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ABSTRACT

The Role of Political Partisanship during Economic Crises *

Large economic crises require quick policy reactions. They bring a sense of urgency by increasing the cost of the status quo, and may thus force policy-makers to reform. However, large crises increase also uncertainty for many individuals (entrepreneurs, workers, retirees), and thus induce more demand for protection particularly in the labor and product markets. The ideology and political partisanship of the ruling government may contribute to determine which of these two orientations will prevail during crisis. In good times, conservative parties are typically pro-reform. However, do these parties try to exploit periods of crisis to carry on their reform? Do social-democratic parties support even more social protection? To answer these questions, this paper uses indicators of structural reforms in the labour, product, and financial markets for twenty-five OECD countries over the 1975-2008 period. Besides examining the role of major economic crises and of political partisanship in enhancing, or perhaps hindering, reforms, particular emphasis is given to how governments of different political orientation or strength react to economic crisis. The empirical analysis shows that large economic crises promote liberalization in product markets, but lead to more regulation in financial markets. Partisan politics matters in product and labor markets, as right parties are associated with more product market liberalization and privatization, with less rigid labor markets, and less generous welfare states. However, partisan politics takes different patterns during crisis: right parties refrain from promoting product market privatizations, but also from introduce more financial market regulations. By contrast, left parties are willing to privatize during crisis. Furthermore, weak, fractionalized governments are associated with more regulated product markets, but are more likely to liberalize during crisis.

JEL Classification: D7 and H5
Keywords: economic crisis, partisan politics and structural reforms

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1. Introduction

Large economic crises require quick policy reactions. As the recent financial (and economic) crisis has clearly shown, recessions induce expansionary fiscal and monetary policies, but also labor market reform measures aimed at increasing job security and providing active labor market policies to the unemployed. Structural reforms are also often advocated during crisis. The economic rational for this pro-reform view is that in countries with strong financial, product and labor markets regulations, a crisis brings a sense of urgency by increasing the cost of the status quo. Hence, policy-makers are forced to react and to reform.

Large crises, however, increase uncertainty (and perhaps anxiety) among many individuals (entrepreneurs, workers, retirees), who will demand more protection particularly in the labor and product markets. This may contribute to hinder structural reforms, which are typically associated with large short term costs, often concentrated on a small category of individuals (for example, workers in public enterprise in the case of a privatization), and only diffused, long term gains.

However, the adoption of structural reforms depends also on political determinants. Political partisanship, for instance, shapes the government political program, and its willingness to reform. In particular, conservative governments are typically considered eager to eliminate existing anti-competitive measures, and hence to be pro-reforms. Government strength in Parliament may also affect the ability to carry out reforms.

But is the role of political partisanship in promoting, or hindering, reforms different under crisis? Extending the existing claim in the partisan politics literature (see section 2) to times of economic crisis, one should expect conservative parties, which, for ideological and electoral reasons, are more market oriented to be eager to exploit these periods of crisis to put forward their reform strategies, whereas social-democratic (left) parties should be even less keen on reforming during troubled economic times, in order to avoid putting their constituency under additional strain.

To test this claim, this paper presents a comprehensive analysis of the determinants of labor, product, and financial markets reforms in twenty-five OECD countries over the 1975-2008 period. I use recent data on OECD indicators for labor and product markets. For the product markets, indicators measure the level of anti-competitive regulation and the degree of public ownership in seven non-manufacturing industries (electricity and gas supply, road freight, air passenger transport, rail transport, post and telecommunications). For the labor market, they capture the degree of employment protection legislation, which assesses the restrictions placed on the firing processes by labor legislation and collective bargaining agreements, and the unemployment benefit replacement rate, which represents a measure of welfare state generosity. Furthermore, for retirement policies OECD data on the implicit tax on continuing to work for individuals aged between 60 and 64 year old are used, which provide a measure of the cost of postponing retirement. The financial market liberalization indicator is provided by the IMF, and records policy changes along seven different dimensions: credit controls and excessively high reserve requirements, interest rate controls, entry barriers, state ownership in the banking sector, policies on securities markets, prudential regulations and supervision of the banking sector, and restrictions on the capital account.

The focus of the empirical analysis is on the role of major economic crises and of political partisanship in enhancing, or perhaps hindering, reforms. But, special emphasis is given to the politics of economic crisis by examining how parties or governments of different political orientation or strength react to economic crisis.

The empirical findings show that crisis may both enhance and hinder reforms. In fact, large economic recessions promote liberalization in product markets, but increase regulation in financial markets. The crucial role of partisan politics is confirmed in these OECD countries, particularly for product and labor markets reforms. Conservative governments appear to be associated with both liberalization and privatization in product markets, with more flexible labor markets and also with less generous welfare states. However, partisan politics differ during crisis. In times of large economic turmoil, right parties seem to adopt a more moderate strategy: they refrain from promoting product market privatizations, and from reducing protection in the labor market, particularly for the unemployed. However, they oppose the introduction of more financial market regulations. By contrast, left governments exploit crisis to privatize.

The empirical analysis confirms that other features of the ruling governments also matter for reforming. Fractionalized governments, which are composed of a coalition of different parties, are associated with more regulated product markets. Again, periods of crisis modify the politics of reform. In fact, during economic crisis, fractionalized governments become more likely to liberalize product markets. Additional evidence shows also that governments that have been in power for a long time, and may hence be responsible of the status quo policy, are less prone to liberalize product markets during crisis.

These empirical results extend previous findings by Brooks & Kurtz (2007) on the role of economic crisis to different markets and countries, and by Allan & Scruggs (2004) on political partisanship to different markets and sectors. Their novelty is however to show that political partisanship matters during crisis in a non-trivial way. Pop-Eleches (2008) argued that the very same interpretation of economic crisis may differ depending on the parties political orientation. The empirical results of this paper instead portray political parties that during crisis are willing to cross the ideological line and to act in exceptional manners, which may contradict their traditional political orientation. Left parties being willing to privatize only during crisis may suggest that, during crisis, either these parties learn about the true cost of these non-competitive regulations, or that they act under less stringent electoral constraints. On the contrary, conservative parties are less inclined to reform in bad economic times, perhaps to avoid being blamed as ultra-liberal – and thus having to incur in electoral backslashes, although they do oppose any increase in financial market regulations. The politics of crisis seems thus to suggest that political partisanship matters, but so do electoral incentives.

2. Related literature

There exists a large empirical literature on the link between economic crisis and reforms. Drazen and Easterly (2001) focus on inflation and black market premium to conclude that crisis spurs reforms. Duval and Elmeskov (2005) construct an aggregate indicator of labor market reforms to show that crisis (as measured by an increases in the output gap and higher unemployment rates) are associated with reforms. The empirical evidence in IMF(2004) suggests instead that a current

economic crisis may actually hinder labor market reforms, although the length of past economic crisis may promote them. Using disaggregated indicators, Hoj et al. (2006) provide in fact evidence that the direction of reforms differs for insiders and outsiders: large increases in the long-term unemployment rate are associated with lower employment protection legislation for temporary workers and with more generous unemployment benefits, but have no effect on employment protection legislation for permanent workers. Tompson (2009) analyzes twenty case studies of OECD countries to conclude that labor market reforms were not correlated to economic crisis. Using financial market indicators, Abiad and Mody (2005) show that different economic crises lead to different outcomes: a balance of payment crisis spurs reforms, but a banking crisis hinders liberalizations.

The interaction between politics and structural reforms has also been largely analyzed. Allan and Scruggs (2004) concentrate on the welfare state – namely on the replacement rates of unemployment benefit and sickness transfers – to show that, after the mid80s, political partisanship matters, since retrenchments have been more likely under right governments. Murillo and Martinez-Gallardo (2007) and Murillo (2009) study market reforms in the Latin American public utilities to conclude that ideological polarization and political competition matters for reforms. Brooks and Kurtz (2007) examine instead capital account and trade liberalization in 19 Latin American countries. They find that crises matter, but not always to promote liberalization. Capital account openings occur during good economic times, while trade liberalization occurs during positive trade balance and/or hyperinflation. Moreover, the former reform is more likely to occur with fractionalized governments where the blame is more easily shared.

