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The Political Costs of Reforms: Fear or Reality?

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EXECUTIVE SUMMARY

Many countries are experiencing persistent, weak medium-term growth and limited fiscal space. Against this background, economic policy agendas—in both advanced and developing economies—are focusing increasingly on structural reforms. While there is broad agreement on the economic benefits of structural reforms, the political-economy of reform is less settled. This is because reforms may generate gains only in the longer term while distributional effects may be sizable in the short run, and because governments may lack political capital to confront vocal interest groups. In these circumstances, politicians may hold back on reforms, fearing they will be penalized at the ballot box. The aim of this Staff Discussion Note is to examine whether the fear of a political cost associated with structural reforms is justified by the available evidence, and whether there are lessons from the data about how reform strategies might be designed to mitigate potential political costs. It provides a major addition to recent IMF analysis examining the output and employment effect of reforms (Ostry, Prati, and Spilimbergo 2009, IMF 2016, and 2019).

Using a newly constructed database on structural reforms, this note finds that reforms do not lead to electoral costs when implemented in a way that internalizes political economy considerations. First, because the gains of reform often take time to materialize, reforms are associated with significant electoral costs only when implemented in the runup to elections. In contrast, reforms undertaken earlier in an incumbent's term do not affect election prospects. Second, reforms have political costs when enacted in periods of weak economic activity, and have benign electoral consequences in good times. Third, not all types of reform are equal from an electoral perspective: the data suggest that reforms that engender large short-term adverse distributional effects—notably some types of financial deregulation and external capital account liberalization under some conditions—can prove electorally costly.

There is both a pressing need and strong case for well-designed, appropriately timed and carefully implemented structural reforms, but political economy elements need to be internalized. Experience with past reforms demonstrate reforms must be carefully designed and prioritized based on good communication and transparency to ensure broad-based support. First, governments should act swiftly following an electoral victory to implement reforms during their political "honeymoon." Second, reforms are best implemented when economic conditions are favorable—that is, governments should "fix the roof when the sun is shining." During recessions, macro policy support may reduce political costs from reform. Third, policymakers should factor in and address upfront the income-distribution effects of reforms. Fiscal incentives and policies (such as job search assistance, retraining, and stronger social safety nets) to support those who are most affected by reforms may help advance the reform agenda by mitigating potential social and distributional costs. Finally, credible political commitment to reforms—including strong ownership and enhanced dialogue to garner support from business and civil society—are key.

INTRODUCTION

1. **Context.** Against the background of persistent, weak medium-term growth and limited scope for macroeconomic policy, the economic policy agenda in both advanced and developing economies is increasingly focused on structural reforms. The scope and areas of reform vary across countries and include reducing regulatory barriers to competition in product and financial markets, opening to trade and financial flows, and increasing the flexibility of the labor market. Structural reforms are motivated by multiple policy objectives. They can foster medium-term economic prospects and living standards by raising productivity and employment (Ostry, Prati, and Spilimbergo 2009, IMF *World Economic Outlook* 2016, 2019), improving debt sustainability (Banerji and others 2017), and enhancing the resilience of the economy to shocks (Aiyar and others 2019).

2. **Political cost of reform.** Although the economic benefits of structural reforms have broad agreement, the political economy of reform is less settled. The reason: even if reforms are known to produce a net benefit for society as a whole, the losses from reform may be concentrated and the gains diffuse. The opponents of reform, even if in a minority, may be highly motivated to organize resistance, face low costs to structure themselves as an organized pressure group, and be politically "strong" (Olson 1971). Under such conditions, politicians may hold back on reforms out of a fear that they will be penalized at the ballot box by vocal opponents to reform.

3. **Fear or reality?** The aim of this note is to examine whether the fear of a political cost from economic reforms is justified by the available evidence, and whether we can glean lessons from the data and case studies as to how policy approaches might be adjusted to mitigate potential political costs. Our aim is to provide answers to the following questions:

- Do structural reforms lead, on average, to electoral costs?
- Does the timing of the reform in the electoral cycle and the state of economy matter?
- Does the effect depend on the type of reform?

4. **Data and empirical analysis.** Despite theoretical work rationalizing a possible political cost from enacting reforms, empirical evidence is typically scant, based on a limited set of countries and with mixed results.[2] To advance our understanding of the electoral consequences of reforms, we have developed the most comprehensive data set to date of structural reform regulation for a large sample of 90 advanced and developing economies during 1973–2014. This data set is unique not only in terms of country-time coverage, but also in the breadth of the

[2] Very few studies directly examine the impact of reforms on electoral outcomes. Pacek (1994) finds that nearly all post-communist reform governments were penalized at the polls. Weyland (1998) finds mixed electoral fates for reforming governments in Latin America. Governments in that region facing the prospect of deep economic losses were sometimes able to frame reform as a strategy to avoid even deeper losses. Buti and others (2010) examined the effects of product and labor market reform in Organisation for Economic Co-operation and Development (OECD) economies and found that, on average, these reforms did not lead to significant electoral effects.

(continued)

sectoral areas covered. The data set identifies structural policy settings and reforms in the areas of trade (tariffs), domestic finance (regulation and supervision), external finance (current financial account and capital account openness), labor market regulation (job protection legislation), and product market regulation (barriers to entry in two large network industries). The data set was compiled through a systematic reading and coding of policy actions documented in various sources, including national laws and regulations, as well as IMF staff reports.[3] The analysis combines the reform data set with a new electoral data set that contains information on election dates, incumbent leaders and their party affiliation, and the vote share of each party of the coalition supporting the incumbent leader for each country covered in the reform data set.

5. **Key results.** The results of the empirical analysis suggest that, while on average reforms are associated with electoral costs, specific effects depend on the type of reform and on when in the electoral cycle reforms are implemented. First, not all reforms lead to electoral costs. Although financial sector reforms seem to have adverse electoral consequences, real sector reforms on average are electorally benign. Second, electoral costs seem to be present only relatively late in the political calendar—that is, when implemented in the year prior to an election—but they appear electorally benign at other times. Third, overall economic conditions matter: while reforms of both the financial and real sectors are penalized in bad times, real sector reforms undertaken in periods of strong economic activity are rewarded. Finally, a review of selected case studies suggests that, even in periods of difficult economic conditions, governments may not be penalized at the ballot box when (1) reforms coincide with a transition to democracy, or (2) there is strong ownership and consensus that a broad reform package (including to foster macro-stabilization) is unavoidable, and (3) the government effectively signals political commitment and an enhanced dialogue to garner support with business and civil society.

6. **Qualifications**. Selection bias may imply that the electoral costs of reforms are larger than those estimated for several reasons. Governments may have stronger political support to implement reforms at the beginning of their mandate. In addition, weak governments, recognizing their vulnerability, may not implement reforms, but then, precisely because they are weak, may lose at polls (the reverse holds for strong governments). Such scenarios would lead to underestimating costs of reforms. Indeed, the results presented in Online Annex 3 suggest that addressing endogeneity may yield larger negative effects of reform on election outcomes. Beyond selection bias, this note considers reforms essentially aimed at improving the functioning of (financial, labor, product) markets which by their nature may generate uneven gains across the population. Other reforms—for example polices aimed at promoting economic opportunity for all (improving education and health systems, public infrastructure spending frameworks, governance, and laws and regulations to foster women's labor force participation)—may generate fewer political costs owing to smaller inherent distributional impacts.

[3] See Online Annex 3.2 for details on the indicators and the country coverage.

7. **Roadmap.** This note starts out documenting stylized facts as to reform progress and the political circumstances surrounding the enactment of reforms. The next section distills key analytical considerations related to the electoral consequences of reforms, focusing on gains from reforms, their distribution, and interaction with politics. It then presents empirical evidence on the electoral consequences of reforms, and presents selected case studies in which governments managed to increase their political support even when enacting reforms in difficult economic conditions. The note concludes by discussing key findings and their implications.

STRUCTURAL REFORMS: STYLIZED FACTS

A. Structural Reforms Data

8. **We develop the most comprehensive data set to date of structural reform regulation for a large sample of 90 advanced and developing economies during 1973–2014**.[4] This data set is unique for not only its country-time coverage, but also its breadth of the sectoral areas covered. The indicators cover both the financial (domestic finance, financial current account, and capital) and real (trade, product, and labor) sectors.[5] All indicators are scaled to vary between zero and one, with higher values representing greater liberalization. Differences in indicator values across countries and time provide information on the variation in the absolute degree of reform within each sector. However, indices are not strictly comparable across sectors, so a higher value of, say, the trade reform index compared to domestic finance does not imply that an economy is "more liberal" with respect to international trade than domestic finance.

9. **The data set identifies, documents, and provides the implementation date of major reforms**. To the best of our knowledge, this is the first database to provide such information.[6] Specifically, the indicators capture reform progress in the following:

- **Domestic financial sector**. The index covers six broad areas: interest rate controls, entry barriers, privatization, supervision and regulation, securities markets, and credit controls.

[4] The data set includes 29 advanced economies, 50 emerging market economies, and 21 low-income countries, with a broad geographical representation. The country sample represents 96 percent of the world's 2017 nominal GDP. See Online Annex 2 for details on the coverage and on the construction of the reform indicators.

