems, is getting the same message from the chattering classes as well as the deep-pocketed multilateral finance agencies like the IMF and the European Central Bank: half measures are not enough.

In practice, structural reform has come to represent a grab bag of policies meant to enhance productivity and improve the functioning of the supply side of the economy. These measures aim to sweep away impediments to the functioning of labor, goods and services markets – to make it easier for firms to fire unwanted employees, to break business and union monopoly power, to privatize state assets, to reduce regulation and red tape, to remove licensing fees and other costs that deter market entry, to improve the efficiency of the courts, to enforce property rights, to enhance contract enforcement and so on. Indeed, the grab bag is even bigger. Often, for example, structural reform includes changes in taxes and social security programs with an eye toward fiscal sustainability.

The overarching goal is to increase the efficiency with which labor and capital are allocated in the economy, ensuring that these resources go where their contribution to national income is largest. Success comes in the form of increased productivity, more private investment and, of course, more rapid economic growth.

Perhaps nowhere in recent years has the gospel of structural reform been promoted with greater vehemence than in Greece. Indeed, Greece's creditors have made it crystal clear that structural reform, boldly conceived and implemented without slippage, is critical to economic recovery and growth – and most persuasively to Greeks, that bailout funds will not be forthcoming without it.

The International Monetary Fund and European public lenders understood that the fiscal austerity they prescribed would be costly to incomes and employment (though a retrospective IMF study later showed they significantly underestimated by how much). But there would be a compensatory boost to the economy, they argued, that would come from the long-delayed and much-needed opening of the Greek economy to competitive market forces.

The specifics demanded from Greece ranged from gut-wrenching to mundane. They included (in no particular order) lower barriers to entry in service businesses such as notaries, pharmacies and taxis; reduced scope of collective bargaining; privatization of state assets; a rollback of pensions and the cleanup of Greece's notoriously inefficient and arguably corrupt tax administration. The IMF's then-chief economist, Olivier Blanchard, (among others) argued that such reforms were critical in light of the "dismal productivity growth rec-ord of Greece before the program." Less ambitious reforms wouldn't do because they would have less impact on growth potential and necessitate greater debt relief.

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Partial Amnesia

But the policy prescribers, it seems, suffered from selective memory. Structural reform as a remedy for slow (or no) growth has been around at least since the early 1980s. At that time, the World Bank began to insist on economywide liberalizing reforms as the quid pro quo for developing countries in Asia, Africa and the Middle East in return for "structural-adjustment" loans. These policies were then extended and codified in Latin America during the 1990s under the umbrella of the Washington Consensus. Many of the former socialist economies adopted similar policies (in some cases, voluntarily) when they opened up their economies during the 1990s.

Oddly, though, debate over the reforms pressed on Greece and other crisis-battered countries on the periphery of Europe did not benefit from lessons learned in these other settings. A serious look at the vast experience with privatization, deregulation and liberalization since the 1980s – in Latin America, post-socialist economies and Asia in particular – would have produced much less optimism about the benefits of the kinds of reforms Athens was asked to impose.

That experience suggests that structural reform yields growth only over the longer term, at best; more often than not, the short-run effects are negative. One meta-study of 46 different research papers on post-socialist economies found that the impact of structural reform varied across the board. The modal estimate of the impact was statistically insignificant, meaning that it was impossible to conclude with any confidence whether the effects were positive or negative. In Latin America, for example, some economies have flourished in the wake of reform (think Chile) and some have lagged (as in Mexico).

These results may seem surprising at first glance but are, in fact, consistent with what economic theory teaches. The standard convergence framework that economists use to analyze growth across countries gives us little reason to expect strong short-term growth-promoting effects. Reform works by raising the potential income of the economy in the long run.

Take Greece. Opening the regulated professions will eventually lead more productive firms to drive out inefficient suppliers. The privatization of state enterprises will lead to the rationalization of production (and dismissal of all the excess workers employed through political patronage). But these changes will require years to work themselves through the economy. And in the short run, they may yield perverse effects. For example, the loss of the (however disappointing) output of workers laid off by privatized enterprises will subtract from, rather than add to, national income.

Economists have spent significant effort at estimating the speed with which economies tend to converge to their long-run levels of income. The near-consensus of academic studies is that convergence is pretty slow, at a rate of about 2 percent per year. That is, an economy tends to close 2 percent of the gap each year between its actual and potential income levels.

This estimate helps us gauge the magnitude of growth we can expect from structural reform. Let's be wildly optimistic and suppose that structural reforms enable Greece to double its potential income over three years, which would push Greece's potential per-capita GDP significantly beyond the European Union average. Applying convergence math, this would produce an annual growth boost of only about 1.3 percent per year on average over the next three years. To place this number in perspective, remember that Greek GDP has shrunk by 25 percent since 2009.