The idea to analyze the politics of crisis and its impact on reforms was also in Alesina, Ardagna and Trebbi (2006). They analyze the stabilization of budget deficit and inflation to conclude that crises promote fiscal reforms and adjustments – hence, the politics of crisis matter. Furthermore, strong and new governments act more quickly. Pop-Eleches (2008) examines Latin American and Eastern European countries to suggest that economic crisis matters, but to an extent that depends on the government's partisan interpretation of the crisis.

3. Reform patterns

At least until the 2008 financial and economic crisis, a growing consensus was emerging on the view that structural reforms were needed in many countries to improve on a disappointing growth performance and to respond to emerging challenges, such as ageing, new technologies and globalisation[2] Nevertheless, the implementation of structural reforms during the last few decades has widely varied in its pace and magnitude across countries, but also across markets within a country.[3]

[2] See for instance the EU's Lisbon agenda, the G-7 countries' "Agenda for Growth", and the 2003 OECD Ministerial Council Meeting setting an Agenda for Growth and Development (OECD, 2003).

[3] Summaries of these reforms can be found in OECD (1999, 2001, 2006).

OECD indicators on anti-competitive regulation in seven non-manufacturing sectors[4] show that the timing and intensity of product market reforms have been very different across countries. Figure 1 suggests that product market liberalization (measured as a reduction in the anti-competitive regulation index) picked up in the late 80s to continue until today. Yet, different trends have emerged. The United States implemented comprehensive reforms already in the 1975-85 period, while the United Kingdom, New Zealand, Norway and, to a lesser extent, Canada, Finland and Austria followed in the early to mid-80s. For most other European countries, product market liberalizations came in the 90s due to the influence of the EU's internal market programme, as well as to access into the Euro zone (see Alesina et al. 2009). Across sectors, liberalizations started with road transport to spread to the air transport industry, and, since the mid-90s, to the electricity and telecommunications sectors (see Conway and Nicoletti, 2006). Figure 2 displays the large degree of cross-country convergence in product market regulations, due to the fact that countries with strong product market regulation in 1975, such as Italy, Portugal, France, Denmark and Germany, have been more active in deregulated their product market.

IMF indicators on financial sector policies show that financial market liberalizations have also taken place in many countries between 1973 and 2005. Again, the timing and magnitude of the reforms have largely varied across countries, as well as across the different policy areas analyzed. Figure 3 suggests that financial market liberalizations (measured as an increase in the financial sector reform policy index) increased speed in the early 80s. Again, different trends have emerged. While Germany, Canada, the United States and the United Kingdom had already liberalized their financial sector in the mid-70s, other OECD began to catch up in the late 70s and continued to liberalize until today. Policy reversals were also frequent, although more so in Latin America and East Asia, where reforms were also typically larger in magnitude (see Abiad and Mody, 2005, and Abiad, Detragiache, and Tressel, 2008). Figure 4 displays the large degree of cross-country convergence in financial markets. The negative correlation between the initial level of financial regulation in 1973 and the subsequent deregulation is remarkably strong.

Labor market reforms in OECD countries have proved more difficult to implement. During the 60s and 70s, many European countries adopted employment protection legislation (EPL), which increased the rigidity in the labor market, and hindered adjustments in the job flows. Additionally, early retirement provisions were introduced in many social security schemes, which created massive economic incentives to retire early. Since the late 80s, however, there have been some moves to make the overall labour market regulation more employment friendly, in particular with some easing of employment protection legislation (for a comprehensive analysis, see OECD, 2006). This was mostly aimed at modifying the labor market prospects of "outsiders", that is, workers with temporary contracts[5] and unemployed with low employment probability, and was sometimes accompanied by targeted active labour market policies. Virtually no reform measures were instead implemented to reduce EPL for regular workers on permanent contracts, with the

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[4] The seven sectors are: gas, electricity, postal services, telecommunications, passenger air transport, railways (both passenger and freight services) and road freight.

[5] The first major reforms of temporary contracts took place in Spain in 1984, while Portugal had already liberalized the use of fixed-term contracts in 1976. In Spain, the maximum duration for temporary contracts was extended to three years, and little or no termination compensations were offered to workers. Similar reforms took place in Italy (1997 and 2003), Sweden (1996-97), and Germany (2003).

notable exceptions of Spain, Portugal, and, to a lesser extent, Finland. Figures 5 shows how the overall index of EPL, which combines regular and temporary workers, changed from 1985 to 2008. Other labor market reforms, which modified the generosity of unemployment benefit systems, widely differed across countries. For instance, Portugal largely increased the generosity of its unemployment benefit schemes, while the Netherlands, among many other countries, reduced it (see figure 6). Reforms aimed at postponing retirement age came only later, since the early 90s, for instance in Italy (1992, 1995 and 2004), Germany (1992, 1997 and 2003) and France (2003). Increases in the effective retirement age were pursued by legislating a raise in the legal (statutory) retirement age, and by reducing the incentives to retire early. Figure 7 shows that Italy and Sweden, and to a lesser extent Belgium, France and Germany, were particularly effective in decreasing the incentives to retire early, as measured by the implicit tax on continuing to work for elderly (aged 60 to 64 years) workers.

4. Economic and political determinants of reforms

4.1 Economic crises

The economic and political literature on structural policies has long suggested that economic crisis may facilitate the adoption of reform measures (see Haggard and Kaufman, 1992, and Drazen, 2000, for a review). Deep economic crises call for quick reactions. If this translates into reform measures depends however on the perception of what sort of change is needed. Macroeconomic stabilization following hyperinflation or budget crisis may be easy to achieve (Rodrik, 1996), either because there is more consensus on the policy to follow, as in the case of trade opening after hyperinflation (Brooks and Kurtz, 2007), or because the crisis itself emerged as a result of a "war of attrition" among socioeconomic groups, where the losing side stood to bear the cost of stabilization (Alesina and Drazen, 1991, and Drazen and Grilli, 1993). Expansionary policies may be equally likely to follow a crisis (Perotti, 1999).

An economic crisis may also promote structural reforms, if existing institutions or regulations are recognized to be, at least partially, responsible for the deterioration in the economic conditions. For instance, countries with more stringent labor market regulations and more generous early retirement provisions may be in more urgent need of reforming their pension systems and labor markets. Yet, generous programs are also known to induce a status quo bias, by creating their own political constituency among programs' beneficiaries and bureaucrats. Crises, by raising the cost of the status quo, may impose a sense of urgency to reform, if there is sufficient consensus that structural reforms may easy recovery and raise potential output. In particular, the worsening of the economic conditions[6], together with the release of relevant and credible information on the cost of the status quo (Tompson, 2009), may help to weaken the resistance of the pro status quo coalitions (Nelson, 1990 and 1994), and to persuade risk averse individuals, who are uncertain about the distribution of future benefits and costs from reforming (Fernandez and Rodrik, 1991, and Laban and Sturzenegger, 1994).

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[6] See Ellwood (1982), Layard (1986) and Machin and Manning (1999) for the long lasting negative effects of crisis on earnings and human capital, particularly for the young, and Ball (2009) for the risk of unemployment "hysteresis".

However, crisis may also hinder reforms. In fact, during economic crisis, individuals and socioeconomic groups will be less keen on loosing their rents or benefits, unless alternative compensations are provided. Furthermore, costly compensatory reform packages are more difficult to finance during economic crises. So, while reforms aimed at improving the functioning of the labor market may be particularly needed in periods of high unemployment rates, the same economic crises may also hinder reform measures, since an increase in flexibility can be seen as imposing adjustment costs on (other) workers already suffering from adverse economic conditions (Bean, 1998). Analogously, debt crisis may lead to nationalization, more regulation and capital market closure (Edwards, 1995) in order to limit episodes of capital flights (Brooks and Kurtz, 2007), while large crises may lead to great reversals in financial liberalizations (Rajan and Zingales, 2003).

