Coping (or not) with Change

2.1 INTRODUCTION

The European Union's 'ever-closer-union' trajectory no longer seems realistic in the face of populist tendencies in many of its member countries. Tendencies towards disintegration are not only emerging at an EU level, but also within nation states, as today's populism is also promoting more individualist attitudes. The prospect of economic losses does not seem to deter voters, who do not see any of the gains coming to them from supporting anti-immigration nationalists.

Europe's centrifugal tensions make it increasingly similar to the late Habsburg Empire, a powerful symbol of the problems of integration in a multinational, multi-linguistic, and multi-ethnic society. The Habsburg Empire was divided, and appeared to be doing less well (i.e. growing less successfully) than rival states (Germany or Russia). After its collapse, the problems of social division and low growth remained unresolved. As a result, many of the Empire's former citizens developed a deep nostalgia for a setting that contrasted with the intolerant nationalism of the successor states, but in its last decades, most of the monarchy's subjects felt only dissatisfaction and resentment.[1] These sentiments, as well as the constant search for linguistic reformulations that bridge deep divisions of interest, appear uncannily familiar in modern Europe. Like the Habsburg Empire, the European Union is incomplete and unstable.

The overarching aim[2] of the European Union is to foster economic and political integration in Europe leading to balanced economic growth, full employment and social progress. Economic integration – the Single Market, the Economic and Monetary Union of the European Union (EMU) etc. – is perceived to ensure convergence to higher levels of material well-being across Europe. This development is expected to reinforce political integration and deepen the Union.

Actual developments leave a more blurred picture. There has definitely been progress in some areas, but economic differences persist across EU countries and even seem to be growing in some cases. The centripetal forces expected to be generated by economic integration are contested by centrifugal forces.

EU enlargement raised concerns over heterogeneities and a core-periphery divide between the 'old' and the 'new' member states. However, experience has shown a more mixed picture. Some new member countries – like the Czech Republic, Slovenia and Slovakia – have been catching up to high income countries, and this has contributed to convergence within the European Union. Among the 'old' EU countries (EU-15), however, there has been no convergence over the last two to three decades. The observed convergence for the EU-28 or EMU countries is thus driven by some Eastern countries catching-up, as documented in EEAG (2018).

The bleak economic performance in many countries is contributing to a widespread perception that current societal developments are not serving ordinary people. Problems are widely attributed to economic integration going too far and the European Union being unable to cope with the resulting situation. Developments are falling short of promised and expected trajectories, the prevailing policies and institutions are drawing criticism, and support for cooperative solutions within the European Union is dwindling. There are tendencies towards disintegration, while nationalism and populism are on the rise. The EU integration trajectory no longer seems realistic in view of the economic and political forces working against it.

What went wrong? Perhaps too much was promised, and convergence was seen as an automatic response to economic integration. Countries are continuously affected by shocks and changes; some global, some country-specific. Some are short-lived while others are longer-lasting, not least structural changes. Transformations due to technological changes, globalisation etc. are particularly important, as they are a source of progress, but societal gains do not come automatically. To reap such gains, adjustments are necessary – across firms, sectors, geographical areas, types of labour/qualifications etc. – and some policies and institutions may be better apt to handle such changes than others.

[1] There are many powerful literary evocations of the Habsburg world in the works of authors like Joseph Roth, Stefan Zweig, and Felix Salten. One of the most striking, only recently translated into western languages, is the Transylvanian trilogy written by the Hungarian politician Miklós Bánffy, published in Hungarian between 1934 and 1940. It gives a clear indictment of the failure of the ruling class. The second volume opens with a debate in Hungary in 1906 about the need for a separate National Bank and about the customs union in the Hungarian half of the Dual Monarchy. There is talk about a reformulation so that the customs arrangements should be termed customs treaty rather than customs union

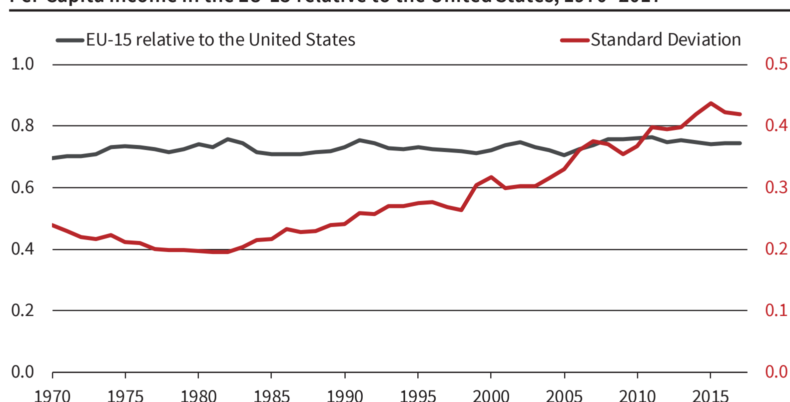
[2] The European Union shall, according to the Treaty "… work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance." (Consolidated Version of the Treaty on European Union, Article 3)

EEAG (2019), "Coping (or not) with Change",
EEAG Report on the European Economy, CESifo, Munich, pp. 38–60.

This chapter studies interactions between country-specific structural changes and reforms, or the lack thereof. We focus on structural change and reform patterns across the EU-15 countries given the particularly striking lack of convergence across these countries after decades of integration, and study some country experiences in detail. There is much to learn from Italy, which has been a laggard in recent decades, but it is not the only country experiencing increasingly turbulent politics and persistent productivity slowdowns. We also review the more positive shock and reform experiences of those countries that managed to break out of relative decline, namely Denmark, the Netherlands, Sweden, Finland, and Germany.

Figure 2.1

Per Capita Income in the EU-15 relative to the United States, 1970–2017



Note: Per capita income is measured in current prices and current purchasing power parities. The EU-15 average is weighting countries according to population sizes. The standard deviation is computed for relative incomes of EU-15 countries, i.e. the country-specific per capita income relative to the EU-15 average, running 5-year averages.

Source: OECD.

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We trace poor country-specific economic performance to its sources. Bad outcomes can merely reflect bad luck: a country's territory may, for example, expose it more heavily than others to the bad or good consequences of climate change, or migration pressures. But it is more interesting to trace their roots back to unsuitable institutions or policies. These can magnify the negative implications of a changing world not only when they become obsolete and fail to be reformed, but also, and perhaps more importantly, when they do not even out the costs and benefits of shocks and reforms in such a way as to make change politically acceptable.

The chapter starts by briefly summarising economic developments across EU-15 countries, pointing to the large variations between them and the lack of convergence (Section 2.2). This leads to a discussion of how economic (and political) integration may or may not imply convergence (Section 2.3) and the notion of competitiveness often used when discussing country developments (Section 2.4). The political economy of reforms or absence hereof is then discussed (Section 2.5) before turning to country experiences. We illustrate more general points analysing the case of Italy, one of the nations barking at the Habsburg heels (Section 2.6), and briefly consider a few examples of more successful reform countries (Section 2.7). Some concluding remarks are offered in Section 2.8.

2.2 DIVERGENCE OR CONVERGENCE IN EUROPE?

Economic performance can be compared along many dimensions. Here attention is restricted to one key variable, per capita income. While there are measurement problems and per capita income is not one-to-one related to welfare, it is an important variable and a widely used metric in international comparisons of economic performance. Trade-offs with other objectives like inequality are important, but are beyond the scope of this chapter.

Considering the EU-15[3] as an entity, its development since the 1970s has been rather steady. Using per capita income relative to the United States as a performance indicator, the gap between the EU-15 and the United States has been slightly reduced over the period 1970 to 2017. Hence, average growth in per capita income has been roughly on par with US growth. EU-15 countries have not moved closer to the United States – an objective that has been mentioned occasionally – but the gap has not grown either. In terms of single country performances, however, major differences exist, which have not diminished over time. In Figure 2.1, we also report the standard deviation of relative incomes across EU-15 countries (country specific per capita income relative to EU-15 per capita income, and smoothened to eliminate short run business cycle fluctuations). Country differences have widened[4], especially after the mid-1990s.

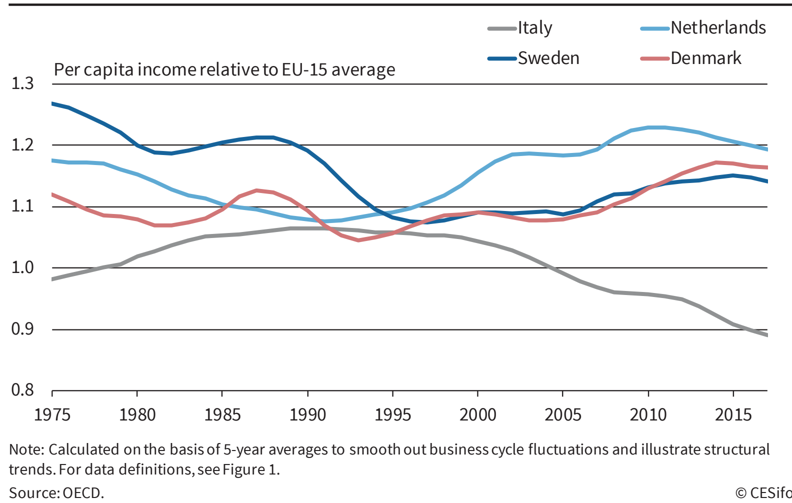
To elaborate on the different country experiences, Figures 2.2–2.4 plot the development in relative incomes for different groups of EU-15 countries.[5] To highlight systematic country differences rather than business cycle effects, 5-year averages are shown. The developments for Italy, Denmark, the Netherlands, and Sweden show very interesting, but different patterns. For Denmark, the Netherlands, and Sweden there is a U-shaped pattern – first a decline and then

[3] EEAG (2018) consider convergence for EU-28, EU-15 and Euro Area countries in more detail.

[4] The standard deviation is calculated based on relative incomes here. If computed using log-relative incomes, the increase in dispersion is less pronounced, as may be expected since the log-function is concave.

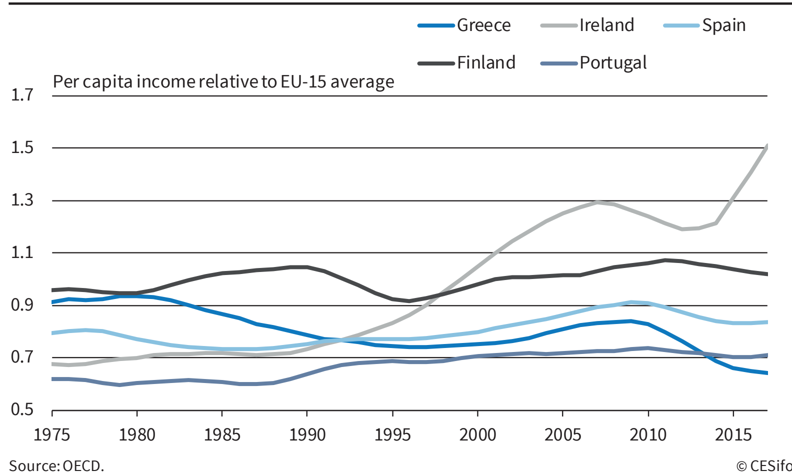
[5] Luxembourg is not shown here. The relative income of Luxembourg is showing a trend increase from 1.49 in 1970 to 2.35 in 2017. For Luxembourg Gross National Income (GNI) is about 50 percent lower than GDP in 2017.

