Structural Reforms at OECD Countries

The international monetary and domestic legislative causes of policy similarity

Nobuhiro Hiwatari

Abstract

This paper explores the international economic and representative democratic determinants of production market policies, which has been showing a very similar trend among OECD countries since the 1980s. The originality of this paper lies in its incorporation of economic recessions and partisan preferences as critical causes. This paper finds that most countries undertook structural reforms in order to revive the economy and boost trade without disrupting monetary stability in a volatile international context, although some governments undertook the reforms as a domestic response to a banking crisis. This finding combined with the discovery that a right legislative median rather than the inauguration of a rightist government promotes structural reforms casts doubts on the interpretations that claim structural reforms are a creature of governments representing international trade interests or staunchly devoted to market fundamentalism.

Key words: economic recessions, structural reform, partisan preferences, OECD countries, international political economy

I. Introduction: Why Structural Reform?

One of the most prominent offshoots of economic globalization is the effort by governments to stabilize monetary policy and currency values against the volatile world of rapid and massive short-term capital movements. The spread of financial liberalization and the increase in capital mobility have introduced monetary volatility that has fundamentally changed economic policymaking. Generally speaking, financial globalization has increased the danger of a currency crisis or a twin crisis, it has synchronized economic downturns and made financial crisis contagious, and it has limited the utility of traditional policy tools available for governments to revive the economy from recessions (Eichengreen et al. 1995, Eichengreen and Wypolz 1998, Kaminski and Reinhart 1998, Cusack 1999, 2001, Oatley. 1999, Clark and Hallerberg 2000, Leblang and Bernhard 2000, Way 2000).

In the advent of these new economic circumstances, international economic organizations, such as the OECD, the IMF, or the EU, have insisted that advanced economies pursue a course of monetary stability and carry out structural reforms to enhance domestic competition and international competiveness. The prescription has been insisted upon even during hard economic times of high unemployment as an alternative to counter-cyclical fiscal spending, and has become a prescription often chided by the critics as market fundamentalism.

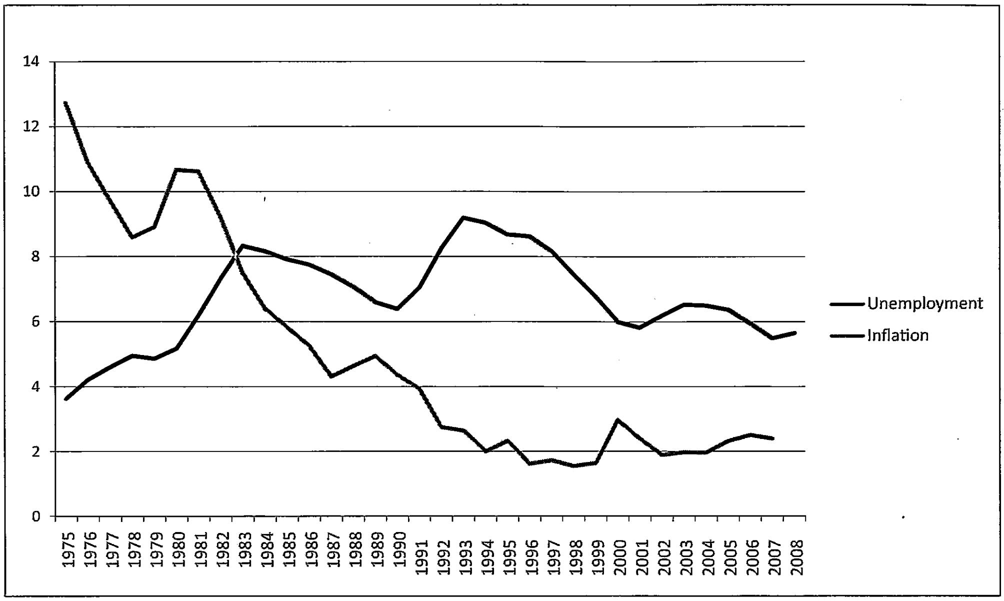
Table 1 lists the years of recessions at OECD countries since the mid-1970s. The Table shows a synchronization of economic cycles among OECD countries. Figure 1 traces the trends in average inflation and unemployment rates of OECD countries. The data clearly indicate that governments have been able to control inflation even while allowing unemployment rates to remain higher after recessions. In spite of efforts to stabilize monetary relations, the early 1990s recession triggered currency crises across Europe causing what are to date the only three known cases of a twin currency and banking crisis in OECD members - those of Norway, Finland, and Sweden. Although twin crises are more frequent in developing countries, the fact that developed economies are by no means safe from both a banking or currency crisis has been amply demonstrated by the 2008-09 global recession. Furthermore, persistent high unemployment in the wake of recent recessions is often ascribed to the inability of OECD governments to deploy the full arsenal of monetary and fiscal policies in the advent of the free capital flows (cf. Cusack 1999, 2001, Clark and Hallerberg 2000, Way 2000) In the face of free capital movements, governments facing recessions can no longer rely on fiscal and monetary expansion, instead finding themselves compelled to choose between fiscal expansion, if they have adopted a fixed exchange rate, and monetary expansion, if they have allowed the currency to float. Moreover, if governments heavily prioritize monetary stability and fear that expansionary monetary or fiscal policies, whichever available, might ignite inflation, that fact might

Table 1. Recessions at 20 OECD countries (1975-2008)

	Late 70s	Early 80s	Late 80s	Early 90s	Late 90s	Early 2000s	Late 2000s
Australia	1977	1980,82-83	1985-86	1990-91		2001	2008-
Austria	1975,78	1980-81,84		1991-93		2001,03	2008-
Belgium	1975,77	1981,83		1991,93	1996,98	2001	2008-
Canada	1977	1980,82	1986	1989-91	1995	2001	2008-
Denmark	1975,77	1980-81	1987,- 89	1993		2001	2007-
Finland		1980-81		1991-93		2001-2002	2008-
France	1975	1980,83		1993		2001	2008-
Germany	1975,77	1980-82		1992-93		2002-2003	2008-
Ireland	1976,79	1983	1985-86	1991	1996,98	2000-01,03	2008-
Italy	1975,77	1981-82		1993	1996	2002-2003	2008-
Japan		1980	1986	1991-93	1997-99	2001-2002	2008-
Netherlands	1975,77	1981-82	1987	1991,93		2001-2003	2008-
New Zealand	1975,77-78	1982	1985	1991	1995,98	2001,2005	2008-
Norway	1977	1981-82	1986-89		1998	2001-2003	
Portugal	1975,77-78	1981,83-84		1990,92-93		2001-2003	2008-
Spain	1975,78-79	1981		1992-93		2001	2008-
Sweden	1976-77	1980-81		1990-93	1996	2001	2007-
Switzerland	1975-76,78	1981-82	1986	1991	1999	2001,03	2008-
UK	1975	1980-81	1984	1989-92	1995	2001	2008-
US	1975	1979-80,82		1990-91	1995	2001	

Recession Year: De[ined as when growth rates (a) fall one standard deviation below country average, (b) are negative, or (c) decline over 1.25 percentage points

Figure 1 Unemployment and inflation rates of OECD countries



make them reluctant to undertake bold expansionary measures. Under such circumstances, instead of counter-cyclical spending, or disruptive monetary expansion, governments are advised to expedite structural reform.