[5] The data set that provides the best comparison to ours is Ostry, Prati, and Spilimbergo (2009). Compared to Ostry, Prati, and Spilimbergo (2009), our data set has a larger time coverage, covers the postcrisis period, includes additional areas of regulation (labor market), and provides more granular information regarding the regulatory stance of some sectors (e.g., it provides a decomposition of capital account openness in several subcategories).

[6] Duval and others (2018) provide information on major reform events for 26 advanced economies on product and labor market reforms. In regard to labor market institutions, other databases—such as the European Commission's Labref, the Fondazione Rodolfo de Benedetti-IZA databases, and the International Labour Organization EPLex database—provide information about the nature and date of government measures. However, they have significantly shorter time series and country coverage and, importantly, they do not attempt to identify major reforms.

- **Current and capital account**. These cover restrictions on external payments (for imports, invisibles, capital) or receipts (exports, invisibles, capital), as well as components of the capital account in relation to foreign direct investment, portfolio investment, bonds and other debt securities, money market instruments, and financial credits.

- **Trade**. The indicator measures trade tariffs at the product level. Product-level tariff data are aggregated by calculating simple and weighted averages, with weights given by the export share of each product.

- **Product market**. The indicator covers liberalization in two network sectors: telecommunication and electricity. For each, the index covers three broad areas: privatization, entry barriers, and supervision and regulation.

- **Labor market**. The indicator is a new measure of employment protection legislation (EPL) related to termination of full-time indefinite contracts for objective reasons, in a typical firm of 250 workers. Three dimensions of EPL are considered: procedural requirement, firing costs, valid grounds for dismissal, and redress measures (in case of unfair dismissal).

10. Implementation of reform has been heterogenous across countries over the past four decades (Figure 1):

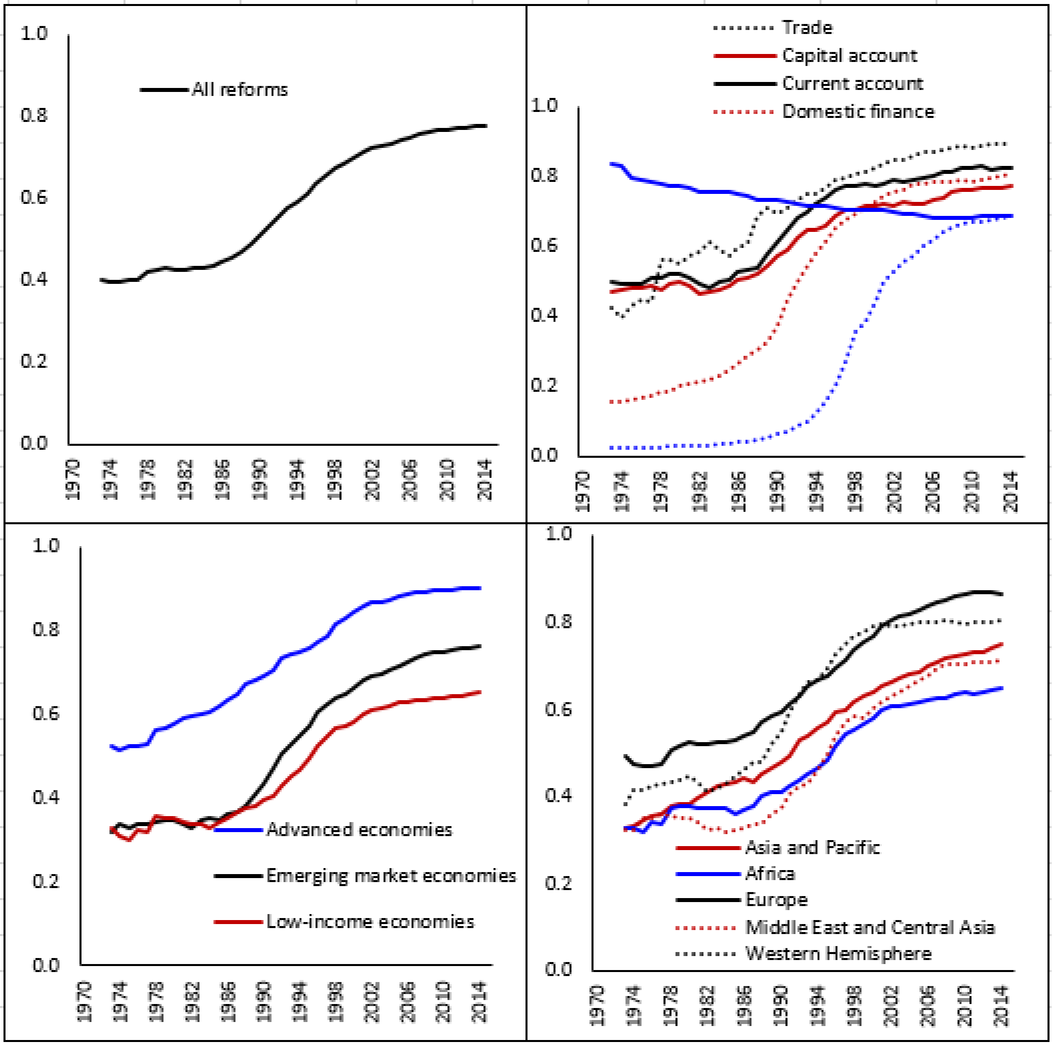
- **Since the late 1980s, there has been a broad tendency to pursue liberalization (Figure 1, panel 1).** The pace of liberalization, however, has typically declined since the global financial crisis, especially in relation to domestic finance, and the external current and capital accounts, where there has been a modest reversal of reforms in some countries.

- **The reform process has proceeded unevenly across sectors (Figure 1, panel 2).** Reforms appear to have been more frequent in domestic finance, trade, capital and current account than in product and labor markets. In addition, major liberalization pushes across different areas have occurred in different periods: trade reforms were concentrated in the 1970s and 1980s; domestic and external finance reforms in the early 1990s; and product market reforms in the late 1990s. In labor market regulation (i.e., EPL), there has been no deregulation trend and there has even been a tightening in recent years.

- **Advanced economies are more liberalized than emerging market economies, which are themselves more liberalized than low-income countries (Figure 1, panel 3).** While emerging market economies and low-income countries had a similar degree of liberalization until the 1990s, reform progress has been stronger in emerging market economies than in low-income countries since then. An exception is labor market regulation (i.e., EPL), where the level of development does not appear to drive systematic differences in the extent of regulation.

- **Reform progress has also been diverse across different regions of the world (Figure 1, panel 4).** Reform progress has been the strongest in Europe, but generally modest in the Middle East, Central Asia, and sub-Saharan Africa.

Figure 1. Stylized Facts on Reform Progress



Source: IMF staff calcualtions.

Note: The regulatory indicators ranges from 0 to 1. Higher levels denote more liberalization. All reforms denote the average of the six reform indicators.

B. The Electoral Data Set

- **A new electoral data set is constructed containing information on each election that has taken place in the countries covered in the structural reform data set.** The most relevant information contained in the data set are (1) the election date; (2) the name of the incumbent leader (prime minister or president) and his/her party affiliation; (3) the name of the new leader and party affiliation; (4) the date in which the incumbent leader took office; and (5) the vote share of each party of the coalition supporting the incumbent at the current, last, and second-last elections. Additional information includes the types of political systems (presidential vs.

parliamentarian), the electoral system (majoritarian vs. proportional), the number of parties in the coalition and the ideology of the government (right, center, and left). The sources of the data and the construction of the main election variables included in the analysis are reported in Online Annex 1.

C. Who Implements Reforms and When

11. **The literature has put forward several theories to rationalize why and when reforms happen.** Political economy explanations focus on ideology, the form of government, the degree of political fragmentation, and the strength of democratic institutions. Other explanations examine the role of crises as catalysts for reforms. This section briefly reviews the literature on the determinants of reforms and then provides stylized facts regarding the institutional, political, and economic context under which they are carried out.

12. **The "war of attrition" theory.** The theory of Alesina and Drazen (1991) sets off with the assumption that politicians seek reelection and exchange policy distortions for political support. Structural reforms that remove distortions have redistributive consequences and hence are particularly scrutinized by different interest groups. Each interest group is represented by a political party with veto power, and parties disagree on how to allocate the reform's costs. Because no party wants to bear the costs, waiting and delaying reform is preferable. However, if the benefits of reform decrease over time (or the costs increase) and they do so in a way that varies across parties, at some point one party will want to proceed with reform. According to the war of attrition model, the probability that a reform is delayed is higher the weaker or the more fractionalized the executive power is. For instance, in multiparty governments, veto power of a single player can increase. In countries with more fragmentation, the government is more likely to be formed by a coalition of parties with more divergent interests, which makes it difficult to compromise and increases the chances that the status quo is maintained (Haggard and Webb 1994, Roubini and Sachs 1989). In presidential regimes, by way of contrast, where the executive power is generally stronger, the opposition to reforms tends to be weaker.

