What Are Structural Policies?

Monetary and fiscal policies deal with short-term economic fluctuations, but an economy's problems often go deeper

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ECONOMIES can get out of whack for a variety of reasons. Policymakers, in turn, have a number of ways to try to fix them, depending on what is wrong.

For example, when prices are rising too fast and consumers and businesses are buying at a rate that exceeds an economy's underlying ability to produce goods and services—that is, overall demand is growing too fast—policymakers can take steps to reduce demand. Similarly, during economic downturns, when businesses and consumers close their wallets—aggregate demand is shrinking—governments can take steps to encourage them to open their pocketbooks or substitute government spending for diminished private spending. Such government actions are called *demand management* or *stabilization policies.*

Sometimes an economy's problems are deeper and longer lasting than excessive or inadequate demand, usually as a result of government policies or private practices that impede efficient and fair production of goods and services—that is, supply. Fixing such problems can require changes to the fabric of the economy, called *structural policies*.

Stabilization policies are important in the *short run*, because it is easier to alter the various components of overall demand for a short time than it is to make a country's resources more productive. Stabilization policies include taxing and spending actions (see "What Is Fiscal Policy?" *F&D,* June 2009) and changes to interest rates and the money supply (see "What Is Monetary Policy?" *F&D,* September 2009).When longer-term, structural changes are required to improve aggregate supply, governments must address specific impediments. This may involve the core *structure* of the economy, such as how prices are set, how public finance is conducted, government-owned enterprises, financial sector regulation, labor market rules and regulations, the social safety net, and institutions.

The recent financial and sovereign debt crises triggered calls for bold structural policies in several euro area countries, while declining growth in many developed and developing countries pointed to a need for fiscal, financial, institutional, and regulatory reforms to enhance productivity and raise growth and employment. Structural policies not only help raise economic growth; they also set the stage for successful implementation of stabilization policies.

Dealing long term

Structural policies can zero in on a number of areas.

Price controls: Prices in free markets reflect the underlying cost of production. However, governments in some countries set the prices for certain goods and services—such as electricity, gas, and communication services—below production costs, particularly when the goods or services are produced by government-owned companies. These price controls lead to losses that the government must make up—which can cause budget and stabilization problems. Moreover, controls encourage higher consumption than would be the case if the prices of goods and services reflected the true cost of production. Underpricing leads to poor allocation of a society's resources. Were controls eliminated, prices would rise to cover costs, which would promote competition and efficiency.

Management of public finances: Although governments may briefly have to spend more than they take in during a recession—or collect more taxes than needed for a while to dampen spending in a boom—over the long term spending and taxing should be in synch. But complex tax laws and inefficient systems of tax administration, for example, can make it difficult to raise sufficient public revenue, which often leads to large budget deficits and accumulation of debt (a stabilization problem). That in turn can restrict a government's ability to finance development needs such as health care services, education, and infrastructure projects. Tax reforms can facilitate taxpayer compliance and raise revenue by removing exemptions, requiring advance payment of estimated tax liabilities, and simplifying the tax rate structure. Improved tax administration can also increase revenue. For example, better training and higher salaries for tax collectors could reduce corruption and help retain competent staff. Better management of public expenditures could result in more productive use of public funds.

Public sector enterprises: Government-owned enterprises make up a considerable share of the economy in some countries. Some operate efficiently and in the best interest of consumers. But often, because there is little if any competition, government-owned businesses deliver low-quality goods and services. Public businesses that compete with private firms often operate at a loss because of political influence or higher operating costs (as a result of unneeded workers, for example), and the government must make up the losses. Stabilization problems can arise if these government enterprises have to borrow from commercial banks to cover the losses. The loans are usually guaranteed by the government, which imposes contingent liabilities on the government budget because the government will have to pay if the enterprises don't. Countries with large state-owned enterprises could sell them to private individuals or firms. Or they could maintain public ownership in general, but take such steps as closing enterprises that are inefficient or have losses, changing their management, or reducing the labor force to align it with business needs—with an appropriate safety net to protect the laid-off staff.

Financial sector: The financial sector's role is to channel funds from savers to borrowers. A sound financial sector helps ensure that such funds are used in the most productive manner, which leads to higher economic growth and development. However, underdeveloped or poorly regulated financial systems in some developing countries could hamper economic growth and make it more difficult to conduct stabilization policies. For example, central banks generally carry out monetary policy by buying and selling on the open market securities that governments have sold to the public. But if there are no so-called secondary markets for government securities, or if they are poorly developed, central banks could be constrained in their attempts to carry out effective monetary policy and may have to resort to inefficient (or unfair) policy tools, such as credit rationing or interest rate controls. Inadequately regulated banks may engage in risky behavior that leads to banking crises—such as a "run," when worried depositors rush en masse to take out their funds, or a failure, which is generally the result of bad lending practices. But even sound banks can fail if they get caught up in a systemwide run that exhausts the cash they have to pay depositors. Banking crises can interrupt the flow of funds to borrowers, discourage saving, and lead to higher government deficits if the state guarantees deposits or recapitalizes banks. Policymakers can fix underdeveloped financial systems through the introduction of secondary markets, the development of stock markets, and the privatization of government-owned banks. To mitigate crises, policymakers must shore up the financial system through effective regulation and supervision.

Social safety nets: Governments often have programs designed to safeguard a minimum standard of living for the poor and other vulnerable groups. But in many developing countries some costly programs—like fuel and food subsidies—are poorly targeted and benefit the rich more than the poor. In developed countries, pay-as-you-go pension programs have huge unfunded liabilities because more people are retiring than entering the workforce. In addition, generous unemployment benefits often contribute to high unemployment because employers, who pay unemployment insurance premiums, are reluctant to hire new workers. Governments can change social safety nets to target the needy and achieve considerable savings. To focus on the needy, governments could give low-income households vouchers for basic food items or distribute food only in areas where the poor live. The government could also replace food and fuel subsidies

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with cash transfers. Pension programs can be changed so that benefits are aligned with projected revenues by raising the retirement age or fully funding pension systems.

Labor market: Unemployment is prevalent in many countries for a variety of reasons and usually rises when the economy is not doing well. But sometimes the cause of unemployment is deeper than the effects of the business cycle. For example excessive social security contributions or a relatively high minimum wage may so boost the cost of hiring that demand for labor shrinks and unemployment rises. Demand for labor may also fall if workers lack the necessary skills because of inadequate training or education. Reforming education and improving on-the-job training programs can help restore demand for labor.

Public institutions: The performance of public institutions can significantly affect a country's economic environment. For example, low government salaries, say in tax administration, can encourage corruption. Also, inefficient legal systems and shortages of courts and judges make it hard for businesses to resolve disputes, which increases costs for businesses and deters investment, especially foreign direct investment—hurting economic growth. Governance and institutions can be improved by simplifying business regulations and licensing, enhancing the country's legal system, streamlining the system of tax administration, and raising salaries for government staff in charge of providing vital services while limiting employment in the public sector to business needs.

Hand in hand

Raising an economy's growth potential requires stabilization and structural policies that complement one another. Stabilization policies lay the foundation for economic growth by helping lower inflation, smooth out consumption and investment, and reduce government deficits. Successful implementation of structural policies is possible only after such macroeconomic imbalances have been resolved. Similarly, though, structural policies enhance the effectiveness of many stabilization measures: promoting competition (a structural policy), for example, can lead to lower prices and, hence, lower inflation (the goal of stabilization policies). ■

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