

## What Shapes the Implementation of Structural Reform?<sup>1</sup>

*Over past decades many OECD governments have devised structural reforms in product and labour markets aimed at enhancing competition pressures and productivity. Some of these reforms have been successfully implemented; others met strong political opposition and were aborted or postponed. This chapter draws on recent OECD empirical analysis that looked at past structural reform experience in member countries and sheds some light on the factors driving the political feasibility of reforms. It discusses how reform-minded governments can facilitate the implementation of the desired changes in policies and institutions through a careful design of the reform process.*

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## Introduction

Governments throughout the OECD are committed to strengthen growth, employment and public finances. That the pursuit of these objectives requires in many countries extensive structural reform is also broadly recognized. Yet, progress has been uneven across both countries and policy fields. One reason for this arises from possible trade-offs with worthwhile non-economic objectives. However, differences in the depth, scope and timing of reform also reflect political constraints. Because reforms do not only increase overall welfare but also tend to alter its distribution across society, it has proved difficult to generate the necessary pro-reform consensus in the electorate. Better understanding the factors behind resistance to reform and finding the ways to overcome it are at the core of a new area for research, the so-called “political economy of structural reforms”, a field that the OECD has recently investigated in some depth.

These political economy issues are the subject of this chapter, which provides a brief review of reform patterns in OECD countries before taking stock of recent OECD research on the way in which economic and political conditions can affect the course of reform in product and labour markets.<sup>2</sup> The chapter then draws some conclusions on the reform strategies that could improve the chances of successfully implementing growth-enhancing policies.

## The bumpy road to structural reform

Progress in structural reform has been achieved in OECD countries over the past two decades. Over this period, the sequencing of reforms has generally seen reforms of trade, foreign direct investment and financial markets precede domestic product market reforms (IMF, 2004; Høj *et al.* 2006). Moreover, product market reforms have often preceded labour market reforms (Brandt *et al.* 2005).

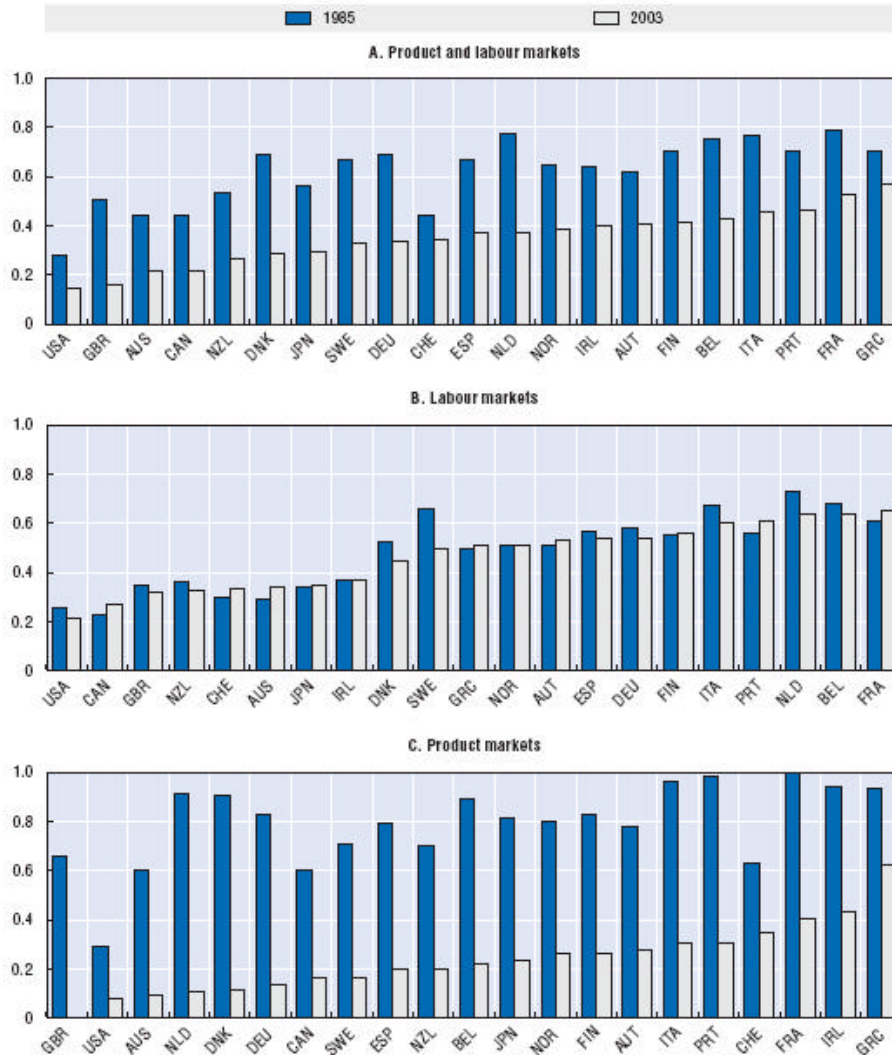
However, reform progress has been unevenly distributed across countries and policy fields (Figure 7.1). Reforms have generally been extensive in product markets, where competitive pressures have been enhanced, but much more limited and hesitant in labour markets. Especially in large Continental European countries and Japan, labour market reforms mainly resulted in lower tax wedges and more flexible temporary contracts. These reforms often interacted with other policies – such as strict hiring and firing rules for other contracts – to generate labour market dualism, with highly protected jobs for some groups but precarious job prospects for others that have a weak attachment to the labour market (such as young workers and women). In product markets, the depth and pace of reform differed across countries and sectors, with a few countries (the United States and other English-speaking countries as well as some smaller European countries) beginning reforms before the mid-1980s and large Continental European countries pushing ahead with reform, to different degrees, only over the past decade (Figure 7.2). Moreover, while in many OECD countries certain non-manufacturing sectors (road freight, air transport) were opened up to competition early on, in other sectors (energy, postal services and railways) regulations still hinder competition.<sup>3</sup>

