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Short-Term Pain for Long-Term Gain: The Impact of Structural Reform on Fiscal of Outcomes in EMU

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ABSTRACT/RESUMÉ

Short-term pain for long-term gain: The impact of structural reform on fiscal outcomes in EMU

The 2005 reform of the EU Stability and Growth Pact has provided leeway for governments to let their fiscal deficit temporarily breach the 3% rule to finance the immediate budgetary cost of structural reform, such as compensation schemes to offset redistributive effects. Against this backdrop, it is useful to dispose of empirical estimates of the effect of structural reform on fiscal outcomes, not only the short term cost but also the long-run fiscal gain stemming from changes in spending parameters and better economic performance. Based on econometric estimates for a pool of 21 OECD countries, this study finds a significant net fiscal gain of structural reform.

Key words: Economic and Monetary Union; Stability and Growth Pact; Fiscal policy.

JEL codes: E61; E62; H3; H5; H6.

* * * * *

Quelques coûts à court terme pour des gains durables: Les conséquences budgétaires des réformes de structure dans l'UEM

La réforme du Pacte de stabilité et de croissance (PSC) de l'Union européenne opérée en 2005 a ouvert la possibilité d'autoriser les États membres à dépasser temporairement le seuil de 3% afin de financer les coûts budgétaires de court terme que les réformes de structure peuvent engendrer, comme par exemple la compensation des effets redistributifs non souhaités. Dans ce contexte, il est utile de disposer d'estimations empiriques des effets budgétaires des réformes de structure, non seulement s'agissant des coûts de court terme mais aussi des gains à long terme qui résultent des modifications des programmes de dépense publique et d'une meilleure performance économique. Au moyen d'estimations économétriques réalisées sur un panel de 21 pays membres de l'OCDE, cette étude conclut que les réformes structurelles se traduisent au plan budgétaire par un gain net d'une ampleur significative.

Mots clefs : Union économique et monétaire ; Pacte de stabilité et de croissance ; politique budgétaire.

Classification JEL : E61; E62; H3; H5; H6.

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SHORT-TERM PAIN FOR LONG-TERM GAIN: THE IMPACT OF STRUCTURAL REFORM ON FISCAL OUTCOMES IN EMU

by

Paul van den Noord and Boris Cournède¹

1. Introduction

1. The disappointing compliance with the EU fiscal rules since the inception of the euro has prompted a lively debate, from which new rationales for allowing governments to temporarily run deficits in excess of the 3% of GDP ceiling emerged. Specifically, it has been argued that the long-run benefits from structural reform are often uncertain whereas the immediate budgetary costs – such as compensation schemes to offset redistributive effects – are perceived with greater precision. This asymmetry would discourage structural reform in the face of a tight fiscal rule, especially with regard to the labour market which entail the highest up-front fiscal costs. Allowing governments to run temporary deficits beyond the 3% mark to finance the up-front cost of structural reform would therefore be welfare enhancing (Beetsma and Debrun, 2005 and Von Hagen, 2003).

2. These arguments have not fallen on deaf ears at the European authorities. In September 2004, the European Commission put forward a proposal that encapsulated most of the ideas that had been around for some time (Van den Noord, 2006). Along with various other “exceptional circumstances”, the budgetary upfront cost of countries’ structural reform would have to be taken into consideration when assessing the fiscal situation. The interpretation of the “exceptional circumstances” clause enshrined in the Stability and Growth Pact (SGP) and the adjustment path towards compliance with the rules after a breach would both need to be adjusted. The reform that was adopted by the European Council in March 2005 went a long way towards incorporating these views. First, it explicitly included structural reform in the list of “other relevant factors” which the European authorities examine when deciding whether public deficits above 3% of GDP are excessive or not. Second, while the SGP calls EU countries to maintain their public finances close to balance or to move towards that objective by a minimum benchmark adjustment each year, the 2005 reform opens the possibility of deviations from these requirements for countries that introduce structural reforms.