In spite of efforts by OECD governments to realize monetary stability, even at the cost of rising unemployment, there has been little empirical investigation on whether international financial volatility and synchronized economic downturns have made them receptive to structural reforms, liberalizing their supply - side policies. Recent empirical studies of structural reform have unearthed some of its determinants but without providing an underlying explanation (Pitlik and Wirth 2003, Belke et al. 2007, Pitlik 2007, Alesina et al. 2006, Alesina et al. 2008, Duval 2008, Buti et al. 2009, Wölfi et al. 2009).

This paper hopes to fill that vacuum. Thus, the focus, or dependent variable, of this paper is policies aimed at liberalizing regulations in production markets to increase the mobility and efficient use of capital, i.e. policies aimed at increasing investment, facilitating competition, and promoting industrial structural change. The paper focuses on production markets since the existing research on labor market reform suggests that politics of reform differ considerably between production and labor markets (Elmeskov et al. 1998, Blanchard and Wolfers 2000, Howell ed. 2005, Nickell, et al. 2005, Baccaro, and Rei 2007).[1] This makes a detailed examination of labor market reform including necessary comparisons with product market reform beyond the scope of a single paper.

1) It should be noted that the dependent variable in the empirical studies of labor market reform have almost always been unemployment rates, reflecting the practical concern that highly regulated labor markets are the cause of persistent high unemployment in Europe during the 1990s.

Figures 2a and 2b depict the trends of structural reforms analyzed in this paper. The trends seem quite straightforward: Structural reforms have been proceeding since the 1980s, depicting a very similar trajectory across all OECD countries. This convergence of policy outcomes, however, does not mean that a single cause is responsible. There are two widely accepted explanations concerning this convergence: one is economic globalization and the other is diffusion of policy ideas (Simmons and Elkins 2004, Simmons et al. 2006, Swank 2006). Although these explanations are powerful, there is enough circumstantial evidence against these ideas to warrant an investigation. For instance, if economic globalization matters, why would a low trade dependency country like the United States be a trailblazer and continue to do so, or why would a similarly low trade-dependency country with chronic trade surpluses like Japan feel compelled to follow? Similarly, if neoliberal ideas matter, why would countries with social democratic governments eagerly adopt a neoliberal prescription? Even if such European countries were small open states dependent on trade, why don't we see more policy reversals and idiosyncratic movements as party governments change, instead of the consistent pattern we see in Figures 2a and 2b?

In short, this paper investigates the circumstances under which governments are more likely to enact structural reform to facilitate industrial competition, investment, and restructuring. More specifically, this paper asks three interrelated questions that hitherto not fully addressed in the existing literature on the policy effects of economic globalization or on idea dissemination. The first question is whether international recessions and the quest for monetary stability is the major cause that prompts governments to contemplate structural reforms. Secondly, this paper probes whether there are any domestic policy factors that facilitate structural such reforms regardless of the ideological orientation of the government. Here, the paper focuses on the size of the fiscal state, derived from the "small state" literature of the 1970s and 80s (Katzenstein, 1983, Cameron 1978, 1984). Finally, and most importantly, this paper asks why the changes in policy positions of major party and changes of government have not introduced more diversity in product market policies, a venue of investigation inspired by the literature on dynamic representation and democratic institutions (Lijphart 1999, Budge and McDonald 2005). Thus, international financial volatility, the fiscal size of the state, and preference shifts constitute the independent variables of this study.

With regard to these issues, there are reasons to expect that (a) governments facing recessions in the advent of economic globalization have strong incentives to pursue monetary stability and enact production market reforms, (b) a large fiscal state could facilitate such reforms by subsidizing labor mobility and easing opposition to industrial restructuring regardless of the incumbent government's ideology, and that (c) the stable pattern of structural policy changes reflect the legislative median's preference rather than shifts in the government or the underlying electoral institutions. Brought together, and if corroborated, these expectations provide a coherent explanation, hopefully more persuasive than the economic globalization or idea diffusion literature. A short explanation of the theoretical foundations of each expectation,

Figure 2a Trends in OECD regulation

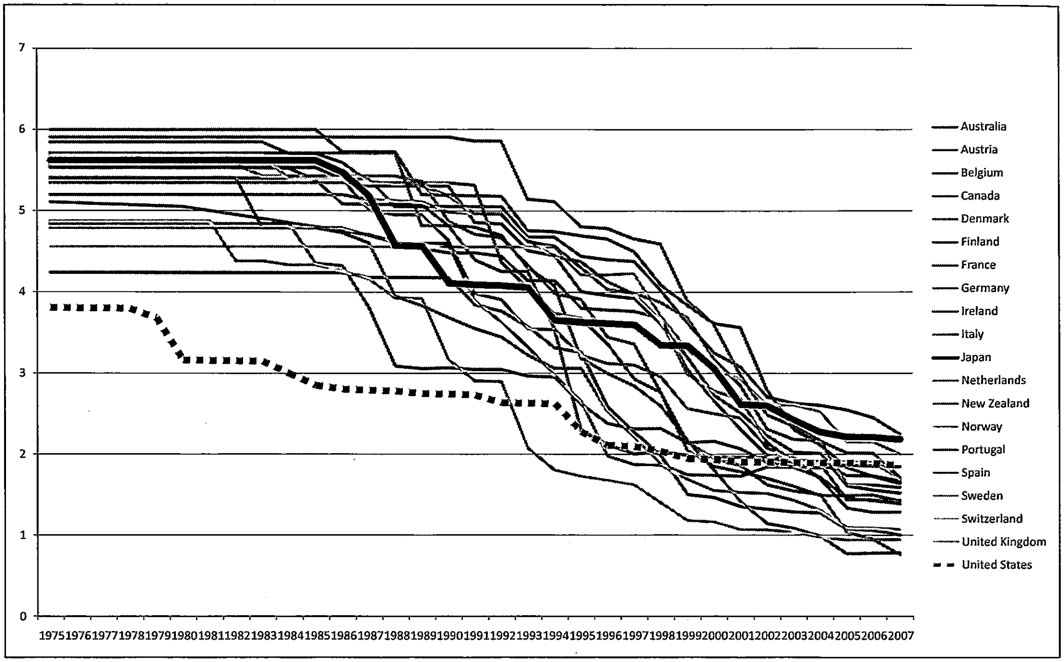
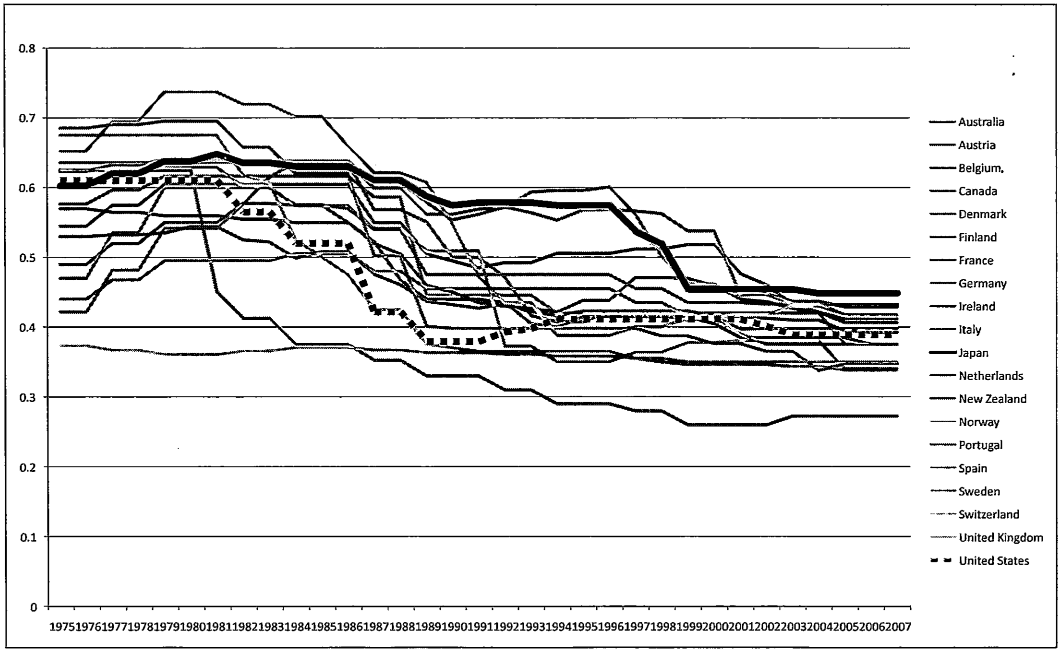