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<sup>2</sup> The chapter is based mainly on Duval and Elmeskov (2005), Duval (2005) and, especially, Høj *et al.* (2006). All of these studies use panel regressions covering both the country and time-series dimensions to identify the link between indicators of structural policy settings and a number of political economy influences. The studies differ in coverage and methodology but, due to data constraints, all of them focus on the experience of 21 OECD countries, excluding the Czech Republic, Hungary, Iceland, Korea, Luxemburg, Mexico, Poland, the Slovak Republic and Turkey.

<sup>3</sup> Conway and Nicoletti (2006) provide a more detailed description of trends in sectoral product market reforms in OECD countries.

Figure 7.1. **Structural policy rigidities in 1985 and 2003**  
 Synthetic indicators of product and labour market policies



There are several reasons for these uneven reform patterns. Different initial conditions, collective preferences and – in the case of product markets – technology developments may have affected the feasibility and timing of reforms in different countries and sectors.<sup>4</sup> However, the most common explanation lies with the political difficulties met by reforms at the adoption and implementation stages. Indeed, even when reform needs were clearly identified by the policy community, pushing them through often proved challenging. In a number of cases, especially

<sup>4</sup> For instance, telecommunications reform is arguably related to technological advances that occurred over the past two decades and a similar case can be made for the role played by more recent technological developments in electricity generation (see, for instance, the discussion in OECD, 2001).

during the 1980s and early 1990s, the need to combine structural reform with fiscal consolidation further complicated the task.

Political obstacles to reform are of two kinds. In some instances, economic efficiency goals may be seen to clash with the attachment to existing policies of individuals or groups concerned by reform. This attachment may relate to notions of fairness (as in protection against arbitrary job dismissal), security (as for unemployment insurance) and avoidance of disruption (as in policies to secure the supply of crucial products and services). Sometimes the fear that reforms would endanger such values generates opposition also from groups that are not directly concerned by the change in policies. These concerns are especially acute when reform strategies include changes in income support schemes and hiring and firing rules.