Figure 2.2
Income Developments in Denmark, Italy, the Netherlands, and Sweden, 1975–2017



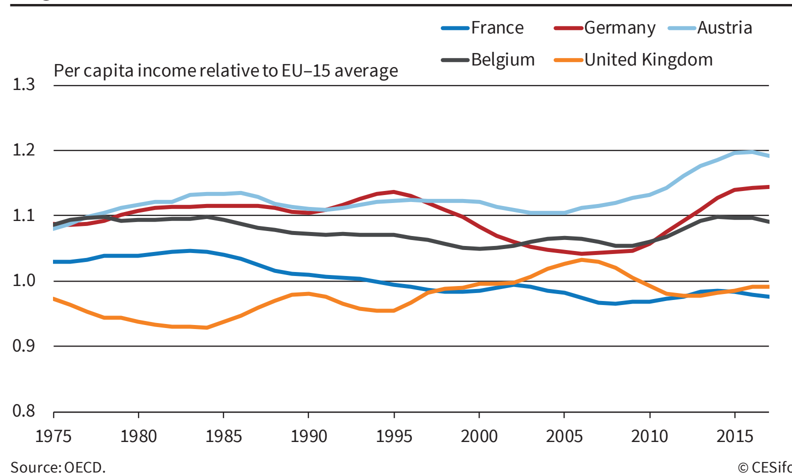
Note: Calculated on the basis of 5-year averages to smooth out business cycle fluctuations and illustrate structural trends. For data definitions, see Figure 1.
Source: OECD. © CESifo

Figure 2.3
Starting Low–Relative Income Developments for Finland, Greece, Ireland, Portugal, and Spain, 1975–2017



Source: OECD. © CESifo

Figure 2.4
Income Developments for Austria, Belgium, France, Germany, and the United Kingdom, 1975–2017



Source: OECD. © CESifo

an improvement. For Italy an inverted U-shaped trajectory emerges – an initial improvement followed by a deterioration in relative performance. It is striking that these countries basically had the same per capita income levels in the early 1990s. At that time Italy experienced a favourable development, catching-up to the best performers among EU-15 countries, while the other three countries lost pace and approached the average. After the early 1990s these developments reversed and the relative positions in 2017 are close to those in the 1970s. This raises the questions of why developments since the early 1990s have been so different against a background of tighter integration and other events over the period. Why did Italy run out of steam, and how did the other three countries regain their relative positions? These key questions are addressed below.

There are also other interesting developments for countries starting out below the mean as shown in Figure 2.3 (note the wider scale than in Figures 2.2 and 2.4). Finland is an interesting case as it falls in between the four countries shown in Figure 2.2. Until the early 1990s Finland experienced a favourable development much like Italy, but then experienced a large set-back in the early 1990s (the ‘Soviet-shock’) followed by a recovery and yet another set-back when the decline in the ICT sector (the ‘Nokia-shock’) coincided with the global financial crisis. Greece has experienced a general deterioration in its relative position, while Portugal and Spain are examples of countries experiencing some catching-up over the period. The same applies to Ireland, although the income metric used here may give an exaggerated impression of the improvements in living standards.[6]

[6] The income concept used is Gross Domestic Product (GDP). However, some part of GDP may be payments to foreign factors of production. For most countries, there is not a large discrepancy, but for Ireland, Gross National Income was about 20 percent lower than GDP in 2017.

Developments have been relatively steady in Austria and Belgium (see Figure 2.4), while France has experienced a soft version of the developments in Italy, with some initial improvement followed by a deterioration since the early 1980s. Developments in Germany and the United Kingdom have been more erratic. The United Kingdom has followed a path resembling Denmark, the Netherlands, and Sweden: with some initial deterioration and a trend towards improvement since the 1980s. Developments in Germany are clearly affected by unification, but it has since recovered to a relative income level on a par with the level seen in the mid-1990s.

All counties have their specific circumstances, institutions and shocks. It is beyond the scope of this report to provide a detailed account of developments in all countries. Below we consider the experience of Italy as an example of a country that has seen its relative position deteriorate over the last two or three decades, and Denmark, Finland, Germany, the Netherlands, and Sweden as examples of countries that have successfully reversed a downward trend and improved their relative economic performance.

2.3 GOOD POLICIES OR GOOD LUCK?

Explaining why country performances differ, or why economic integration has not produced more similar economic developments, raises many issues. Frequently observed favourable performances are attributed to good policies and institutions, and it is argued that we should learn from them and copy their policies. However, a set of policies and institutions may perform well under some conditions, but not under others, and caution should be exercised in drawing such simple conclusions.

A first warning against such simple reasoning is the difficulty of predicting future 'winners'. As an example, growth rates over a given period are a poor predictor of future growth rates. Figure 2.5 shows average growth rates for the periods 1990–99 and 2000–2009 for 22 OECD countries. There is no systematic or statistically significant relation between growth rates in the decade starting 1990 and the one starting in 2000.[7] Similar conclusions hold for the 1980s relative to the 1970s and the 1990s relative to 1980s. In other words, observed outcomes are very unreliable predictors of future outcomes.

In a comparative study aiming at separating the role of policies from various other factors affecting economic performance, Easterly et al. (1993, p. 430) conclude that: "… with a few exceptions, the same countries do not do well period after period; countries are 'success stories' one period and disappointments the next". Unpredictable external events (such as changes in the terms of trade) are a major determinant of country-specific growth rates.

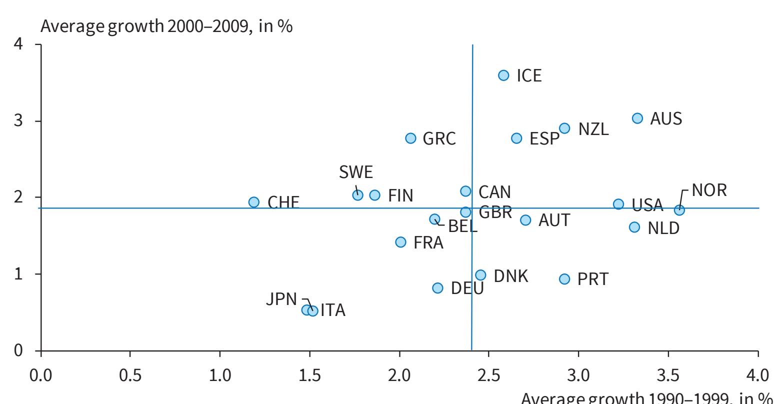
Changes in economic conditions – shocks – can arise from both internal and external sources and thus have both country-specific and global components. Although empirical evidence[8] shows a tendency towards greater synchronisation of business cycles across countries, there are significant country differences.

Country exposure to different types of shocks differs depending on economic structures, policies and institutions. This applies not only to business cycle shocks, but also more generally to structural changes. The role of economic integration is particularly important, as this is the most visible structural change running over recent decades, and is driven both by technological changes reducing information and transportation costs, as well as by political decisions.

Economic integration is strongly associated with convergence arguments. The removal of various barriers for trade in goods, services, and capital and for the movements of factors of production is widely assumed to release economic gains and a process of convergence. This has been the key argument underlying integration steps in the European Union including the Single Market, and the EMU etc. All of these measures were based on the idea that all countries would stand to gain and EU-wide convergence to higher living standards would follow.

While there are potential gains from economic integration, and convergence in income levels is a possible outcome, such effects are

Figure 2.5
Average Growth Rates 1990–1999 and 2000–2009 for 22 OECD Countries



Note: The vertical line marks average growth rates for the included countries over the period 1990–1999. The horizontal line marks average growth over the period 2000–2009.
Source: OECD, EEAG calculations.

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[7] Note that if there is low/no catching up between countries, there will also be a low/no correlation in growth rates across periods of time.

[8] See Frankel and Rose (1998), and Duval et al. (2016). Ductora and Leiva-Leonb (2016) find a stronger global business cycle component since the early 2000s.

not automatic. Reaping the gains from economic integration requires changes and adjustments. Impediments reducing adjustment capacities – market structures, regulations, policy design etc. – reduce the benefits from integration. The labour market plays a key role. Structural changes are associated with changed qualification requirements in the labour market and reallocation of labour across firms and regions. If product and labour market rigidities impair such adjustments, convergence is impaired, and the gains from integration are lower.

The need for adjustment as a result of technological developments and economic integration is often taken to imply that all should be alike. This is a misinterpretation. Convergence in outcomes like income levels does not require that all countries should be alike in all other dimensions. On the contrary, the gains from integration come from the exploitation of comparative advantages. Countries should cultivate and exploit their comparative advantages, with convergence to higher living standards across the integrating economies becoming possible via trade and other forms of economic exchanges. No single recipe for achieving this exists. Comparative advantages are country-specific, meaning that appropriate policies and institutions also vary. There is not one unique and superior economic and political system[9] to which all countries would or should eventually convergence.[10] The point that one system may perform strongly under certain conditions, but less well under others is underlined by the facts already presented and the detailed information provided below for selected countries.

2.4 COMPETITIVENESS

Discussions of country performance often centre around the notion of competitiveness with phrases like "the need to improve Europe's competitiveness" (Europe 2020 strategy[11]) or "country x suffers from competitiveness problems". The political attention paid to competitiveness is reflected in one of the configurations of the European Council, namely the 'Competitiveness Council' (COMPET)[12] and the existence of national competitiveness boards such as, for example, the Irish National Competitiveness Council.[13] Indices ranking country competitiveness according to various measures are also regularly published. But what is meant by competitiveness and can it be related to specific policy tools?

Among firms, the notion of competition is pretty clear – they compete over customers. If firm A rather than firm B can attract a customer, it is good for firm A and bad for firm B. If firm B is not attractive to a sufficient number of customers, it goes bankrupt and disappears from the scene. In that sense, firms are in a zero-sum game and competition over customers and market share that has a clear meaning.

When it comes to countries, the situation is rather different. Countries trade with each other and gains from trade are a means of increasing economic well-being and welfare. The source of trade is comparative advantages – countries exploit their different advantages allowing for more product differentiation, specialisation etc. – which in turn makes welfare improvements possible. This is not a zero-sum game and both countries can end up being better off. A key insight from trade theory is that trade depends on comparative and not absolute advantages; and there is always room for a country in the international division of labour (Krugman, 1994). This is not the same as saying that countries will be similar, or have the same material well-being. The point is that a country cannot lose competitiveness in the sense of not being part of the international division of labour. A country always has some comparative advantages that provide a basis for international trade.

What does it then mean for a country to be competitive? To match the best high tech firms from Silicon Valley or low cost producers from China? What really matters is living standards, and countries can be competitive and having either low or high living standards. Competitiveness is not a target in itself, but is it a meaningful and useful intermediary target guiding policies to support wealth and welfare?

Competitiveness can be defined broadly and narrowly, and a very broad notion of competitiveness is associated with competitive markets (market supporting regulations) and innovation.

The report "Restoring EU Competitiveness" by the European Investment Bank (2016, p. 11) defines competitiveness as "… the ability of firms to mobilise and efficiently employ the productive resources required to successfully offer their goods and services in a global economic environment … Competitiveness is important for achieving a high standard of living and long-term sustainable gross domestic product (GDP) growth built on real gains in productivity ...".

A similar definition underpins the Global Competitiveness Index produced by World Economic Forum, where national competitiveness is defined as "… the set of institutions, policies and factors that determine the level of productivity", (World Economic Forum, 2018, p. ix). The index is based on assessments and thus sub-indices for twelve different areas grouped in basic requirements, efficiency enhancers and innovation, and sophistication

[9] However, culture (behaviour) and institutions (rules/norms) can be both more or less efficient, and the less efficient are not necessarily wiped out by international integration, and therefore convergence is not a given consequence (see, for example, Belloc and Bowles, 2017).
[10] This is related to a large body of literature discussing welfare regimes (Esping-Andersen, 1990) and the varieties of capitalism (Hall and Soskice, 2001).
[11] The Europe 2020 strategy is the EU's agenda for growth and jobs for the current decade. It emphasises smart, sustainable, and inclusive growth in order to improve Europe's competitiveness and productivity and underpin a sustainable social market economy.
[12] http://www.consilium.europa.eu/en/council-eu/configurations/compet/
[13] Available at: http://www.competitiveness.ie/

factors. The reasoning underlying the index takes a broad perspective on the concept of competitiveness (see e.g. Porter et al., 2008). So-called *foundational competitiveness* is defined as: "the expected level of output per working-age individual given the overall quality of a country as a place to do business" (Delgado et al., 2012). This concept focuses on productivity and the ability to include as many economic activities as possible.

Such broad definitions may be said to underline the point that it is hard, if not impossible, to define competitiveness precisely, and it therefore becomes synonymous with productivity or per capita income as considered in Section 2.2. Or alternatively, that competitiveness has become a catch phrase for factors supporting a sustainable economic development with high living standards. The importance of productivity for competitiveness and livings standards also point to the role of human capital – both its level and its distribution across the population – as a key factor in sustaining a high level and equal distribution of income. The same applies to R&D investments and the possibilities of advancing technologies (see Chapter 4 for further discussion). Clearly social welfare also depends on other factors, and there are trade-offs between material well-being and the environment, distribution, social inclusion and other goals.