Figure 2b Trends in OECD taxes



which generate the hypotheses of this paper, is given in the next section. The hypotheses section will be followed by the presentation of the evidence. The paper concludes by listing the implications of this paper's findings for the broader literature.

II. The Hypotheses

(1) The Importance of International Recessions

In a world of free capital flows, monetary stability is not only in the interest of businesses oriented towards international markets but also in the interests of governments hoping to strengthen such industries in order to realize growth and increase trade. The notion that stable monetary policy is in the interests of international businesses can be derived from a standard Mundell - Fleming framework. Frieden's (1991) succinct overview explains the distributive conflicts implied in this framework. As his explanation goes, when capital liberalization (i.e. the abolishment of capital and exchange rate controls) is a given condition, international market oriented businesses prefer exchange rate stability (and therefore price stability) over the autonomous employment of monetary policy, whereas domestic market oriented businesses (import competing and domestic service industries) prefer the government's unilateral use of monetary policy, even at the cost of monetary instability.

Now, if the performance of the trade sector is vital to economic recovery, governments are expected to pursue monetary stability along with structural reforms, especially after recessions, and they will probably do so regardless of their exchange policy commitments and opposition from industries confined to the domestic market. However, a caveat is in order: the government's pursuit of monetary stability to expand economic activity and trade after recessions is not synonymous with the incumbent government acting an agent of international trading and investment industries. Since this difference is more important to students of representative democracy than to international political economists, the empirical studies by political economists have hardly addressed the representative conditions for structural reforms. In contrast, this paper will shed light on this issue by asking whether other policies help structural reform regardless of the partisanship of the government and whether structural reform represents the stable preferences of the legislative median instead of incumbent right-center parties representing specific interests amplified by the electoral system (see below).

This paper assumes that governments undertake structural reforms as a way to revive the economy during adverse economic conditions while adhering to monetary stability. An alternative hypothesis would claim that governments pursue structural reform to promote the interests of the exporters and international investors, against the opposition from domestic market-oriented industries. If the alternative claim is right, movements in trade – trade openness and trade volatility – should trigger structural reforms rather than financial volatility. The set of alternatives about the international economic conditions for structural reform can be stated in the following way:

Hypothesis 1: Production market policies are shaped after recessions while maintaining monetary stability, making it more likely that states facing recessions and susceptible international financial turbulences to develop market-oriented production market policies.

Hypothesis 1a: Production market policies are shaped to cater to international trading interests, making it more likely that states dependent on trade and facing trade turbulences to develop market-oriented production policies.

Economic downturns against the backdrop of monetary volatility have never been considered as a cause of structural reforms. Instead, empirical studies so far have asked whether adopting fixed exchange rates or joining the EMU facilitates structural reforms (Belke et al. 2007, Alesina et al. 2008), reflecting the overwhelming practical interest on structural reform among the Euro countries. Hypothesis 1, if corroborated, will not only be one of the first to provide a business cycle account of structural reform but will mark a crucial first step toward integrating the international with the domestic motivations of government policy, which is what the next two sets of hypotheses plan to do.

(2) The Role of the Fiscal State

The idea that structural reforms may be fostered when states have large revenues that enable them to assist labor mobility draws its inspiration from the "small states" literature of the 1980s. The seminal works of Katzenstein (1983) and Cameron (1978, 1984) argued that open economies are associated with large fiscal expenditures that enable them to compensate labor displacement caused by volatile changes in trade (cf. Rodrik 1998, Adsera and Boix 2002). However, in this literature the crucial political factor that turns the interests of the export sector into large expenditures is highly organized unions and peak associations in manufacturing industries. Iversen and Cusack (2000) challenge the small open states theory by claiming that industrial structural change and not trade openness is the direct cause of social spending increase. Both sides of the debate share the assumption that a large fiscal state enables the government to win support for labor mobility and industrial structural change.[2] As such, both theories provide foundations compatible with this paper's hypothesis that a large fiscal state conducive to labor mobility is also complementary to structural reforms aimed at realizing the efficient allocation of capital (cf. Alesina and Drazen 1991, Duval 2008).

However, this paper departs from the small open states literature and its critics in two ways; firstly, it assumes that large fiscal states are conducive to structural reform regardless

2) Both theories examine the causes of fiscal state expansion. Although the expansion of fiscal programs may be the result of partisan preferences, the reforming of such programs might require a much broader political alliance. On the argument that the politics of reforming spending programs is quite different from expanding them, a perspective shared by this paper, see Pierson (1995, 1996, 1998, 2001)

of the partisan composition of government, and, secondly, it specifies international recessions as the economic condition that pressure government to undertake structural reform. Hypothesis 1 assumed that structural reform is carried out during economic downturns in a financially volatile global economy, as a strategy to revive the economy without disrupting monetary stability (cf. Drazen and Grilli 1993, Pitlik and Wirth 2003). Based on this notion, this paper claims that structural reform is undertaken during difficult fiscal times even at the cost of aggravating public debt.