1. The authors are members of the OECD Economics Department and can be contacted at paul.vandennoord@oecd.org and boris.cournede@oecd.org. The views expressed in this paper are the authors’ and are not necessarily those of the OECD or its member countries. Earlier versions of this paper have been presented to the European Commission Workshop on the Budgetary Implications of Structural Reform held in Brussels on 2 December 2005 and at the Banca d’Italia Workshop on Public Finance in Perugia on 30 March to 1 April 2006. The authors are indebted to Roel Beetsma, Marco Buti, Jean-Philippe Cotis, Ekkehard Ernst, Peter Hoeller, Vincent Koen, Dave Rae and Ludger Schuknecht for their valuable comments.

3. Obviously the underlying rationale is debatable. Countries not in breach of the rules (mostly the smaller countries) are not concerned, so with more fiscal leniency their better behaviour would not be rewarded, whereas the “sinners” (mostly the largest countries) would be off the hook for a while. The political economy behind this is straightforward (Buti and Pench, 2004). Owing to their greater trade exposure, smaller countries benefit more from international competitiveness gains associated with structural reform – they enjoy a first-mover advantage. This mechanism is much weaker in the large countries that, moreover, face larger multiplier effects on activity when forced to check their fiscal balance. As a result, big countries claim more fiscal “flexibility”, whereas small countries do not.²

4. Against this backdrop it is useful to dispose of empirical estimates of the effect of structural reform on fiscal outcomes. Two categories of fiscal effects are relevant in this context:

- The short-term cost of compensating the expected losers of structural reform or more generally of “bribing” the electorate. This is seen as a potential deterrent of structural reform to the extent the fiscal rules are biting.
- The longer-term impact of structural reform on expenditure and revenue levels, either directly via tax and expenditure parameters or via the effect of better economic performance onto the budget. This long-term benefit could help motivate structural reform, but this is strongly dependent of the degree of myopia of the government.

5. There are different approaches on which estimates of fiscal costs and benefits can draw: case studies, econometric estimates and estimates based on model simulations. The pros and cons of each of these approaches are well known. Case studies may not be fully representative and the validity of an (ex ante) model simulation is hard to ascertain – the good old Lucas critique still applies. In this paper basic econometrics is applied, complementing findings from case studies and model simulations reported by Giorno and Hoeller (2006). Econometric estimates suffer from selection bias since only structural reforms that actually have been implemented are included in the observations of whatever sample one uses. These are likely to be the least costly ones in terms of their short-run cost since the more costly ones have probably not been carried out. Hence econometric estimates may put a somewhat too favourable gloss on the short-term fiscal pain and long-term fiscal gain to the taste of policy makers. The results reported in this paper should be considered with this caveat in mind.

2. Methodology and data

6. The econometric technique used here tests for the existence of short-term cost and long-term benefits on the budget and gauges their respective size for a broad sample of OECD countries including euro area members. We first look at general government expenditure, which are expected to respond to structural reform. Given that we are interested in the short-run and long-run effects of structural reform, it is quite natural to apply an error-correction framework. Specifically, we estimate the following equation:

$$(1) \quad \Delta PRI_{it} = -\lambda (PRI_{it-1} - \alpha STR_{it} - \sum_k \gamma_k CON_{it-1} - \delta_i) + \beta \Delta STR_{it-1} + \varepsilon_{it}$$