Most often, however, it is the mismatch between the real or perceived costs and benefits of reforms that generates opposition to them. Reforms frequently entail highly visible costs concentrated on clearly identifiable groups of people (*e.g.* firms and workers incumbent in a sector or enjoying particular contractual arrangements) while benefits generally come later, may be seen as more uncertain, and are more widely diffused across society (*e.g.* among consumers or potential new job holders or businesses).<sup>5,6</sup> Typically, those who feel they would lose from reform – either because it would dispel advantages created by existing policies (such as when legal monopolies are eliminated)<sup>7</sup> or because it would imply transitional costs (such as when job losses are temporarily involved) – pose the greatest political economy hurdles to reformers.

### **What influences the progress of structural reform?**

While political difficulties in implementing reform are common, both their intensity and the ability of reformers to overcome them depend on a host of factors, which tend to shape the extent and course of reform in each country. Some of the factors influencing reform either cannot be controlled by the government or would involve undesirable collateral costs if they were exploited purposely. However, the ability to change the course of policy also depends on the way reforms are designed and implemented. The timing, scope and modalities of reform efforts as well as the interactions with macroeconomic policies, and among structural policies themselves, are levers that policy makers can use, in principle, to foster consensus around a structural reform agenda.

### ***Some drivers of reform are outside the government reach***

Deep economic downturns are typically associated with increased intensity of reform (Figure 7.3, Panel A). This observation is confirmed by cross-country empirical analyses showing that structural reform is often set off in times of crisis.<sup>8</sup> This may occur because crises weaken opposition to reform by exposing the unsustainability of existing policies. Country specific examples include the United Kingdom at the end of the 1970s, the Netherlands and New Zealand

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<sup>5</sup> The “collective action” problems generated by the asymmetry between the losers and beneficiaries of public policies have been stressed by Olson (1965); distributional and timing effects of reform by Coe and Snower (1997); and the role of uncertainty about reform outcomes by Fernandez and Rodrik (1991).

<sup>6</sup> In some cases, notably for labour market reforms easing employment protection legislation for regular contracts, the *perception* of costs and benefits dictates attitudes towards reform, with a large number of regular workers tending to overestimate the probability of losing their job and the smaller pool of unemployed tending to ignore the possibility of increased job opportunities under the new proposed rules.

<sup>7</sup> The influence of private interests on the design of public policies has been stressed earlier on by Stigler (1971) and Peltzman (1976).

<sup>8</sup> See, for instance, IMF (2004), Pitlick and Wirth (2003), Duval and Elmeskov (2005) and Høj *et al.* (2006).

in the 1980s, and Italy in the early 1990s. The influence of poor economic performance on reform implementation can be substantial: Duval and Elmeskov (2005) find that an output gap under 4% increases the probability of at least one major structural reform in product and labour markets by almost a third.<sup>9</sup> Of course, this empirical regularity is of little help to policymakers, insofar as experiencing a major crisis is hardly a productive way to promote structural reform. Even so, knowledge of the reform opportunities spurred by a deep downturn may be used to design a successful way out from an economic crisis.

Reforms are also conditioned by the political cycle. Given that the benefits of reform accrue with a lag whereas the costs typically arise upfront, the timing within the electoral period may influence a government's scope and appetite for change. In principle, the beginning of government tenure should be more propitious for reform. In practice, possibly reflecting political and execution lags, actual implementation of structural reforms in OECD countries has tended to gain momentum at mid-government term<sup>10</sup>. As shown in Figure 7.3 (Panel B), this has especially been the case for labour market reforms, perhaps reflecting the need to build up the necessary expertise. One implication is that political stability tends to be a prerequisite for reform. In addition, empirical analysis indicates that, on average, governments classified as left-of-centre have been less inclined to implement those labour market reforms that, aside from their expected effects on economic efficiency, are perceived to have potentially adverse effects on equity (Høj *et al.* 2006).