So if structural reforms have so far not paid off in Greece, it is not necessarily because the country's governments have slacked off. Indeed, it is easy – but also largely erroneous – to blame successive Greek governments for unenthusiastic implementation of structural reform and significant slippages. Certainly, Greece has not delivered on every measure it agreed to adopt. Given the magnitude of effort needed, which government could? Yet, remarkably, Greece moved up by nearly 40 positions between 2010 and 2015 in the World Bank's Ease of Doing Business rankings. The country's labor markets are more "flexible" – meaning liberalized – today than those of most other eurozone countries. Greece's "failure" arises instead from the very logic of structural reform: the bulk of the benefits comes much later, not when their creditors (and unemployed Greeks) need them most.

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What Triggers Takeoffs?

This leaves us with an apparent puzzle. If structural reforms deliver their growth payoffs so slowly, how are we to explain the numerous instances of abrupt takeoffs in East Asia and elsewhere? If such takeoffs are not the product of conventional structural reform, what does drive them?

A few words first on growth takeoffs. A decade ago, Ricardo Hausmann, Lant Pritchett and I published an article that documented the basic stylized facts about what we called "growth accelerations." We defined a growth acceleration as an increase in per-capita growth of two percentage points or more (with most of the episodes we identified exceeding this threshold by a wide margin). To qualify as acceleration, the increase in the growth rate had to be sustained for at least eight years, and the post-acceleration rate had to be at least 3.5 percent annually (per capita). In addition, to rule out cases of acceleration purely attributable to recovery from recession, we required that post-acceleration output exceed the pre-episode peak level of income.

We were surprised to discover how frequent these episodes of growth acceleration are. We identified more than 80 cases over the 35-year period from 1957 to 1992. This meant the probability that any given country would experience a growth acceleration sometime during a decade was as high as 25 percent. Of the 110 countries included in the sample, 60 had at least one acceleration in the 1957-92 period.

More important, we found that standard factors economists think play a role in growth do not do a good job of predicting acceleration. In particular, structural reforms were only loosely correlated with turning points in economic performance. Fewer than 15 percent of significant economic liberalizations produced growth accelerations, and only 16 percent of growth accelerations were preceded by economic liberalization.

Some growth accelerations were obviously the result of fortuitous external conditions (such as a rise in the world prices of a country's major exports) or other changes not directly attributable to economic policy (such as changes in political regime). But in most cases, there was no smoking gun. That got us thinking about what might lie behind these instances when economic prospects suddenly brightened.

India's growth acceleration in the early 1980s is perhaps a paradigmatic case. The country's growth rate more than doubled, from 1.7 percent in 1950-80 to 3.8 percent in 1980-2000, with a clear turning point in 1981-82. Yet serious liberalizing reforms in India did not arrive until 1991, when Manmohan Singh slashed trade barriers, welcomed foreign investment and began both privatization and the dismantling of what is derisively called the license raj. In other words, the pickup in India's growth preceded the 1991 liberalization by a full decade.

Arvind Subramanian and I concluded that the trigger to India's economic growth was an attitudinal shift on the part of the national government in 1980. Until that time, the rhetoric of the reigning Congress Party had been all about socialism and pro-poor policies. When Indira Gandhi returned to power in 1980, she realigned herself politically with the organized private sector and dropped her previous rhetoric. The national government's attitude toward business went from being outright hostile to supportive.

Note that this was a pro-business shift rather than a pro-market shift. It was not supported by liberalizing reforms, which would only come a decade down the road. Indira Gandhi's switch was further reinforced, in a more explicit manner, by Rajiv Gandhi after his rise to power in 1984. This seems to have been the key change that unleashed what Keynes called the "animal spirits" of the Indian private sector.

The moral of the Indian story is that small changes can make a big difference in economies that suffer from multiple distortions. The Chinese growth acceleration after 1978 very much bears this out. The Chinese economic takeoff wasn't the product of economy-wide reforms or a major liberalization. It was the consequence of specific reforms that loosened collective farming rules and allowed farmers to sell excess production – after state quotas were fulfilled – at un-controlled market prices. The same type of selective, targeted reforms in urban industrial development, trade, foreign investment and finance would unfold over the next three decades, keeping the Chinese miracle going and going and going.

Or consider Mauritius, one of Africa's few growth successes in the 20th century, which experienced its growth acceleration in 1971. The trigger seems to have been the establishment of a largely unregulated export processing zone that led to a boom in garment exports, even as the rest of the economy remained heavily controlled and protected.

What is common to these cases is that the takeoffs were associated with a targeted removal of key obstacles to growth, rather than broad liberalization and economywide reforms. India, China and Mauritius all benefited from growth strategies that specifically focused on removing binding constraints on growth. Targeting reforms on areas where the growth returns are the greatest maximizes early benefits. It also ensures that scarce political capital and administrative resources are spent on the battles that really matter.

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Maximum Gain For Minimum Pain

Along with my Harvard colleagues Ricardo Hausmann and Andres Velasco, I undertook to identify the binding constraints to growth in specific settings in a 2005 article. For example, an economy in which the main constraint on growth was poor access to finance should exhibit different symptoms (high interest rates, strong responsiveness of domestic investment to foreign capital inflows, etc.) than an economy whose main problem was low profitability of private investment (low interest rates, ample liquidity in the banking system, etc.). When entrepreneurship is hampered primarily by market failures rather than government failures, the country may rank high on standard creditworthiness measures like transparency or institutional quality, but private investment will remain low.