While there are fundamental differences between single firms and countries, comparative advantages depend not only on technological factors and endowments, but also on relative prices. Trade, firm location etc. respond to relative prices, so costs matter. Narrower definitions of competitiveness attempt to capture this idea.

One measure is wage competitiveness measuring relative wages or relative unit labour costs, the idea being to assess a key cost component – see Table 1.1 in Chapter 1. Beyond the obvious point that costs also depend on other factors than wages and various measurement problems, this is not an unproblematic measure, since firms adjust factor inputs.[14] Wage competitiveness is nonetheless clearly relevant, and in a fixed exchange rate regime (EMU or unilateral pegs), the development of wage costs relative to productivity is obviously important. Wage competitiveness plays a centre role in economic policy discussion, particularly in small and open economies (see Chapter 1 and Section 2.7). A notable example is Belgium, which has institutionalised this concept in a Competitiveness Law whereby the government can intervene if wage increases exceed a norm defined by the wage growth for its main competitors (France, Germany, and the Netherlands).[15]

Wages cannot be assessed independently of productivity levels. Wage growth outrunning productivity growth is problematic, but wage growth driven by productivity growth is not. Productivity growth leading to higher wages is the main transmission mechanism through which living standards improve. Wage formation may also affect future productivity via the profitability of investments, and relatively low wages in one period may result in larger future wages. Wages may be misaligned with productivity due to, for instance, excessive wage growth during booms or structural changes affecting production conditions. Notions of competitiveness and flexibility are closely related: a country in which wages flexibly adjust to changes in economic conditions can also more easily remain competitive in the sense of having wages aligned with productivity.

Another key variable is the terms-of-trade; the ratio of export prices to import prices. If a country experiences an increase in the prices of its exports relative to the prices of its imports, this is a potential source of real income gains. However, terms of trade can change for many reasons. Export prices rise relative to import prices if domestic firms innovate and move up the value chain, or if foreign demand for domestic products increases. But such relative price changes may also arise if domestic wages increase excessively, and firms are able to pass on cost increases to their output prices.

Competitiveness is important both in the broad sense of enhancement of productivity and innovation and in the narrower sense of wage and prices adjustments relative to changes in business cycle conditions and structural changes. We return to this in the discussion of specific country experiences below.

2.5 POLITICAL ECONOMY OF ECONOMIC REFORMS

When and where can reforms be expected? What triggers reforms? Why have some countries been able to undertake reforms, while they have been delayed or not implemented in others?

The policy debate is not short of reform proposals. Reform proposals are abundant in the academic literature, as well as in a steady flow of reports from national and international organisations, and think-tanks. Some proposals are politically motivated to shift course, while others are made because existing policies or institutions have to be adjusted to achieve shared political goals in terms of economic well-being and development. A lively debate over such issues is an essential part of democracy, and yet reforms seem to be implemented on a 'too little, too late' basis. Why is this?

Any reform requires a motivation – why is it needed? The agenda is to foster awareness that the status quo is unacceptable or unsustainable. The framing and presentation of facts is crucial, and,

[14] In the standard textbook case of a competitive firm producing with a Cobb-Douglas production technology, the wage share is constant – wage deflated by average productivity equals price. Hence, if the wage increases, the firm reduces employment until the value of labour productivity equals the wage. The wage share is unaffected, but employment is lower.

[15] See e.g. https://www.eurofound.europa.eu/publications/report/2009/belgium-wage-formation.

as recent events have demonstrated, facts can be twisted and tweeted in many different ways. While information is flowing freely, people clearly tend to choose media according to their individual views, while all other news are dismissed as biased or fake (see e.g. Glaeser and Sunstein, 2013). The importance of agenda capture, information flows, media etc. is very large, and the process is not strictly rational. Simple solutions to difficult problems may be more popular than more complicated, but ultimately sustainable solutions. Policy action does not necessarily follow, even if experts agree on the problem diagnosis and the reforms needed.

Agenda setting is easier in times of crisis, as dismal performance, a loss of foreign reserves or unsustainable debt levels make it easier to argue that action is needed. But the term 'crisis' is not well-defined. When is a crisis so serious that action is required? Will problems solve themselves or do steps need to be taken? Policymakers resisting change may attribute serious economic problems to bad luck, while others in favour of change may portray current developments as a crisis. Even the term 'reform' is inflated: in political discussions any policy change, small or large, may be denoted a reform to brand it as something making a change for the better.

External factors are also often cited as reasons why reforms are necessary, but the policy reactions can differ. In some cases the outside world is blamed for all problems, and nationalist/populist views gain support. In others, however, it is used as a motivation for reforms, citing the argument that we are in this together and need to cope with change, and manage in a tougher world (see the cases discussed in Section 2.7).

The step to political action is particularly difficult. Established structures and policies may build their own power structure creating a status quo bias. This results in inertia and barriers that need to be overcome for larger reforms to be enacted. It may seem obvious that a reform should follow, if a Pareto improving reform can be identified. Even that, however, is far from clear. To move from an inferior to a superior situation changes along many dimensions are typically required and a coordinated move is thus a precondition. Even if all are well-informed about the gains from the reform, single actors may have insufficient incentives to change course because strong complementarity makes behaviour strongly dependent on what others are doing. This leads to a deadlock with nobody taking the first step. One reason for this is that markets and institutions interact with culture (social norms). Even if all of the stakeholders realise that there is a superior outcome, it may not be individually rational to move in that direction.[16]

The scenario whereby everyone stands to gain is often the exception, rather than the rule. Most changes – including reforms – will have both winners and losers. Often the benefits of a reform unfold over time implying more losers in the short-run and more gainers in the long-run. A standard argument for economic integration is that the gainers can compensate the losers, i.e. there are net gains to society. The extent to which such 'compensation' of the losers takes place depends on labour market structures and welfare arrangements, but it is often incomplete and it cannot be taken for granted. This is the root cause of many problems – both associated with integration, but also in formulating acceptable reforms proposals. Reforms will happen if gains can be spread evenly, or if a strong coalition of gainers has the power to force losses on losers. But often neither happens, because gainers cannot credibly promise compensation and losers have blocking power.

This may constitute a barrier to reform. Voters and policymakers may focus on the short-run effects, and even if policymakers are motivated by the long-run effects, they may find it difficult to convince voters that its benefits can be reaped and will not be 'confiscated' via e.g. future tax increases.

Clearly major economic changes – like economic crises – can change power structures by destroying the status quo situation. This gives rise to the view that major reforms are crisis driven, and a major problem must be present to pave the way for reforms: "Reform naturally becomes an issue only when current policies are perceived to be not working ... that policy reform should follow from crisis is no more surprising than smoke following a fire" (Rodrik, 1996, p. 27).

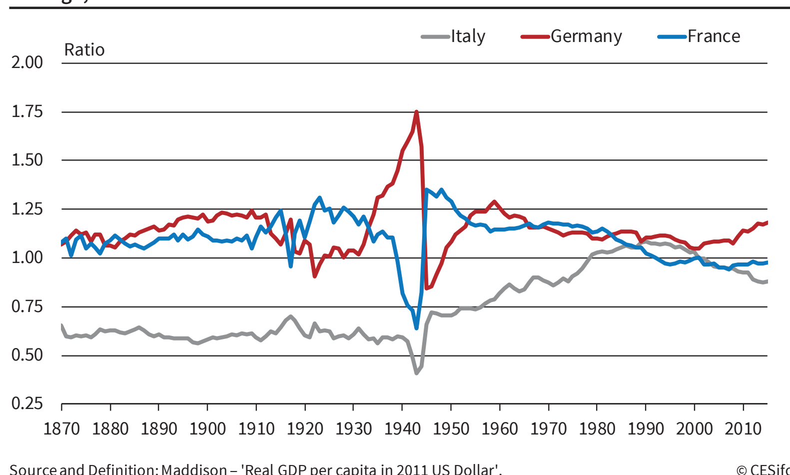
If a crisis is needed for reform to take place, it gives a rather dismal view of policy formation in democracies. It is not clear that a crisis is either a necessary or a sufficient condition for reform.[17] There are examples of countries where a crisis has not led to significant reforms – as discussed in Section 2.6 on Italy – and there are also examples of wide ranging reforms being implemented without an urgent crisis, e.g. pension reforms in Sweden and Denmark, see below. Many steps in the process of EU integration – like the Single Market – have not been undertaken in a crisis, but to move Europe forward. The EMU can partly be ascribed to the recurrent crises under the preceding fixed exchange rate regime, but also had a clear forward-looking element.

[16] Belloc and Bowles (2017) show how strategic complementarity between contracts and social norms can produce multiple cultural-institutional equilibria. The specific setting is labour market contracts and the interaction between incentives, monitoring, and effort. In this setting there are multiple equilibria (a superior and an inferior outcome). If, in the inferior equilibrium, there is not automatically a move to the superior equilibrium – that requires a coordinated action, and single actors cannot enact such a change. Interestingly, greater international integration makes a shift from the inferior to the superior equilibrium more difficult.

[17] There is a small body of empirical literature on crisis-driven reforms, with Drazen and Easterly (2001), Høj et al. (2007), and Duval et al. (2018) finding that crises lead to reforms, while Agnello (2015) does not. While it is relatively easy to show that major reforms are preceded by a crisis, it is more challenging to explain why crises do not necessarily lead to reform.

Figure 2.6

Real Income per Capita: France, Germany, and Italy relative to Western European Average, 1870–2016



Source and Definition: Maddison – 'Real GDP per capita in 2011 US Dollar'. © CESifo

External forces may also have ambiguous effects on reform activity and direction. In the run up to the establishment of the EMU it was widely expected that structural reforms would come more or less automatically. Although convergence prior to establishing the EMU was incomplete, it was expected that countries being unable to devalue as a short-term fix of problems, would be forced to undertake structural reforms to make their labour and product markets more flexible. This was referred to as the TINA argument – *There Is No Alternative*.[18] In other words, for euro member countries, the cost of abstaining from reforms was taken to be higher than implementing them, which was expected to act as a trigger. For a more detailed discussion of this issue, see e.g. Bean (1998), Calmfors (1998), Saint-Paul and Bentolila (2000), and Duval and Elmeskov (2005). While it would be wrong to say that there have not been reforms in EMU countries, it is equally clear that the TINA argument has its limitations.

While the literature on political economy offers various explanations of why reforms have either not been undertaken, or were delayed, it has very little to offer in terms of how reform agendas can be promoted. The fact that many reforms are crises-driven does not have obvious normative implications. However, one lesson is the importance of carefully explaining why reforms are needed, and how specific elements can help to solve problems. It is easier to gain political support for broad reform 'packages' designed so that there is no gaping discrepancy between 'winners' and 'losers'.

2.6 LAGGING BEHIND – ITALY

To understand how a country can fail to react constructively to the challenges and opportunities of a changing world, consider Italy's 25 years of stagnation and crisis experience.

2.6.1 Where Have All the Miracles Gone?

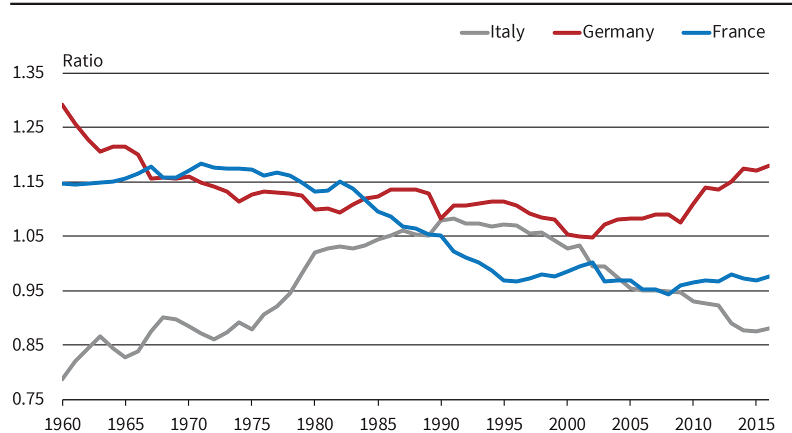
It is useful to look further back to earlier experiences, and particularly to Italy's strong performance during the glorious period of post-war European economic development. Figure 2.6 plots the real GDP per capita GDP of Italy, France, and Germany relative to the average of all Western European countries (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom). The normalisation hides events that affected the whole of Europe, like wars and technological falling behind or catching-up relative to the United States, and highlights country-specific dynamics (these and other countries fought wars on different sides, and rode Europe-wide growth cycles at different speeds). The data are from the Maddison Project Database (Jolt et al., 2018) and start in 1870, when Italy and Germany had just begun to exist as nation states. They differ from the National Income Account data shown in the figures above, because they measure real production along the cross-country as well as the time dimension; assessing the purchasing power of currencies with "prices that are constant across countries, but depend on the current year."