4.2 Political partisanship and electoral constraints

Successful reform attempts require governments to use their political capital to circumvent the resistance coming from within the government, from opposition parties, and from crucial veto players in society, such as unions or employers' organizations (Tsebelis, 2002). Several political and institutional features affect the government's incentives to reform, and ultimately its reform strategy. Besides economic crises, ideological and electoral motivations may represent potential drivers leading the policy-makers to commit to a reform pattern.

The literature on political partisanship suggests that different political parties typically have diverging policy preferences, as each party tries to appeal to its own constituency. Hence, parties actively pursue different policies when in office (Boix, 1998, and Garrett, 1998). Conservative governments are expected to adopt efficiency-enhancing policies aimed at reducing the role of the public sector in the economy through welfare state retrenchments and privatizations, and at liberalizing financial and product markets (Abiad and Mody, 2005, and Brooks and Kurtz, 2007). Left governments emphasize instead equity and redistributive factors, and may hence wish to expand welfare state and social spending. Contrary to this view, however, a credibility argument has been put forwards to explain why some governments have been successful in promoting reforms, which were in sharp contrast with their political constituency – and often even with their electoral program (Cuckierman and Tommasi, 1998). If voters are unable to verify whether a reform policy is pursued for pure ideological reasons or for true economic convenience, they will be more willing to believe that it is driven by economic motivations if for instance liberalizations are presented by a left governments.

While the expansion of the welfare state and the introduction of protective labor market institutions have often been associated with the increasing power of the left parties and of the unions (Esping-Andersen, 1990), the retrenchment phase that has started in the 90s has not been linked to partisan politics (Pierson, 1994). Analogously, no partisan political preference has been identified as a main driver of the introduction of market reforms in Latin America in the 90s (Stokes, 2001, and Weyland, 2002). However, this view has recently been challenged by Allan and Scruggs (2004), who find a significant effect of right governments in the welfare state retrenchment efforts that took place after 1980; and by Murillo and Martinez-Gallardo (2007), who emphasize the importance of political competition, and, to a lesser extent, the relevance of

partisan preferences in the process of liberalization of public utilities in Latin America. Recent empirical contributions (Pettersson-Lidbom, 2008) confirm the role of political partisanship in policy decisions.

Partisan politics may be particularly relevant during economic crisis, when there is more need for – or at least discussion about – reforming, and parties may differ in their degree of interventionism and/or reform patterns (Alesina, Ardagna and Trebbi, 2006). Indeed, Pop-Eleches (2008) suggests that even the very same definition of crisis is – at least partially – in the eye of the beholder, since different political parties may have different perceptions about the intensity of a crisis, as well as about its roots and possible solutions.

A different strand of literature has emphasized the role of the electorate in determining economic policies and regulation. In this case, policy-makers are identified with opportunistic, non-partisan incumbent politicians, aiming at achieving re-election, or with candidates at election drafting a political platform. In both cases, politicians have an electoral interest in adopting economic policies that are supported by a majority of the voters, or by the voters who are more easily convinced by the policies – the undecided or swing voters (Stromberg, 2008).

The government's tenure in office and the expected lag to the next election may thus affect the reform process. If the government is approaching a general election, it may refrain from implementing reform policies with high short-term costs, but it may be more keen on policies with short term benefits – and viceversa for newly elected governments. Well functioning financial markets may however bring forward the long term benefits from reforming, thereby helping reformist governments to pursue their strategy (Buti et al., 2008). A government's political strength may also affect its willingness and ability to reform. Weak, fragmented governments, which can only count on the support of a minority or a coalition in the Parliament, are not well equipped to pursue reforms (Brooks and Kurtz, 2007). Indeed, they can still be successful in implementing policy changes, but their strategy has to rely on broadening the base for reforms. Strong governments may instead exploit their majority.

These considerations on the electoral costs and gains from reforming are remarkably well suited for broad policy measures, such as retirement and labor market policies, which typically affect a wide range of individuals, and may potentially have large electoral effects. Pension reforms are known to be politically costly,[7] since the elderly, who are to suffer a cut-back, are "single-minded" (Mulligan and Sala-i-Martin, 1999) over social security benefits. In fact, while for the elderly pensions constitute a large share of their retirement income, other (younger) individuals' interests tend to be more diversified, as they depend on their family status, occupation, income and so on.

Recent research has instead downplayed the relevance of the median voter in determining economic policy in order to draw more attention on the role of organized pressure groups and of their partisan allies within the party structure (Nielson, 2003). This approach seems particular well suited to address liberalization of product and financial markets, which may lead to large

[7] Pensions are often referred to as the "third rail" of politics (according to Tip O'Neill, a former US House Speaker in the eighties). The argument is that politicians cannot cut benefits without suffering electoral losses.

concentrated costs for the losers from the reform, and only to small, diffused benefits for the winners.

4.3 Macroeconomic policy and external constraints

Monetary policy may affect structural reforms. In particular, the adoption of a fixed exchange rate regime, or of a single currency, as in the case of the Euro, requires relinquishing the control of the monetary policy, and hence prevents the country from using this policy to accommodate negative shocks. This may create incentives to pursue structural reforms (such as liberalizations in the labor and product market) in order to enhance market-based adjustments[8] (Bean, 1998, Duval and Elmeskov, 2005, and Obstfeld, 1997). On the other hand, Saint-Paul and Bentolila (2000) argue that, under a currency union, such as the European Monetary System, the up-front cost of structural reforms may increase, since the use of expansionary aggregate demand policies to accompany structural reforms becomes more limited, due to fiscal constrains and lack of monetary authority.

Besides economic crisis, reforms may also be induced by supranational constraints imposed by international agreements or treaties, such as within the European Union (EU). These have been instrumental in strengthening domestic competition (especially in the service sector) or creating domestic institutions that stimulate reform (*e.g.,* antitrust or sectoral regulatory authorities), while the implementation of the EU Single Market Programme has pursued the removal of remaining barriers to trade and FDI (often resulting in the elimination or reduction of subsidies or protection).

5. Empirical Analysis

5.1 Measuring reforms

I consider structural reforms in product, labor and financial markets in 25 OECD countries: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, the UK, and the US.

To measure product market reforms, I use data on anti-competitive regulations for the period 1975-2007 collected by Conway and Nicoletti (2007), and described in detail in Nicoletti and Scarpetta (2003). These regulatory indicators measure restrictions on competition and private governance in seven non-manufacturing industries: electricity and gas supply, road freight, air passenger transport, rail transport, post and telecommunications (fixed and mobile), on a scale from 0 (the least restrictive) to 6 (the most restrictive). The overall index of regulation includes

[8] Additionally, the use of a single currency, by increasing price transparency, and thus comparability on the international markets, facilitates trade. More international competition will create pressure for deregulating product markets, reduce the rents to be shared by inside workers and firms, and thus lead to deregulation also in the labor market (Blanchard and Giavazzi, 2003).

information on entry barriers, public ownership, market share of the dominant player(s) (in the telephone, gas and railroad sectors), and price controls (in the road freight industry). In particular, entry barriers cover legal limitations on the number of companies in potentially competitive markets and rules on vertical integration of network industries. Public ownership measures the share of equity owned by central or municipal governments in firms of a given sector between two polar cases: no public ownership (a value of 0 for the indicator) and full public ownership (a value of 6). In the benchmark regressions, I use two indexes of overall regulation. A regulatory indicator REGREFNOPO, which does not include public ownership, is obtained by averaging, in each of the seven industries, the indicators of barriers to entry, market share of new entrants, and price controls; whereas an indicator which includes only public ownership information REGREFPO is a simple average of public ownership over the seven industries.