13. **Partisan theory.** The partisan theory asserts that different parties have different distributional and policy preferences (Hibbs 1987, Alesina and Roubini 1992). Since presidential systems and majoritarian electoral rules tend to deliver governments that are dominated by fewer and more polarized political parties, there are reasons to expect that countries with such institutions might also be characterized by larger swings in economic policy (reforms going in different directions). In parliamentary regimes, with a proportional electoral rule and coalition governments, it is more likely that centrist political parties have enough power to veto radical proposals. Partisan models also make predictions regarding the type of reforms that get implemented. According to these models, right-wing governments are more likely to implement market-oriented reforms. Cukierman and Tommasi (1998), however, notice that history is rich of episodes in which left-leaning governments implemented "right-wing policies" and propose a

representative-democracy model that rationalizes this evidence.[7] The main argument: it is easier for leaders that are ideologically distant from pro-market economic reforms to elicit the necessary support to implement them. The fact that left-leaning governments might implement "right-wing reforms" is also supported by theoretical models with endogenous redistribution (Jain and Mukand 2003). If a reform benefits only a minority of the population and the government has its electoral base among the population sector that would lose from the reform, it could implement the reform and credibly commit to redistribute some of the gains from the winners to the losers.

14. **Crisis-induced hypothesis**. Another strand of the literature considers the role of crises in fostering reform (Krueger 1993, Tommasi and Velasco 1996). Crises can act as turning points and catalyze popular support for reform. While in normal times a well-organized minority might block reform, during a crisis the pressure on the "blocking minority" becomes too high for it to keep opposing the reform. Drazen and Grilli (1993) show that for this reason a crisis could be welfare improving: it reduces welfare directly by worsening economic conditions, but it would be welfare improving if it leads to reforms and the payoff of reforms is greater than the direct loss associated with the crisis. At the same, crises may lead to increased parliamentary fragmentation that could weaken reform efforts (Mian, Suffi, and Trebbi 2014).

15. **Do the data support the theories discussed above?** Four main stylized facts emerge from our analysis on the frequency and intensity of reforms (Figures 2 and 3).

- **Countries with presidential systems are characterized by larger and more frequent swings in economic policy**. In presidential systems, liberalizing and tightening reforms are more frequent than in parliamentary systems. This lends support to both the war of attrition and the partisan models. At the same time, there is no significant difference in reform progress depending on the initial vote share of the governing parties, and on whether the government is single- or multiparty.

- **Countries with a majoritarian electoral rule are characterized by larger reforms and reform reversals**. This observation is consistent with the partisan theory, according to which majoritarian electoral rules tend to deliver parliaments with fewer and more polarized parties.

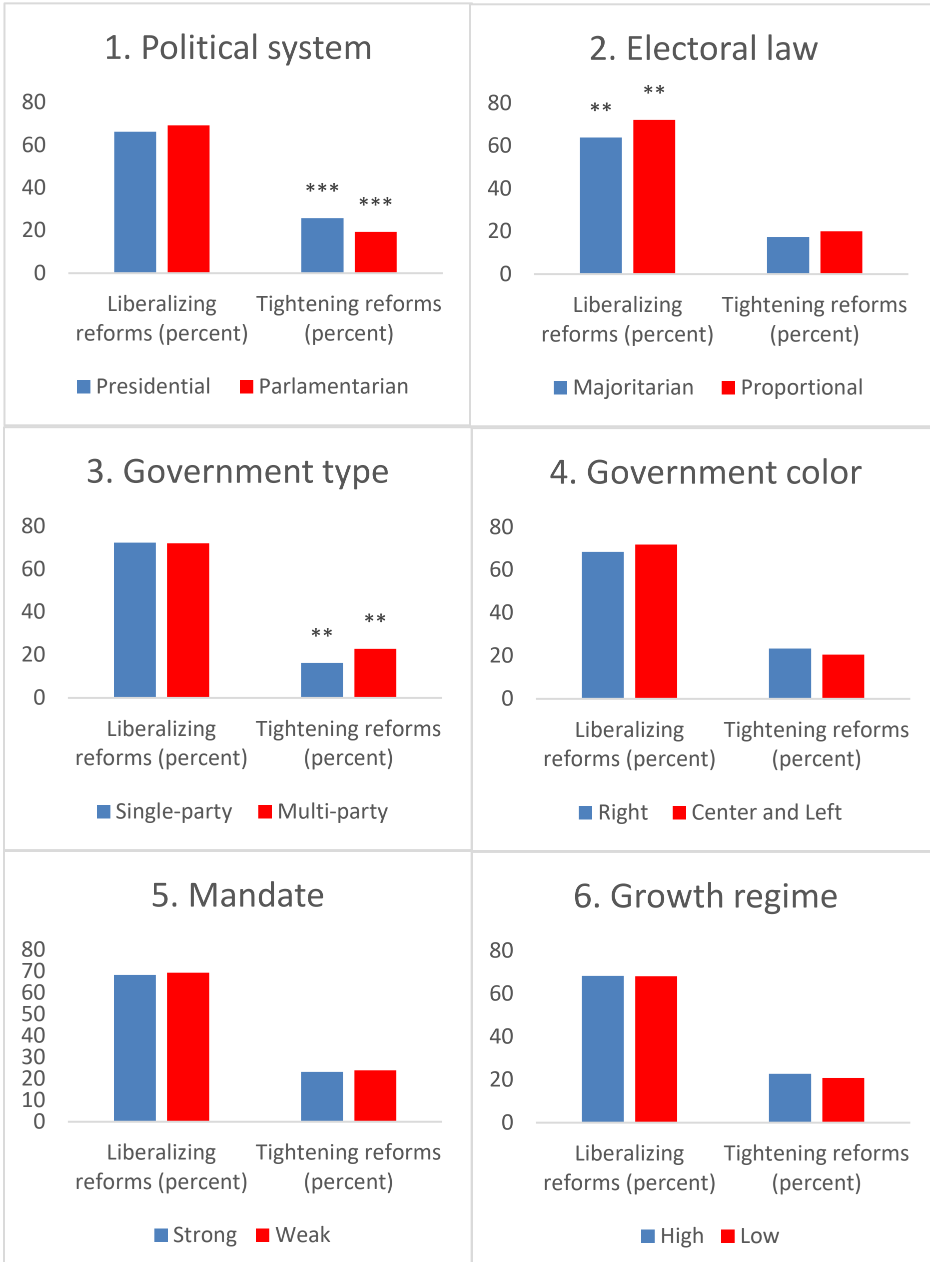
- **Right-leaning governments do not adopt more free-market policies than left-leaning ones**. On the contrary, left-leaning governments typically implement larger liberalizing reforms, as predicted by Cukierman and Tommasi (1998).

- **Crises do not foster reforms on average**. If anything, during periods of low growth, reform tightening is relatively common. The effect of crises on reform however varies depending on the type of crisis and regulation. As shown in Chapter 3 of the October 2019 IMF *World Economic Outlook*, while economic recessions foster trade, labor market, and domestic financial

[7] Examples include the reforms carried out in Peru under Alberto Fujimori, in Bolivia under Víctor Paz Estenssoro, and in Argentina under Carlos Menem.

liberalization in the medium term, banking crises tend to lead to higher regulation in both the domestic finance and capital account.