This claim on the fiscal conditions of structural reforms actually speaks to a recent debate over whether fiscal discipline is compatible with structural reforms, a query strongly reflecting the policy controversy over the European Union's Stability and Growth Pact. Skeptics of the compatibility view claim that structural reform worsens budget deficits and diminishes the power of automatic fiscal stabilizers, while supporters of this view claim that structural reform has positive fiscal effects (van den Nood and Cournède 2006, Buti et al 2009). The evidence is mixed (Duval 2005, Duval and Elmeskov 2005, Buti et al. 2009). In comparison, this paper examines whether structural reform takes precedence over fiscal discipline for governments. Note that this paper has reversed the question of the above debate. Instead of asking whether structural reforms are compatible with fiscal discipline, this paper asks whether governments pursue structural reforms at the cost of sacrificing fiscal discipline.

In short, this paper assumes that governments of a large fiscal state are more likely to embark on structural reforms after recessions regardless of their partisan composition. An alternative hypothesis (Hypothesis 2a) based on the idea dissemination theory and the compatible theory would assume that governments undertake structural reform indifferent to the size of the fiscal state or the public debt. Governments endorsing neo-liberalism are more likely to enact structural reforms without feeling the need to mollify opponents or to solicit support beyond trading interests and/or believe that structural reforms will generate revenues to ameliorate fiscal problems. Thus, while Hypothesis 2 is in line with Hypothesis 1, Hypothesis 2a is compatible with Hypothesis 1a.

Hypothesis 2: Structural reforms are likely to progress when the fiscal size of the state is large, even when the state is accumulating public debts.

Hypothesis 2a: Structural reforms are likely to progress indifferent of the fiscal size of the state or the condition of public debts.

An interesting point made by the skeptics of the compatibility view is that governments usually do not have enough political capital to realize both fiscal reconstruction and structural reform (cf. Eichengreen and Wyposz 1998). This raises the question of what sort of governments, or what sort of political conditions, accompany structural reform. To answer this question, this paper refers to another debate in the small open state literature, which is the issue of whose interests are represented in shaping policies characteristic of small open states. The initial explanation focused on the export sector and its heavily organized business associations and labor unions (Cameron 1978, 1984), whereas a later revision emphasized the importance of broader "cross-class" alliance (Swenson 1991). This paper will approach this question by asking whether a broad electoral coalition is necessary or whether a government representing the sectoral interests would suffice to foster structural reforms. However, to understand the relevance of this question, it is necessary to briefly review the recent discussions on how political institutions and preferences are likely to shape policies.

(3) The Significance of Political Preferences and Institutions

Domestic politics is crucial in explaining when and how external shocks result in structural reforms, although sorting out what aspects of domestic politics matter is a daunting task. So far, empirical studies of political economy have overwhelmingly focused on electoral institutions. For instance, Persson and Tabellini (2005) on fiscal policy, Iversen and Soskice (2006) on redistributive spending, and Rogowski (1987) on trade policy, all ascribe policy outcomes to the country's electoral system. Persson and Tabellini (2005) argue that proportional electoral systems are more likely to create large fiscal states by shaping party competition in a way that a party can win a stable majority by offering public goods and spreading its costs, whereas single member districts generate collective action problems by enabling parties to occasionally win power representing those fearing being levied with disproportionate costs. Iversen and Soskice (2006) elaborate this basic idea with regard to distributive policies. Similarly, Rogowski (1987) argued that proportional districts, large electoral districts, and centralized parties are better equipped to overcome local protectionist demands and develop an open trade economy.

Interestingly, recent studies refine the impact of electoral systems by claiming that the structure of the ballot, especially the incentive to cultivate a personal vote by representing specific interests, is a better predictor of policies aimed at intervening in the market (cf. Carey and Shugart 1995). The advantage of this revision is that it provides an explanation about the ability of party leaders to overcome internal opposition against formulating nation-wide policies. Ehrlich (2007) and Hankla (2006) revisit Rogowski's results and find that the incentive to cultivate a personal vote is a better predictor of actual trade policies (for which Rogowski uses trade dependence) than electoral systems *per se*. Thus, this paper will examine the effects of a personal vote along with those of electoral systems. In short, institutionalist analysis suggests that proportional electoral systems, multi-party legislatures, and smaller incentives to solicit personal votes are capable of promoting nation - wide regulatory and redistributive policies aimed to rectify the workings of a free market because they are better suited to overcome local or parochial opposition.

However, the limits and inadequacies of institutional analysis become apparent when one realizes that parties will often revise their policies in facing the electorate and, as a result of elections governments are replaced with new ones with completely different ideological dispositions. In comparison, electoral systems and ballot structure seldom change. This obvious point is important in probing whose interests are reflected in structural reform, and whether government change generates policy change. Thus, it is necessary to rectify what is missing from institutionalist explanations, which can be summarized into three points. First of all, not all economic policy issues are position issues in which parties take a clear position in opposition to, or show significant ideological distance among, each other. For instance, more often than not, politicians under certain circumstances agree to delegate monetary policymaking to central banks by increasing their autonomy and thereby insulating monetary policies from partisan battles. Secondly, policies change as parties shift their positions in facing the electorate. Although major parties never swap policy positions, they may nonetheless "co-move" by softening their positions and adopting policies similar to their rivals in order to appeal to the median voter. Finally, governments change with elections, meaning that a new government might embrace policies opposed to its predecessor (Budge 1994, Budge et al. 1987, Budge et al. 2001 McDonald et al. 2004, McDonald and Budge 2005, Budge and McDonald 2007).

The incorporation of electoral and government change into the framework corresponds to the thorny problem of whether policies reflect the legislative median (Krehbiel 1991, 1993, 1998) or the governing (or the legislative majority) party's median (cf. Cox and McCubbins 1993, 2005, Binder 1999, Lawrence 2006, Smith 2007); an issue that is heatedly debated among students of U.S. Congress over "responsible party government." It is noteworthy that policies representing the legislative median are likely to approximate valence issues over which competing parties do not oppose each other and which can be realized through compromise, and are likely to remain stable. In contrast, policies that reflect the governing majority are likely to be position issues over which competing parties are opposed to each other and which have to be pursued by confrontation and might be repealed once the opposition party is in power.

Based on the above discussion, the final set of hypotheses of this paper addresses the possibility of policies being a consequence of (a) the legislative median, as a result of comovements of partisan preferences, (b) the governing majority, and (c) the underlying electoral institutions. Consistent with Hypothesis 1 and Hypothesis 2, this paper assumes structural reforms to proceed with a right-leaning legislative median even without the inauguration of a rightist government, and suggests that institutions alone cannot predict structural reform. As such, if corroborated Hypothesis 3 provides a repudiation to the common criticism that structural reforms and liberal supply-side policies embody a rightist government's adherence to market fundamentalism.

Hypothesis 3: Structural reforms reflect the legislative median in tandem with majoritarian electoral systems that hinder the development regulatory and redistributive policies to rectify market forces.

Hypothesis 3a: Structural reforms reflect the ideology of the incumbent government, assisted by majoritarian electoral institutions that promote strong partisan governments.

Having stated the hypotheses and explained their theoretical foundations, this paper is now ready to explain the empirical model and the variables used to test the hypotheses.

III. The Model

Table 2 lists the variables - their names, expected signs, and summary information, and sources - used to test the above hypotheses and their alternatives. All the linear regressions have used panel corrected standard errors and country unit fixed effects.