Other factors escaping near-term government control that may have a bearing on the propensity to implement structural reforms are demographic developments and country size. However, their effects are less clear-cut. The effects of ageing on reform implementation are, in principle, ambiguous, but the limited available empirical evidence suggests that it could spur at least some kind of structural reform, especially in product markets.<sup>11</sup> Country size may also matter, with small countries sometimes found to undertake more reform, as in Continental Europe over the past two decades. Reasons for this could comprise greater population homogeneity, which may ease decision making, and greater openness to trade, which increases competitive pressures and eases concerns that structural reform could lead to imbalances between aggregate demand and supply (see below).

**Figure 7.3. Crises, government tenure and progress in labour  
and product market reform**

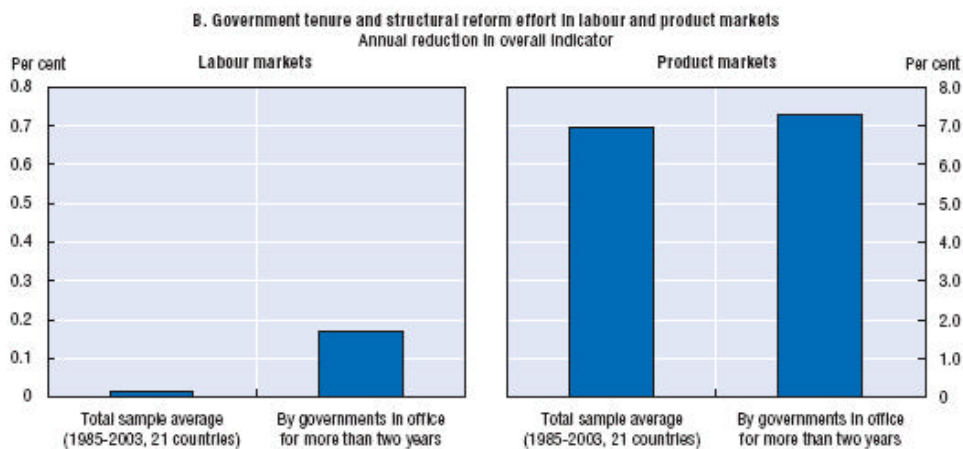
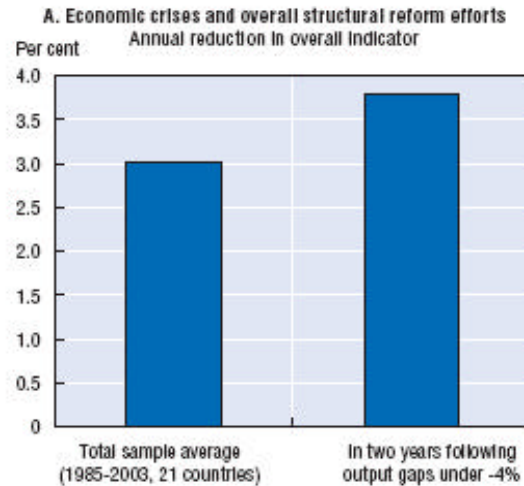
Annual percentage reduction in synthetic indicators of labour and product market policies

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<sup>9</sup> Nevertheless, reforms in certain specific labour market areas (*e.g.* job protection and income support systems) seem to be more easily implemented during upswings (Høj *et al.* 2006).

<sup>10</sup> See Høj *et al.* (2006). Presidential political systems and majoritarian electoral rules are sometimes held to favour structural reform. In practice, however, the empirical evidence for structural reform is more fragile than for macroeconomic policy reforms such as fiscal stabilisation.

<sup>11</sup> To the extent that older workers' and retirees' incomes are particularly affected by the rate of return on their savings, it is understandable that they should favour reforms making product markets more efficient and competitive (Høj *et al.* 2006). At the same time, they are likely to oppose reforms affecting pension systems (see, for instance, Galasso, 2006).