Financial market reforms are measured using a recent IMF database which covers the period 1973-2005 (see Abiad, Detragiache, and Tressel, 2008, for a detailed description). Among the 25 countries listed above, data for Iceland and Luxemburg are not available. The database records financial policy changes along seven different dimensions: credit controls and excessively high reserve requirements, interest rate controls, entry barriers, state ownership in the banking sector, policies on securities markets, prudential regulations and supervision of the banking sector, and restrictions on the capital account. In the regression analysis, I use the overall index, which aggregates the liberalization scores for each category, and normalizes them between zero and one. Unlike in the previous case (with the OECD product market indicator), the IMF financial market reforms indicator takes a value of zero for the highest degree of repression and of one for full liberalization.

To measure reform policies in the labor market, I consider two indicators of labor market policies: the degree of employment protection legislation (EPL) for the 1985-2008 period (data for Iceland and Luxemburg are not available), and the unemployment benefit replacement rate (UB) from 1975 to 2007. Both indicators are provided by the OECD, and described respectively in the OECD Employment Outlook (2004), and in the OECD, Benefits and Wages (several issues). The indicator on employment protection ranges from 0 to 6 (from least to most restrictive) and measures the restrictions placed on the firing processes by labor legislation and collective bargaining agreements. It is provided separately for regular and temporary workers. For the regular workers, the employment protection legislation indicator measures three aspects: i) difficulty of dismissal, i.e., legislative provisions setting conditions under which a dismissal is "justified" or "fair;" ii) procedural inconveniences that the employer may face when starting the dismissal process; and iii) notice and severance pay provisions. The index also provides a measure of the regulation of fixed-term contracts and temporary work agencies, which captures the restrictions on the use of temporary employment. The employment legislation for regular contracts constitutes the core component of the overall summary index of EPL strictness that we use. The indicator on the level of insurance provided to the unemployed considers the unemployment benefit replacement rate, that is, the ratio of the unemployment benefit to the last wage. In particular, I concentrate on the average of the unemployment benefit replacement rates obtained by a worker with average labor income over a three years unemployment spell.

Retirement policies are captured by OECD data on the implicit tax on continuing to work for individuals aged between 60 and 64 year old over the period 1985-2003 (data for Czech Republic, Hungary, Iceland, Luxemburg and Poland are not available). Postponing retirement may represent

a cost, if the net social security wealth – given by the discounted difference between future benefits and contributions – decreases when an individual works one additional year. The implicit tax on continuing to work is calculated as the average ratio between this reduction in the net social security wealth and the individual annual wage for individuals aged from 60 to 64 (see Duval, 2004, for a detailed description).

Data on political variables are from the World Bank Database of Political Institutions (DPI), compiled by Beck, Clarke, Groff, Keefer, and Walsh (2001) and updated in 2007. Political partisanship is measured by a dummy variable for right governments. Electoral incentives (or rather constraints) are captured by the number of years to the next election (yrcurnt). A measure of government strength is given by the number of years that a government (namely the chief executive) has been in office both in current and previous legislations (yroffc). A complementary index of the government weakness is given by its degree of fractionalization (govfrac), which measures the probability that two deputies picked at random among the government's parties are from different parties.

To measure (large) crises, I consider situations in which the output gap, defined as the difference between the actual output to potential output, is below the 90th percentile of the output gap empirical density (which is equal to -3.4%). Data on output gap are from the OECD Economic Outlook database. This definition gives raise in our sample to a total of 76 crises, as detailed in table 1. In these country-year observations, the dummy variable crisisgap takes value one. EU membership is defined as a dummy variable set to 1 when a country is a member of the European Union (after 1999), while EU's single market programme is a dummy variable equal to one when a country is in the EU's Single Market Programme (after 1993).

Table 2 presents these variables' summary statistics.

5.2 Empirical strategy

The econometric analysis uses as dependent variables the annual variation in the policy indicators described above for the product, labor and financial markets. The explanatory variables used in the empirical analysis were divided in three groups: economic crises dummy, political factors, and interactions between crisis and politics.

A preliminary issue in the empirical analysis of the political economy of structural reform is how to identify such reforms. Previous work (Duval and Elmeskov, 2005, Pop-Eleches, 2008, Abiad and Mody, 2005) concentrated on radical reforms as characterized by sudden, large changes in the policy indicators. The econometric analysis in this paper follows another strand of literature (Alesina, Ardagna, and Trebbi, 2006, Allan and Scruggs, 2004, Brooks and Kurtz, 2007), and aims at examining all reforms, as measured by any variation in indicators of labour, financial and product market policies. A linear specification is thus used that allows also to test for policy convergence by introducing the lagged level of the policy indicator among the explanatory variables in the regression equation.

The linear econometric model relates the level of a policy indicator (Y) to the lagged level of the policy indicator and to a set of lagged explanatory variables (X) according to the following equation:

$$Y_{i,t} = \alpha Y_{i,t-1} + \sum_j \beta_j X_{j,i,t-1} + \upsilon_i + \eta_t + \varepsilon_{i,t} \ ,$$

where i is a country index, t is a time index, υ_i is a fixed country effect, η_t is a fixed time effect and ε is a random error. A value of the parameter α below one hence identifies policy convergence towards some (possibly country specific) level.

Regression analysis based on panel cross-country/time-series data are associated with well-known drawbacks (Beck and Kats, 1995). The specification used for this model tries to address some of these issues. First, since the reform indicators are very persistent (particularly, the labor market regulation indicators), the above specification includes the lagged dependent variable. Second, all the economic and political explanatory variables are also lagged. This is to deal at least partially with simultaneity bias problems, as well as to account for the fact that it takes time for politicians to respond to shocks, and that there is an obvious lag between when the (political) reform process begins and when the reform policies are actually implemented. Third, I use OLS estimates and account for heteroskedasticity by using White robust standard errors. Forth, country and time fixed effects are used in all regressions, to account for unobserved heterogeneity at country and year level. This allows to filter out of the analysis country or year specific unobserved components, and thus to identify the effects of crisis and political variables from within-country rather than from cross-country variations. The inclusion of the lagged dependent variable and of country and year fixed effects clearly represent a conservative strategy.

Finally, in interpreting the empirical results, it is worth noticing that while the direct effect of political partisanship on reforms may suffer from an omitted variable problem, this limitation is less severe when the effect is analyzed during economic crisis. For instance, a positive correlation between conservative governments and reform policies may be driven by an underlying economic, social or political process (such as a need of reducing the role of the state in the economy) that leads the voters to elect conservative governments exactly because they want reforms to be implemented. However, unless one believes that large economic crises are either easily predicted by the voters, or voluntarily generated by governments, the reaction of conservative governments to a large, unexpected crisis identifies the true effect of these government characteristics on policy reforms, at least during crisis. This justifies the emphasis on the role of political partisanship during crisis.

6. Results

The first objective of this empirical analysis is to assess the role of economic crisis and political partisanship on structural reforms. All results are reported for six reform indicators: the overall product market regulation indicator (REGREFNOPO), the indicator of public ownership in the product market (REGREFPO), the financial market reform indicator (FINREFORM), the employment protection legislation (EPL) and the unemployment benefit replacement rate (UBRR)

for the labor market, and the implicit tax on continuing to work (IMPTAX6064) for the retirement policy.

Table 3 shows the results of the regression analysis for these six reform indicators by considering the direct effects of crisis and of the political variables. The strong persistence in the regulation indicators is apparent from the coefficients of the lagged dependent variables being highly statistically significant and close to one. Table 2 shows that large lagged economic crises are associated with deregulation in the product market (column 1), but not with privatization (column 2). Crises do affect financial markets, but in opposite direction. Column 3 suggests that a crisis is associated with an increase in the financial market regulation. Crisis has no impact on employment protection legislation (column 4), generosity of the unemployment benefits (column 5), and incentive to retire (column 6).