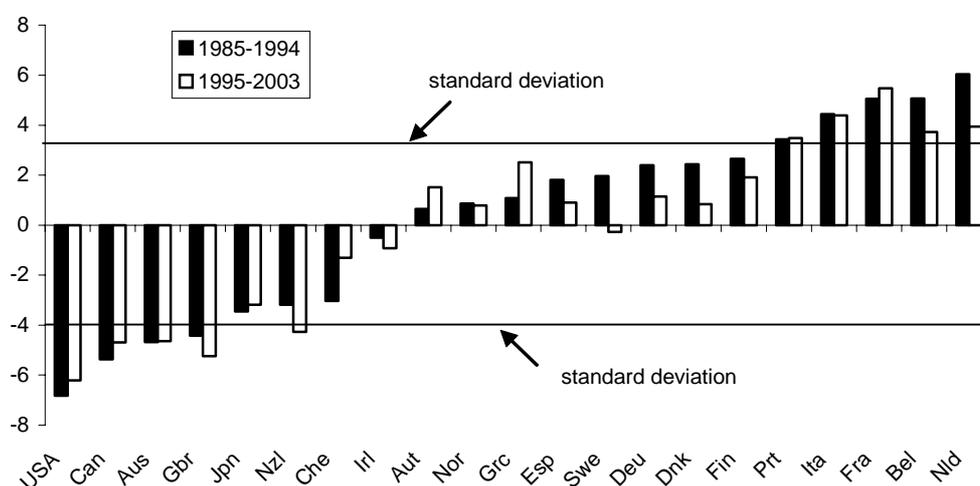
7. In this relationship PRI_{it} is the level of cyclically-adjusted primary expenditure as a per cent of GDP in country i in year t , and ΔPRI_{it} is its change over the previous period. In the second relationship. Time series for this variable is readily available in OECD’s *Economic Outlook* database. The variable STR_{it}

2. By the same token, large countries call for “co-ordination” of structural policies (in the absence of a first-mover advantage), while small countries care less.

is the overall stance of structural policies, with a higher value denoting a tighter stance, *i.e.* greater rigidity in product and labour markets. The term ΔSTR_{it} measures the intensity of structural reform, with a negative value indicating an easing of the structural policy stance, which is introduced in the equation to capture any upfront budgetary effects structural reform might have. δ_i are country fixed effects and ε_{it} is the normally distributed residual. Finally, CON_{it-1} is a vector of standard control variables to capture any other structural determinants of public expenditure, such as for example the age profile of the population, as well as the impact of longer-term fiscal constraints, in particular the liability position of the government. We expect structural reform to generate, *ceteris paribus*, higher expenditure in the short run, hence $\beta < 0$. We also expect the size of the public sector and therefore both public expenditure to be lower in the long run, hence $\alpha > 0$.)

8. Measuring structural policy has become a blooming new industry, so it is not obvious from the outset what indicator to use. The structural policy indicator capturing structural reform efforts referred to here is the one used by Duval (2006), which provides us with annual observations for the period 1985-2003 for 21 countries. The indicator is calculated as the sum of normalised OECD indicators in five fields (unemployment benefits, tax wedges, employment protection legislation, retirement incentives and product market regulation). They are displayed in Figure 1; as noted a higher value corresponds to a tighter stance (more rigidity) and *vice versa*, and a decline in the indicator suggests that “appropriate” structural reforms have been implemented. Countries that stand out by relatively “tight” stances (high value of the indicator) all are European countries. Some of these countries have also implemented major structural reforms in the past decade (notably Spain, Sweden, Denmark, Belgium and the Netherlands), suggesting that poor initial conditions are a good “predictor” of future structural reform (as confirmed by Duval, 2006). This is encouraging and suggests some tendency towards global convergence, perhaps helped by the Lisbon agenda.

Figure 1. Aggregate structural policy stance indicator



9. As noted, public expenditure is likely to be co-determined by a number of other structural variables (other than structural reform), for which we will need to control. Following Martinez-Mongay (2002), four controls have been considered³:

3. The type of electoral system is another factor that emerges from the literature as relevant for the size of government (majoritarian voting rules yield smaller welfare systems), but it will not be considered here (or rather this will be picked up by the country fixed effects). Baumol’s “cost disease”, which predicts that as