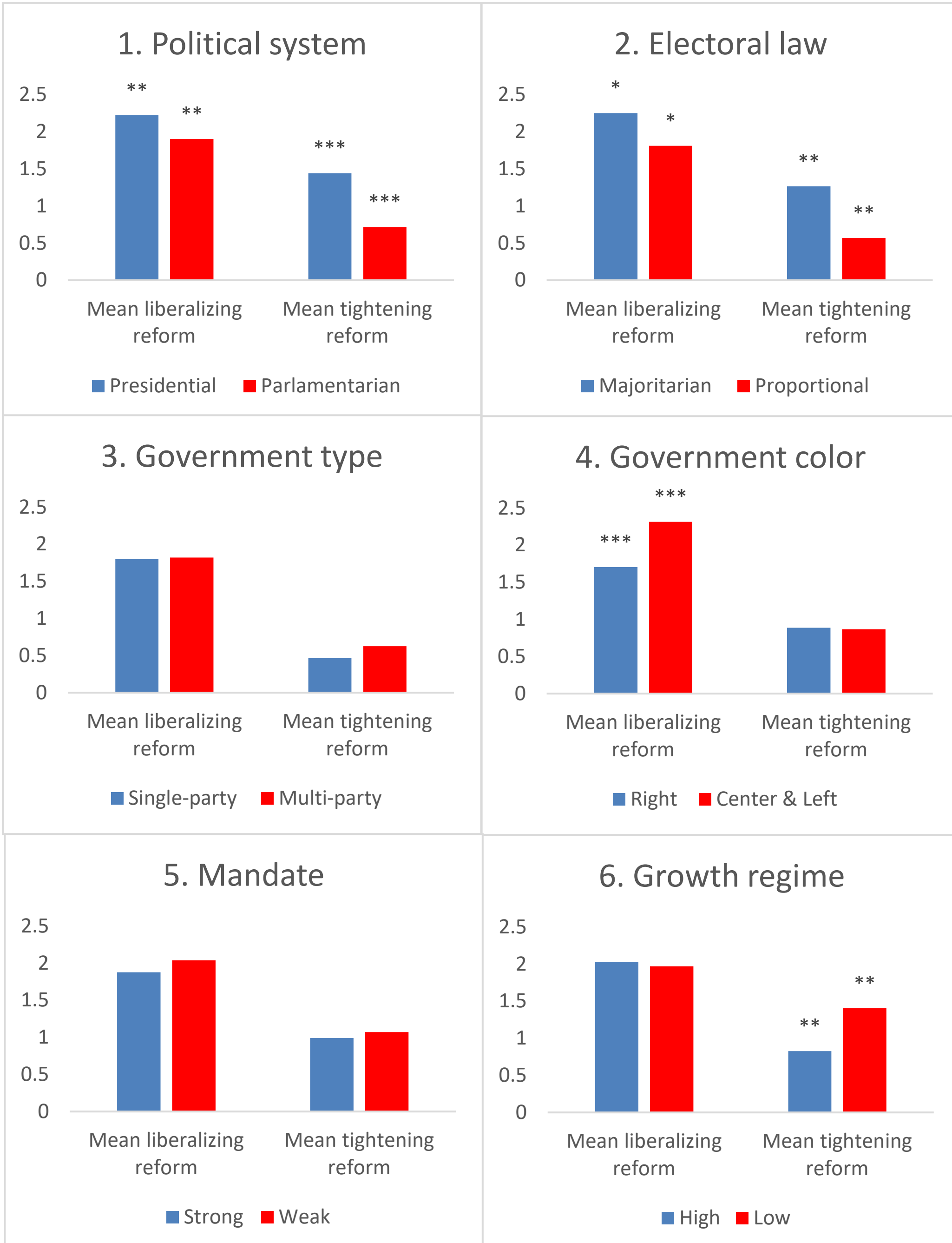
Figure 2. Stylized Facts on the Frequency of Reforms



Source: IMF staff calculations.

Note: The figure shows the frequency of liberalizing and tightening reforms according to (1) the political system, (2) the electoral system, (3) type of government, (4) ideologic orientation, (5) initial vote share, and (6) growth regime. *, **, *** denote whether the difference in the frequency of reforms is statistically significant at 10, 5, and 1 percent, respectively.

Figure 3. Stylized Facts on the Intensity of Reforms



Source: IMF staff calculations.

Note: The figure shows the intensity of liberalizing and tightening reforms according to (1) the political system, (2) the electoral system, (3) type of government, (4) ideologic orientation, (5) initial vote share, and (6) growth regime. *, **, *** denote whether the difference in the frequency of reforms is statistically significant at 10, 5, and 1 percent, respectively.

REFORMS AND ELECTIONS: ANALYTICAL CONSIDERATIONS

16. **This section presents some analytical considerations on the potential electoral outcomes following reforms**. It draws from an extensive theoretical literature on the political economy of reform to shed light on the mechanisms explaining reform inertia, the electoral consequences of reforms, and the scope of conditions under which reforms may be rewarded or penalized by the electorate. The theoretical predictions from the literature suggest that the impact of structural reforms on the re-election of an incumbent government can go both ways: election officials could face both potential benefits and costs from enacting structural reforms.

17. **Reform inertia is partly owing to uncertainty about what to do.** Why are economic reforms that would eventually benefit most segments of society resisted or delayed? A first set of arguments relates to the possibility that, with uncertainty about what to do, the best thing may be to do nothing. A second explanation is that the country may lack technical expertise to implement the desired reform. A third explanation is that if the need for reform comes from perceived temporary weakness or failures in the economy, the government may wait to see if the problem resolves itself. Finally, a common argument for inaction is that societies, like individuals, tend to postpone difficult decisions, even when they know that addressing them would be optimal and postponing them increases costs down the road.

18. **Reforms may face political opposition and a post-election penalty when they cause uneven gains across the population.** Even if reforms are known to produce a net benefit for society as a whole, losses may be concentrated, and gains may be diffused (Rodrik 1994). The opponents of reforms may be highly motivated to organize resistance to reform, facing lower costs to structure themselves into an organized pressure group and be politically "strong" (Olson 1971). In voting models, this non-neutrality operates through the distributional consequences of reforms, so that the median voter may prefer the status quo and penalize reformers. Another source of non-neutrality arises when individuals do not know whether they will gain or lose from reforms, which dampens aggregate support for reform (Fernandez and Rodrik 1991, Alesina and Drazen 1991).

19. **Reform could nevertheless be electorally beneficial**. Implementing reform may signal competence and be rewarded by well-informed voters (Rogoff 1990). Given that economic conditions are expected to improve following a reform (see, for example, IMF 2016 and the October 2019 IMF *World Economic Outlook* Chapter 3), incumbents who have implemented successful reforms might expect to enhance their re-election prospects. In addition, improvements in the quality of democratic institutions often go hand in hand with economic reforms (Haggard and Webb 1994; Giuliano, Mishra, and Spilimbergo 2013). In these circumstances, the electorate may place less weight on economic reforms—even when unpopular—and reward the government for enacting them. In addition, a transition to

democracy could lead to successful reform efforts when a new government acts swiftly at the outset of its term to exploit its "honeymoon" period.

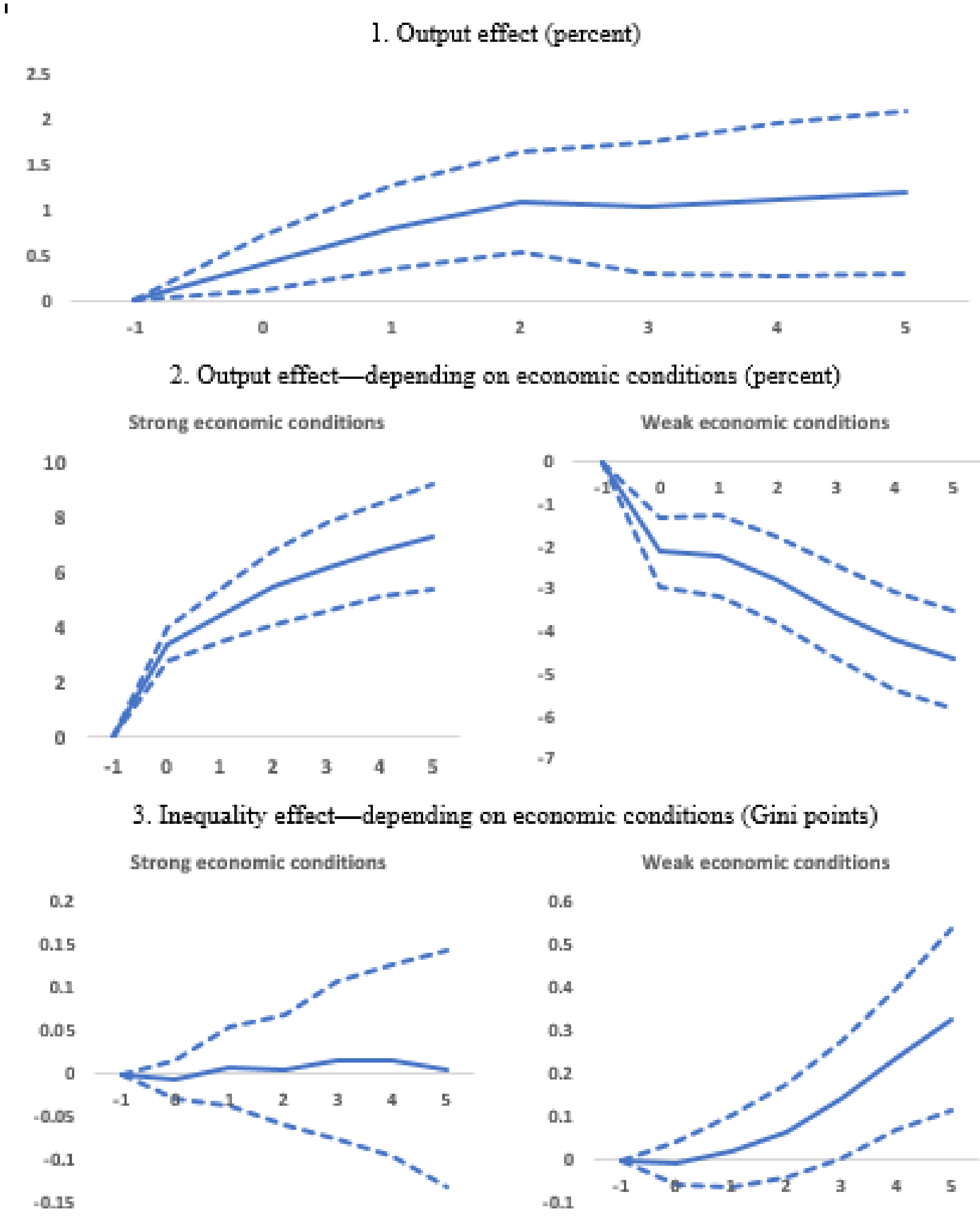
20. Reforms implemented at the beginning of an electoral term are likely to prove less politically costly. First, voters may be "myopic" and give higher weight to policies implemented in the runup to elections. As a result, even unpopular reforms implemented earlier may not be penalized. Second, the overall gains from reforms may materialize gradually, as shown in Figure 4, panel 1, raising the odds that reforms early in the term will show benefits at election time.

