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The short term effects of structural reforms and institutional improvements in OECD economies*

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Employing institutional indicators from the World Bank and an updated OECD dataset on product and labor market regulation and after controlling for the endogeneity via the augmented inverse probability weighting method we find that it is primarily governance or institutional improvements that have positive effects on real GDP in the short to medium term. On the contrary, product and labor market reforms increase real GDP only when government effectiveness is high and reform intensity is moderate.

*Authors' note: The views expressed in this column are the responsibility of the authors and do not necessarily reflect the position of the Bank of Greece and the Hellenic Parliamentary Budget Office.

Introduction

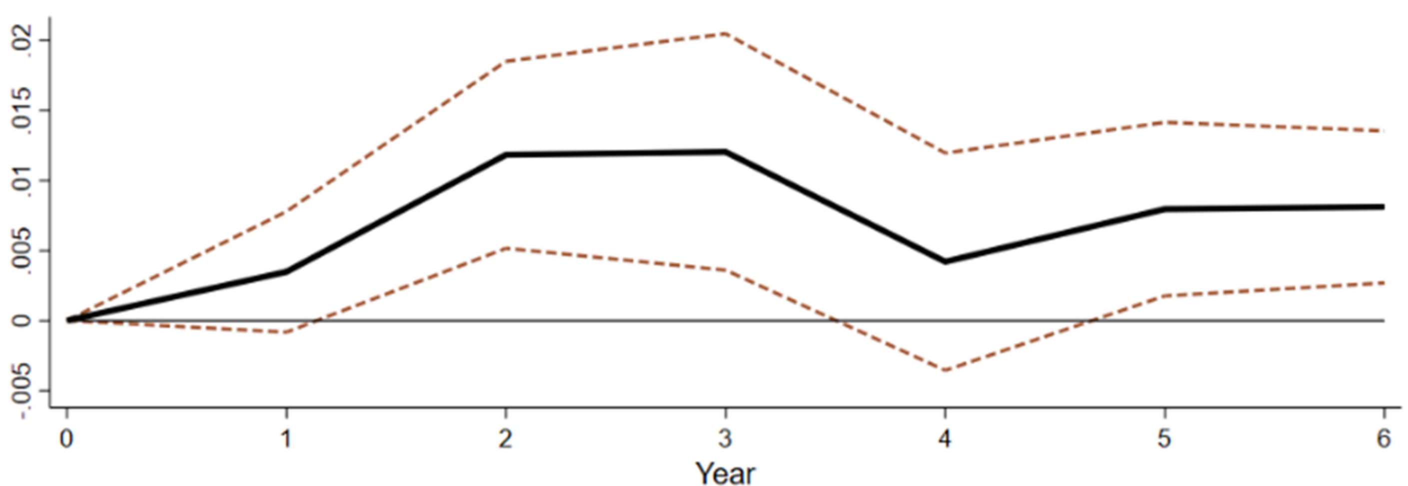
The level of regulation in various sectors of an economy can explain different growth trends across countries (Nicoletti and Scarpetta, 2003; Bassanini and Duval, 2009; Egert 2016; de Haan and Parlevliet, 2018), so structural reforms are high on the policy agenda in many OECD economies in the post-pandemic era as a way of boosting recovery and improving economic resilience and long term sustainability (OECD, 2021). Moreover, many scholars and policy makers recognize that better institution quality is a fundamental ingredient of sustained economic development (Kauffman and Kray, 2008; Fernandez and Tamayo, 2017; Li et al., 2020). Although there is plenty evidence for the benefits of structural reforms in the long term (Cacciatore and Fiori 2016; Barkbu et al. 2014), there is considerable doubt as regards their growth impact in the short term.

The main contribution of our paper (see Mavrogiannis and Tagkalakis, 2022) relates to the following: First, we study the impact of institutional improvements on growth (based on government effectiveness, regulatory quality and the rule of law obtained from the Worldwide Governance Indicators –WGIs) a topic that is not extensively covered by the literature ECB (2015). Second, we use the new OECD indicators of product and labor market regulation, which are available up to 2018. Third, based on the WGIs and the OECD indicators we construct reform dummies. Fourth, we account for the intensity of reforms, by examining both moderate and quite sizeable reform efforts. Fifth, based on the above we assess whether it is product and labor market reforms or institutional improvements that matter the most for growth in the short to medium term. Sixth, we use the augmented inverse probability weighting method to account for endogeneity and selection bias (see de Haan and Wiese 2022).

Results

Institutional changes aim to improve the functioning of public and economic institutions, to ensure the efficient functioning of the economy and consequently have a direct positive impact on economic growth. Improvements in government effectiveness lead to a higher quality of public services, greater independence from political constraints, and better policy outcomes. A major policy improvement in government effectiveness increases real GDP by 0.8% after six years (Figure 1).