A focus on binding constraints helps us see why remedies that are not well targeted – broad structural reforms – are ineffective, at best, and sometimes counterproductive. Cutting red tape and reducing regulation does little to spur private economic activity when the constraint lies on the finance side. Improving financial intermediation does not raise private investment when entrepreneurs expect low profits. Successful policy design must rely more on domestic experimentation and local institutional innovations – and much less on "best practices" and blueprints adopted from international experience.

Going back to Greece, where is the binding constraint on that economy today? With a quarter of the labor force out of work, I would argue that the quickest way to get the economy back on its feet would be to increase the private sector's demand for workers. Supply-side measures, such as conventional structural reforms, can't be particularly effective at present because the binding constraint is on demand rather than supply. Deregulating professions does not boost entry when aggregate demand is depressed. Making it easier to fire workers does not induce firms to invest and produce more; it just facilitates laying off workers. As helpful as these measures may be in promoting long-term growth, they don't do much for the economy in the short run and may even make things worse.

However, conventional demand-side remedies like government spending, tax cuts or devaluation are ruled out by both the burden of public debt and Greece's membership in the eurozone. In principle, wage deflation should have been a substitute for currency depreciation, making Greek goods and services cheaper in foreign markets. And Greek wages have come down substantially. But here, too, the absence of a single-minded focus on the binding constraints has proved costly.

Different elements in the structural reforms have had conflicting effects on export competitiveness. In manufacturing, for example, the competitiveness benefits of wage cuts were offset by the cost of increases in energy prices resulting from fiscal austerity measures and state enterprise price adjustments. A better prioritized reform strategy could have protected export activities from this adverse effect.

The absence of the ability to devalue or depreciate the currency remains a serious impediment. But the experience of other countries provides a rich menu of alternative tools for export promotion ranging from tax incentives to special zones to targeted infrastructure projects. Greece and its creditors need to recognize the importance (and priority) of improving the profitability of sectors that produce tradable goods and services, and to reorganize reforms around that task.

Most urgently, the government needs to set up an institution close to the prime minister tasked with fostering a dialogue with potential investors – both domestic and foreign – in export-oriented projects. This institution needs to have the ability to remove obstacles identified in the process, to avoid having its proposals languish in ministries with other priorities. These obstacles are typically highly specific to the investment – a zoning regulation here, the lack of a labor-training program there – and are unlikely to be targeted by broad structural reforms.

Some observers of the Greek economy deride the value of export promotion, arguing that the country is hindered by a lack of diversity in tradable goods and services, and is thus unlikely to respond to incentives. But the experience of other countries makes clear that low export and diversification levels are not destiny. Sizable – and credible – changes in export incentives typically produce robust responses, even where exports are confined to a few traditional crops. It is now forgotten that Taiwan exported sugar, rice and little else before its trade took off in the early 1960s.

Closer by, export pessimism was the dominant mood among Turkey's elites before the reforms in the early 1980s, which mainly consisted of export subsidies, produced a rapid rise in the export-GDP ratio. In Taiwan, Turkey and elsewhere, new exports rather than traditional products have led the way. There's no straightforward means to predict what these new exports will be before the incentives are put in place. But this opacity should not be grounds for pessimism about their likelihood of emerging.

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Pay Now, Pay Later

Ultimately, the choice of reform boils down to one of two approaches. The conventional structural reform agenda relies on a "big bang" – as many changes as possible, as quickly as feasible. Politically, this approach typically exploits a window of opportunity created by economic crisis that reformers fear will close when normal times return. The costs of big-bang reform – higher unemployment, slower recovery – are tolerated in order to reap what is hoped will be sizable benefits down the line. This kind of reform perhaps works best when there are external anchors that prevent backsliding as short-term costs mount.

Poland in the early 1990s is arguably the model. The prospect of European Union membership – and the promise of becoming a "normal European country" after a half century of isolation from the West – held the reforms together despite high unemployment and serious economic dislocation early on.

Elsewhere, in the absence of external anchors there is always a real threat that the backlash will dominate. Bolivia and Venezuela in Latin America fit this latter mold.

The second approach is less ambitious, consisting of sequential targeting of binding constraints. The political strategy underpinning this style of reform is the expectation that early wins will create political support for reforms (and reformers) over time. When binding constraints are successfully targeted, the early growth payoffs can be quite spectacular.

This is the quintessential model perfected in China, but versions have been at play in South Korea, Taiwan and India at different times. Because the reforms are partial, they never quite do away with the insiders (and their ability to extract gains through market power and political connections), who are typically less than enthusiastic about continuing reforms. So there is always the risk that such reforms will get stuck midway and the early growth benefits will dissipate.

Greece has taken the first route – likely less because this was the country's choice than because its creditors left it with little alternative. If the results have been disappointing to date, it is for reasons that should have been expected at the outset. It remains to be seen whether Greeks' evident desire to remain in the eurozone (or at least their fears of the alternative) will prove sufficient counterweight to the pain that the country has yet to endure.