***Government policies can “grease the wheels” of reform***

***Monetary anchors and sound budgets may make reforms easier***

Macroeconomic policy plays a potentially important role in accommodating, and thus facilitating, structural reform. Such reform may alter the balance between demand and supply and monetary and fiscal policies have the potential to speed up the restoration of balance. For example, reforms that lower the structural rate of unemployment (NAIRU) and thereby expand potential output may not be accompanied by a corresponding immediate expansion of demand. Indeed, if structural reform increases uncertainty and precautionary saving, the opposite could happen.<sup>12</sup> Hence, it could take a while before actual unemployment falls to the level of the new, lower

<sup>12</sup> Reforms, notably in financial markets, could in some cases boost demand more than supply in the near term in which case the issue would relate to a need to restrain aggregate demand. As well, in countries with efficient financial markets, even labour market reforms could boost aggregate demand in the short run as expected gains in output are being capitalised in asset prices and thus stimulate consumption. Unfortunately, many of the countries most in need of labour market reform also appear to be ones where financial markets are unlikely to play such a role.

NAIRU. The prospect of such slow adjustment might discourage structural reform in the first place.

There are some reasons to believe that monetary policy could play a role in ensuring that aggregate demand and supply remain balanced in the wake of structural reform. Monetary policy anchored to a domestic target would ease if a widening margin of slack between supply and demand were to put downward pressure on inflation. Awareness of this “safety net” should in theory facilitate the implementation of structural reform.<sup>13</sup> Monetary policy geared to an external anchor – including exchange-rate targets, currency boards and participation in monetary union – cannot be expected to provide such a “safety net”, unless reforms are coordinated among countries and deflationary pressures arise in the common currency (or exchange rate) area. Nonetheless, such external monetary anchors may increase the pressure to undertake structural reform.<sup>14</sup> This is because, for instance, competitiveness losses suffered by individual members of a monetary union will not, in general, be addressed by the union’s monetary policy. Model simulations suggest that, in this context, incentives to reform would be particularly strong for small open economies, which would benefit most from the related competitiveness gains (Hoeller and Giorno, 2006). Empirically, there is no compelling evidence that an external anchor helps or hinders structural reform in general, but there is some indication that major structural reforms could be aided by monetary policy autonomy.<sup>15</sup>

While the evidence is mixed as to whether monetary policy influences structural reform patterns, there is stronger empirical support for the notion that fiscal policy can play a supportive role. The exact nature of the influence appears to differ across studies, however. One reason for finding a role for fiscal policy is that, like monetary policy, it can facilitate structural reform through the demand-management channel. This may explain why Høj *et al.* (2006) and Duval (2005) find that fiscal expansion is associated with more structural reform and contraction with less, an empirical finding which is illustrated in Figure 7.4. A similar reasoning may explain why these studies find that a healthy initial budgetary situation is associated with reform, notably in some labour market areas (such as benefit systems and labour tax wedges) – the scope for fiscal accommodation being larger when public finances are in better shape. Thus, while fiscal consolidation may make concomitant structural reforms difficult – notably because it draws on the political capital available to the government – it may prepare the ground for future reforms as budget balance is restored.<sup>16</sup> As illustrated by Figure 7.4, the quantitative impact of fiscal policy on reform may not be very large, with estimates suggesting that the likelihood of major reforms increases by 3 to 5% when a country improves its fiscal surplus by around 2 percentage points of GDP. Examples of

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<sup>13</sup> A number of further arguments as to why the orientation of monetary policy may affect structural reform are discussed in Nicoletti *et al.* (2001) and, in particular, Duval and Elmeskov. (2005)