Among the political variables, political partisanship proves its relevance. Right parties are associated with a reduction in regulations in product and labor markets, with more privatizations in the product markets, and with less generous unemployment benefits. Weak governments, as measured by their degree of fractionalization, are associated with more regulations in the product markets. Instead, government tenure and distance to the next election, which may capture the government's electoral incentives, play no role in promoting or hindering reforms. Finally, countries belonging to the EURO zone are associated with more product market liberalization and more generous unemployment benefits' replacement rates, while access to the European Single Market leads to product market liberalizations and privatizations.

To examine the relevance of partisan politics during economic crisis, table 4 presents the results of the regression analysis which include as explanatory variable the interaction between the (lagged) crisis indicator and the (lagged) right government parties. Some interesting patterns emerge. First, while being in general associated with more product market privatizations, right parties are however less keen on privatizing during economic crises (column 2). Second, while in general economic crisis leads to more financial market regulations, this pattern is does not emerge when right parties are in power (column 3). Third, there is weak evidence (this effect is not statistically significant) that right parties are also less keen on reducing unemployment benefits replacement rates during economic crisis. Finally, left parties are more likely to privatize during crisis (results available upon request).

Do other political determinants change their relevance during economic crisis? To address this question, tables 5 and 6 show the results of the regression analyses which include as explanatory variable the interaction between the (lagged) crisis indicator and respectively the (lagged) numbers of years in office for the current government and the (lagged) level of government fractionalization. In both cases, the relevance of these political factors is modified during an economic crisis, but only for product market regulations, and, to a lesser extent, for the generosity of the unemployment benefit. In particular, during economic crises governments that have been in power for longer years, and may thus be responsible for the status quo policy, are less keen on liberalizing product markets, and instead increase the unemployment benefit replacement rate. On the other hand, while fractionalized governments are associated with more regulated product markets, during crisis they become more keen on implementing reform measures.

7. Concluding remarks

Using a large dataset of structural reforms in the labor, product and financial markets of 21 OECD countries from 1975 to 2007, I confirm that economic crisis matter for reforms. Do crises promote or hinder reform policies? In the theoretical literature, arguments have been provided to support both views. This paper's empirical analysis suggests that indeed both arguments apply. Large economic crises facilitate product market liberalizations, but lead also to an increase in financial market regulations of OECD countries. This last result extends previous findings by Brooks and Kurtz (2007), who use a sample of 19 Latin American countries to show that crises matter, but not always to promote financial liberalization.

Partisan politics also matters for reforms. Right governments are associated with liberalization and privatization in product markets, with less rigid labor markets and less generous welfare state. These findings confirm previous work by Allan and Scruggs (2004), who show how since the mid-80s welfare state retrenchments have typically been associated with right governments, and extend their results to the product market.

Perhaps more interestingly, the empirical analysis in this paper allows to uncover an additional effect of political partisanship on structural reforms. Political parties have radically different response to economic crisis. Furthermore this response differ also from their usual political orientation in good economic times. In particular, the empirical findings suggest that during crises, right governments refrain from privatizing product market and from reducing unemployment protection in labor marker. However, right parties also block the introduction of more financial market regulations which typically take place during economic crisis.

The empirical analysis suggests the existence of additional elements of this "politics of crisis". First, governments that have been in power for a long time – and may hence be responsible for the status quo policy to be reformed – are less prone to liberalize product markets during crisis, and instead provide more protection on the labor market by increasing the generosity of the unemployment benefits. Second, fractionalized, and hence typically weak governments, are associated with more regulated product markets. However, during economic crisis, these fractionalized governments are more likely to overcome these divisions and to liberalize product markets.

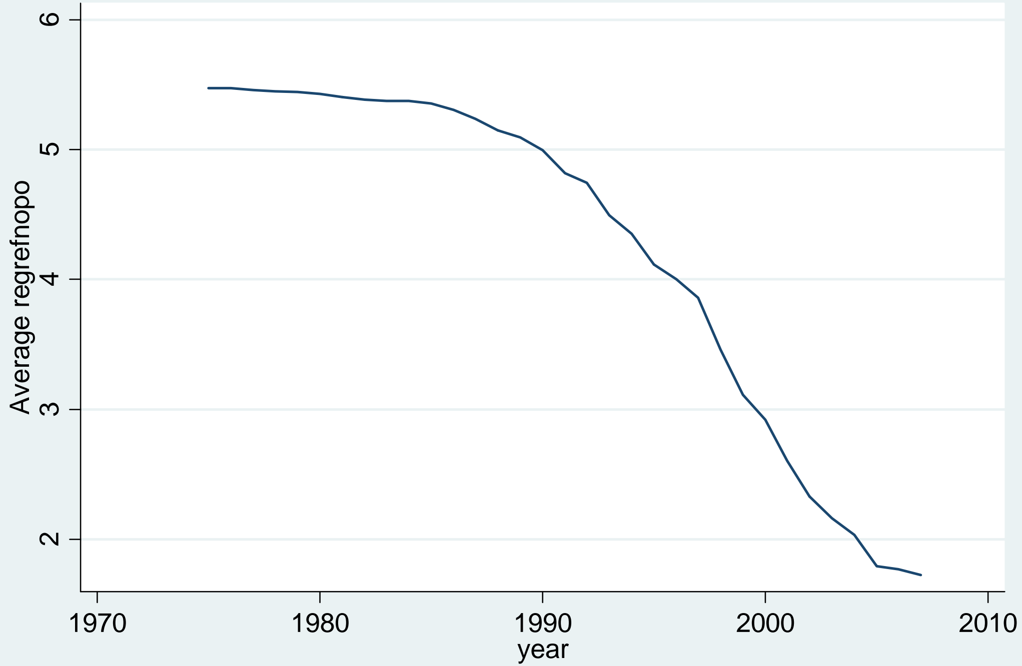
Figure 1: trend in product market regulation
Average regrefnopo
6
5
4
3
2
1970
1980
1990
2000
2010
year

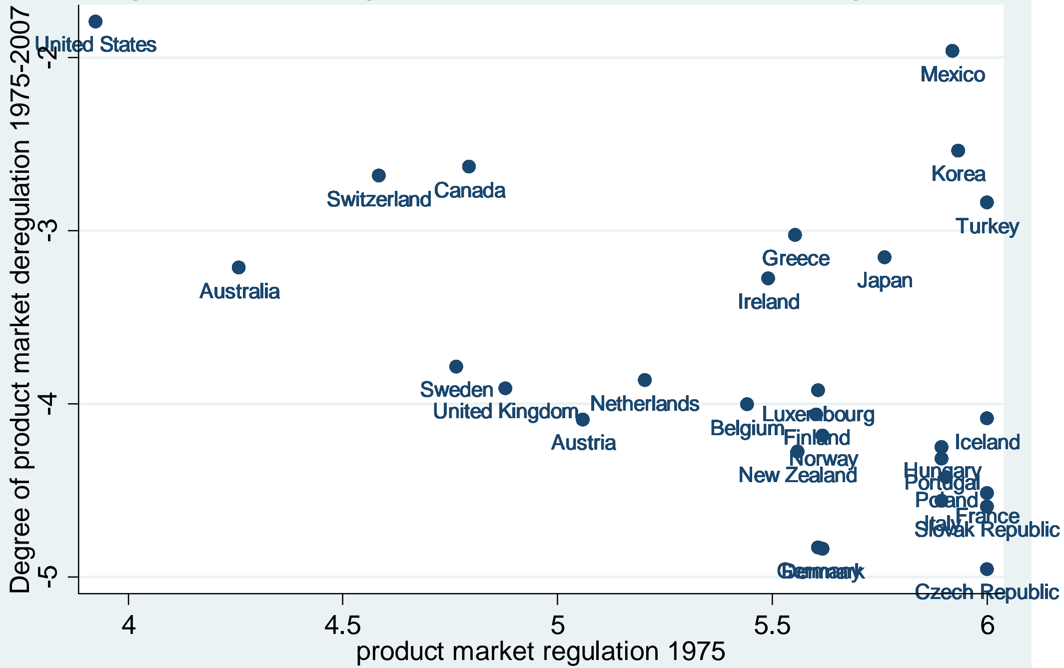
Figure 2: convergence in production market regulation
Degree of product market deregulation 1975-2007
-2
-3
-4
-5
4
4.5
5
5.5
6
product market regulation 1975
United States
Mexico
Korea
Turkey
Switzerland
Canada
Australia
Greece
Japan
Ireland
Sweden
United Kingdom
Netherlands
Austria
Belgium
Luxembourg
Finland
Norway
New Zealand
Iceland
Hungary
Portugal
Poland
France
Italy
Slovak Republic
Germany
Denmark
Czech Republic