Table 1. Primary expenditure and its standard determinants

	Primary expenditure ratio (%)		Debt ratio (%)		Dependency ratio (%)		Openness (%)		GDP per capita (at 2000 prices and PPP, US\$)	
	1985-1994	1995-2003	1985-1994	1995-2003	1985-1994	1995-2003	1985-1994	1995-2003	1985-1994	1995-2003
Australia	31	33	29	30	17	19	35	42	34388	40831
Austria	47	47	58	69	22	23	70	84	33799	40647
Belgium	43	42	131	122	22	25	134	152	31551	38420
Canada	38	35	79	89	15	17	55	78	33499	38188
Denmark	49	52	74	63	23	23	69	80	34999	41837
Finland	47	48	30	58	12	13	52	69	30869	36492
France	46	48	42	67	21	24	43	50	34517	40164
Germany	41	43	39	60	22	25	50	59	37342	37164
Greece	31	35	74	110	22	27	46	50	16521	19717
Ireland	35	29	99	51	18	17	112	160	24755	42852
Italy	39	39	95	128	21	26	40	51	26902	31696
Japan	24	28	73	122	17	24	19	20	33239	37961
Netherlands	47	42	86	72	18	19	108	121	34166	42149
New Zealand	40	36	64	40	16	17	56	61	28474	32274
Norway	53	55	34	37	15	12	71	72	34502	46292
Portugal	30	37	65	64	20	23	64	66	19418	25232
Spain	33	32	53	67	20	24	37	54	24358	30583
Sweden	56	54	65	72	16	14	61	79	36600	40637
Switzerland	28	31	36	51	21	22	69	77	41653	43892
United Kingdom	38	37	43	48	24	24	51	56	32993	40808
United States	31	30	68	66	18	19	20	24	44591	52872
EU15 ¹	38	39	62	70	19	21	59	72	27473	33304
Average	39	40	64	71	19	21	60	72	31864	38129
Standard deviation	9	8	26	28	3	5	29	35	6670	7219

1. Unweighted average.

Source: OECD *Economic Outlook* database.

- *Per capita gross national income at 2000 purchasing power parities.* This captures “Wagner’s law”, which predicts that high-income countries will exhibit higher shares of public spending in GDP than low-income countries owing to a change in preferences in favour of public goods and services such as health care, education and social services. The expected sign is positive.
- *The dependency ratio.* Ageing puts pressure on notably health care and pension expenditure, hence a priori one expects public outlays to be higher in countries that portray a high dependency ratio (measured by the share of people older than 65 in the total population). The expected sign is again positive.
- *Trade openness (sum of exports and imports of goods and services as a per cent of GDP).* A standard finding in the literature is that more open economies will have bigger governments in order to protect their citizens against cyclical volatility in economic activity. However, in a globalising world small open economies, due to their greater exposure to international

an economy grows the relative price of public services and hence the share of public expenditure in GDP will increase, will be considered as already being captured by the per capita income effect.

competition, will also be under pressure to keep public expenditure and taxes low so as to secure flexibility and resilience, see Buti and van den Noord (2005) for evidence. Hence, the net effect on government size is ambiguous.

- *Public debt ratio to GDP.* There is a large body of literature providing evidence that governments whose debt position threatens to become unsustainable will rein in public expenditure or increase taxes. Hence in countries where public debt is high, expenditure will be negatively and revenues positively affected, and vice versa.

10. Table 1 provides an overview of the controls along with primary expenditure ratios to GDP. European countries which generally portray higher primary expenditure ratios, as expected, also tend to score higher on dependency and openness. But they nonetheless score lower on GDP *per capita* than the United States and their public debt is high. This suggests that the control variables are unlikely to be able to explain the bulk of the cross-country variation in primary expenditure. Accordingly, country fixed effects should play an important role, as confirmed by the estimation results.

11. For the error-correction specification to be valid, primary expenditure must be integrated of order one, hereafter abbreviated as I(1). Overall, the balance of evidence suggests that primary expenditure and current receipts are generated by an integrated process. Breitung's (2000), Im, Pesaran and Shin's (2003), the augmented Dickey-Fuller and Phillips and Perron's (1988) unit root tests fail to reject the null hypothesis of a unit root at standard confidence levels (Table 2). Furthermore, Hadri's (2000) test strongly rejects the null hypothesis of no unit root. Levin, Lin and Chu's (2002) test nuances of these findings as it rejects the null hypothesis of a unit root at the 5% level. The same battery of tests indicate that the first-differences of primary expenditure and current receipts are stationary. The upshot is that the series can be safely modelled as being I(1).