Figure 2.6 shows Italy hovering at around 60 percent of the European average throughout World War I (which it expensively won) and the Depression (which was about as bad in Italy as elsewhere), then crashing to 40 percent after World War II (which it lost). Figure 2.7 focuses on the last 60 years. It shows Italy first shooting from 70 to 105 percent of the European average, outshining both France and Germany, during the post-war period when European countries were broadly converging towards each other and towards the United States. As shown in Figure 2.1 above, both convergence processes ceased in the 1970s and 1980s, when Figure 2.6 shows Italy's relative income still growing strongly, but then sliding back at around the same speed from the early 1990s, and eventually returning to the level of the late 1960s. Through this lens, Italy's economic performance appears as astounding in the post-war period as it has been disappointing over the past 25 years.

Fast post-war growth originated in opportunities for change that Italy exploited effectively: adoption of American technology, urbanisation, and internal

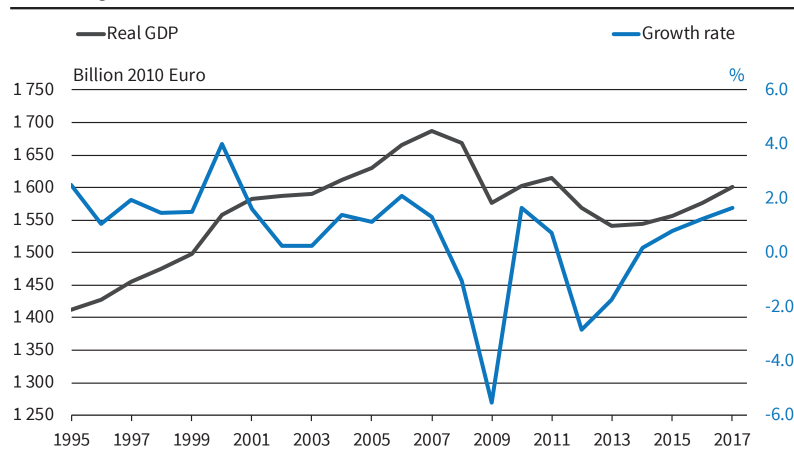
[18] Originally coined by former UK Prime Minister Margaret Thatcher in the mid-1980s to justify her economic policy initiatives.

Figure 2.7
Real Income per Capita: France, Germany, and Italy relative to Western European Average, 1960–2016



Source and Definition: Maddison , Real GDP per capita in 2011 US Dollar. © CESifo

Figure 2.8
Real GDP in Italy, 1995–2017
Levels and growth rates



Source: AMECO. © CESifo

migration vastly increased the Italian economy's productivity.[19] No such 'miracle' has happened since the 1990s. The striking relative decline of relative per capita GDP in Figure 2.6 starts in the 1990s, accelerates in the 2000s, and continues over the past decade. While both Italy and Europe had to cope with the Great Recession, Italy's slower recovery merely appears to be a continuation of the country's previous poor economic performance. Distinct phases of stagnation and crises are also apparent in the dynamics of Italy's real GDP. As shown in Figure 2.8, this grew very slowly in the 1990s, even more slowly until 2007, and then experienced a series of sharp repeated declines that brought it back down to the level of 2000.

2.6.2 The Mechanics of Stagnation

Figure 2.6 dates Italy's relative income turning point fairly precisely to 1992, a momentous year inside the country and around the world. In Italy, the political hegemony of the Christian Democratic party (Democrazia Christiana, DC) ended in that year. Throughout the post-war period Italy's coalition governments fell and were reappointed frequently, but always included the DC (itself a loose coalition of various interests). In 1992, judicial investigations swept away that political system. Thereafter, electoral competition was between a right-wing alliance of Mr Berlusconi's Forza Italia and smaller parties, and a variable set of centre-left coalition, under the leadership of Mr Prodi in the 1990s and early 2000s.

Around Italy, economic integration shifted into high gear in Europe, with the 1992 Single Market Programme, and globally, as the end of the Cold War fostered trade integration with China and other developing countries. At around the same time the World Wide Web and the first GSM mobile networks were switched on, and information technology began to be broadly adopted. These European and global developments affected all countries, but Italy appears to either have been hit more negatively; or, more interestingly, to have reacted less appropriately.

Italy's malaise starts at the same time as the introduction of the EU's Single Market and the run-up to the adoption of the euro, which is associated with a further acceleration of the country's relative decline. Renouncing the frequent devaluations that played some role in supporting Italy's good economic performance in the 1980s, at a cost in terms of instability for both Italian and foreign producers, may have played some role in the subsequent decades of stagnation. There is evidence that in less developed countries a lower real exchange rate is associated with a medium-term growth acceleration (Rodrik, 2008), which may be explained by institutional or technological improvements triggered by a shift in production out of backward and distorted non-tradable sectors and into export or import-substituting sectors. That evidence is corroborated by Italy's experience, suggesting that

[19] Crafts and Magnani (2013) outline and discuss the various phases of Italy's economic development.

the country may be more similar to developing countries than to its European peers in this respect. However, the correlation is more plausibly generated by mechanisms that link low productivity to overvaluation, rather than by a causal effect from devaluations to higher productivity. In the run up to the euro, Italy did not experience overvaluation, as nationally coordinated indexation to decreasing planned inflation rates restrained nominal wage growth, which persistently turned out to be lower than realised inflation. Loss of wage competitiveness and a smaller tradeable-goods sector may plausibly explain the faster decline after the introduction of the euro, when wage growth resumed (especially in the public and other non-tradable sectors) and to some extent priced Italian employment out of international markets. It is true that after the adoption of the euro, devaluations could no longer realign nominal wages to productivity; but it is hard for nominal rigidities to explain decades of stagnation, so devaluations could hardly be expected to bring it to an end. A more plausible mechanism sees even moderate wage growth outpaced by even slower productivity growth, which can be explained in turn by two conceptually different implications of the country's changed circumstances since the 1990s.

Sources of Structural Change

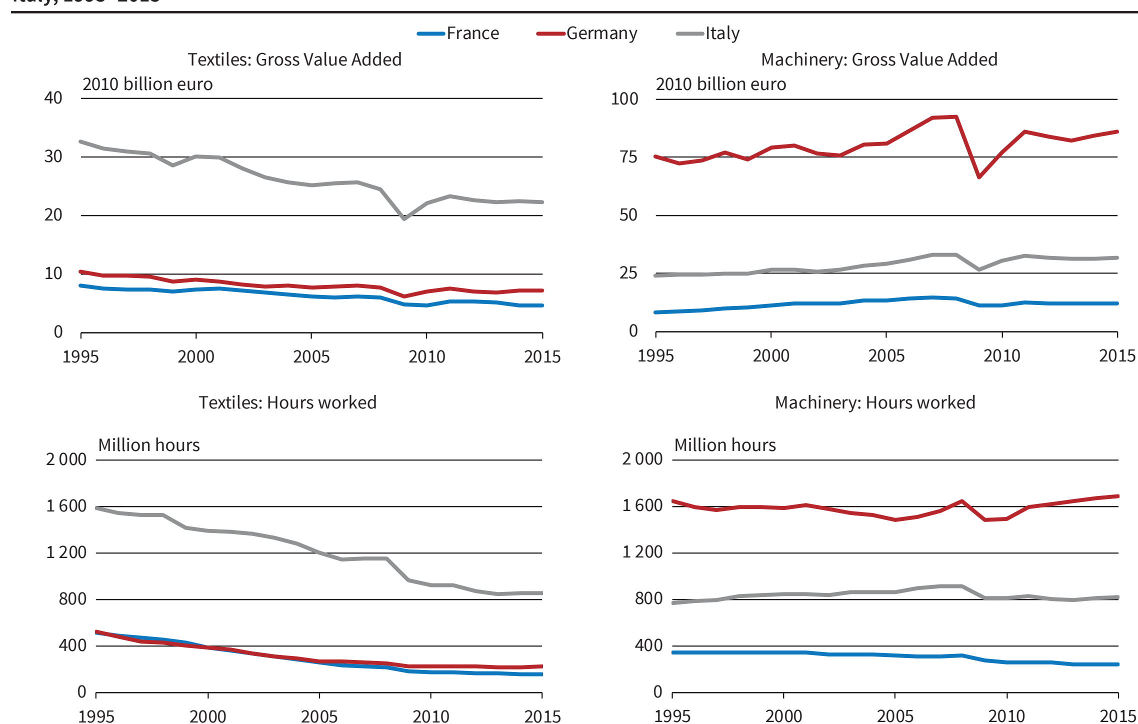
One is the country-specific impact of international economic integration (and technological progress, which has similar implications). Undistorted trade among undistorted economies improves average welfare in each, but has different implications across occupations and factors of production: when markets integrate, those that supply factors that become less scarce suffer income reductions. If Europe as a whole integrates with the global economy, the implications will be different not only for individuals within countries, but also across countries within Europe. There is strong evidence that trade integration with extra-European economies had more favourable implications for the exports and terms of trade of the core economies than for peripheral economies in the European Union (European Commission, 2012, and Chen et al., 2013). Italy as a whole may be relatively worse off thanks to this mechanism. If, for instance, globalisation enables Germany to sell more machinery to China and buy clothing from Vietnam rather than Italy, it benefits the average German more than the average European, and far more than the average Italian.

The structural change that globalisation and technological trends require is not country-specific as such. It affects sectors or occupations, and the regions and cities within countries where the relevant factors of production are more or less abundant. The relative importance of positively or negatively affected sectors at an aggregate level nationally, however, determines the relevance of such change for different countries.

Figure 2.9 shows that in Italy, France, and Germany the production of textiles declined between 1995 and 2015, but not that of machinery, and that employment

Figure 2.9

Gross Value Added and Total Hours Worked – Sectoral Developments for Textiles and Machinery in France, Germany, and Italy, 1995–2015



Source: EU Klems Database.

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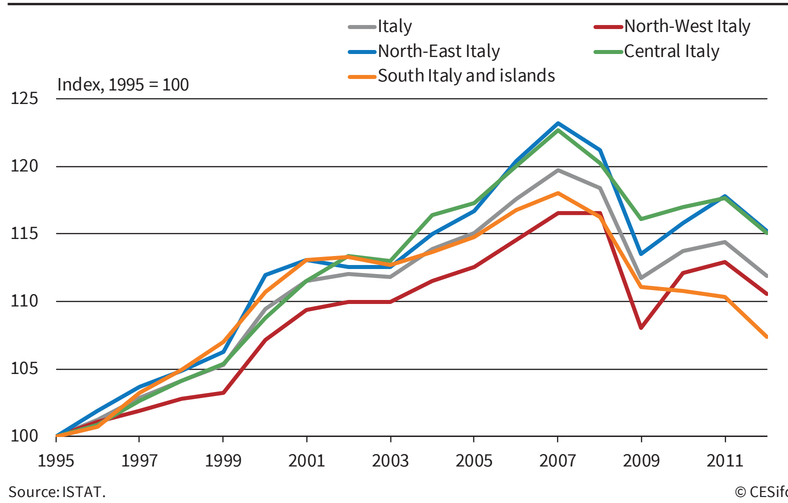
Figure 2.10

Regional Developments in Italy in GDP, 1995–2012



Source: ISTAT.