21. Economic conditions when reforms are implemented are likely to impact electoral outcomes. When voters are unable to disentangle the effect of reforms from other forces driving economic conditions, they may attribute good (poor) economic performance to the effect of reforms. In these circumstances, governments enacting reforms in periods when the economy is flourishing may be rewarded, while governments implementing reforms in periods of recessions may be punished. Second, the macroeconomic and distributional consequences of reforms may depend on prevailing economic conditions, as shown in Figure 4, panels 2 and 3. Although reforms implemented during economic expansion are associated with significant macroeconomic benefit and limited distributional cost, reforms tend to be contractionary and distributionally adverse when implemented in periods when the economy is already weak (see Duval and Furceri 2018; Ostry, Berg, and Kothari 2018; and the October 2019 *World Economic Outlook* Chapter 3). In the latter scenario, reforms may lead to a limited increase in the overall "pie" and significant costs for a large share of the population, and therefore to electoral costs.

REFORMS AND ELECTORAL OUTCOMES: WHAT DOES THE EVIDENCE SHOW?

22. This section explores the electoral outcomes associated with structural reforms. Specifically, the following questions are examined: Do structural reforms lead to electoral losses or gains, and if so, under what scope conditions? Do the parties in a coalition government equally share credit or blame in the reform process? Do the timing, state of the economy, and type of reform matter for electoral outcomes? Is there symmetry in the political effect of liberalizing and tightening reforms? Do reforms implemented in countries pursuing an IMF program influence electoral outcomes differently?

Figure 4. Macroeconomic and Distributional Effects of Reform



Source: IMF staff calculations.

Note: Output and inequality effects of reforms are estimated using the local projection method (Jorda 2015). See Online Annex 3 for details. t = 0 is the year of the reform; solid lines denote the response of output (Gini) to a major reform event, defined as a change of two standard deviations in the average reform indicator. Dotted lines denote 90 percent confidence bands.

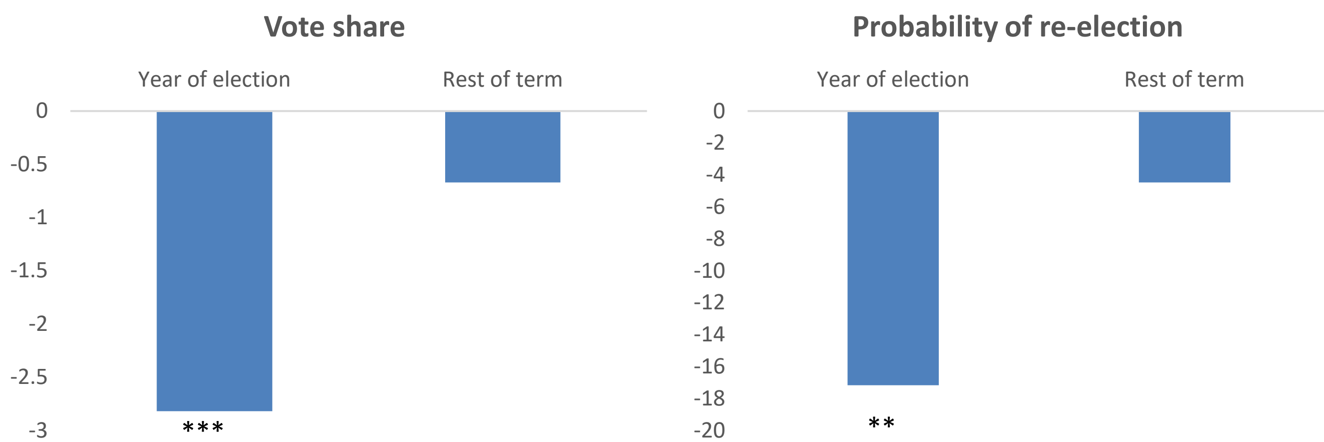
23. To examine these issues, we estimate the effect of reforms on the change in the incumbent coalition (party) vote share. This measure of election outcome is especially useful in assessing the magnitude of electoral penalties or gains. A leader might retain office, but with a much-reduced majority, or might be forced into a coalition government. Following Brender and Drazen (2008), we also model whether a reforming (or reversing) incumbent or her party remains in office after reforms are implemented, with 1 denoting re-election and 0 otherwise. The key explanatory variable in the initial specification is the unweighted average of all six reform indices. The analysis further distinguishes between financial sector reforms (domestic finance, capital and financial current account) and real sector reforms (trade, product and labor markets).[8] The analysis is based on an unbalanced sample of democratic elections from 1973 (or the first year in which the country is characterized as a democratic regime) to 2014 for 66 countries (see Table A1.1 in Online Annex 1).[9]

24. Reforms are associated with electoral costs, but only when implemented in the year prior to an election. The results suggest that a major reform (defined as an increase larger than two standard deviations in the reform indicator) is associated with about a 3 percentage points decrease in the vote share of the coalition. This effect is economically significant and is equivalent to a reduction in the chance of the incumbent leader of the coalition being re-elected by about 17 percentage points (Figure 5). In contrast, reforms undertaken in earlier periods of an incumbent's term do not appear to affect election prospects. These results provide evidence of myopic behavior of the electorate and are consistent with empirical evidence that the economic gains from reforms materialize only gradually over time. The results also show, consistent with the economic voting literature, that better economic conditions during the year before the election are associated with more favorable political outcomes. In addition, we find that the changes in vote shares are typically larger in advanced economies and in majoritarian systems (consistent with Brender and Drazen 2008). We do not find evidence that the effect of reform varies significantly across countries, or with the ideology of the government. Similarly, we do not find evidence that the speed of implementation has a salient impact on electoral outcomes (see Online Annex 3 for additional details).

[8] Estimates for each reform indicator are reported in Online Annex 3. The baseline specification includes the following set of control variables: (1) the average GDP growth during the electoral term; (2) an advanced economy dummy (1 = continuous membership in the OECD since 1963, or 0 otherwise); (3) a dummy variable for new democracies (1 = countries for the first four elections after a year with a negative Polity score on the –10 to 10 scale, or 0 otherwise); (4) a dummy variable for a majoritarian political system (1 = countries with an electoral system that awards seats in "winner-take-all" geographically based districts according to the Database of Political Institutions, and 0 otherwise); (5) the initial level of regulation; and (6) the initial level of vote share. See Online Annex 3 for further details on the empirical methodology.

[9] The identification of democratic regimes is based on the POLITY2 score—a measure of regime characteristics ranging from –10 (strongly autocratic) to 10 (strongly democratic) published by Marshall, Gurr, and Jaggers (2017). A country is defined to have a democratic regime if its POLITY2 score is greater than or equal to 1.

Figure 5. The Effect of Reform on Electoral Outcomes



Source: IMF staff calculations.

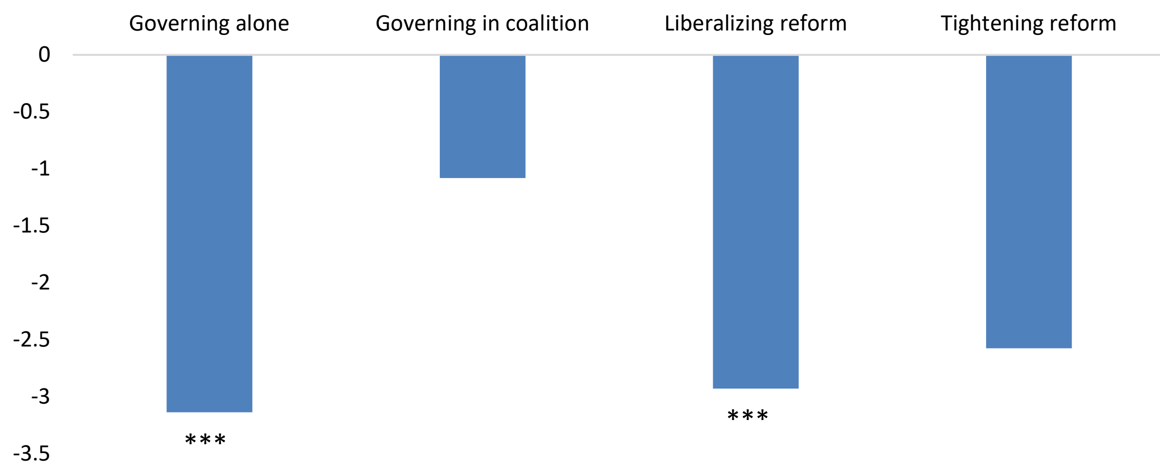
Note: The bars denote the effect of a major reform event—defined as a change of two standard deviation in the reform indicator—on the change of the incumbent coalition vote share (panel 1) and probability of the leader of the coalition to be re-elected (panel 2). The effects are differentiated between reforms occurring in the election year and those implemented in the rest of the coalition (leader) political term. **, ***, denote statistical significance at 5 and 1 percent, respectively. See Online Annex 3 for details on the estimation.