Table 2. Panel unit root tests on cyclically-adjusted primary expenditure

Test statistics, p-values between brackets

Test	Result
<i>Null hypothesis: unit root</i>	
Levin, Lin and Chu t statistic	-2.12** (0.02)
Breitung t statistic	-0.91 (-0.9)
Im, Pesaran and Shin W statistic	-0.43 (0.33)
Augmented Dickey Fuller chi square	50.9 (0.16)
Phillips and Perron chi square	26.4 (0.97)
<i>Null hypothesis: no unit root</i>	
Hadri z statistic	9.0*** (0.00)

Note: *, ** and *** denote rejection of the null hypotheses at 10, 5 and 1% levels. Tests assume the presence of country fixed effects.

12. The specification of Equation (1) as an error-correction relationship further requires the presence of co-integration between primary expenditure and the control and structural policy stance variables. Johansen's (1995) trace and maximum eigenvalue tests indeed find a co-integrating relationship between these variables.⁴

3. Estimation results

3.1. *Cyclically-adjusted primary expenditure*

13. Estimation results for the primary expenditure ratios following the specification in Equation (1) are shown in Table 3. The coefficients on the controls are all significant, and broadly in line with those reported by Martinez-Mongay (2002), except for the trade-openness indicator for which he finds the opposite sign.

Table 3. Estimated error-correction equation for primary expenditure

Explanatory variables	Dependent variable: Change in the share in GDP of Primary expenditure
Primary expenditure ratio (-1) (λ)	-0.15*** (0.03)
Dependency ratio (-1) ($\lambda\gamma_k$)	0.16*** (0.04)
Per capita income (-1) (log) ($\lambda\gamma_k$)	1.67*** (0.6)
Trade-openness (-1) ($\lambda\gamma_k$)	-0.017** (0.007)
Debt ratio (-1) ($\lambda\gamma_k$)	-0.015*** (0.004)
Structural policy stance (-1) ($\lambda\alpha$)	0.19*** (0.07)
Change in structural policy stance (-1) (β)	-0.22 (0.17)
Observations	357

Note: *, ** and *** denote significance at 10, 5 and 1% levels. Standard errors are reported between brackets.

14. The key result in Table 3 concerns the impact of the structural stance indicator on primary expenditure. The sign is as expected *i.e.* a tighter stance leads to higher primary expenditure and revenues. The long-run impact is not negligible: a structural reform equivalent to a cut in the stance indicator by one standard deviation (roughly corresponding to half the difference between *e.g.* France and New Zealand, Figure 1) reduces the primary expenditure ratio by around 4 percentage points. One health warning is in place though, namely that a country with a good regulatory environment for product and labour markets will typically also have a sound fiscal framework in place, in which case we may be over-estimating the pure impact of structural policy stances on public expenditure. Either way, though, the basic message would be that sound structural policies are associated with less rather than more public expenditure.

4. Detailed results available from the authors.

15. The change in the stance indicator captures possible upfront budgetary costs of structural reform. The sign in the expenditure equation is indeed negative as expected, and the absolute value of the coefficient is relatively high: a one standard deviation reduction in the stringency of regulation is associated with a temporary budgetary cost of 2/3 per cent of GDP in the following year. Despite its economic significance, however, the coefficient does not come out as statistically significant in the regression. The lack of statistical significance suggests that, while occurring, upfront costs are not very stable over time or across countries. But obviously the upfront cost may not be confined to higher expenditure; these could also show up as lower taxes in an effort to compensate losers through that channel. It is therefore likely that the short-term impact on the fiscal balances exceeds the expenditure effect. We provide evidence of this below, but we take a closer look at individual expenditure items first.