© CESifo

followed similar, but interestingly different paths.[20] These trends and the fluctuations associated with the Great Recession are fairly similar across the three countries, suggesting that sector-specific forces largely explain them. But their relevance at the country level was not the same: in Italy textiles were initially, and remain, far more important than in the other two countries, while machinery (although more important than in France) was, and remains, much less important in Italy than in Germany. Hence, sector-specific developments in the aggregate of the EU-15 countries, all of which traded in a single market for goods and faced similar technological innovations, may partly, but not entirely explain some of Italy's relative decline; not least because, as we proceed to argue, the country was not well equipped to deal with structural change.[21]

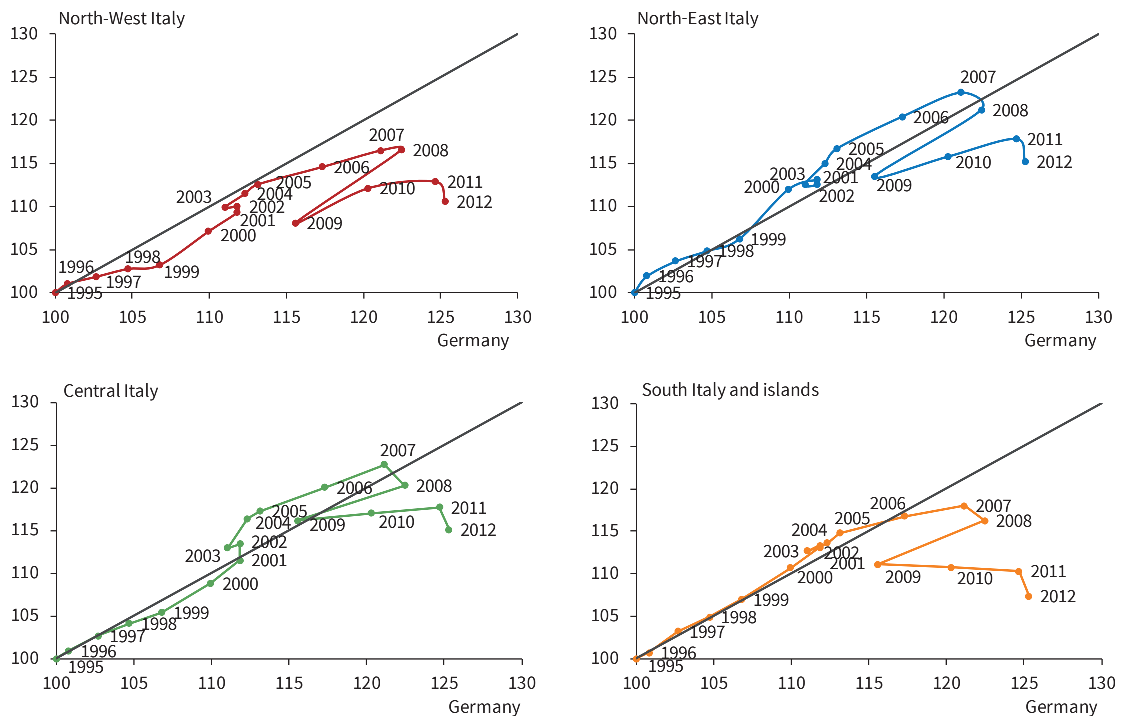
Of course, there were sectors and regions in Italy (those most similar to Europe's 'core') that did relatively well. Indeed, Figure 2.10 shows that economic performance was uneven within Italy in ways that partly reflect indigenous political and economic developments, but also arguably relate to European and extra-European economic integration.

[20] Labour productivity in each sector is not the same across countries over time, partly because countries specialise in different segments of the market. For transport equipment the data (not shown) clearly indicate that cars produced in Germany differ from those produced in France and Italy, in ways that appear particularly beneficial over the past two decades.

[21] It is possible to perform standard shift-share growth accounting exercises on broader sets of the EU KLEMS data used in the figure. Our preliminary results suggest that sector structure explains only a small portion of growth differences across Italy, France, and Germany in the 1995–2008 period, when EU-15 external trade patterns changed due to enlargement and globalisation, and in the 2008–2015 period of crisis and recovery.

Figure 2.11

Regional Developments in Italy Compared to Germany, Fixed Prices, 1995–2012



Note: GDP in four marco regions of Italy (*Prodotto Interno Lordo Lato Produzione* at 2005 prizes, normalized to 1995=100) plotted against time for the available period and against real GDP for the whole of Germany (normalized to 1995 = 100).
Source: ISTAT and AMECO.

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Interestingly, those parts of Italy that are closer and more similar to Germany did relatively well before the crisis. Between 1995 and 2007 North-East Italy actually outperformed Germany (itself an aggregate of more or less fortunate regions), while not only the South, but also the North-West lagged behind (see Figure 2.11). This suggests that the former benefitted, and the latter were hurt by international market opportunities that allowed some sectors and regions to exploit complementarities and left others facing substitution by competing producers.

For a large and heterogeneous country it can be difficult to adjust to shocks that have different implications across skill types and industries, as well as across geographical units. The impact of globalisation and new technologies has more dramatic implications for income distribution when factor markets are segmented by obstacles to labour and capital mobility, and for welfare distribution in the absence of suitable public transfer schemes and private financial flows.

Institutional Structure

Economic integration was a new development, with both aggregate and distributional implications, that called for suitable reactions. To understand how it resulted in persistent stagnation, we need to identify plausible country-specific sources of disappointing performance. In Italy, markets, policies, and institutions were not up to the task of dealing with change. Labour and financial markets should steer factors of production towards high-productivity firms and sectors, but Calligaris et al. (2016) document that Italy experienced not only an almost uninterrupted decline in average total factor productivity (TFP), but also a very large and steady increase in TFP dispersion across firms. These phenomena are particularly strong in the North-West, where many traditional factories continued to operate long after their workers should have found new jobs. The extent to which factors are misallocated across firms is clearly related to indicators of poor corporate ownership, control, and governance, finance, workforce composition, internationalisation, cronyism and innovation, both before and after adoption of the euro.

Such shortcomings of the Italian economy predate its stagnation, of course, as do other weaknesses like organised crime, corruption, deeply rooted regional heterogeneity, an ineffective legal system, and a somewhat less than constructive political climate which can, in turn, be traced back to cultural factors like the influence of private television and a somewhat dysfunctional educational system. While most of these problems were present throughout previous periods of strong economic performance, and some may have worsened in recent decades (partly as a result of declining and poorly distributed economic welfare), all have plausibly become more damaging in the light of recent developments. Italy's labour force, for example, has always been far less educated than that of other industrialised countries. This did not hinder the country's productivity as long as it was producing traditional manufacturing goods, but became problematic when economic integration and technological developments called for a transition to high-technology production.[22] It would take generations, even in the best of circumstances, to react appropriately to new educational demands. But Italy was slow to even detect the need to change. In these and other respects, Italy needed to adjust more, but proved less capable of doing so than its peer countries.

Sharing the Costs and Benefits of Change

Inside every country, international economic integration does not benefit all equally and is not uniformly beneficial unless gainers compensate losers. Government policies, along with more or less tightly regulated and well-developed factor and product markets, distribute the costs and benefits of change across individuals and firms. Private financial markets could enact the appropriate transfers if it were possible to trade insurance contracts that hedge trade developments. In a world of imperfect financial markets, compensating losers and easing change is, in principle, the task of taxes, transfers, and public education and training programmes.

All this is particularly important in cases where international economic integration (inside the European Union with the Single Market and EMU, and outside the Union with globalisation and enlargement) or technological progress have large distributional implications and call for intense reallocation. The economic and policy system that Italy inherited from the 1980s was arguably ill-equipped to deliver the necessary changes. Poor sharing mechanisms are a more relevant problem in a large and regionally heterogeneous country. The decades during which Italy as a whole stagnated were particularly bad for its less developed regions, which compete more closely with developing countries, and saw the rise of the separatist Lega Nord party in the richer (and more similar to European core countries) Northern regions.

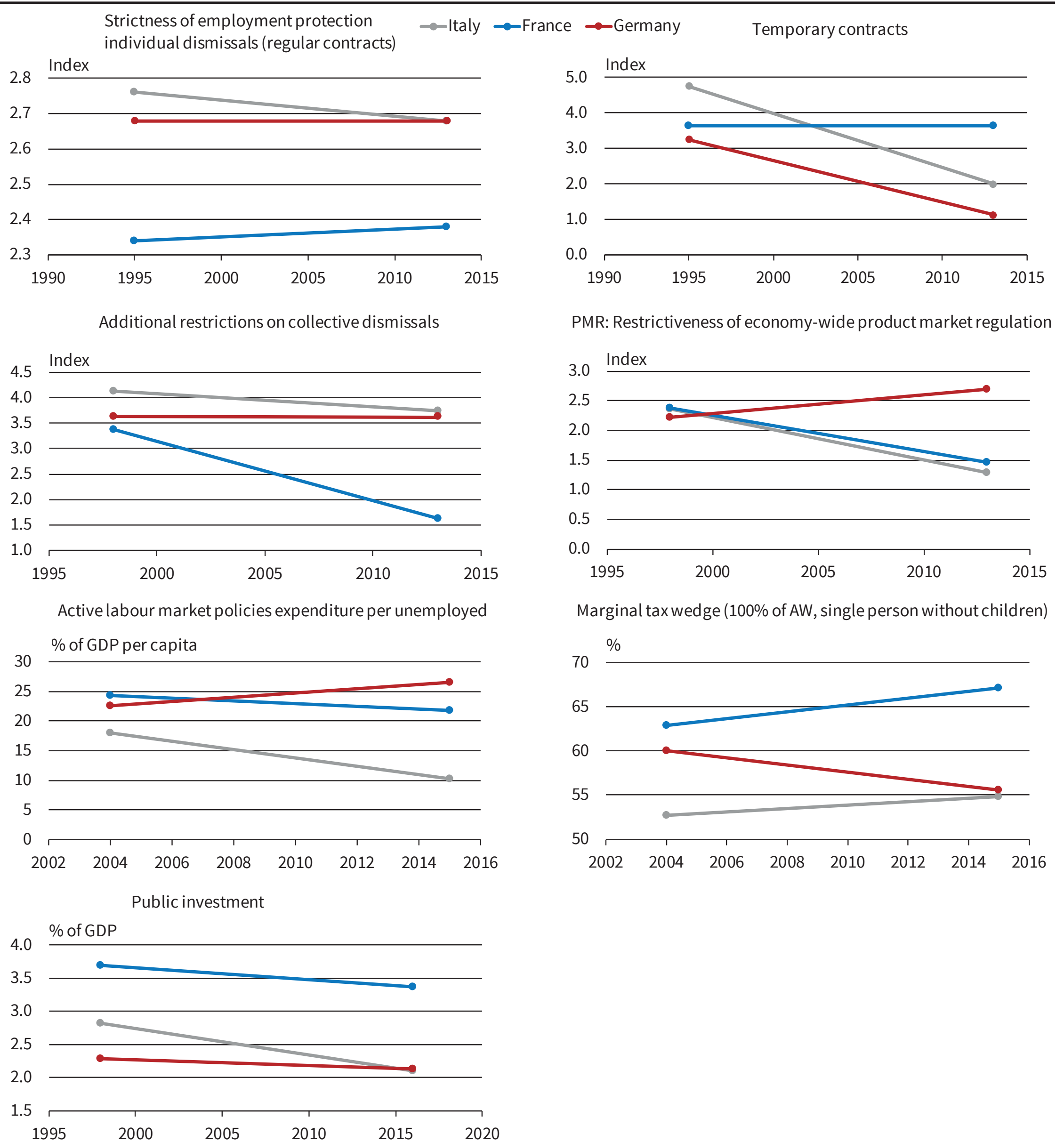
An appropriate reaction to external calls for change was also difficult across sectors and more or less dynamic firms. To see whether Italy indeed was less well prepared as its peers to face the new challenges, it is useful to compare its position relative to France and Germany (see Figure 2.12).

In the earlier of the two periods shown (first observation available for each indicator) Italy features a highly centralised wage setting, the most stringent employment protection, restrictive product market

[22] Bertola and Sestito (2013) review and discuss the Italian school system's institutional evolution, and its interaction with the country's production structure.

Figure 2.12

Labour and Product Market Policy Indicators for France, Germany, and Italy



Note: The OECD indicators of employment protection and product market regulationare are synthetic indicators of the strictness of regulation. For each year, indicators refer to regulation in force on the 1st of January. Data range from 0 to 6 with higher scores representing stricter regulation.

Source: OECD Going For Growth database and Employment Protection database.