25. "Selection bias" may imply that the electoral costs of reforms are larger than those estimated. Governments may have a stronger political support to implement reforms at the beginning of their mandate. Elected politicians may also anticipate the electoral consequences of their policy choices, therefore opting out from implementing reforms which may jeopardize re-election. In addition, weak governments, recognizing their vulnerability, do not implement reforms, but then, precisely because they are weak, they lose at polls (the reverse holds for strong governments). Such circumstances would lead to not finding significant costs of reforms. Indeed, the results presented in Online Annex 3 suggest that addressing endogeneity (through instrumental variables, or by focusing on exogenous elections—that is, those that cannot be discretionally called by the leader) results in larger negative effects of reform on election outcomes. Another source of concern is that reforms are typically implemented as part of economic packages aimed also at fostering economic stability (that is, reducing inflation and deficit). To the extent that budget outcomes and inflation affect electoral outcomes this may bias the estimated impact of reform. To address this issue, the analysis includes as control variables: (1) changes in the budget during the election year and in the rest of the term and (2) a measure of inflation. These results, although smaller in magnitude, are not statistically different from those of the baseline specification (Online Annex 3). In addition, the analysis on "exogenous" fiscal consolidations suggest that their effect on electoral outcomes depend on the design of the stabilization package: while tax-based consolidation episodes with significant contractionary effects tend to be associated with sizeable political costs, growth-friendly spending-based consolidation are largely benign from an electoral standpoint and may increase the chance of re-election (Box 1).

26. **Clarity of responsibility matters.**[10] Consistent with the literature on clarity of responsibility, the electoral penalty for reforms falls largely either on the party governing alone or the majority party in a coalition. Specifically, the results suggest that the effect of reforms on the incumbent majority party's vote share is three times larger when the party is governing alone than when governing in a coalition (Figure 6, first and second bars). In addition, the electoral effects on the major party of the coalition are significantly larger than those for minority parties.

27. **Electoral gains from reform tightening are small.** The effect of liberalizing and tightening reforms is not symmetric: while liberalization tends to decrease electoral support, tightening does not significantly influence voters (Figure 6, third and fourth bars). This result is consistent with the argument that support for reform may increase with the number of groups that benefits from the reform.

Figure 6. The Effect of Reform on Vote Share: Clarity of Responsibility and Symmetry



Source: IMF staff calculations.

Note: The bars denote the effect of a major reform event—defined as a change of two standard deviation in the reform indicator—in the election year on the change of the incumbent coalition vote share. The effects are differentiated between government governing alone and governing in a coalition (first two bars), and between liberalizing and tightening reforms (third and fourth bars). *** denotes statistical significance at 1 percent. See Online Annex 3 for details on the estimation.

28. **Not all reforms are associated with political costs.** Electoral costs arise mainly from pro-finance reforms, that is that liberalize the domestic and the external financial sector (financial current and capital accounts), with real sector reforms being largely benign from an electoral standpoint

[10] Clarity of responsibility refers to political institutions and party structures that make it easy for voters to monitor their representatives, identify those responsible for undesirable outcomes, and hold them accountable by voting them out of office. Clarity of responsibility is high when a single party majority controls the government; it is low when the government is controlled by multiple parties or lacks majority support altogether.

(continued)

(Figure 7).[11] These results are consistent with prior findings suggesting that financial sector reforms are prone to engender increased income inequality (see, for example, de Han and Sturm 2017; Furceri and Loungani 2018; Ostry and others 2018, 2019; Furceri, Loungani, and Ostry forthcoming).[12] The results presented in Figure A3.1 of Online Annex 3 corroborate these findings and show that while financial sector reforms are associated with increased inequality, real sectoral reforms have minor distributional consequences.

29. Reforms are politically costly only when enacted in periods of weak economic activity. In bad times, both financial and real sector reforms are associated with lower vote share (Figure 7). In good times, while financial sector reforms do not have a statistically significant effect on voter shares, real sector reforms have a *positive* and statistically signficiantly effect on the vote share. In other words, real sector reforms enacted in good times appear to help governments be re-elected. In addition, the results suggest that both liberlizing and tightening reforms are electorally costly in periods of weak economic activity. This set of results is consistent with reforms leading to higher economic and distributional costs when implemented when economic conditions are weak, and/or that voters are unable to distinguish between the effects of reform from those owing to the underlining economic conditions.[13]

Reforms implemented under an IMF-supported program do not appear to have an additional impact on electoral outcomes. Voters may penalize reforms implemented during IMF programs because they signal government incompetence, or surrendering sovereignty on economic policy. Conversely, more-benign electoral effects might result if voters believe that the reform implementation is not a government choice. The results suggest that the estimated effects of government-undertaken reforms while under an IMF-supported program are not statistically different from those implemented in other circumstances. In addition, we do not find evidence that being in an IMF-supported program per se comes with an electoral cost.[14] As illustrated in the next

[11] The results presented in Table A3.3 of Online Annex 3 show that reforms to domestic finance, financial current and capital account are all associated with electoral costs. Similarly, reforms in trade, product, and labor markets do not have a salient effect on electoral outcomes.

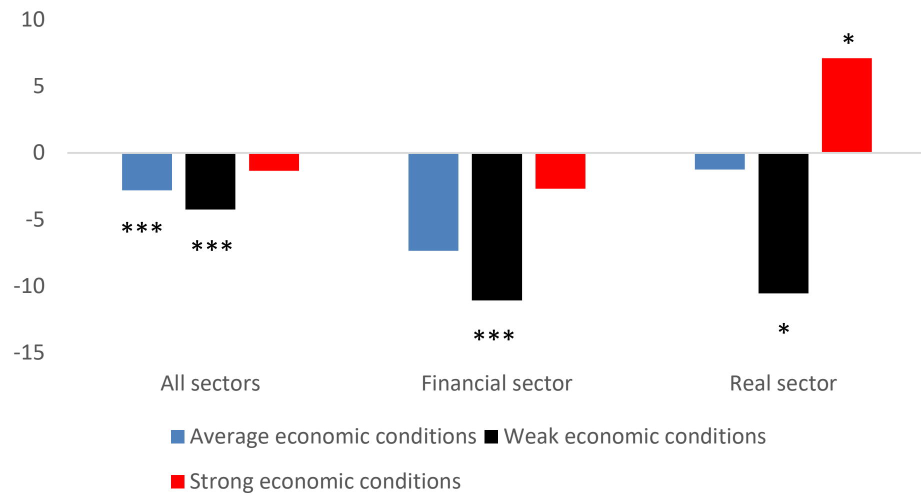
[12] Theory provides ambiguous predictions for the impact of domestic financial liberalization on income distribution. Financial imperfections, such as information and transaction costs, may be especially binding on the poor who lack collateral and credit histories so that relaxation of these credit constraints may benefit the poor (Galor and Moav 2004; Beck, Demirgüç-Kunt, and Levine 2007). In contrast, improvements in the quality and range of financial services do not tend to broaden access to financial services, but instead improve the quality of financial services enjoyed by those already purchasing financial services (Greenwood and Jovanovic 1990). The benefits of these intensive margin effects accrue primarily to the rich, widening the distribution of income. Finally, the impact of financial liberalization on income inequality may depend on the quality of institutions (Rajan and Zingales 2003) and the degree of financial inclusion (Sahay and others 2015). Empirically, recent studies report that financial liberalization increases income equality (Jaumotte, Lall, and Papageorgiou 2013; de Han and Sturm 2017; Furceri and Loungani 2018; Ostry, Berg, and Kothari 2018, Ostry, Loungani and Berg 2019). The results presented in Figure A3.1 of Online Annex 3 corroborate this finding and show that financial sector reforms are associated with increased inequality, while real sectoral reforms have minor distributional consequences.

[13] The results of the analysis suggest that both liberalizing and tightening reforms are politically costly when enacted in periods of weak economic activity. See Alesina and others (forthcoming a) for further details.

[14] Similar results are obtained for reforms implemented during EU membership.

section that discusses selected case studies, program ownership, good communication and enhanced dialogue with business and civil societies are key elements of success.

Figure 7. The Effect of Reform on Vote Share: Types of Reform and Economic Conditions



Source: IMF staff calculations.

Note: The bars denote the effect of a major reform event—defined as a change of two standard deviation in the reform indicator—in the election year on the change of the incumbent coalition vote share. The effects are differentiated across types of economic conditions (average, weak, and strong) and between average reforms across all sectors, financial sector reforms, and real sector reforms. **, ***, denote statistical significance at 5 and 1 percent, respectively. See Online Annex 3 for details on the estimation.

CASE STUDIES

30. Even if reforms in bad economic times typically have electoral costs, there are exceptions to this "rule." This section presents case studies suggesting that even in periods of difficult economic conditions, governments may succeed in implementing reforms without an electoral penalty. The cases of Spain (1979) and Peru (1995) illustrate three elements that may have contributed to political success of reforms. First, reforms may coincide with a transition to democracy. Second, strong ownership may help, especially amid a consensus that reform-cum-stabilization is unavoidable. Finally, the government builds broad support through a deliberate enhanced dialogue with business and civil societies.