3.2. *A closer look at expenditure*

16. When looking at components of social public expenditure, drawn from the OECD's *Social Expenditure Database* (SOCX), the data confirm that inflexible structural policy settings are associated with higher levels of spending on social programmes and *vice versa* (Table 4). Statistically, the association is strongly significant for overall social expenditure and incapacity benefits. The close statistical relationship between the overall indicator of structural rigidities and spending on incapacity benefits is consistent with the view that disability pensions can be used as a form of income support for people who would otherwise find jobs in more flexible economies. Similarly, the link between spending on old age pensions and structural rigidities can be viewed as an outcome of the usually stronger incentive to retire earlier in more rigid economies (OECD, 2005). Expenditure on unemployment benefits is only weakly related to the structural policy stance with a lower confidence level and a smaller value of the coefficient, probably reflecting the presence of "Danish-model" labour markets that combine job flexibility with generous unemployment benefits.

3.3. *Implications for the fiscal balance*

17. Our estimates suggest that structural reform raises expenditure in the short run, and therefore we expect to find some deterioration in the fiscal position following structural reform in the short run. However, because in the short run revenues may fall in response to structural reform as compensation schemes may involve tax cuts, the short-run impact on the fiscal position should be rather stronger than that on expenditure. On the other hand, the long-run impact on the budget position may be expected to be small if one assumes that the tax take will be adjusted to the government's financing needs. These predictions can be directly tested by estimating a reduced form equation for the fiscal position. The equation has been specified in a partial-adjustment rather than error-correction form, as is common practice in the fiscal rules literature:⁵

$$(2) \quad BAL_{it} = \lambda BAL_{it-1} + \alpha STR_{it} + \beta \Delta STR_{it} + \sum_k \gamma_k CON_{it-1}^k + \delta_i + \varepsilon_{it}$$

5. Moreover, panel unit roots tests give compelling indications that the cyclically-adjusted fiscal balance, unlike some of its potential determinants, is stationary. Detailed test results are available from the authors upon request.

Table 4. Estimating error-correction equations for different spending items

Explanatory variables	Dependent variables:			
	Change in the ratio to GDP			
	Unemployment benefits	Old age benefits	Incapacity benefits	Overall social expenditure
Lagged ratio (-1)	-0.14*** (0.03)	-0.18*** (0.03)	-0.13*** (0.03)	-0.15 (0.03)***
Dependency ratio (-1)	0.004*** (0.01)	0.056*** (0.02)		0.19 (0.05)***
Per capita income (-1) (log)		0.77*** (0.3)		1.4** (0.6)
Trade-openness (-1)	-0.01*** (0.002)	-0.001*** (0.003)		-0.05*** (0.009)
Debt ratio (-1)	-0.006*** (0.001)		-0.0024*** (0.00078)	-0.02*** (0.005)
Structural policy stance (-1)	0.06*** (0.02)	0.095*** (0.03)	0.063*** (0.002)	0.33*** (0.08)
Change in the structural policy stance (-1)	-0.06 (0.05)	-0.11 (0.07)	0.04 (0.04)	-0.27 (0.18)
Observations	315	315	315	315

Note: *, ** and *** denote significance at 10, 5 and 1% levels. Standard errors are reported between brackets.

18. The equation, which includes country fixed effects, has been estimated with Bun and Kiviet's (2003) bias-corrected least-squares estimator for dynamic panels. Correcting for bias was necessary because the model includes a lag of the dependent variable and the time dimension is relatively short (18 years). In such conditions, the standard fixed-effect panel OLS estimator suffers from a sizeable downward bias on the coefficient on the lagged endogenous variable, which in turns implies biases on the other coefficients.⁶ Schematically, Bun and Kiviet's (2003) estimator is calculated in two steps. The first step is to run a regression without correcting for the Nickell bias. The results of the first-step regression are used to derive an estimate the bias (using Kiviet's [1995] formula), which is then subtracted from the first-step estimator to obtain the bias-corrected estimator. The probability distribution of estimators and the resulting confidence levels have been obtained with a bootstrap procedure.