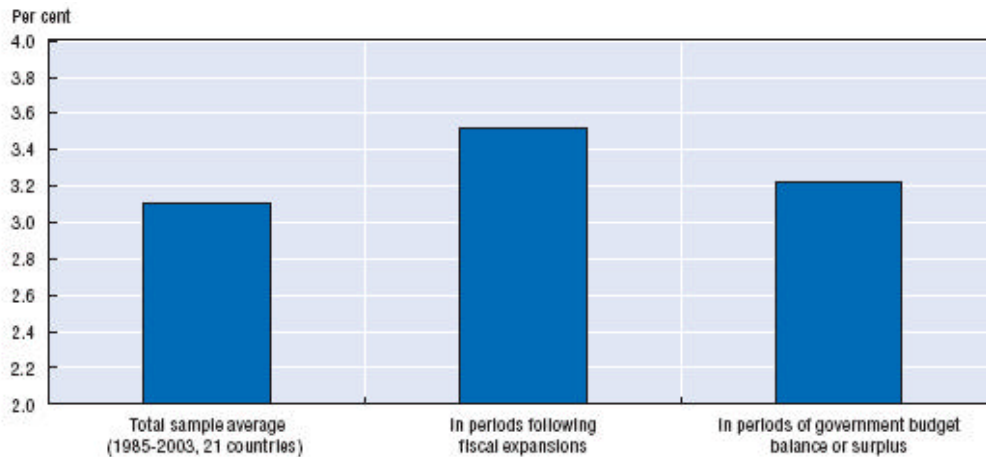
<sup>14</sup> This may be particularly true of participation in “hard” currency regimes, such as a monetary union, under which renegeing on existing exchange rate arrangements is typically more costly than under “looser” regimes – such as an exchange rate target

<sup>15</sup> Nicoletti *et al.* (2001) and, in particular, Høj *et al.* (2006) find little evidence of monetary autonomy playing a role at either the level of aggregate product and labour market reforms or at the level of individual policies. Duval and Elmeskov (2005), by contrast, find that the likelihood of major structural reforms in labour and product markets could be increased by between 5 and 20 percentage Points (the latter applying to larger, more closed economies).

<sup>16</sup> To some extent, structural reform may itself create the resources for fiscal adjustment later on. For example, reforms that boost the sustainable employment level also tend to durably improve government budgets, giving scope for tax cuts if the initial fiscal position allows. Empirical evidence of this phenomenon is provided by van den Noord and Cournède (2006).

this sequencing of policies are, for example, the experiences of Denmark and Ireland, which lowered labour tax wedges and liberalised product markets after extensive fiscal consolidation in the 1980s.

**Figure 7.4. Fiscal policy and progress in labour and product market reform**  
Annual percentage change in synthetic indicator of labour and labour market policy



However, the empirical results concerning fiscal policy may reflect more than its role in demand management. In particular, overcoming the resistance of groups opposed to reform may require the payment of compensation or the “grandfathering” of existing policies, which may show up as fiscal easing and require sufficient scope in the government budget. Regardless of whether it is the demand-management or the compensation argument that explains the empirical link between fiscal policy and structural reform, the current environment of substantial fiscal deficits and consolidation needs would not appear to be very propitious for structural reform. That said, in the case of EU countries, the 2005 revision of the Stability and Growth Pact provides scope to overshoot the Maastricht deficit threshold to some extent in the case of structural reform, and therefore in principle allows fiscal policy to “grease the wheels” of such reform<sup>17</sup>.

#### ***Structural reforms may strengthen each other***

There is substantial evidence that liberalisation in some policy areas is associated with an increased likelihood of subsequent liberalisation in other areas. At a very general level, estimates suggest that the likelihood of reform in one area is increased by over 5% when reforms in other areas have already been implemented (Duval and Elmeskov, 2005). In principle, such policy inter-linkages could be exploited to move forward on structural reform – to the extent policy areas can be identified where progress is easier and where such progress then makes it easier to reform other policies. A few examples are provided below. Nonetheless, caution is warranted: conclusions from the empirical evidence essentially rely on establishing causal relationships from the average past experience of OECD countries, which may not necessarily apply in all cases.

<sup>17</sup> Van den Noord and Cournède (2006) find that, on average, in those OECD countries where structural reform has been implemented, the estimated budgetary savings brought about by improvements in structural policy settings dominate their short-term costs.