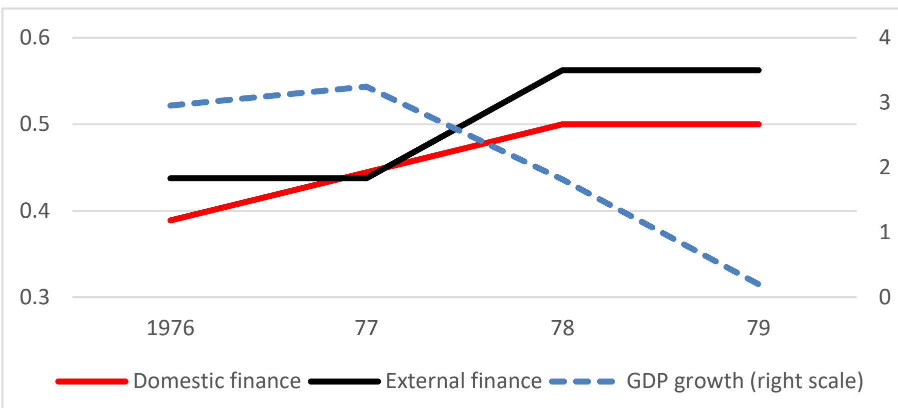
Spain 1979

31. Two main factors contributed to the electoral success of the government party despite unfavorable economic conditions and the adoption of a substantial reform package (Figure 8). First, the government adopted economic reforms in parallel with sweeping political reforms aimed at fostering democratization. Second, the government engaged with society and the political parties to build consensus.

- Soon after Franco's death in 1975, King Juan Carlos, the new head of state, charged Adolfo Suárez, a young and reform-minded member of the Francoist movement, with the formation of a new government. Suárez set June 15, 1977, as the date of the new election. In the time leading to the election, he adopted several measures: the proclamation of a major political amnesty, the legalization of the trade union federations, the recognition of the right to strike, and the legalization of all political parties. Suárez himself formed a party, the Union de Centro Democratico (UCD), and ran for election. The first election in modern democratic Spain was a success, as voters turned out to vote in big numbers. Eleven different political parties gained representation in the new parliament, and with 34 percent of the vote share, the UCD garnered the largest share, though not enough to avoid a minority government.

- The election of 1977 occurred during a period of slowing economic growth, high inflation and historically high unemployment (Bermeo and García-Durán 1991). The need for reform was recognized by large parts of society and the new government was committed to structural transformation. Reforms involved fiscal stabilization, external and domestic finance liberalization (Figure 8), and a reduction in the growth rate of nominal wages.[15] In parallel with economic reforms, Suárez also proceeded with pro-democracy political reforms, including the drafting of a new constitution.[16] In the March 1979 elections, Suárez 's party (UCD) won the electoral contest once again and managed to increase its vote share.

Figure 8. Financial Reform Indicators and GDP Growth in Spain, 1976–79



Source: IMF staff calculations.

Note: The figure shows that evolution of the reform indicators (left scale) and GDP growth (right scale) prior to the 1979 election.

[15] In the second half of 1977, the new government passed a law giving banks the freedom to decide the interest rate to be charged and to be paid by banks for assets and liabilities operations with maturity longer than one year. Soon after, the government also reduced the amounts that banks were mandated to invest in specific government-sponsored projects. The reform effort continued a year later in the domain of external finance, as the government passed a decree allowing foreign banks to operate in Spain.

[16] The parliament finished drafting the constitution in April 1978. This was later approved by both the parliament (October 1978) and the voters in a referendum (December 1978).

(continued)

Peru 1995

32. Three key factors contributed to the re-election of the government. First, structural reforms were part of a broad macro-stabilization program aimed at ending the crisis (Figure 9).[17] Second, the government leader was perceived as ideologically distant from stabilization and promarket reforms and managed to elicit the necessary support to implement them. Third, several measures to reduce poverty and improve social cohesion were implemented.

- Fujimori was first elected president in June 1990. His election was rather unexpected, as he entered politics only in the second half of 1989, and his candidacy was supported solely by the new party Cambio 90 that he himself had created in October 1989. Soon after taking office, Fujimori had to confront the harsh reality of deep recession and inflation. He blatantly reneged on his promise to avoid the adoption of a macroeconomic adjustment package, adopting one 10 days after his inauguration, on August 7, 1990. The plan removed many subsides and raised prices of basic goods by up to 3,000 percent (Weyland 1998, Stokes 1997). To defend the adoption of the plan, Fujimori argued that budget and current account deficits were so large that his government had no other choice than to embark on austerity. A poll released in September 1997 showed that the adjustment plan received support from the majority of the population (Stokes 1997).

- Fujimori then continued his administration along the lines of economic liberalization. He removed import and export tariffs, liberalized capital market, reduced employment in public administration, and implemented reforms of social security state-owned enterprises, and financial institutions, as well as flexibilization of the labor markets (Figure 9, panel 1). Economic growth turned around, from –5.3 percent in 1990 to 7.1 percent in 1995 (Figure 9, panel 2), while inflation declined from 432.8 percent in 1990 to 10.6 percent in 1995.[18]

- In 1993, the government adopted several anti-poverty social programs, mostly targeted in those areas where the new constitution received less support during an October 1993 referendum (Weyland 1998). Fujimori arrived at the presidential elections (April 1995) with a solid

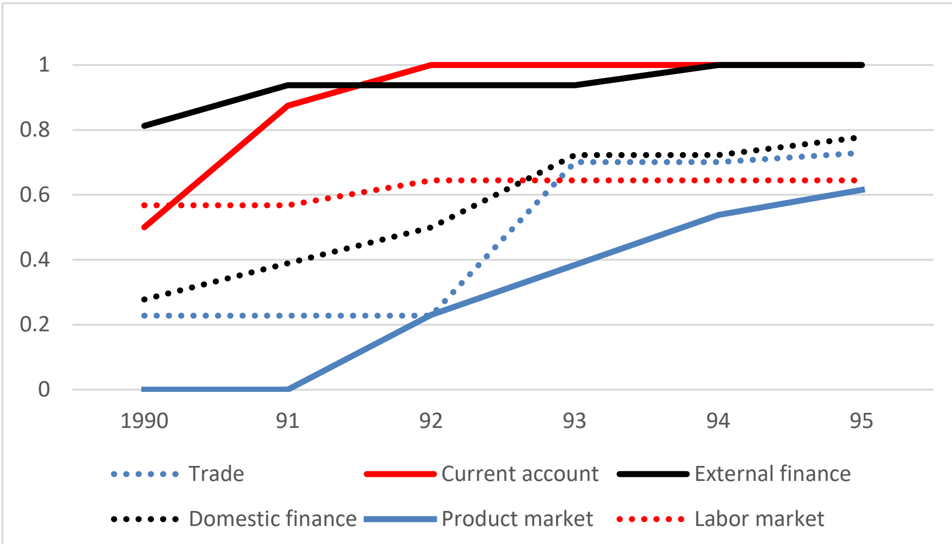
[17] See Santos and Werner (2015) for a discussion on the success of economic reforms in Peru.

[18] In addition to economic liberalization and improving macroeconomic performance, Fujimori's administration was also characterized by an important political development: the so-called autogolpe of 1992. During the first part of his administration, the lower and upper houses of parliament were still controlled by the opposition, which resulted in delays in the approval of Fujimori's proposed legislation. The president accused the opposition of obstruction and in April 1992 announced that he was temporarily dissolving the parliament and reorganizing the judicial branch of government. The legislative power was temporarily given to the executive branch and Fujimori managed to pass important economic as well as internal legislation to fight terrorists (guerillas). He called a new election for congress in 1993. Fujimori's party received absolute majority and the new congress was charged with drafting a new constitution. This was approved in 1993 in a referendum.

macroeconomic management track record and won the elections with a large majority (64 percent of votes).