The dependent variable of this paper - product market policies - is represented by two variables, which capture the different aspects of such policies. The variables are, the regulation in non-manufacturing industries (regulation) and the average of corporate tax and top marginal income tax rates (tax rates). The first variable regulation is actually the mean of three separate indices compiled by the OECD on the extent of the public ownership, government regulation, and entry barriers to seven non-manufacturing industries. This is the only index of government regulation currently available as annual data, and the choice of industries is justified on grounds that cost reduction and competition in these industries, which provide intermediate goods to export manufacturing, lower the costs of exports (Nicoletti and Scarpetta 2003 Conway et al. 2005 Boeri et al. 2006, Conway and Nicoletti 2006, Høj et al. 2006, Wölfi et al. 2009)[3]. The second variable, the two rates that compose the tax rates variable have been frequently debated in governments and policy circles across countries as a key tool to encourage investment in times of economic downturns. Also, corporate tax rates have been a major issue in the neoliberal "race to the bottom" debate on whether economic globalization, especially the threat of corporate exit, forces countries to lower tax rates and cut social expenditures (Swank 1998, 2002). These two variables capture crucial aspects of supply-side policies and always appear in the debates over structural reform, making them suitable as the dependent variables of this paper.

(1) The Importance of International Recessions

The independent variables can be divided into three groups corresponding to the three sets of hypotheses of this paper. **Growth** and **unemployment** are the standard measures of economic cycles. Thus we expect, **growth** to be positively and **unemployment** to be negatively correlated with changes in production market policies. Hypothesis 1 and 1a differ as to whether

3) The industries are electricity, gas, airlines, rail, telecommunications, and post.

Table 2. Summary of variables

Variable Name	Hypothesis No.	Hypothesis Sign	Summary mean	Summary sdv	Summary min	Summary max	Sources
Regulation	D.V		3.88	1.52	0.759	6	OECD Indicators of product market regulation homepage <http://www.oecd.org/document/36/0,3343,en_2649_34323_35790244_1_1_1_1,00.html>
Tax rates	D.V.		0.48	0.11	0.26	0.737	Institute for Fiscal Studies <http://www.ifs.org.uk/publications/3210>, Devereux et al. (2002) and Fraser Institute conomic Freedom of the World database <http://www.freetheworld.com/datasets_efw.html>
Inllation	1	+	0.05	0.05	−0.02	0.27	
Growth	1	+	0.03	0.02	−0.07	0.115	OECD Economic outlook <http://stats.oecd.org/>
Unemployment	1	−	0.07	0.03	0.002	0.20	
Drastic depreciations	1	−	5.86	3.21	0	14	Calculated by the author using IMF International Financial Statistics, <http://www.imfstatistics.org/imf/>
Trade Openness	1	n.s	0.65	0.32	0.161	1.84	Calculated from PENN World Tables <http://pwt.econ.upenn.edu/> & World Bank World
Trade balance deteriorations	1	−	3.96	2.16	0	8	Development Indicators database <http://databank.world-bank.org/ddp/home.do>
Central bank autonomy	1	−	0.56	0.23	0.19	0.94	Arnone et al (2007), Daunfeldt et al. (2010)
EMU	1	−	0.15	0.36	0	1	EUROPA website <http://europa.eu/index_en.htm>
GSP	1	−	0.22	0.41	0	1	
Banking crisis	1	+	0.04	0.18	0	1	Boyed et al. (2009), Laeven and Valencia (2008)
Revenue	2	−	0.36	0.07	0.184	0.522	OECD Revenue database <http://stats.oecd.org/>
VAT	2	−	0.13	0.09	0.00	0.25	OECD Tax database <www.oecd.org/ctp/taxdatabase>
Government Debt	2	−	0.45	0.27	0.024	1.638	Jaimovich and Panizza (2006)
Legislative median	3	−	−1.49	11.36	−30.6	39.71	Manifesto Project (MRG/CMP/MARPOR), Berlin:
Government party median	3	n.s	−0.05	16.87	−37.26	48.46	Wissenschaftszentrum Berlin für Sozialforschung (WZB) (<http://www.wzb.eu/zkd/dsl/Projekte/projekte-manifesto.en.htm>), Woldendorp et al. (2000), *European*
Government median	3	n.s	−0.03	16.74	−37.41	48.46	*Journal of Political Research* (various issues)
Legislative right-center	3	−	0.51	0.19	0.06	0.97	
Government party right-center	3	n.s	0.29	0.24	0.00	0.80	Duane Swank Comparative Parties dataset <http://www.marquette.edu/polisci/faculty_swank.shtml>
Government right-center	3	n.s	0.60	0.39	0.00	1.00	
Legislative fragmentation	3	n.s	68.11	11.16	40.91	88.98	Klaus Armingeon, Sarah Engler, Panajotis Potolidis, Marlène Gerber, Philipp Leimgruber, Comparative Political
No. of Effective legislative parties	3	n.s	3.61	1.48	1.69	9.07	Dataset <http://www.ipw.unibe.ch/content/team/klaus_armin-
Electoral districts	3	+	0.59	0.80	0	2	geon/comparative_political_data_sets/index_ger.html>
District Magnitude	3	+	14.99	31.78	1	150	
Personal Vote	3	−	2.81	1.61	0	5	Electoral Systems and Personal Vote dataset, Johnson and Wallack (2007)

Note: only the variables in bold appear in the results

monetary stability or trade stability is more important in shaping product market policies. Hypothesis 1 expects structural reforms to proceed during difficult economic times. Monetary stability is measured by a country's **inflation** rates as well as the number of **drastic** depreciations it has experienced in the past. The number of past drastic depreciations is the times the exchange rates ($S = \Delta S_{j,t} / \sigma_{\Delta Sj}$) falls more than two standard deviation from the average.[4] As such, Hypothesis 1 expects **inflation** to be positive (meaning low inflation is conducive to structural reforms) and **drastic depreciations** to show significant negative signs. By comparison, Hypothesis 1a assumes trade stability, measured by a country's **openness** and the number of **trade deteriorations**, to be a better predictor of product market policies. **Trade openness** is the export and import ratio-to-GDP. **Trade deterioration** is measured by the number of years a country's trade balance drops more than one standard deviation below the average. Hypothesis 1a expects both variables to show a negative sign.

In addition to international financial volatility, this paper includes three other measures of international recessions and the government's quest for monetary stability. One variable is the **banking crisis**, which occurs during recessions, increases financial instability, and prods governments to undertake structural reform to revive the economy. The **banking crisis** index is a dummy variable with a 0.25 score for non-systemic banking crisis and a score of 1 for systemic banking crisis during the duration of the crisis. The variable is created from several sources, which seem to be in accord about the duration and severity of a banking crisis among OECD countries (see Table 2). Another measure examined here is membership in the **EMU** (European Monetary Union) or Stability and Growth Pact (**SGP**): both international pacts commit signatory governments to undertake monetary stability. The final measure is **central bank autonomy**, which can be seen as a tool for governments to control inflation. Since all three types of measures help governments to realize monetary stability in order to pursue structural reforms, this paper expects **banking crisis**, **EMU** (**or SGP**), and **central bank autonomy** to be negatively correlated to the dependent variables.

