Reform Reversal in Former Transition Economies of the European Union: Areas, Circumstances and Motivations

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Reversals are important, but under-researched

- Why focus on reform reversals?
  - Apparently wide-spread
  - No well-fitting models
  - Can be particularly damaging

- Why look into FTEs?
  - Uniquely fast-paced reforms in one generation
  - Uniquely strong role of external anchors
  - Possibly strong peer pressures, in opposing directions

- Why are they happening now?
  - Post EU accession
  - Post Crisis
  - Important episodes: role of path dependency
Slovenia: The anatomy of a major reversal episode

- Interplay of behavioral reversals in banking, SOEs/corporate governance and supervision
- External anchor (MIP) → Reversal of reversals: behavioral and formal (privatization)
- Spill-over → central bank independence
- Strong external anchor: ECB
- Spill-over
  - formal → behavioral
  - CB → banking
Poland and Hungary
Despite some similarities, very different episodes
Will the middle class protect reforms?

Gross disposable income of households per capita in PPS, 2005=100

Share of disposable income, three middle quintiles

Source: Eurostat
Reversals are inherent, spill-overs are central

- Rapid journeys stress-tested social learning in FTEs, leaving best-practice institutions with weak social norms

- Reversals:
  - an inherent characteristic of the reform process
  - wide-spread
  - formal (legislation) or behavioral (quality of institutions)

- Spill-overs are central:
  - formal to behavioral (and vice versa)
  - one area to another
  - one institution to another

- Major reversal episodes: interplay & spill-overs among reversals in different areas
Internal anchors remain weak

- Partial & opportunistic reversals can happen everywhere, Major & multifaceted reversals require strong governments
- Asymmetries in reversals & social norms
- Financial system: particularly prone to reversals
- Best-practice fiscal frameworks
  - not enough to anchor fiscal behavior.
  - reversals in fiscal behavior can transform into formal reversals in other areas (pensions)
- Crisis made FTEs more prone to reversals, but reversals can happen in good times too
- Other factors matter, but do not explain reversals
IMF and WB as external anchors

- Dominant anchors until EU accession started, afterwards EU gradually takes over
- (EU-) IMF programs:
  - Strong reform promoters, fending off major reversals
  - But prone to opportunistic reversals
  - Successful only up to a point
- IMF surveillance (A4):
  - Very efficient in identifying formal reversals
  - Less so regarding behavioral ones
  - Overall, a weak anchor
Strong anchor against formal reversals, but weak in preventing behavioral ones

- EU is a strong external anchor against formal reversals in areas covered by EU law, but
  - Can shift reversal efforts into other less-protected areas
  - Or transform formal reversal attempts into behavioral ones
- Weak against behavior reversals and areas not covered by EU law
  - MIP worked well when imbalances became excessive, but had weak preventive power
  - Difficult to detect behavioral reversals, especially in less transparent or legally well-protected areas – perverse behavior of independent institutions
How to strengthen internal and external anchors?

- Accelerate social learning
  - EU schemes: Erasmus+, similar for mid-career, life-long

- Focus on quality and coherence of institutions & reforms
  - SSRS: help quality & coherence & accelerate social learning

- Strengthen external surveillance, also based on an understanding of the nature of reversals & the role of spill-overs

- The political ambition ("want") of Euro area accession
  - Can spur reforms & lock in more than before (SSM)
  - But may well remain a weak anchor in other areas