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regulation, and low generosity of unemployment insurance. This policy configuration may have been compatible with some country characteristics. Administrative and information-gathering skills are both relatively scarce in Italy's government and needed to run an efficient unemployment insurance scheme. As better information may well be available within firms, it can be a good idea to mandate employers to insulate labour incomes from productivity shocks. Of course, small firms cannot easily do so and should be exempted from job security provisions (which may partly explain why many Italian firms remain small). Larger firms, burdened by insurance duties, will try and obtain the protection from competitive pressures and entry threats offered by product market regulation. Along Italy's long growth past, and especially after internal migration and urbanisation came to an end in the 1970s, the internal reallocation of permanently employed labour might well have been a good alternative to imposing on workers the risk, mobility, and search costs of adjustment, steered by the unstable wage differentials that centralised wage contracts tend to erase.

If shocks are increasingly sectoral or regional rather than country-specific, a centralised wage setting logically becomes increasingly inappropriate. Moreover, if structural change calls for firm exit and entry, rather than intra-firm reorganisation, unemployment insurance makes more sense than employment protection. And while centralised wage contracts play a useful role when a country

needs to keep aggregate wage growth in check, a rigid salary structure is not what the economy needs in times of labour reallocation across sectors and occupations. These labour market institutions may well need to be reformed to face the structural challenges posed to the country by international economic integration and new technologies, but it would be difficult to blame them for Italy's poor performance relative to its peer countries. Institutions and reforms are not very different in OECD data across Italy, France, and Germany, as shown above.

While there may be more pronounced differences in other countries (such as those discussed in the next section), specific reforms of labour market institutions are just one of the country-specific features that can ease adaptation to structural shocks, by sharing the costs and benefits of change. Job security is not necessarily a bad thing when financial and other markets function poorly. Support for social protection and labour market regulation may well be rooted in the myopic defensive culture that prevents positive growth feedbacks, but it is also motivated by the impact of product and financial market imperfections on the level and volatility of labour income, which for most households accounts for a major share of lifetime resources. To the extent that productivity growth depends on more general institutional features, it may be advisable not to prioritise unpopular labour market deregulation.

The indicators in the Figure 2.12 also show Italy spending less on the active labour market programmes that could retrain workers in times of change, and subsidising research and development to a far lesser extent than its peers. These indicators worsen over time as a result of poor tax collection, slow income growth, and the resulting budget pressures that moved expenditure further away from programmes that promote growth, reallocation, and innovation. Old-age pension spending, despite reforms that promise long-term sustainability, is about 16 percent of GDP in Italy: like the over 4 percent of GDP devoted to public debt interest payment, this is not exactly the kind of public expenditure that can ease reallocation of labour towards more productive sectors and occupations. By contrast, spending on education accounts for just 4 percent of GDP (and is especially low at the tertiary level), and the post-crisis slowdown in public spending was concentrated on capital expenditure, which declined by around 28 percent in nominal terms between 2009 and 2016.[23] For the same reason, tax wedges could not decline as much as they did in Germany (but increased in France).

Other features of the Italian economy at the beginning of its stagnation were less well-suited to ease adjustment than those of other advanced economies. Cumbersome governments and underdeveloped markets are not well equipped to foster change by appropriately sharing its costs and benefits. In Italy firms were, and still are, relatively small, funded by banks and employee's severance pay funds rather than by risk capital. Intergenerational transfers, rather than bank loans, are also common for house purchases. Hence, shallow markets and poorly-developed public policies arguably made it particularly difficult for Italy to face globalisation and technological innovation.

The most recent regulation indicators, however, are not so bad. Italy did reform its labour market around 2000, introducing similar flexible and low-tax contractual arrangements to those of the Hartz reforms (see below) in Germany (Bertola and Garibaldi (2006) review these and earlier labour market policies and outcomes). There was no need to reduce unemployment insurance, which was very generous in Germany, but not in Italy where it was recently – and appropriately considering the above arguments – extended and made more generous. The OECD indicators find that product markets were deregulated in Italy more than in France, while Germany regulated more tightly (it also reduced public investment and R&D subsidies). Product and service market deregulation was particularly strong and visible during the 2011 crisis when the Monti government abolished licenses for small and medium shops, and removed all constraints on opening hours.

2.6.3 Complacency on a Cliff Edge

Italy did reform, but perhaps not as fast as other countries, and certainly not at a pace that would let it swim against negative shocks and keep up with its peers. This is not because change is ruled out a priori. Political parties do routinely promise reforms, and some do follow through when they win elections. Sparse and hesitant reforms and frequent government turnover, however, do signal that there is no stable consensus about which reforms should be enacted, and that the policy status quo has considerable political support.

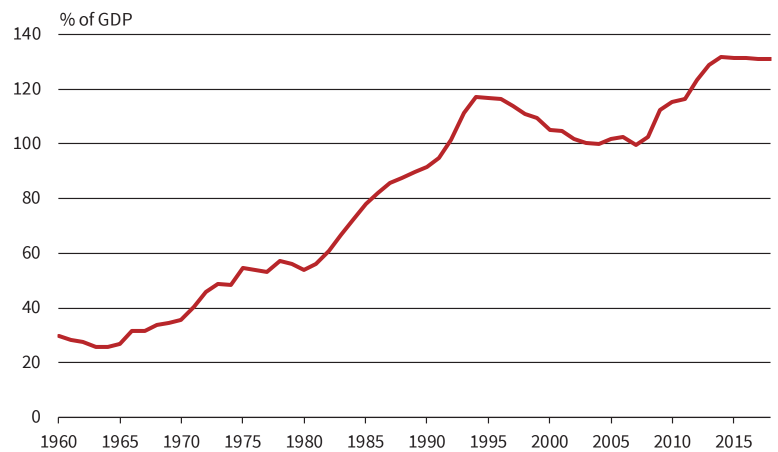
It is not difficult to understand why. As discussed above, a crisis is often needed to trigger reforms, but good past performance in living memory can reduce the urgency of reforms. Many Italians remember better times, and wonder whether just waiting for them to come back is the best strategy: after all, everything was going so well just a while ago, and past growth lets the standard of living remain high. President Berlusconi expressed this feeling well when at the November 2011 G20 in Cannes he wondered how everybody could be so worried about an Italian crisis even as the country's "restaurants are full." Reforms can be perceived to be adding risk to an already complicated situation (a feeling well expressed by the 19th century British politician who said: "reform, reform, reform: aren't things bad enough already?"). A complacent

[23] These and other data are documented and discussed by Andrle et al. (2018).

'no need to change' attitude is understandable for a rich country, where a majority is content to enjoy a high standard of living.

The lack of reliable growth prospects is problematic, however, for a country that is integrated with a changing world (and draws from this integration a large share of its economic well-being). To see why, consider the financial perils of stagnation and crisis. Figure 2.13 shows that Italy's debt/GDP ratio rose sharply in the 1980s, and declined in the 1990s only to begin growing again sharply in the mid-2000s. Figure 2.14 shows the factors driving its dynamics during the country's stagnation and crisis: mathematically, for the debt/GDP ratio to decline the government's primary surplus (excluding interest payments) should be a larger proportion of GDP than interest payments, net of the denominator's growth. It is hard to reduce the debt/GDP ratio if its denominator does not grow and fears of default increase interest payments in the numerator. In other words, stagnation and fiscal unreliability put debt on a cliff edge that would make the country fall towards North Africa or Latin America.

Figure 2.13
Public Debt in Italy, 1960–2018



Source: European Central Bank.
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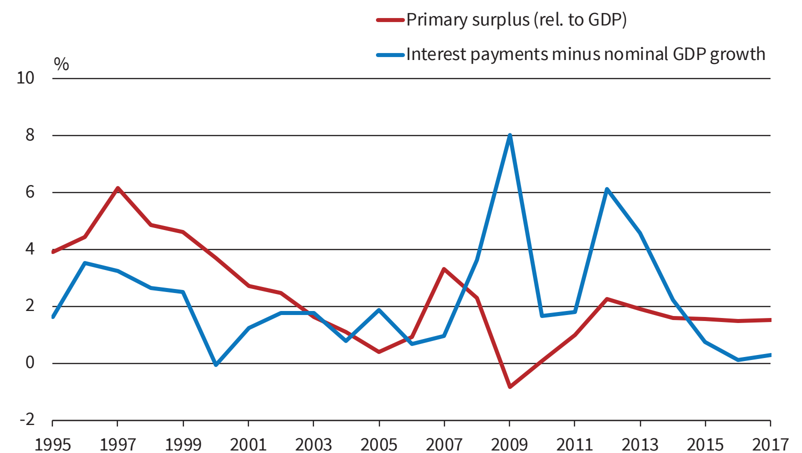
Figure 2.14
Primary Budget Surplus and Growth – Corrected Rate of Return of Italy, 1995–2017



Source: European Central Bank.
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Hard does not mean impossible: what is needed to ward off the vicious circle of a ballooning debt/GDP ratio is a large primary surplus, such as that shown in Figure 2.14 for Italy in the late 1990s, when the country successfully strived for euro membership under a Prodi government. The debt/GDP ratio continued to decline for a few years, thanks to lower interest payments, if no longer to large primary surpluses. The vicious circle and the edge of the cliff loomed large once again when the crisis-related deficits triggered fears of default and/or redenomination, and increased interest rates. Primary surpluses have been remarkably large in recent years, especially relative to the shrinking GDP that is a common feature across all of Italy during the debt crisis (see Figure 2.10), when difficult financial conditions and a widespread lack of faith in the country's future reduced investment and consumption across the board. A commitment to fiscal austerity (as enacted in the '6-pack' context) can, in principle, restore credibility and growth, but will not do so in a country where many think it is unwise, ineffective, and unpopular. Italy's fiscal policy is characterised by much the same hesitant and partial character as the country's response to structural challenges. It suffers in particular from weak tax enforcement and frequent tax amnesties, which constitute a myopic and ineffective way of increasing the state's tax receipts.

2.6.4 And Now What?

Coping with change is difficult indeed. History offers many other examples of rich countries' decline and stagnation, which can be interpreted along the same lines as Italy's experience: "In Venice in the 1600s or Amsterdam in the 1700s, members of rich societies turned efforts away from innovation and competition and towards the defence of small or large privileges. Particular interests loom large in a stagnating economy, where redistributive coalitions' veto power

makes it increasingly difficult to innovate and grow. It is up to political interactions to find a way to break this vicious circle."[24]

During the crisis, the Monti government enacted some emergency reforms, and notably reduced pension rights. As the Italian economy finally ceased to shrink and shiver, centre-left governments enacted some other reforms. A particularly relevant one, known in Italy as the 'Jobs Act' and introduced in 2015, made unemployment insurance more generous and introduced a single standard employment contract, with a pre-set scale of tenure-based redundancy payments, meant to replace both the existing standard contracts with stronger job security provisions, and the many non-standard contracts liberalised by earlier reforms around 2000. In 2016 a very substantial set of institutional reforms was also submitted to a constitutional referendum which, along with a proposed change of electoral law, would have streamlined political decision-making processes.

Both the political feasibility and the practical success of these reforms hinged on a hopefully self-sustaining wave of optimism and forward-looking orientation. More specifically, the flexibility-oriented labour reform could have made a favourable impression on the electorate if it had boosted hiring in a strong economic upswing. Growth did not come soon enough, however. Even as Italy began to grow modestly, the referendum failed, the government fell, and a caretaker government could only add some modest amounts of additional flexibility (with good payoffs in times of somewhat stronger growth, driven by exports boosted in turn by the ECB's quantitative easing and by US fiscal policy).

The 2018 vote, shaped by strong populist sentiment, brought to power a coalition of two odd bedfellows. One is the Cinque Stelle movement, which gathers its consensus from the economic discontent of youth and residents of poorer regions. The other is the Lega party which, while remaining rooted in higher-income (if low-education) social strata and regions, changed its electoral platform to ride a wave of resentment against budget constraints and immigration by adopting a nationalistic anti-European and anti-globalisation stance. The coalition dubs itself a 'government of change' (*del cambiamento*), an appropriate stance if a lack of constructive change is what kept Italy's economy in stagnation. Change for change's sake, however, does not necessarily go in the right direction. If what is needed to cope with change is suitable sharing of adjustment gains and losses, the winning parties' platforms can be more dangerous than inaction, because they are largely incompatible and uninclined to compromise. The Northern employed supporters of Lega would like lower taxes, smaller government, and earlier retirement. The younger, less employed, and Southern supporters of Cinque Stelle would like minimum income guarantees, and more public employment.