(2) The Role of the Fiscal State

The variables used and the expected signs of Hypothesis 2 and Hypothesis 2a are quite straightforward. To measure the fiscal size of the state, this paper uses **revenue**-to-GDP ratio as well as **VAT** rates. To test the fiscal situation, this paper uses **government debt**: The difference between Hypothesis 2 and its alternative is the role of the fiscal state and the precariousness of the fiscal situation when governments are assumed to carry out structural reform. According to Hypothesis 2 governments are more likely to embark on structural reform to reinvigorate the economy when it rules a large fiscal state in spite of adverse fiscal condition. In comparison, in Hypothesis 2a governments do so regardless of the fiscal state size and the fiscal situation. Hypothesis 2 expects all of the signs to be negative, while Hypothesis 2a expects it to be insignificant or positive.

4) S is the bilateral exchange rate of country j with the U.S. dollar (and the nominal effective exchange rates for the United States). The monthly changes ($\Delta S_{j,t}$) are standardized with standard deviations serving as country - specific weights ($\sigma \Delta_{Sj}$).

(3) The Significance of Political Preferences and Institutions

With regard to the effect of partisanship, this paper uses the Comparative Manifesto Project dataset (see Table 2). To test Hypothesis 3, this paper uses the mean preferences of the major parties in the legislature weighted by to their seat share (**legislative mean**) and size of right-center parties in the legislature (**legislative right-center**). To test Hypothesis 3a the following indices are used: the weighted preferences of the government parties (**government mean**), the seat share of right-center parties in government (**government party right-center**), and the government portfolio share of right-center parties (**government right-center**).

It is noteworthy that the **legislative mean** or the **legislative right-center** on the one hand, and the other measures are totally different measures. This can be better explained by example. Figure 3 charts the trends in the **legislative mean** and the **government party mean** for the OECD and the United States. The point worth noting is that the legislative mean of U.S. Congress has been shifting to the right throughout the period examined and has been much further right of the OECD average since 1981, regardless of whether the Republicans or the Democrats are the majority. Furthermore, although the U.S. **government party mean** during the Clinton administration is to the left of its predecessor and its successor, it is much further to the right than most OECD government parties. This means that whether the government's party is right-center or left center as measured by seat (or portfolio) shares is something quite different to where the **government party mean** preference is on the right left scale. Usually,

Figure 3 Mean government and legislative preferences of the OECD and the United States

when one talks of the government being right or left, it is the share of seats or portfolios that the person has in mind. Incidentally, Figure 2 also shows a gradual rightward shift in the OECD countries' **legislative mean** and a more cyclical trajectory for the **government mean**, especially after the 1980s.

Hypothesis 3 expects the signs of the **legislative mean** to be significant and negative, meaning a right leaning median will result in liberal supply-side policies. Since a right leaning median is likely to translate into a larger share of right-center parties in the legislature, Hypothesis 3 also assumes that the size of right-center parties in the legislature (**legislative right-center**) will be negatively correlated with liberal supply-side policies while the **government party right center** and **government right-center** to be insignificant. By comparison, Hypothesis 3a expects **government party right-center** and/or **government right-center** to be significantly and negatively correlated to the policy variables but **legislative mean** and **legislative right-center** to be insignificant. A statistically significant result of the **government mean** variable lends support to either hypothesis depending on what other variables are significant. If the **legislative mean** variable is also significant, that implies that the government mean co-moves with the legislative mean and that preferences are more important than what party is in power, supportive of Hypothesis 1, whereas if the seat or portfolio seats are also significant that implies that the strength of what party is in government matters more than what policies it had advocated in the last election, corroborating Hypothesis 2.

In addition, several variables are used to test the effect of electoral institutions. Among them two variables – **electoral district** and **district magnitude** – directly measure the electoral system. Electoral district is a coarse measure, which differentiates among single-member (=2), mixed-member (=1), and proportional (=0) districts. **District magnitude** is defined as the mean number of representatives elected from each district, taking the value of 1 for single member districts and a specified number larger than 1 for other type of districts. In addition, a **personal vote** index, which is the mean of the three variables that generate incentives to solicit a personal vote (Carey and Shugart 1995, Johnson and Wallack 2007), is included to check for the policy effects of the ballot structure. Finally, since single member districts facilitate two party systems and other electoral systems create multi-party systems, the composition of the legislature is also taken into consideration. The two measures for legislative composition are the **legislative fragmentation** index and the effective number of legislative parties (**legislative parties**). However, the last two variables never had significant power to explain the dependent variables and thus will be omitted hereafter from the explanation of the results.

For the institutional variables, Hypothesis 3 predicts **electoral district** (or **district magnitude**) to be positively significant and personal vote to be negatively significant. By comparison, Hypothesis 3a these institutional variables show the same signs as Hypothesis 3 but to be less significant since the major role of electoral institutions is assumed to be one of creating strong partisan governments rather than generating market friendly policies.

IV. The Results

(1) The Importance of International Recessions

Table 3 presents the economic conditions under which structural reforms take place. The upper row shows the results for **regulation** equations, while the lower row shows the results for **tax rates**. In the two measures of production market policies changes take place when the government is pursuing monetary stability (i.e., low inflation), or facing adverse economic conditions (i.e., high unemployment), and has been exposed to international financial volatility. The results show that **inflation** in positive and significant, whereas **unemployment** is negative and significant, although the two variables cannot be put in the same equation because of apparent collinearity. Economic **growth** rates, although statistically significant, turned out to be a quite inferior predictor compared to **unemployment** with regard to the economic conditions under which structural reforms take place. This result strongly suggests that governments pay more attention to the employment situation than to the actual growth of the economy.