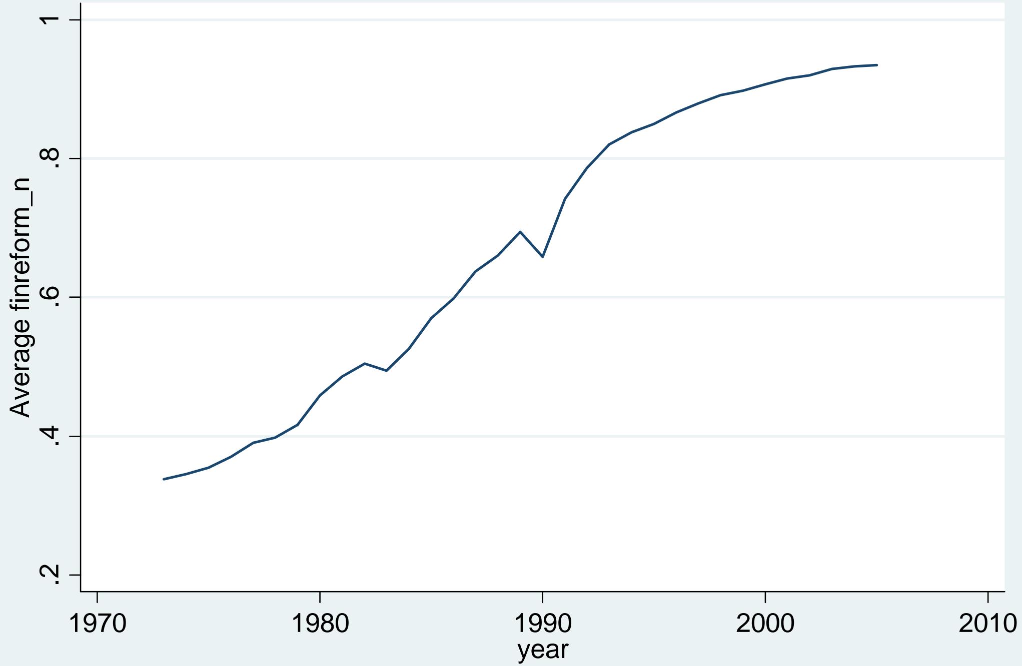
Figure 3: trend in financial market regulation
Average finreform_n
.2
.4
.6
.8
1
1970
1980
1990
2000
2010
year

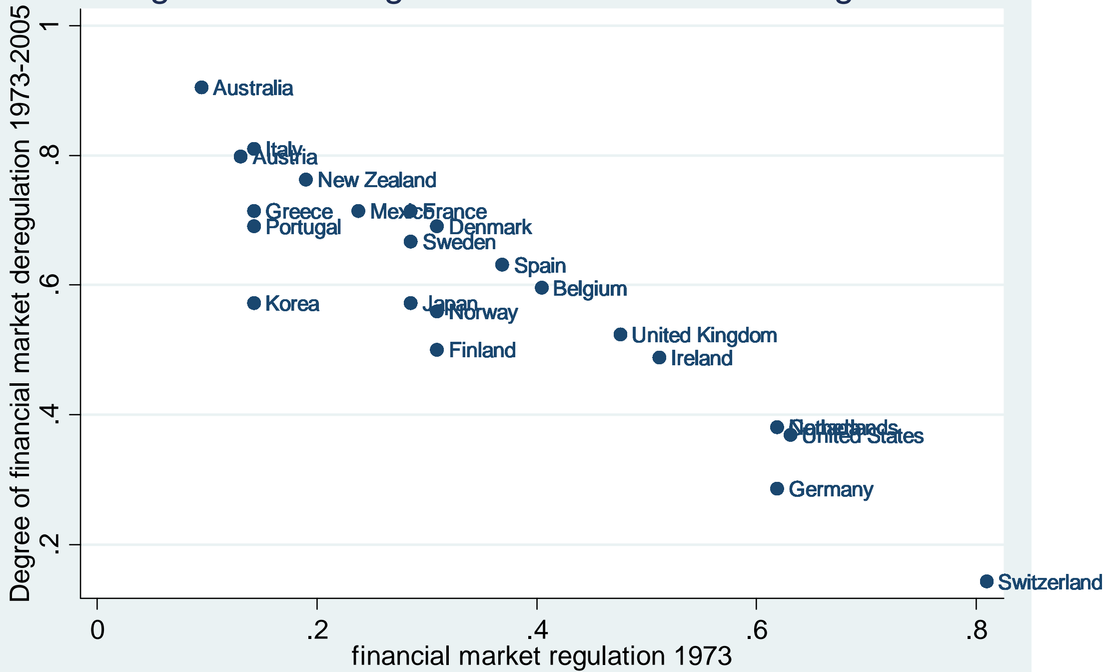
Figure 4: convergence in financial market regulation
Degree of financial market deregulation 1973-2005
.2
.4
.6
.8
1
0
.2
.4
.6
.8
financial market regulation 1973
Australia
Italy
Austria
New Zealand
Greece
Portugal
France
Denmark
Sweden
Spain
Belgium
Korea
Norway
Finland
United Kingdom
Ireland
United States
Germany
Switzerland