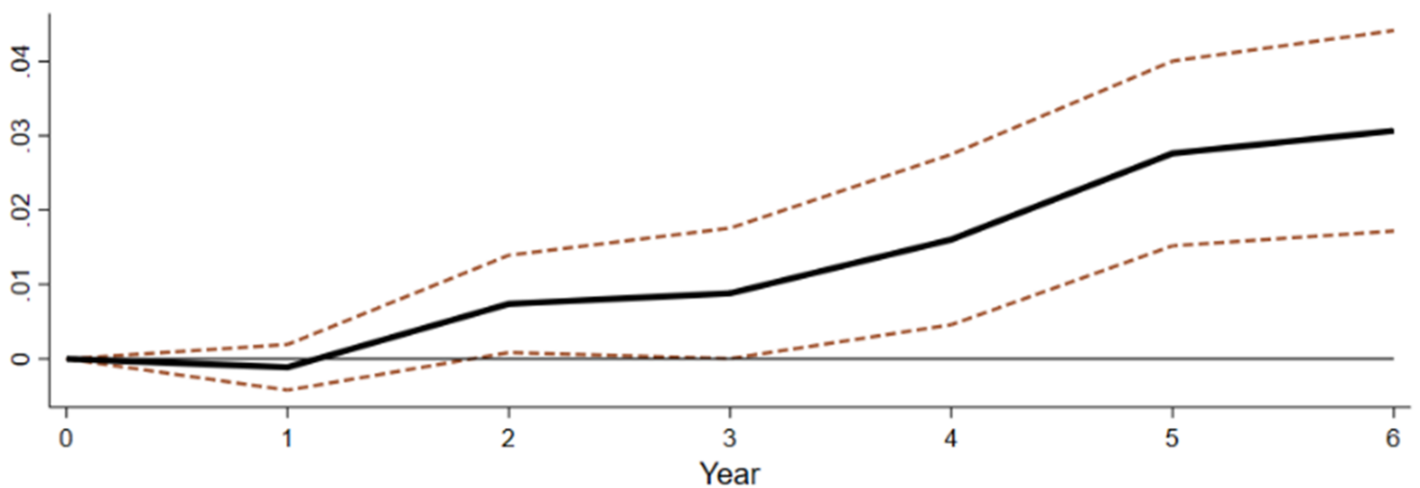
Figure 1: The impact of governance effectiveness on real GDP



Notes: The graph shows the cumulative response of real GDP on a major policy improvement of government effectiveness after six years. The red dotted lines denote the 90% confidence interval.

Major policy improvements in regulatory quality increase real GDP by 3% after six years (Figure 2). These interventions improve the government's ability to design and enforce appropriate rules and regulations that promote the better functioning of the private sector and promote economic growth.

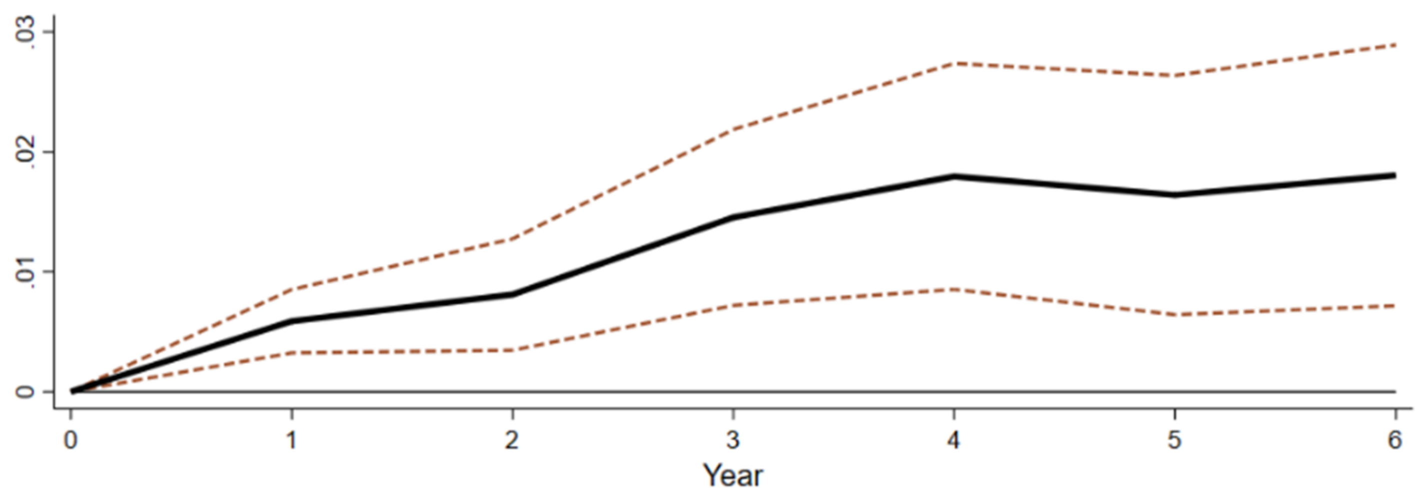
Figure 2: The impact of regulatory quality on real GDP



Notes: The graph shows the cumulative response of real GDP on a major policy change of regulatory quality after six years. The red dotted lines denote the 90% confidence interval.