Table 3. International monetary determinants of structural reforms

	International financial volatility								International trade volatility			
Regulation	Coef.	StdErr.	z	P>|z|	Coef.	StdErr.	z	P>|z|	Coef.	StdErr.	z	P>|z|
regulation (t-1)	0.959	0.012	78.61	0.000	0.966	0.012	79.93	0.000	0.996	0.011	91.07	0.000
Inflation (t-1)	0.767	0.240	3.20	0.001								
Unemployment (t-1)					−0.9222	0.308	−2.99	0.003				
Drastic depreciations (t-1)	−0.022	0.006	−3.71	0.000	−0.0251	0.006	−4.52	0.000				
Openness (t-1)									0.122	0.091	1.33	0.182
Trade deteriorations (t-1)									−0.029	0.010	−2.88	0.004
Banking crisis	−0.140	0.045	−3.13	0.002	−0.1465	0.044	−3.30	0.001	−0.139	0.048	−2.89	0.004
EMU	−0.125	0.030	−4.15	0.000	−0.1347	0.030	−4.49	0.000	−0.155	0.036	−4.35	0.000
Country dummies	Omitted				Omitted				Omitted			
Number of obs.	640				640				640			
R-squared	0.988				0.988				0.987			
Wald chi2 [# of vari.]	37194.4 [24]				35247.5 [24]				28936.7 [24]			
Taxes	Coef.	StdErr.	z	P>|z|	Coef.	StdErr.	z	P>|z|	Coef.	StdErr.	z	P>|z|
Taxes (t-1)	0.885	0.023	38.52	0.000	0.897	0.022	40.32	0.000	0.920	0.021	44.3	0.000
In5lation (t-1)	0.098	0.033	2.95	0.003								
Unemployment (t-1)					−0.116	0.048	−2.42	0.015				
Drastic depreciations (t-1)	−0.002	0.001	−2.28	0.022	−0.002	0.001	−2.66	0.008				
Openness (t-1)									0.018	0.013	1.37	0.170
Trade deteriorations (t-1)									−0.005	0.001	−4.25	0.000
Banking crisis	−0.021	0.005	−4.42	0.000	−0.022	0.005	−4.46	0.000	−0.017	0.005	−3.48	0.001
EMU	−0.004	0.005	−0.74	0.460	−0.006	0.005	−1.21	0.226	−0.011	0.005	−2.12	0.034
Country dummies	Omitted				Omitted				Omitted			
Number of obs.	576				576				576			
R-squared	0.9667				0.9666				0.9665			
Wald chi2 [# of vari.]	24439.7 [22]				25238.7 [22]				36707.4 [22]			

More importantly, the results show that past experience of international financial volatility, indicated by the rate of **drastic depreciation** and number of **currency crises**, prods governments to liberalize production markets as expected in Hypothesis 1. In comparison, as discerned from the third column of Table3, the degree of trade **openness** was not significant in explaining product market change, although the number of **trade balance deteriorations** was.

Among the other measures that might induce governments to contemplate structural reform, banking crisis and EMU were statistically significant. A baking crisis has a clear effect in reducing regulation and initiating tax cuts. Membership in the EMU facilitates structural reform, although its effect on tax rates did not reach statistical significance. EMU turned out to be a better predictor of supply - side policies than SGP. Unexpectedly, however, central bank autonomy turned out to be insignificant, and often showed the wrong sign when the international financial variables were entered. A plausible explanation is that although central bank autonomy contributes to lowering inflation rates and realizing monetary stability, it does not serve as a proxy for monetary stability and its existence may spare the government from undertaking drastic supply-side policies. All in all, it could be said that the overall results corroborate Hypothesis 1.

(2) The Role of the Fiscal State

Table 4 adds fiscal policy variables to the results shown in Table 3. In all equations, **rev-**

Table 4. International monetary and fiscal determinants of structural reforms

Regulation	Coef.	Std.Err.	z	P>|z|	Coef.	Std.Err.	z	P>|z|
regulation (t-1)	0.966	0.012	80.56	0.000	0.960	0.012	79.67	0.000
Inllation (t-1)					0.698	0.238	2.93	0.003
Unemployment (t-1)	−0.702	0.333	−2.11	0.035				
Drastic depreciations (t-1)	−0.021	0.006	−3.72	0.000	−0.020	0.006	−3.51	0.000
Banking crisis	−0.149	0.044	−3.35	0.001	−0.138	0.045	−3.10	0.002
EMU	−0.129	0.029	−4.38	0.000	−0.124	0.030	−4.08	0.000
Revenue (t-1)	−0.745	0.312	−2.39	0.017				
Government debt (t-1)					−0.067	0.039	−1.74	0.082
Country dummies	Omitted				Omitted			
Number of obs.	640				640			
R-squared	0.9883				0.9883			
Wald chi2 [# of vari.]	35456.8 [25]				37215.5 [25]			
Taxes	Coef.	Std.Err.	z	P>|z|	Coef.	Std.Err.	z	P>|z|
Taxes (t-1)	0.904	0.022	40.21	0.000	0.890	0.022	39.66	0.000
Inllation (t-1)					0.072	0.032	2.27	0.023
Unemployment (t-1)	−0.085	0.049	−1.71	0.086				
Drastic depreciations (t-1)	−0.001	0.001	−1.85	0.064	−0.001	0.001	−1.73	0.080
Banking crisis	−0.022	0.005	−4.59	0.000	−0.021	0.005	−4.28	0.000
EMU	−0.005	0.005	−1.01	0.312	−0.004	0.005	−0.86	0.387
Revenue (t-1)	−0.095	0.041	−2.34	0.010				
Government debt (t-1)					−0.018	0.006	−3.05	0.002
Country dummies	Omitted				Omitted			
Number of obs.	576				576			
R-squared	0.9669				0.9673			
Wald chi2 [# of vari.]	32403.6 [23]				32706.5 [23]			

Table 5. Political determinants of structural reform

Regulation	Coef.	Std.Err.	z	P>|z|	Coef.	Std.Err.	z	P>|z|	Coef.	Std.Err.	z	P>|z|	Coef.	Std.Err.	z	P>|z|
Regulation (t-1)	1.027	0.011	94.58	0.000	1.027	0.01	94.430	0.000	1.027	0.011	94.97	0.000	1.023	0.011	95.85	0.000
Legislative mean	−0.002	0.001	−1.88	0.061	−0.002	0.001	−2.27	0.023	−0.002	0.001	−2.35	0.019	−0.002	0.001	−2.06	0.040
Legislative right-center	−0.176	0.083	−2.13	0.034									−0.087	0.084	−1.03	0.304
Government party right-center					−0.070	0.040	−1.77	0.077								
Government right-center									−0.012	0.021	−0.59	0.554				
Electoral districts																
District magnitude													0.010	0.003	3.08	0.002
Country dummies	Omitted				Omitted				Omitted				Omitted			
Number of obs.	621				622				623				620			
R-squared	0.9856				0.9857				0.9856				0.9858			
Wald chi2 [# of vari.]	25872.3 [22]				25528.8 [22]				23530.4 [22]				27795.5 [23]			
Taxes	Coef.	Std.Err.	z	P>|z|	Coef.	Std.Err.	z	P>|z	Coef.	Std.Err.	z	P>|z|	Coef.	Std.Err.	z	P>|z|
Taxes (t-1)	0.956	0.022	43.41	0.000	0.958	0.022	43.21	0.000	0.958	−.02223	43.08	0.000	0.953	0.021	44.37	0.000
Legislative mean	−0.0003	0.0001	−2.58	0.010	−0.00039	0.0001	−2.98	0.003	−0.0004	0.00013	−3.02	0.002	−0.0003	0.0002	−2.10	0.036
Legislative right-center	−0.027	0.010	−2.63	0.008												
Government party right-center					−0.006	0.005	−1.14	0.254								
Government right-center									−0.001	0.00277	−0.40	0.688				
Electoral districts													−0.016	0.007	−2.14	0.032
District magnitude																
Country dummies	Omitted				Omitted				Omitted				Omitted			
Number of obs.	560				560				561				497			
R-squared	0.9632				0.9627				0.9627				0.9637			
Wald chi2 [# of vari.]	23705.9 [20]				25131.2 [20]				25211.3 [20]				19423.9 [19]			

enue showed the expected negative sign and proved significant, indicating large fiscal states makes it easier for governments to carry out structural reforms. The results remained essentially the same when **revenue** was replaced by **VAT** (although not shown in the Table 4) Since the introduction of VAT and subsequent increases of its rates is a relatively recent phenomena among OECD countries, it can be inferred that governments have been trying to maintain the level of spending commitments by depending on VAT to supplement the revenue loss deriving from corporate and high - income tax cuts.