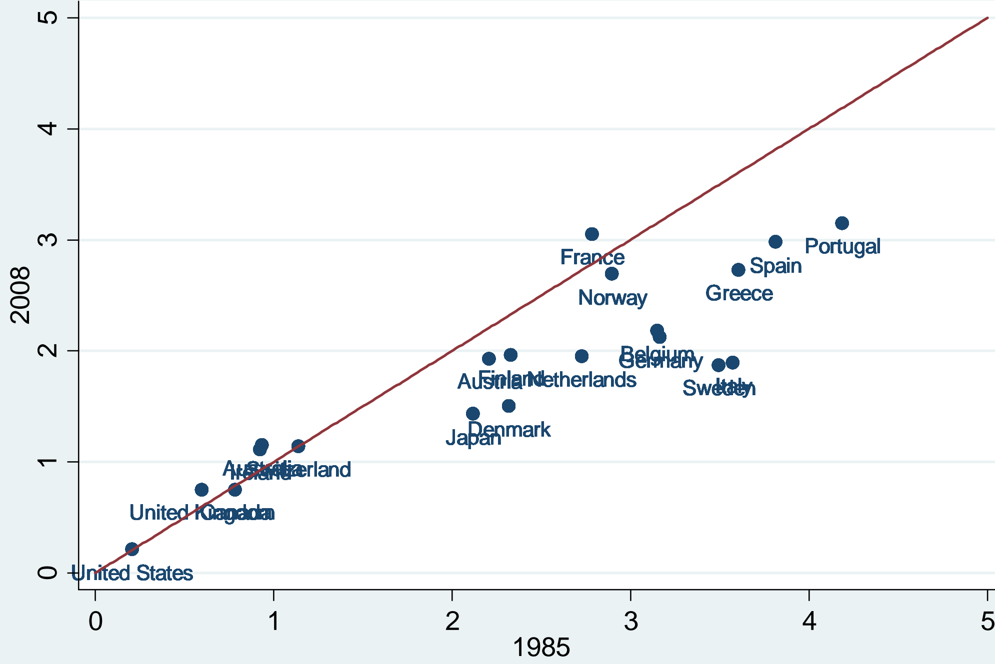

Figure 5: Employment Protection legislation 1985-2008

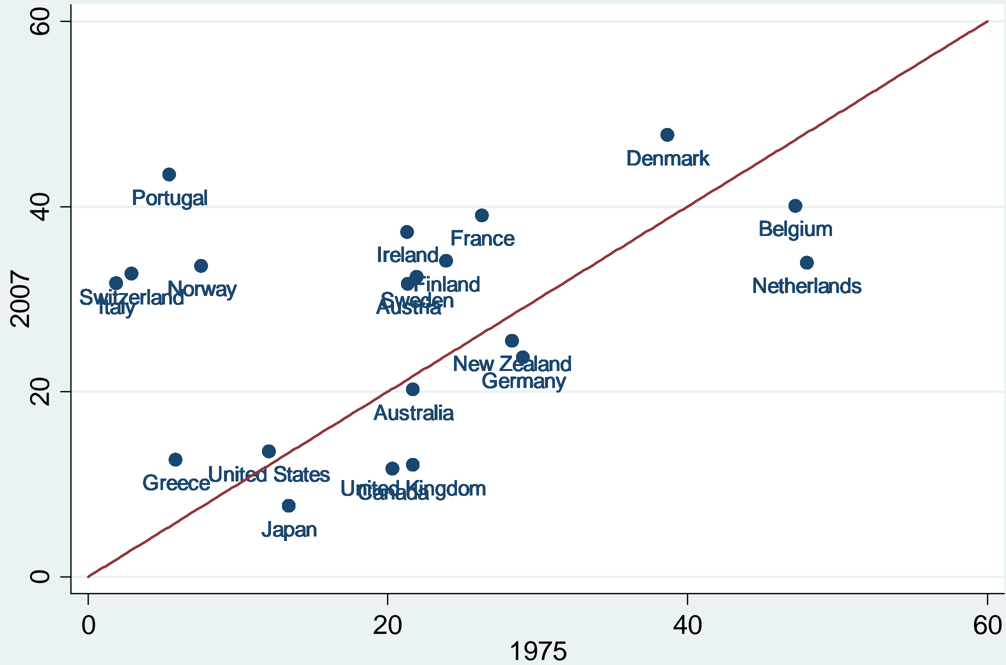

Figure 6: Unemployment benefit replacement rate 1975-2007

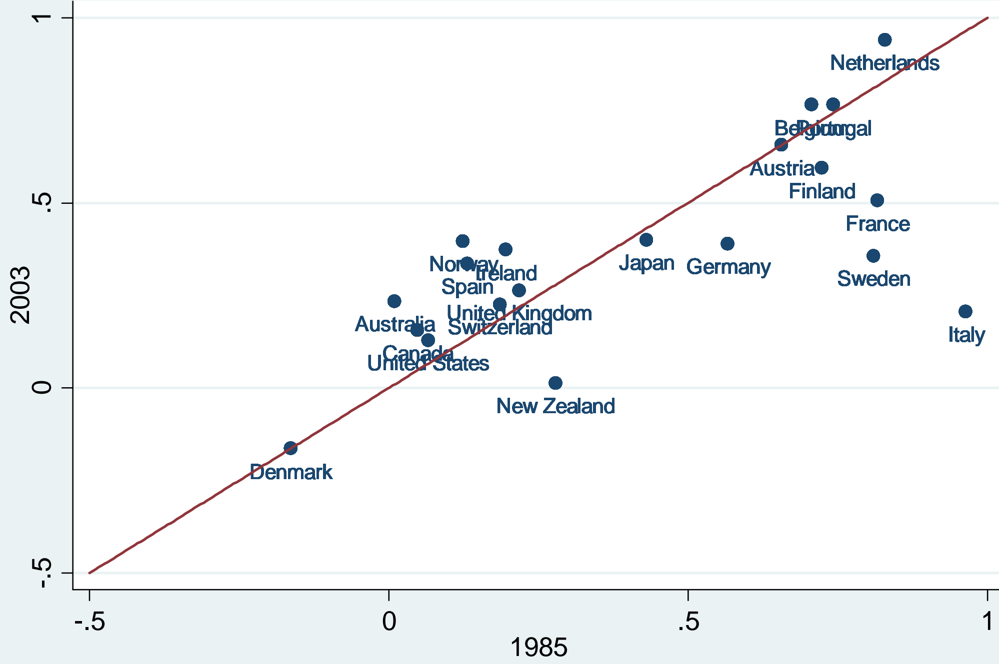
Figure 7:Implicit tax on continuing to work 60-64, 1985-2003
2003
1985
-.5
0
.5
1
Netherlands
Belgium
Portugal
Austria
Finland
France
Sweden
Italy
Japan
Germany
Norway
Ireland
Spain
United Kingdom
Switzerland
Australia
Canada
United States
New Zealand
Denmark

	Table 1: Years of crisis
Country	Years of crisis
Australia	1983
Austria	1984-1987
Belgium	1983-1987
Canada	1982-1983, 1992-1993, 1996
Denmark	1975, 1981, 1993
Finland	1977-1978, 1992-1996
Iceland	1992-1995
Ireland	1986-1987, 1993-1994, 2008
Japan	1984
Luxembourg	1982-1983, 1985, 1996-1997
Netherlands	1970, 1982-1983
New Zealand	1991-1992
Norway	1978-1984, 1989-1993
Portugal	1983-1987, 1994
Spain	1981-1986, 1994-1997
Sweden	1993-1994
Switzerland	1975-1976
United Kingdom	1981-1982, 1984
United States	1975, 1982-1983

Table 2: summary statistics					
Variable	Obs	Mean	Std. Dev.	Min	Max
regrefnopo	682	3.787579	1.545843	.7589929	6
regrefpo	682	4.038961	1.332417	.8265	6
finreform_n	576	.754919	.2291818	.0952381	1
epl	487	2.071129	1.023519	.2083333	4.1875
ubrr	623	28.27541	13.19885	.3472222	64.94407
imptax6064	354	.4113844	.327064	-.164022	1.050933
crisisgap	682	.111437	.3149034	0	1
right	656	.4512195	.4979945	0	1
yrcurnt	657	1.61796	1.259784	0	4
yrsoffc	657	3.884323	2.834137	1	16
govfrac	657	.2798347	.2601088	0	.8278044
emu	682	.1554252	.3625755	0	1
singlemkt	682	.3475073	.476528	0	1