Historically, liberalisation of international trade and financial flows has tended to precede other reforms.<sup>18</sup> This may indicate that reform in these areas are relatively easy to achieve – even if this may be less the case when such liberalisation has labour market implications or involves opening up control rights over enterprises to foreigners. Financial sector reform may prompt reforms in other areas because, as financial markets deepen and corporate control becomes tighter, it tends to put pressure on enterprises to increase their profitability, which is sometimes impaired by costly regulation in product and labour markets. Hence, financial liberalisation should increase pressures to reform such regulation. In practice, however, empirical linkages between financial market liberalization and other reforms have been documented for only a few sectors.<sup>19</sup>

The empirical evidence is much stronger concerning the effect of the external product market environment on domestic policies. Such external factors comprise labour and product market policies in other countries, tariff barriers, participation in international organisations, etc. For instance, OECD estimates suggest that these factors can explain a significant part of observed liberalisations in OECD telecommunications markets over the past two decades. There are different mechanisms at work. Liberalisation abroad may in itself serve as a source of inspiration. Moreover, together with domestic trade liberalisation it may increase competitive pressures on domestic enterprises and thereby strengthen proreform constituencies. EU membership and the Single Market Programme have also been strongly associated with reforms in domestic markets, and NAFTA has been found to exert a liberalising influence on trade policies. This suggests that, historically, an important avenue to generate impetus for structural reform has been an internationally cooperative approach to liberalisation.<sup>20</sup>

A fairly robust empirical finding across a number of studies is that liberalisation in product markets is often followed by liberalisation in labour markets. OECD estimates suggest that roughly one-fifth of the spread between most and least regulated labour markets in OECD countries could be related to differences in the stringency of product market regulations. There are a number of reasons why that may be so. One is that enhanced product market competition reduces the ability of firms to earn excess profits by squeezing their price-cost margins. This in turn undermines labour market institutions that make it easier for workers to share these excess profits with firms. Another is that product market reform may boost demand, employment opportunities and real wages, making it easier to undertake labour-market reform. For instance, product market reforms may improve the conditions for achieving an easing of employment protection rules, as such reforms are found to increase employment opportunities (Bassanini and Duval, 2006; Nicoletti and Scarpetta, 2005), thereby reducing the incentives for incumbent workers to protect their jobs through strict rules.

Regarding labour markets, different approaches to reform seem to be required depending on national circumstances.<sup>21</sup> No general empirical relationships in this area have been identified across countries. Some OECD countries that have gone far in reforming labour markets (*e.g.* United Kingdom, New Zealand) introduced deep changes in the system of industrial relations,

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<sup>18</sup> OECD member countries have progressively engaged in opening up international capital movements ever since the signature, in 1961, of the OECD Code of Liberalisation of Capital Movements.

<sup>19</sup> For instance, significant links were found between financial market deregulation and the liberalisation of telecommunications (Li *et al.* 2001) and air travel (Høj *et al.* 2006).

<sup>20</sup> This said, tariff cuts appear historically to have been associated with higher tax wedges and more generosity in unemployment benefit systems which, if not embedded in a system of mutual obligations, could impair labour market performance. These developments may have been part of the political package to allow liberalisation (Høj *et al.* 2006).

<sup>21</sup> See Chapter 4 in this volume and Chapter 6 in OECD (2006b).

undermining the influence of incumbent workers through, for instance, changes in union rights and procedures for industrial action. Others (*e.g.* Denmark, Ireland, and the Netherlands) have been able to achieve reform in more corporatist set-ups, where organisations are representative of wide constituencies.<sup>22</sup> Others still (*e.g.* Spain) at first bypassed incumbents by introducing reforms that mainly affected workers with a weak labour market attachment (*e.g.* using fixed-term contracts) and, when labour market duality subsequently became glaring, pressed for changes that would affect regular workers as well. In most countries, however, this reform strategy in the area of job protection has not been completed, thereby leading to dual labour markets, with precarious jobs for newcomers.