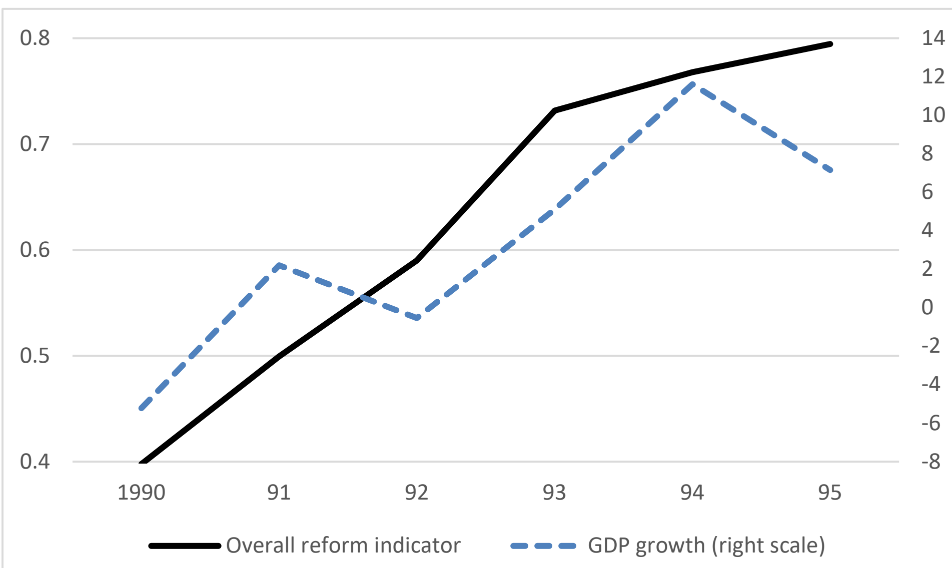
Figure 9. Structural Reforms and Economics Conditions in Indicators in Peru, 1990–95

1. Structural Reform Indicators



Note: The figure shows the evolution of the reform indicators prior to the 1995 election.

2. The Overall Reform Indicator and GDP Growth



Note: The figure shows the evolution of the average reform indicator (left scale) and GDP growth (right scale) prior to the 1995 election.

Source: IMF Staff calculations.

CONCLUSIONS

This Staff Discussion Note examines the question, based on the best-available empirical evidence,is the fear that structural-reform implementation will lead to political cost justified? The main finding: electoral costs can be substantially mitigated if political economy considerations are factored ex ante into policy design. Experience with past reforms points to three key lessons. First, reforms do not lead to electoral costs when implemented at the beginning of a government's term, pointing to the importance for newly elected governments to use honeymoon periods to generate longer-term economic gains. Second, not all reforms are associated with political costs, highlighting the importance of distinguishing real sector reforms that are generally benign electorally from financial reforms which seem to be more electorally costly. Third, the political costs of economic reforms seem to be salient mainly when reform is enacted during periods of weak economic activity. Notably, when overall growth conditions are favorable, enacting real sector reforms seems actually to increase re-election odds, and financial sector reforms seem benign electorally. Finally, even if reforming in bad economic times typically leads to electoral costs, there are exceptions. The case studies suggest that governments can avoid an electoral penalty when implementing reforms during tough times if (1) the country is transitioning to democracy; (2) reform-cum-stabilization is seen as unavoidable and there is strong ownership by political leaders; and (3) the government effectively signals credible commitment—including strong ownership—and enhances dialogue with business and civil society. The bottom line of our political economy analysis: there is a sound case for well-designed, appropriately timed, and carefully implemented structural reforms based on good communication and transparency to ensure broad-based support.

Box 1. Fiscal Consolidations and Electoral Outcomes

This box explores the electoral outcomes associated with fiscal consolidations. It finds that fiscal consolidations are, on average, associated with elector costs, but the effect depends on the design of the consolidation package. Electoral costs arise mostly from tax-based consolidation, with spending-based consolidation being largely benign from an electoral standpoint. In addition, growth-friendly consolidation packages are found to be electorally benign. Across types of tax-based consolidation, the effects are larger for measures aimed to increase corporate income and indirect taxes.

Structural reforms are often an integral part of macroeconomic stabilization packages aiming at reducing the public deficit and debt, improving economic stability, and fostering growth potential. As for structural reforms, fiscal consolidation measures can have political consequences for the governments implementing them. To complement the analysis presented in the main text, this box looks closer at fiscal consolidation measures and their impact on electoral outcomes.

The theoretical predictions from the literature suggest that elected officials could face potential benefits and costs from enacting consolidation. Implementing fiscal consolidation may signal competence and be rewarded by well-informed voters (Rogoff 1990). This is especially the case when the public debt is at high levels (Brender and Drazen 2008) and the voters see fiscal consolidation as inevitable. Fiscal consolidations may face political opposition and post-election penalty, when they lead to significant economic costs, and the tax burden is regarded as already high by voters (Brennan and Buchanan 2000). Besides, some fiscal consolidation measures may be politically costlier than others, depending on the way their costs and benefits are distributed in society. For instance, the median voter can support fiscal measures increasing progressivity while the business sector can provide strong opposition to measures aimed at improving corporate revenues.

Relying on two recent studies by Alesina and others (forthcoming b) and Chen and others (forthcoming), respectively, the box contributes to our understanding of electoral consequences of fiscal consolidation by analyzing how the electoral outcomes depend on the design of fiscal consolidation packages.[2]

To examine these issues, the probability of the re-election of the incumbent government party following fiscal consolidation is estimated using a Probit model. Fiscal consolidation episodes, which are exogenous to economic activity, are identified at their announcement date in the electoral term and, following Alesina, Favero, and Giavazzi (2019), classified between spending-based measures (fiscal contractions in which the predominant component is a cut in spending) and tax-based measures (fiscal contractions in which the predominant component is a tax hike). Within tax-based measures, they are distinguished between direct (corporate and personal income) and indirect measures (Dabla-Norris and Lima 2018). The baseline specification includes a set of control variables that could affect fiscal consolidations and/or electoral outcomes (such as, the initial general government debt, financial and debt crises, growth and change in unemployment during the electoral term, initial tax system characteristics). The sample includes 16 and 10 Organisation for Economic Co-operation and Development countries, respectively, during 1980–2016. The country-coverage and time-dimension of the sample is dictated by the availability of the exogenous fiscal consolidation measures.

The results suggest that fiscal consolidations are, on average, associated with electoral costs. A 1 percentage point of GDP consolidation (for each year of the term) lowers the probability of the re-election of the incumbent government party by nearly 20 percentage points (Figure 1, first bar). However, the effects depend on the design of the consolidation package. Electoral costs arise mostly from tax-based consolidation, with a 1 percentage point of GDP consolidation (for each year of the term) lowering the probability of the re-election of the incumbent government party by nearly 45 percentage points. In contrast, spending-based consolidation does not appear to affect re-election prospect (Figure 1, second and third bar). This result is consistent with previous evidence showing that tax-based consolidations have larger and more persistent detrimental effects on economic activity than spending-based measures (Alesina, Favero, and Giavazzi 2019). In addition, when controlling for changes in growth and unemployment during the party's term, the electoral effect of tax-based consolidation significantly diminishes (turning to be not statistically significant in some specifications), while the effect of spending-based consolidation turns to be positive (Alesina, Favero, and Giavazzi 2019).

Across types of tax-based consolidation, the effects are larger for measures aimed at increasing corporate income and indirect taxes (Figure 2). A 1-percentage point of GDP corporate income tax (indirect tax) consolidation lowers the probability of the re-election of the incumbent government party by almost nearly (11) percentage points. In contrast, the effect of personal income tax (PIT) reforms is small and not statistically significant.

In summary, the results of the box suggest that fiscal consolidation does not necessarily lead to negative electoral outcomes. The electoral costs of consolidations depend on the design of consolidation packages and the number of interest groups affected by these measures. First, spending-based consolidations, as well as reforms on corporate income taxes, are typically benign electorally. Second, growth-friendly tax and spending measures, such as for example a cut in inefficient spending, do not reduce the chance of re-election and in some cases increase it. Finally, fiscal consolidation packages can be designed to mitigate political costs by protecting vulnerable groups who bear the brunt of the reform (Banerji and others 2017).

Figure 1. Impact of Fiscal Consolidation on the Probability of Re-Election
(Percentage points)

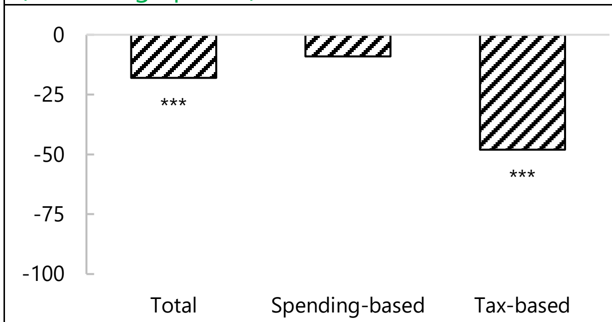
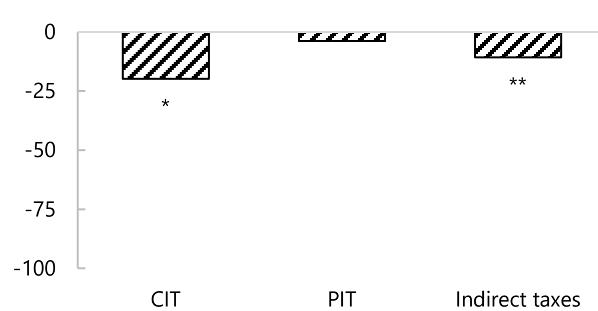


Figure 2. Impact of Tax-Based Consolidation on the Probability of Re-Election
(Percentage points)



Sources: Alesina and others (forthcoming b); and Chen and others (forthcoming).

Note: The regression results show the marginal effects. ***, **, * indicates significance at 1, 5, and 10 percent, respectively.

This box was prepared by Aleksandra Zdzienicka based on Alesina and others (forthcoming b) and Chen and others (forthcoming).

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