Table 3	Crisis and political determinants of reforms					
	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	regrefnopo	regrefpo	finreform_n	epl	ubrr	imptax6064
regrefnopolag	0.910299***					
	(0.016)					
regrefpolag		0.927360***				
		(0.014)				
finreform_nlag			0.878329***			
			(0.019)			
epllag				0.911500***		
				(0.021)		
ubrrlag					0.902293***	
					(0.014)	
imptax6064lag						0.945718***
						(0.028)
crisisgaplag	-0.043017**	0.014517	-0.014271***	0.015260	-0.003582	-0.003324
	(0.021)	(0.018)	(0.005)	(0.011)	(0.145)	(0.005)
rightlag	-0.033043**	-0.024411**	-0.000276	-0.015657**	-0.213002**	0.000552
	(0.015)	(0.012)	(0.004)	(0.007)	(0.099)	(0.003)
yrcurntlag	0.008801*	-0.006360	-0.001313	-0.000366	-0.021438	-0.000021
	(0.005)	(0.004)	(0.001)	(0.002)	(0.026)	(0.001)
yrsoffclag	0.000620	-0.002695	0.000271	-0.000315	0.006108	0.000060
	(0.002)	(0.002)	(0.001)	(0.001)	(0.015)	(0.000)
govfraclag	0.083595**	0.033088	-0.003617	0.036001	-0.279842	0.000495
	(0.042)	(0.035)	(0.011)	(0.030)	(0.249)	(0.010)
emu	-0.150795***	-0.024457	0.007410	-0.013892	0.536162***	-0.010709*
	(0.029)	(0.024)	(0.007)	(0.015)	(0.199)	(0.006)
singlemkt	-0.088245***	-0.088145***	0.004612	-0.000560	0.086882	0.005801
	(0.028)	(0.023)	(0.007)	(0.012)	(0.121)	(0.006)
Country F.E.	YES	YES	YES	YES	YES	YES
Year F.E.	YES	YES	YES	YES	YES	YES
Countries	25	25	23	23	25	19
Observations	682	682	576	468	618	336

Table 4	The effects of political partisanship during crisis					
	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	regrefnopo	regrefpo	finreform_n	epl	ubrr	imptax6064
regrefnopolag	0.908608***					
	(0.016)					
regrefpolag		0.927341***				
		(0.014)				
finreform_nlag			0.875662***			
			(0.019)			
epllag				0.911508***		
				(0.021)		
ubrrlag					0.901881***	
					(0.014)	
imptax6064lag						0.948328***
						(0.027)
crisisgaplag	-0.049264*	-0.016240	-0.022560***	0.012117	-0.130317	-0.006275
	(0.028)	(0.023)	(0.007)	(0.014)	(0.200)	(0.007)
rightlag	-0.034188**	-0.032107**	-0.002483	-0.016152**	-0.226591**	-0.000212
	(0.016)	(0.013)	(0.004)	(0.007)	(0.102)	(0.003)
crisisgaplag_right	0.011125	0.066902**	0.018658**	0.007589	0.226479	0.005620
	(0.039)	(0.033)	(0.009)	(0.021)	(0.271)	(0.009)
yrcurntlag	0.008977*	-0.005976	-0.001048	-0.000304	-0.022345	0.000062
	(0.005)	(0.004)	(0.001)	(0.002)	(0.027)	(0.001)
yrsoffclag	0.000516	-0.002842	0.000233	-0.000404	0.005337	0.000039
	(0.002)	(0.002)	(0.001)	(0.001)	(0.015)	(0.000)
govfraclag	0.084975**	0.028669	-0.004359	0.035679	-0.270366	0.000543
	(0.043)	(0.035)	(0.011)	(0.030)	(0.248)	(0.010)
emu	-0.153102***	-0.026869	0.005997	-0.014344	0.522637***	-0.010740*
	(0.029)	(0.025)	(0.007)	(0.015)	(0.200)	(0.006)
singlemkt	-0.088679***	-0.085781***	0.006185	0.000145	0.100616	0.005784
	(0.028)	(0.023)	(0.007)	(0.012)	(0.122)	(0.006)
Country F.E.	YES	YES	YES	YES	YES	YES
Year F.E.	YES	YES	YES	YES	YES	YES
Countries	25	25	23	23	25	19
Observations	682	682	576	468	618	336

Table 5	The effects of government tenure during crisis					
	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	regrefnopo	regrefpo	finreform_n	epl	ubrr	imptax6064
regrefnopolag	0.911073***					
	(0.016)					
regrefpolag		0.927309***				
		(0.014)				
finreform_nlag			0.878538***			
			(0.019)			
epllag				0.911629***		
				(0.021)		
ubrrlag					0.901358***	
					(0.014)	
imptax6064lag						0.945388***
						(0.028)
crisisgaplag	-0.099947***	0.021430	-0.015679*	0.010238	-0.387908	-0.002556
	(0.032)	(0.027)	(0.008)	(0.019)	(0.256)	(0.008)
rightlag	-0.032618**	-0.024188**	-0.000300	-0.016374**	-0.222077**	0.000577
	(0.015)	(0.012)	(0.004)	(0.007)	(0.099)	(0.003)
crisisgaplag_yrs	0.014140**	-0.002030	0.000357	0.001254	0.083373*	-0.000172
	(0.006)	(0.006)	(0.002)	(0.004)	(0.046)	(0.001)
yrcurntlag	0.008722*	-0.006437	-0.001307	-0.000312	-0.024457	-0.000032
	(0.005)	(0.004)	(0.001)	(0.002)	(0.026)	(0.001)
yrsoffclag	-0.001869	-0.002448	0.000223	-0.000477	-0.001012	0.000083
	(0.003)	(0.002)	(0.001)	(0.001)	(0.015)	(0.001)
govfraclag	0.083386**	0.032958	-0.003416	0.037080	-0.265868	0.000457
	(0.042)	(0.035)	(0.011)	(0.030)	(0.245)	(0.010)
emu	-0.152313***	-0.024182	0.007310	-0.015287	0.520611***	-0.010668*
	(0.029)	(0.024)	(0.007)	(0.015)	(0.199)	(0.006)
singlemkt	-0.087542***	-0.088421***	0.004737	-0.000024	0.101975	0.005868
	(0.028)	(0.023)	(0.007)	(0.012)	(0.121)	(0.006)
Country F.E.	YES	YES	YES	YES	YES	YES
Year F.E.	YES	YES	YES	YES	YES	YES
Countries	25	25	23	23	25	19
Observations	682	682	576	468	618	336

Table 6	The effect of government fractionalization during crisis					
	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	regrefnopo	regrefpo	finreform_n	epl	ubrr	imptax6064
regrefnopolag	0.910477***					
	(0.016)					
regrefpolag		0.926313***				
		(0.014)				
finreform_nlag			0.877821***			
			(0.019)			
epllag				0.910730***		
				(0.021)		
ubrrlag					0.902540***	
					(0.014)	
imptax6064lag						0.945652***
						(0.028)
crisisgaplag	0.001441	-0.012961	-0.011663*	0.019762	0.047998	-0.002477
	(0.029)	(0.025)	(0.007)	(0.015)	(0.190)	(0.006)
rightlag	-0.032689**	-0.024688**	-0.000249	-0.016168**	-0.216655**	0.000430
	(0.015)	(0.012)	(0.004)	(0.007)	(0.099)	(0.003)
crisisgaplag_govfrac	-0.175004**	0.094329	-0.009609	-0.019901	-0.218275	-0.003350
	(0.072)	(0.061)	(0.017)	(0.042)	(0.505)	(0.017)
yrcurntlag	0.008916*	-0.006336	-0.001303	-0.000295	-0.021060	0.000033
	(0.005)	(0.004)	(0.001)	(0.002)	(0.026)	(0.001)
yrsoffclag	0.000563	-0.002575	0.000258	-0.000396	0.005992	0.000044
	(0.002)	(0.002)	(0.001)	(0.001)	(0.015)	(0.000)
govfraclag	0.097064**	0.023154	-0.002816	0.037408	-0.263249	0.000818
	(0.042)	(0.035)	(0.011)	(0.030)	(0.249)	(0.010)
emu	-0.151233***	-0.023119	0.007072	-0.016072	0.525447***	-0.010891*
	(0.029)	(0.024)	(0.007)	(0.015)	(0.201)	(0.006)
singlemkt	-0.087455***	-0.088625***	0.004890	0.000727	0.087720	0.006012
	(0.028)	(0.023)	(0.007)	(0.012)	(0.121)	(0.006)
Country F.E.	YES	YES	YES	YES	YES	YES
Year F.E.	YES	YES	YES	YES	YES	YES
Countries	25	25	23	23	25	19
Observations	682	682	576	468	618	336

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