Although the size of the fiscal state facilitates changes in supply - side policies, that fact does not mean that governments undertake reform during times of fiscal stability. On the contrary, the results show that the size of the public debt actually fostered structural reform, corroborating Hypothesis 2, which assumes that governments undertake structural reform even at the cost of sacrificing fiscal discipline. Table 5 shows **government debt** with an expected negative sign and significant. Thus, Table 5 corroborates Hypothesis 2 rather than 2a.

(3) The Significance of Political Preferences and Institutions

Table 6 displays the results showing the effect of political variables on production market policies. Since the economic and policy variables run the risk of being correlated with the political variables in one way or the other, all such variables were excluded from the regressions.

Table 5 shows that both **regulation** and **tax rates** are shaped by the **legislative mean** and the changes in the strength of legislative parties: both the **legislative median** and **legislative right-center** show the expected negative signs and are significant, whereas **legislative right-center**, **government party right-center**, and **government right-center** are all insignificant. Hence, we can conclude that structural reforms are shaped by the legislative median rather than the party in power. In the case of **regulation**, both the legislative mean and shifts in the legislative median (**legislative median change**) were significantly correlated, while in **tax rates** the **government median** was significant. Neither result is shown in Table 5 for the sake of brevity, since it does not affect the overall argument. In toto, these results suggest that the legislative median shapes supply side policies corroborating Hypothesis 3 but not Hypothesis 3a.

Table 5 also displays the effects of institutions on supply-side policies. However, it was only for **tax rates** that the measures for institutions – **electoral district, district magnitude, and personal vote** – were significant with the right sign, although only the result for **electoral district** is shown. Although **district magnitude** was significant for regulation, the sign was wrong and was the opposite from **electoral district**, which did not reach significance levels. Thus, although electoral districts shape tax policy in expected ways – single member districts are conducive to lower investment taxation – it is dubious whether electoral districts have any effect on regulatory policies. Also, as mentioned earlier, none of the variables measuring legislative heterogeneity proved to be significant from the start. Thus, the effects of institutions were much weaker than expected by Hypothesis 3.

All in all, the above empirical results support the two major claims of this paper that (a) structural reforms are part of a government's strategy to realize growth during economic downturns while maintaining monetary stability and that (b) they are reflect the preferences of legislative medians rather than a partisan government representing international traders or adhering to neoliberal ideas.

V. The Implications

This paper has presented a coherent view of the international economic and domestic political determinants of production market policies, consisting of the following major findings: (a) supply-side policies are shaped during recession in order to spur growth and trade, affected by the governments' quest for monetary stability in a context of international volatility. (b) Structural reforms are more likely to proceed when governments regardless of partisan orientation can mobilize fiscal resources to conciliate opponents and expand support, even at the cost of sacrificing fiscal discipline. And, finally, (c) supply-side policies are shaped by a right - leaning legislative median, rather than by the presence of a right-center government. These findings cast doubt on the interpretation that such reforms are a result of economic globalization *per se*, or governments representing international trade interests, or governments following market fundamentalism. The fact that monetary stability and structural policies are in line with the interests of exporters and international traders does not mean that they are undertaken by governments representing specific interests or devoted to neo-liberalism. In making this distinction and testing hypotheses that conflict with the partisan view, this paper has unearthed some points worth reiterating.

Firstly, this paper points to global recessions in a world of precarious international monetary stability as the main characteristics of economic globalization to which governments must adjust. International monetary disruption matter more to governments than trade or investment because it is the cause, the aggravator and the synchronizer of economic downturns, directly affecting the availability of counter - cyclical spending available to governments. However, theories on the international origins of corporatist policymaking, referred to as the small open states theory, in addition to the research empirically refuting the neoliberal "race to the bottom" theory (cf. Garrett 1998, Swank 2002) regard international trade and investment as the key element that compel governments to embark on policy reforms. Very few works have examined the impact of global recessions accompanying international financial volatility on the development of economic policies beyond monetary policy. The empirical results of this paper suggest such a venue to be rewarding.

Secondly, this paper emphasizes the political utility of large fiscal states on pacifying opposition to structural reforms. This paper has found that when confronted by a recession, governments are likely to shelve fiscal reconstruction for the sake of structural reform because structural reform is viewed as a viable strategy to allow for the revival of the economy while simultaneously expanding trade and maintaining monetary stability. A large fiscal state is more likely to help governments regardless of their ideological orientation by somewhat pacifying the expected opposition to such reforms. This result suggests how important it is to probe into the policy arsenal of governments when they are about to undertake difficult choices in order to construct realistic accounts of policy dilemmas and policy choices.

Thirdly, this paper's finding a right leaning legislature is conducive in structural reform corresponds to puzzles raised at the beginning of this paper and questions the utility of some of the commonsensical political economy regime typologies. The empirical findings of this paper suggest that structural reforms are most likely to progress with large fiscal states characterized by trade openness in line with the small open state theory. On the other hand, many authors writing on structural reform, including advisers to the OECD and the EU, find the liberal markets of the United States, which has the lowest degree of trade openness and fiscal size, to be at the forefront of structural reforms, serving as a model for Europe. These two ostensibly conflicting accounts can be bridged if we acknowledge that the United States is exceptionally rightist in terms of legislative and governmental preferences, making it more of a political outlier than a model (see the above Figure 3). Similarly, Japan's average score on reforms can be understood if one realizes its small state and relative insulation from international monetary turbulence is countered by its prolonged banking crisis and right - center dominance. These results question the usefulness of analyzing policy through the lenses of typologies such as, liberal markets vs. small state corporatism, or liberal markets vs. coordinated markets (cf. Hall and Soskice 2001). More importantly, it speaks to the utility of providing dynamic representative foundations to the explanation of policy adjustments. Political economic typologies have yet to provide such foundations that demands the incorporation of electoral and government change within the framework.

This paper has tried to rectify the lack of attention to the effects of partisan preference changes and government changes on policies, which can be discerned even in the leading works of political economy. With regard to structural reform, this paper has found that not all liberalizing policies need a rightist government. In other words, a rightleaning legislative median is the only common condition that shapes production market policies. This finding not only questions the market fundamentalist criticisms of structural reform but, more importantly, is consistent with the other findings of this paper, namely, that governments pursue structural reform to revitalize the economy, not merely to cater to narrow economic interests, and do so during adverse economic and fiscal conditions, made easier by a large fiscal state which helps forge a broader coalition for reform. As such, this paper provides a coherent explanation of production market policy of OECD countries with some implications for the field in general.

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