## Reform strategies

The review of the evidence on factors affecting structural reform implementation points to some tentative lessons, positive and negative, that can be learnt from the past experience with economic reform highlighted by OECD surveillance processes<sup>23</sup>.

First of all, the fact that opposition to reform is often grounded on complexities related to the costs and benefits of policy changes and the trade-offs between economic and other objectives suggests that comprehensive and transparent explanations are essential elements of successful structural reforms. The various stakeholders should have a clear understanding of the problems and of the solutions – including the involved costs and benefits – in both the short and the long run. To this end, use of outside expertise may bolster the case for structural reform.<sup>24</sup>

Secondly, the role of supportive macroeconomic policies should be recognised. Macroeconomic policies designed to keep aggregate demand close to potential output may facilitate the conduct of structural reforms by minimising the fear that structural change could be associated with deficient aggregate demand. In countries with domestic monetary anchors, it may be worth increasing awareness that if such shortfalls in demand were to result from structural reform, they will not be left to linger. In countries which participate in a monetary union, it may be considered whether there exist co-ordinated approaches to structural reform that would allow monetary accommodation consistent with price stability. Completion of the EU internal market is one case in point.

On the fiscal policy side, sound public finances are likely to create the wherewithal required for the introduction of some structural reforms, by providing confidence and room for manoeuvre. In countries where fiscal deficits are substantial, the necessary consolidation could complicate the course of reform in the short run but will ultimately help to create scope for macroeconomic accommodation or for transitional policies aimed at buffering the temporary costs of reform for stakeholders.

Thirdly, sequencing and synergies between structural policies may significantly facilitate reform. Internationally co-ordinated approaches to product market reform at or inside borders appear to

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<sup>22</sup> The role played by the quality of industrial relations for explaining differential unemployment developments across European countries over the past three decades is stressed by Blanchard and Philippon (2004).

<sup>23</sup> Several OECD bodies are involved in the multilateral peer review of structural reform in its country specific (*e.g.* economic surveys and regulatory reform surveys), cross-country (*e.g.* employment, competition and taxation policies) and international (*e.g.* liberalisation of capital movements) dimensions.

<sup>24</sup> Several OECD countries have established bodies whose primary task is to advise the government and inform the public on topics related to structural reform, a prominent example being the Australian Productivity Commission.

have been successful historically and to be able to generate momentum for further reforms. Obvious opportunities to pursue this route would be a reanimation of the currently stalled Doha Round and a rapid and effective implementation of the internal EU market for services. Further opening of borders and more extensive liberalisation of product markets within countries may also pave the way for labour market reforms. However, it has to be recognised that much of the low-hanging fruit has been picked in product markets and that reforms in those service sectors (including utilities) that remain heavily regulated will not be easy, partly because of the related labour market dimension.

In labour markets, the limitations associated with changes that are both strong and concentrating on the margins of the market have become increasingly clear in a number of OECD countries. For instance, experience suggests that selective easing of employment protection legislation focusing on workers weakly attached to the labour force, is unlikely to lead to more comprehensive reforms. Rather, the resulting labour market duality generally spurs opposition to further marginal reforms. The need for reforms establishing a common set of rules for shaping the career profiles and the mobility of workers without constraining job turnover is therefore more obvious. Several OECD countries were able to implement reforms of this kind, such as Austria in the area of hiring and firing rules and a number of other OECD countries in the area of unemployment insurance. The political viability of such reforms often hinges on the possibility to “grandfather” the initial rights of stakeholders during the transition to the new labour market environment.<sup>25</sup>

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<sup>25</sup> In Austria, new rules for work contracts include compensation in case of lay-off through a system of individual saving accounts that does not distort hiring and firing decisions of firms. Partly inspired by the Nordic “flexicurity” system, a number of countries have reformed unemployment insurance based on “activation/mutual obligations” approaches which seek to balance job-seekers taking more active steps to find work and/or improve their employability with more effective active labour market policies, backed by the threat of benefit sanctions.

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