Both electorates share a nationalistic attitude to economic integration and broad individualistic opposition to regulation (such as mandatory vaccination). In practice, the first economic policy actually enacted (in summer 2018) was a regulation-oriented retraction of labour reforms by previous governments, with higher firing costs and more restrictive temporary employment rules. Reforms that increase labour market rigidity may appear to be a costless remedy to workers' malcontent when resources are scarce; but while labour market rigidity does not increase the numerator of debt/GDP ratios directly, it decreases their denominator by reducing efficiency. Furthermore, more rigidity is as misguided in times of expansion, when it reduces firms' propensity to hire, as deregulation can be in economic downturns, when it pushes employment and wages without a large payoff in terms of employment creation.

Other proposals on the table include the renationalisation of toll highways and of the flagship airline, a reinstatement of earlier retirement ages and accelerated replacement hiring in the public sector, delayed liberalisation of energy markets, and even restrictions on shop opening hours. Many of these reforms reverse previous reforms. This brings back to the Italian economy institutional features that played a role in preventing suitable reactions to structural change and resulted in its prolonged stagnation. The budget for 2019 includes lower tax rates and a minimum income guarantee, that was originally (but is no longer) partly financed by a tax amnesty, and defies EU rules by envisioning a large deficit and paying only lip service to public debt reduction.

Unrealistic promises and reform reversals make it impossible to foster the credibility and investments that the economy needs to cope with structural change. As has all too often been the case over the past 25 years, policy actions in Italy appear to be nostalgically inspired by a wish to return to a past that looks good in living memory. It can be irrationally appealing to restore policies that were in force in better times, but old-fashioned policies alone would not bring back 1960s growth. Memory is selective. It is only too easy to forget the negative aspects of past experience and mistakenly remember both having cakes and eating them. Italy's post-war growth was not really a miracle: it called upon the country to address the thorny problems posed by urbanisation, internal migration, and hard factory work. Those who remember fondly the national currency forget the damage done (not least to pensioners) by high and unstable inflation, and fail to recognise that the public deficits of the past that are so fondly remembered

[24] This is a loose translation of an excerpt from Mario Draghi's introductory speech, available in Italian at https://www.bancaditalia.it/pubblicazioni/interventi-governatore/integov2011/draghi-121011.pdf, at a conference on the first 150 years of Italy's economic growth (proceedings in Toniolo, 2013).

left a heritage of huge debt. Even though the cliff still looms large, the temptation remains strong to try and break out of unpopular constraints by increasing public deficits (see Chapter 3 of this report). But Italians can and do draw sobering conclusions from observing crises in Argentina, Turkey, and Venezuela, which are all countries that do not have to abide by European Union and Euro Area policy constraints, but aren't doing so well.

2.7 OTHER COUNTRY AND REFORM EXPERIENCES

All EU-15 countries – and OECD countries for that matter – have experienced periods of good and bad economic performance. Policy debates tend to elevate specific countries as 'best performers' or 'superstars' setting an example for others to follow. At different points in time Germany, Sweden, the Netherlands, Japan, and Denmark have been the darlings in the debate, but it is telling that no country has persistently been a model example. This highlights the fact that economic performance varies over time depending on a long list of global and domestic factors.

However, some countries stand out in terms of a trend towards deteriorating economic performance, like Italy, as discussed above, and France. There are plenty of bad examples. In an era of great scepticism over the effects of economic reforms, it is worth pointing out that there are notable examples of countries that via reforms – some implemented in a deep crisis and others in less severe situations – have improved their economic performance.

It is impossible to cover the reform experiences of all EU countries in detail – even for the EU-15 countries – but we offer a brief summary of selected experiences below. The purpose is to highlight a few key aspects in terms of the timing and content of reforms. This is done on a case-by-case basis to highlight interesting and important issues in relation to economic reforms. Clearly, numerous issues related to causality, the precise effects of reforms etc. are not addressed.

In the following we begin with a short account of reform experiences in Denmark, the Netherlands, and Sweden. These countries share a path of deteriorating economic performance initially, followed by an improvement, and form interesting contrasts to the developments in Italy. This comparison highlights both why shocks may have different country effects, as well as the importance of reforms. What happened that was bad for (parts of) Italy around 1992 appears to have had other effects for these countries: for example, trade with China was a positive development for the Netherlands, a trading country with the largest European port. These countries, however, also enacted reforms, and were able to take advantages of new opportunities.

Finland is an interesting case since it has been on a catch-up trajectory, but has been also exposed to severe shocks along the road. Finally, we consider Germany as an example of a large country undertaking significant economic reforms. There also other examples like Ireland (especially during the 1980s) and Spain (especially after the crisis) that have made significant improvements in economic performance, but are not covered here due to considerations of space.

2.7.1 Three Reform Cases – Denmark, the Netherlands, and Sweden

The sharpest contrast to the developments in Italy is seen in Denmark, the Netherlands, and Sweden, as illustrated in Figure 2.2. These three countries experienced a relative similar development with a decline in relative economic performance until the early part of the 1990s, and then managed to break this trend via reforms and regain a position among the best performers within the EU-15 group.

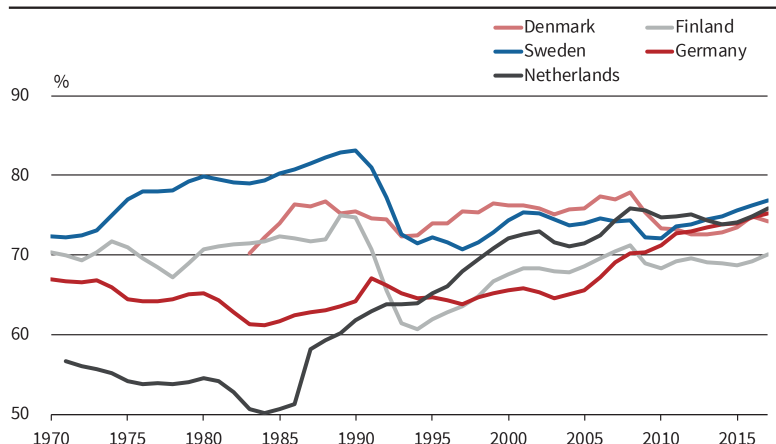
Obviously, these three countries share some characteristics, including the fact that they are small and open economies, they have a long tradition of corporatist[25]/consensus solutions, and have relatively large public sectors. But there are also important differences. Public sector structures and designs are rather different[26], and while the Netherlands is a euro-

[25] In these countries, 85 percent or more of the employed are covered by collective agreements and sector level bargaining, with a high degree of bargaining coordination (Visser, 2016).

[26] As an important example, pensions systems are very different based on a notional defined contribution scheme in Sweden, a largely funded contributions scheme in Denmark and defined benefit scheme in the Netherlands.

Figure 2.15

Employment Rates in Denmark, Finland, Sweden, the Netherlands, and Germany, 1970–2017



Source: OECD. © CESifo

country, Denmark pegs the exchange rate to the euro, and Sweden pursues a flexible exchange rate regime (with inflation targeting). While the specific reform details are country-specific, they share a focus on the need to restore competitiveness – and more broadly strengthen the private sector.

The dismal developments leading to the reforms were also widely recognised and were probably an important factor in creating a consensus-based understanding of the need for reforms. The challenge of needing to remain competitive was seen as a collective problem – "we are in the same boat" – requiring action. The reform trigger is most visible in the case of Sweden's boom-bust pattern, but crisis sentiment was also present in the two other countries. We comment briefly on the reform experiences in these three countries, focusing on reforms related to the developments in the 1990s (see Figure 2.2).

Denmark – The Flexicurity Model

Economic developments in Denmark deteriorated during the 1970s and 1980s, with systematic trade and deficits and persistent high unemployment prevailing. The mood in the late 1980s and early 1990s was pessimistic and there was a widespread perception that "we have to learn to live with high unemployment."

In this spirit a new (1993) Social Democratic-Liberal coalition government launched a 'work sharing' scheme, but policies soon shifted direction. The social safety net was changed from having a passive focus on income maintenance to a more active focus on bringing the unemployed into employment. This happened in a sequence of reforms. The fall seen in unemployment – partly driven by business cycle developments – created a political momentum for further reforms (Andersen and Svarer, 2007). The key elements in these reforms were: i) a shortening of the benefit period for unemployment benefits, ii) eligibility for unemployment benefits no longer to be re-gained by participation in activation programmes, and iii) implementation of activation requirements (workfare) both in the unemployment insurance scheme and in the social assistance scheme.

During the 1990s Denmark changed from a high to a low unemployment country; a development associated with the so-called flexicurity model. Employment rates increased (see Figure 2.15). The reforms can be said to have established a balance between flexible hiring/firing rules, a relatively generous social safety net, and an active focus on bringing the unemployed back into work – known as the flexicurity model. Tighter eligibility conditions for unemployment benefits and social assistance, as well as an active labour market policy, were important drivers of this change.

A number of other factors contributed to the improvement in Denmark's economic performance. Back in the early 1980s, a political commitment was made to a pegged exchange rate, and the requisite discipline to give this policy credibility was established. Wage formation also changed. The social partners made a commitment in the "common declaration" of 1987 to ensure wage developments consistent with maintaining competitiveness for the Danish economy. Wage developments over this period were moderate, despite the falling unemployment rate. Finally, the reforms in the 1990s that had a supply-side orientation were accompanied by expansionary domestic demand. Fiscal policy was expansionary, partly due to a tax reform with tax reductions being phased in prior to tax increases. The reform direction was to broaden tax bases and reduce marginal tax rates. Moreover, capital market liberalisation fuelled a booming housing market and rising domestic demand.

In retrospect, the reforms followed a two-handed approach with structural policies accompanied by expansionary fiscal policies, implying that the structural policy changes more quickly translated into employment and therefore became broadly accepted. The Danish experience over this period was mainly a result of a trial-and-error process, rather than the outcome of a grand master plan. The turn in the country's economic development, and particularly the drop in its unemployment rate, created the political momentum for further reform steps.

A second reform wave was prompted by a concern for fiscal sustainability due to an ageing population. In 2006 and 2011 key steps were taken to increase retirement ages and index them to developments in longevity (see EEAG, 2016). Subsequent reforms of all elements in the social safety net aimed at further strengthening the labour supply and employment. As a result, fiscal policies are sustainable despite an ageing population.

Denmark was hit relatively hard by the financial crisis, partly because the economy was already showing signs of contraction after a boom with growing domestic demand and high wage increases. Its recovery has been relatively slow, but unemployment has remained comparatively low. Most unemployment spells are short and structural unemployment has not increased, and in that sense the flexicurity model has weathered a significant downturn (see EEAG, 2016). The economy has thus been relative resilient, and key macro indicators have been favourable in recent years.

The Netherlands – From 'Dutch Disease' to a 'Dutch Miracle'

During the 1970s and the early 1980s, the Dutch economy performed worse than most other European countries, and the Netherlands entered an economic slump in the early 1980s. This was partly attributed to the so-called 'Dutch Disease' arising from gas

exploration, an overheating economy and a declining manufacturing sector. In the early 1980s, employment rates were low, and an increasing number of people were on disability pension.

This situation led to a radical shift in economic policy in the early 1980s, with a focus on structural policies, fiscal consolidation, and efforts to strengthen the credibility of the fixed exchange rate policy (OECD, 1998).

The so-called Wassenaar Agreement reached in autumn 1982 marked a crucial turning point. An agreement between employer's organisations and trade unions led to wage restraints to improve wage competitiveness. This was accompanied by shorter working hours based on the idea that available work should be distributed more equally across the work force. The need for a small and open economy to stay competitive was a main driver behind this agreement.

The Wassenaar Agreement is a hallmark of the so-called Polder model with tripartite cooperation between unions, employers, and the government institutionalised in the Social-Economic Council. The council discusses labour market and social issues, and there is a tradition of reaching consensus to avoid conflicts and strikes.

The social safety net was also reformed in the early 1990s. The high and increasing number of disability pensioners led to stricter requirements for disability pensions and sickness pay. The unemployment insurance scheme was made less generous, and there was a greater focus on labour market policies targeting weak groups and more opportunities for temporary employment.