Also major rule of law improvements can increase real GDP by 1.8% after six years (Figure 3). This result shows that ensuring the security of private contracts and property rights has a direct positive impact on economic growth Rodrik et al. (2004).

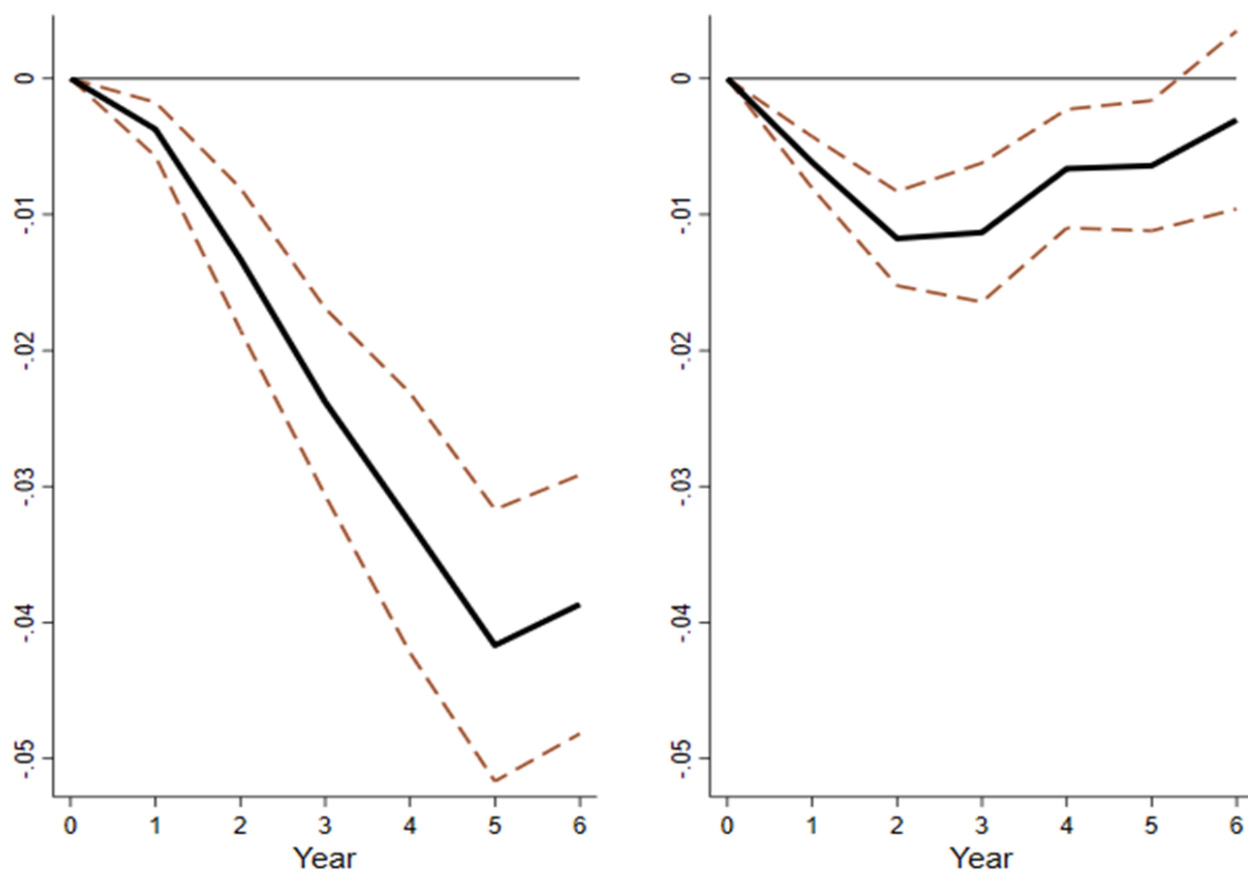
Figure 3: The impact of rule of law on real GDP



Notes: The graph shows the cumulative response of real GDP on a major policy change of regulatory quality after six years. The red dotted lines denote the 90% confidence interval.

Turning to structural reforms, in line with the previous literature (e.g. Duval and Furceri, 2018; de Haan and Wiese, 2022) we find that major reforms have negative effect on real GDP in the short to medium term (Figure 4). These results can be explained on the basis of a creative destruction argument in line with Schumpeter (1942) and Dachs et al. (2017) or alternatively they can be attributed to the fact that in the short to medium-term the cost exceeds the benefit of implementing the reforms.