19. As expected, a move towards more flexible structural policy settings, as indicated by a decrease in the indicator value, is associated with a temporary deterioration of the fiscal balance (Table 5). The coefficient on the change of the structural policy indicator has the expected sign and is strongly significant. On the other hand, the level of the structural policy stance has no statistically significant impact on the fiscal balance. This is consistent with our view that in the long run the stance of structural policy is closely linked to government size but has little effect on the fiscal balance. These results also broadly concur with findings by Heinemann (2006) and Deroose and Turrini (2006).

6. Originally described by Hurwicz (1950), this bias was rediscovered by Nickell (1981) for dynamic panel regressions.

Table 5. Estimated impacts of structural reform on the cyclically-adjusted budget balance

Explanatory variables	Dependent variable: Cyclically-adjusted general government net lending
Cyclically-adjusted government net lending (-1)	0.89 (0.03)***
Dependency ratio (-1) (log)	-3.7 (1.2)***
Debt ratio (-1)	0.036 (0.006)***
Structural policy stance	-0.17 (0.1)
Change in structural policy stance	0.7 (0.2)***
Adjusted R ²	0.91
Observations	378

Note: *, ** and *** denote significance at the 10, 5 and 1% levels. Standard errors are reported between brackets.

Conclusions

20. The econometric exercise in this paper offers evidence that the upfront budgetary cost of structural reform is small in comparison with the longer-term benefits for expenditure levels and, by extension, the tax burden. For the sake of illustration, consider a country which fits the estimated parameter values for primary expenditure in the first column of Table 3 and for the budget balance in Table 6. Assume that initially the budget is balanced and the primary expenditure to GDP ratio is 40%. Suppose this country embarks on a determined programme of structural reforms and, in five years, reduces the policy stance indicator by one standard deviation. The short-term impact will temporarily tilt the budget balance to a deficit of ½ per cent of GDP as the reform is implemented. But primary expenditure will gradually decline to a lower long-term ratio of 35% with half the reduction achieved in seven years after the start of the reform. In present value terms with a very conservative discount rate of 10%, the cumulative expenditure savings amount to 21% of GDP: investment in structural reform is worth making.

21. The very wide margin by which on average the estimated budgetary savings brought about by improvements in structural policy settings dominate their short-term costs begs the question as to why governments do not reform more. Part of the answer may be that, by their econometric nature, the estimates capture the properties of actual reforms but do not take into account potential reforms which have not been undertaken and could have a less favourable cost-benefit ratio. Still, this possible selection bias can hardly explain such a wide margin, suggesting other factors are at play. Short-term fiscal impacts are only one of the obstacles that policy makers face when they consider changes in structural policy settings. Distributional implications can be a source of considerable difficulties as the welfare gains from structural reform tend to be widely spread across society while the costs are more concentrated on smaller groups who can organise themselves more easily to bear on decisions. Because policy makers are under the regular threat of being voted out of office, they may also weigh the consequences of their decisions with a higher discount rate than is optimal for society at large. Ultimately, the budget constraint of the government (evaluated at the social discount rate) is unlikely to be often binding on policy makers when they decide on potential structural reforms or else they would make more use of the opportunities to reap large long-term fiscal gains at small short-term costs. To the extent that other obstacles play a more important role in the political decision making process, alleviating the budgetary constraint can hardly be an effective way of fostering structural reform.

22. What policy conclusions should be drawn from these findings? As noted in the introduction, at the margin the EU fiscal rules can occasionally act as a deterrent against structural reform. Even so, together with the analysis by Hoeller and Giorno (2006), the findings reported in this paper suggest a large degree of caution when using the new possibilities to relax fiscal rules in the SGP to accommodate structural reform. Since the fiscal costs of successful structural reform tend to be small, short-lived in comparison with the long-run benefit, and not often binding on policy makers, any related waiver from SGP rules should be limited, temporary and conditional on a detailed assessment of the short-term costs and long-term gains of the measures.⁷ While this seems to be the intention of the 2005 reform of the SGP, it could usefully be complemented with a strategy to tackle myopia at the source, by committing governments to adopt medium term fiscal frameworks on which they are genuinely held accountable.

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