In the wake of these changes the economic development changed and employment rates increased significantly (see Figure 2.15). However, a significant factor behind rising employment was an increase in part-time jobs. The Netherlands has a high employment rate, but also a comparatively high share of part-time workers – a feature that also characterises the Netherlands today.

More recently, the Polder model has been weakened due to stronger prevalence of 'atypical' jobs, the declining power of unions, as well as political changes (see Afonso, 2017). As an example, an agreement concluded in 2013 between the social partners included an increase in the maximum unemployment benefit period from 24 months to 38 months, representing the roll-back of an earlier reform reducing the duration of this period from 38 months to 24 months. Employers initially resisted the implementation of this agreement, but eventually accepted it (see European Commission, 2017). Moreover, collective agreements have been concluded in recent years without the consent of the largest unions. The incidence of strikes has also risen, but from a low level.

The Netherlands experienced a growth decrease as a result of the financial crisis that was on a par with most European countries. Its recovery has been slow (see Figure 2.2) and its performance has been relatively poor compared to that of countries like Denmark and Sweden.

Sweden – The Rise, Fall, and Rise Again of the Swedish Model

The Swedish model was hailed as highly successful throughout the 1960s and 1970s. Income levels were high, inequality low, and the welfare state extended. However, there were already signs of underlying problems and growth was fading (see Figure 2.2). The future looked bleak and the discussion turned pessimistic, with references to "the rise and fall of the Swedish model" (Lundberg, 1985).

Sweden experienced a boom-bust pattern in the late 1980s and early 1990s. The late 1980s saw a boom, partly driven by capital market liberalisation and a booming real estate market. As a result, wage increases were high and wage competitiveness deteriorated. A major crisis hit Sweden in the early 1990s, partly due to the 'Soviet shock' and the crisis in Finland. Between 1990 and 1993 unemployment increased from 2.3 percent to 10.1 percent, and the public balance went from a surplus of 4.1 percent to a deficit of 11.2 percent of GDP (debt peaked at 83 percent of GDP in 1998). A banking crisis evolved. At the time, Sweden pursued a fixed exchange rate and in the fall 1992 the Central Bank raised the steering rate to 500 percent in an effort to prevent capital outflows. This policy was abandoned in autumn 1992, and a floating exchange rate regime was adopted.

A number of reforms were implemented in the early 1990s. A key element was a fiscal consolidation package involving both expenditure cuts and tax increases to ensure budget surpluses and debt reductions. Top-down budgeting with surplus targeting and expenditure ceilings was introduced. Initially these measures were considered crisis management tools, but they eventually developed into a fiscal policy framework with well-defined intermediate targets for the management of public finances (since 1997), which was later strengthened by the establishment of a fiscal policy council in 2007 (see Calmfors, 2012, and Andersen, 2013). The Swedish fiscal framework became a model example for later developments in other countries and the European Union.

The monetary regime was changed, the central bank became independent and set inflation targets. A banking reform included government take-overs with no bailing out of previous owners. There were privatisations of public utilities like rail, telecom, taxis, schools, the postal service, and electricity. Wage setting changed in the direction of so-called pattern bargaining, with export sectors becoming leaders in the wage setting process. The wide ranging nature of the reforms is also demonstrated by an increase from

three to four years between parliamentary elections as a means of ensuring greater political stability. The reforms shifted the course of Sweden's economic development, but although employment has been increasing, it has not yet returned to the levels seen in the early 1990s (see Figure 2.15).

This period also saw a major tax reform – 'the tax reform of the century' – broadening tax bases and reducing marginal tax rates (top marginal tax rate from 90 percent to 50 percent and corporate taxation was lowered), and a pension reform launching the notional defined contribution scheme (see e.g. Palmer, 2000). Both of these reforms were made before the onset of the crisis, reflecting both the need for reforms perceived before the onset of the deep crisis, as well as forward looking elements in policy making.

This comprehensive reform agenda was visibly crisis driven. 'Crisis' awareness made it clear that reforms were needed. The reforms were the outcome of broad political compromises (between social democrats and liberals). This was important not only for their implementation, but also for the credibility of the reforms, and the main elements have remained intact, despite subsequent changes in governments. It is also interesting that inputs from experts were important for the formulation of reform strategies, most notably the so-called 'Lindbeck Commission', which was appointed in autumn 1992, and presented its recommendations in spring 1993 (Lindbeck et al., 1994). Similarly, a high level of general trust in policymakers and the government facilitated the acceptance of the proposed solutions. In addition, the reform package was comprehensive, implying that a given household could be a winner and a loser from different elements of the overall package. This made it harder to mobilise opposition to the reforms (see Hassler, 2015).

Overall economic performance has since been favourable. The effects of the financial crisis for Sweden were relatively mild, partly due to its export structure and partly due to fiscal space allowing counter-cyclical measures.

2.7.2 Finland – Shocks and Resilience

Finland is probably the EU country which has been the most adversely affected by severe negative shocks in recent times, and yet it is has shown resilience (see Figures 2.2 and 2.15).

Finland experienced rising income levels on a catch-up trend up to the 1990s. This changed abruptly in the early 1990s into a boom-bust pattern. GDP in Finland fell by 13 percent and unemployment increased from three percent to 16 percent from 1990 to 1993. The fall of the Soviet Union in 1991 meant that Finland experienced a collapse of a significant export market (Korkman and Suvanto, 2015). The erosion of wage competitiveness during the boom years contributed to a worsening of the crisis, which had widespread implications, including a banking crisis.

In response, a number of reforms were implemented, including tax reforms broadening tax bases and lowering marginal tax rates. Wage setting in Finland is based on a tripartite system featuring extensive cooperation between social partners and the government in terms of wages and working life conditions, but also with regard to social and tax policies (Asplund, 2017). In response to the crisis, wage restraints were agreed. The currency lost about one third of its value at the onset of the crisis. This devaluation and wage restraint helped to improve Finland's competitiveness, and its recovery from the crisis was mainly export-led.

The Finnish export structure is fairly specialised. Finland's comparative advantage has historically been in primary sectors (wood/paper), but alongside this a knowledge-intensive specialisation in ICT developed during the 1990s and into the 2000s. Investments in R&D expanded rapidly, and included substantial public involvement (public funding of R&D constituted about four percent of total government outlays in the mid-2000s). Finland is an interesting example of how a country can affect technology developments via targeted policy measures, and thus shape the structure of its economy (see Chapter 4). Moreover, the Finnish educational system has consistently ranked among the best in the PISA assessment of learning outcomes.

Difficulties in both the paper and ICT industry (the Nokia crisis) coincided with the onset of the financial crisis, which has been deep and prolonged.

A new broad coalition – the Rainbow cabinet – government took office in 2005. In response to the financial crisis, fiscal policy turned expansionary and included tax cuts, job-training programmes for the young, and support for housing and infrastructure. There were also measures to facilitate export financing and support for financial institutions. Subsequent concerns over fiscal consolidation have taken on a more prominent role, but public finances remain strained.

The political situation is currently more uncertain than previously. Few policy initiatives have been undertaken in recent years, although income policies have been revived in the form of a 'competitiveness package'. The most notable recent reforms are spending cuts on, for example, higher education and R&D, which in the short-run contribute to fiscal consolidation, but have detrimental effects on productivity and long-run growth (see Finnish Economic Policy Council, 2017).

2.7.3 Germany

Germany, for many years Europe's leading economy, experienced economic difficulties after unification. Per capita income was declining (see Figure 2.4) and

Germany became "the sick man of Europe" (Sinn, 2003). Recently, however, it has experienced a remarkable improvement, and has regained a position among the high-income countries in Europe.

Important policy changes took place during 2003-2005 with a sequence of reforms – the Hartz reforms. They included a cut in unemployment benefits for the long-term unemployed, as well as active labour market policies and subsidised employment. Job creation was supported by so-called mini-jobs, made possible by the removal of working hour restrictions. Improved possibilities for firms to use 'leased' temporary workers as well as in-work benefits to top up low earnings were also important elements. The reforms strengthened the economic incentives to be in work and affected wage bargaining, leading to wage moderation, which, in turn, improved wage competitiveness. These improvements also benefitted from the export structure of the German economy.

In the wake of these reforms, employment has been growing (see Figure 2.15), although there has also been widening wage and income inequality (see OECD, 2012, and Dustmann et al., 2014). Burda (2016) attributes the largest reform effects to the labour supply effects and wage bargaining, but the structure of labour demand also played a role. Dustmann et al. (2014) argue that the most important changes were made to the governance structure determining relations and mutual agreements between the three main labour market parties: trade unions, employer associations, and work councils (the worker representatives who are typically present in medium-sized and large companies). This allowed wage-setting decentralisation to secure jobs in Germany.

For Germany, the financial crisis was less negative and less persistent than for less manufacturing- and export-oriented economies. Increased working time flexibility at the firm level in the form of *Kurzarbeit* (the short working week) also played a role. This system allows firms facing a temporary crisis to reduce working hours below normal and claim compensation from the government. In response to the crisis, the generosity of and eligibility for this system were extended, and at its peak on average 3 percent of employees were on short working weeks. According to estimates by Hijzen and Venn (2011), around 235,000 jobs (equivalent to 0.6 percent of employment) were saved due to this system.

Germany proved able to withstand the crisis well thanks to temporary layoff programmes and a strong manufacturing export orientation. Under other circumstances, both could have been a liability. In the crisis as it materialised, they made it possible for the country to limit employment losses and allowed its durable machinery exports to grow fast as emerging countries returned to growth after the crisis (and the euro remained weak against the US dollar and especially against the Japanese yen).

In sum, the country cases considered above reveal that country successes and failures vary over time depending on both internal and external factors. One common theme across all the cases considered is efforts to improve competitiveness by aligning wage formation to productivity developments and strengthening both the incentive structure and job search support. There has been sufficient political capital to ensure broad, though not unanimous, support for the reforms. In all cases, the reforms are outcomes of a process and not a one-off effort, and visible improvements in economic performance have in many cases been essential in maintaining support for the reform agenda.

2.8 CONCLUSION

The EU's 'ever-closer-union' trajectory no longer seems realistic. Economic developments differ across member countries, and dissatisfaction with the European Union is growing while populist and nationalistic policies are gaining ground.

It is too simple to blame the EU's economic integration process for the dismal economic performance of some countries and a lack of overall convergence. A country's performance over a given period of time can reflect shocks, which often originate outside the European Union, and in particular in the EU's integration with the rest of the world, combined with country-specific policies and institutions that make it easier or more difficult to adjust to shocks. There are thus many reasons why country performances may differ, and why some countries may perform better in some periods, and worse in others. However, there are differences across countries, particularly in terms of the ability to undertake requisite reforms on a timely basis.

To understand the mechanisms that underlie country-specific performance, this chapter focuses on structural change and reform patterns across the EU-15 countries, due to the particularly striking lack of convergence across these countries after decades of integration , and studies some of their experiences in detail. There is much to learn from Italy and its difficulties in turning economic developments, but it is not the only country to experience increasingly turbulent politics and persistent productivity slowdowns. There are also lessons to be learned from the reform experiences of countries that managed to break out of relative decline like Denmark, the Netherlands, Sweden, Finland, and Germany.

These cases show that luck matters, but reforms do make a difference. When shocks hit, many economic, political and institutional factors play a role in determining whether reforms are undertaken or not. The country differences observed in economic performance have many causes, of which economic integration is just one. The European integration process is both a response to various crises in

the past and an opportunity to capitalise on new opportunities, which need to be exploited by reforms that manage and spread appropriately the costs and benefits of change.

Reforms are not a one-off effort – future changes may call for new responses, and there is no simple blueprint to be followed. It is too easy not only to disregard the drawbacks of reverting to the past status quo, but also of contemplating simplistic potential solutions. It is important to face reality and react constructively to the policy options available. The wealth of nations depends on circumstances beyond their control, and on their policy reactions to them. It is essential to adopt the right policies in the light of specific sets of circumstances; and not fashionable policies regardless, or policies that were in force in better times. Some countries' political processes are naturally more cohesive and pragmatic, others have to work on it, but all should be aware that finding ways to share gains and losses will help them to avoid stalemates and adapt to change.

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