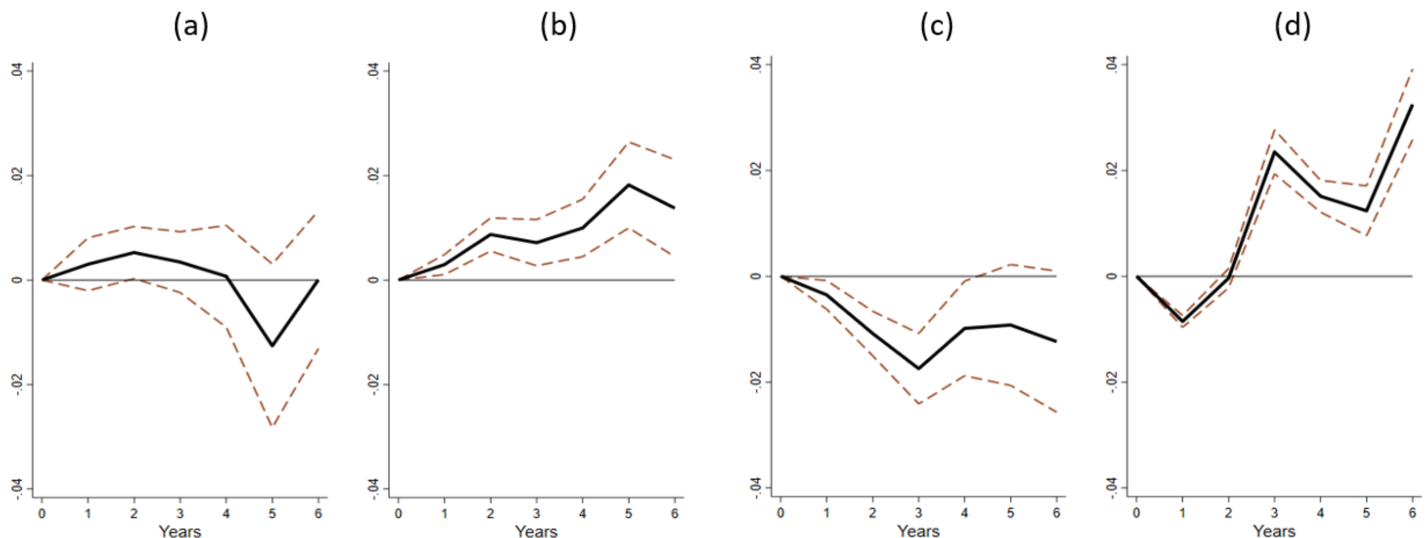
Figure 4: The impact of product market and labor market reforms on growth



Notes: The left graph shows the cumulative response of growth on a major product market reform, The right graph shows the cumulative response of growth on a major labour market reform after six years. The red dotted lines denote the 90% confidence interval.

However, we found that negative effects on real GDP resulting from the implementation of product and labor market reforms could be reversed depending on the reform intensity, the government effectiveness as well as macroeconomic conditions (see Mavrogiannis and Tagkalakis, 2022). More specifically, moderate product market reforms, when implemented within a policy framework of high government effectiveness, increase real GDP by 1.3% after six years (Figure 5.b). Whereas, moderate labor market reforms increase real GDP by 3.2% at the end of the forecast horizon in the context of high government effectiveness (Figure 5.d). When government effectiveness is low, both product and labor market reforms lead either to zero or negative effects on real GDP (Figures 5a, 5c). The results reflect the fact that legislated reforms are actually implemented and deliver the expected benefits when government effectiveness is high (Masuch et al., 2018).

Figure 5: The impact of moderate product market and labor market reforms on real GDP in cases of low and high governance effectiveness



Notes: Graphs (a) and (b) show the cumulative response of real GDP after a product market reform when the government effectiveness indicator is below (a) and above (b) the sample average. Graphs (c) and (d) show the cumulative response of real GDP after a labor market reform when the government effectiveness indicator is below (c) and above (d) the sample average. The estimated horizon is six years. The red dotted lines denote the 90% confidence interval.

Conclusion

According to the findings of the study (for more details see Mavrogiannis and Tagkalakis, 2022), implementing significant improvements in the institutional framework in terms of government effectiveness, regulatory quality and the rule of law should be a high priority on the government agenda and should precede the implementation of labor and product market reforms. Moderate and gradual reforms in labor and product markets should be preferred over drastic changes as they are more likely to lead to an increase in real GDP even in the medium term, provided they are implemented in a context of high government efficiency. This ensures that the reforms that are legislated are actually implemented.

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