The Centre for European Policy Studies
Thinking Ahead for Europe

Contribution of Structural Reforms to Growth and Employment Performance

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Based on "Breaking the Reform Deadlock", *6th Annual Report of the CEPS Macroeconomic Policy Group*

"The Euro after 5 years: successes, lessons and challenges"
Amsterdam, October 11, 2004

Main message: Leaner times are here to stay

- Deteriorating demographics with ratio of working age population to total population falling
- Declining productivity growth as labour quality is falling and investment growth slowing
- Performance gap between big and small countries highlights need for flexibility

And the role of structural reforms in all this?

- Cannot change demographics trends.
- Cannot change declining K/L ratio due to insufficient investment growth.
- But might counteract these two negative trends.
- Performance gap between big and small countries highlights need for flexibility

Deteriorating demographics

- The long term trends are known.
- Less well known is that the demographic decline has already set in and affects already now not only public finances (pensions and health care) but also growth prospects (fall in potential GDP growth for Germany by almost 1%).

Long term: Old-age dependency projections

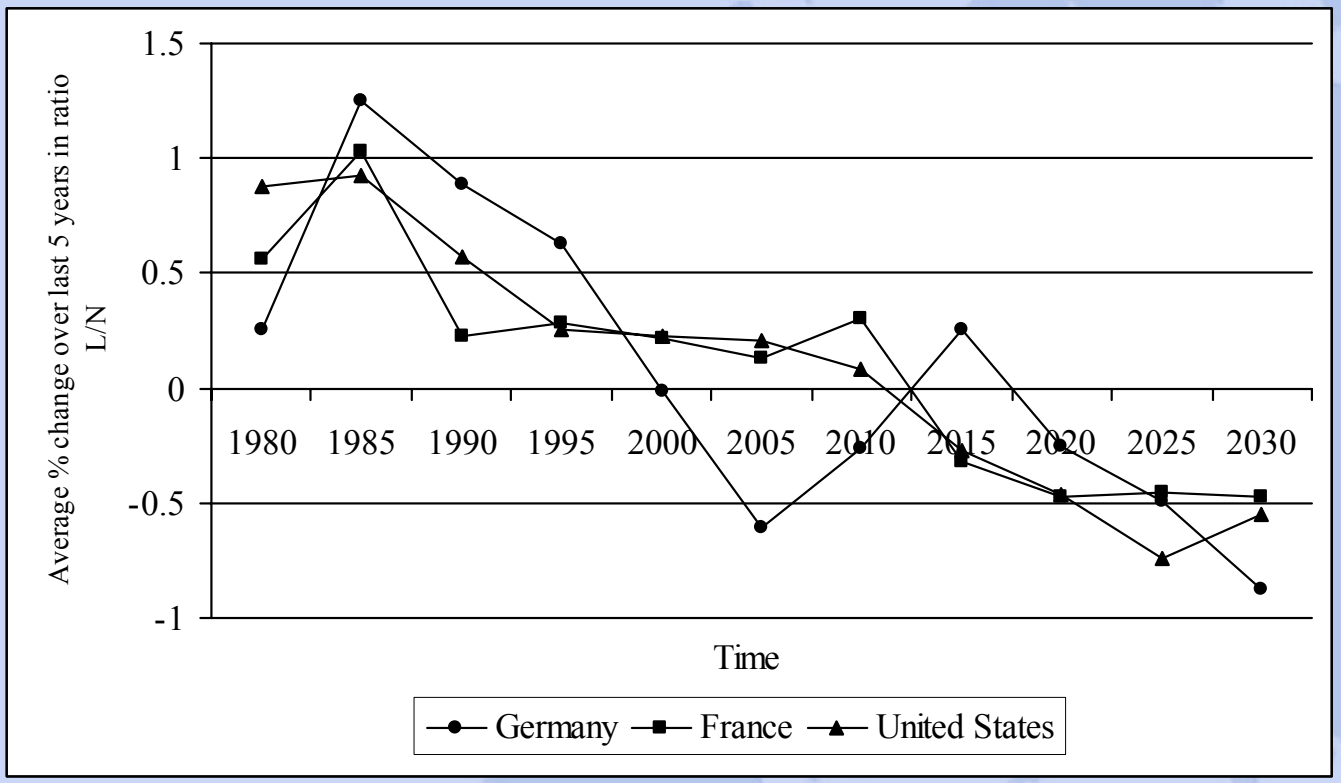
	2000	2025	2050
Japan	25.1%	47.0%	64.6%
US	18.8%	29.3%	34.6%
France	24.5%	36.0%	45.9%
Germany	24.2%	39.4%	52.9%
EU-15	24.4%	36.1%	51.0%
EU-28	21.5%	31.9%	48.5%

Sources: US census data (available at http://www.census.gov/ipc/www/idbnew.html) and own calculations.

Demographic decline is not only for the next generation

- Share of working age population in total population shows « potential GDP ».
- All over Europe this is deteriorating now.
- Germany has worst short run dynamics: loss of momentum of 1 % of GDP between 1995 and 2005.

Change in demographic potential GDP-25, 65+



Continuing structural weakness?

- Not only demographic weakness: productivity growth is also slowing (forget about comparison with the US, the EU is deteriorating with respect to its own past).
- New data allows decomposition to look at causes of slowdown (Daveri 2004):
- Lack of investment and slightly lower labour quality.

Growth of GDP per hour worked, EU versus US, 1979-2001

Total economy, OECD data	1970-80	1980-90	1990-95	1995-02	1995-02 minus 1990-95
EU-11*	3.6	2.3	2.6	1.4	-1.2
US	1.6	1.4	1.2	2.0	+0.8
EU11-minus US	*+2.0*	*+0.9*	*+1.4*	*-0.6*	*-2.0*

* EU-11 is used here instead of EU-15 because of limited data availability.
Source: Daveri (2004).

Decomposing aggregate labour productivity growth, business sector

	US		EU-4	
Business sector	1979-95	1995-00	1979-95	1995-00
Labour productivity growth	1.21	2.46	2.30	2.02
Contributions to labour productivity growth from:				
IT capital	.46	.86	.33	.53
Non-IT capital	.35	.43	.70	.25
TFP growth	.26	1.05	.94	1.07
Labour quality	.13	.13	.33	.18

Source: Daveri (2004).

Is it really that bad?
The employment productivity trade-off

Two versions of the "Panglossian" view:

1) **Levels: Who cares? When EU citizens work they are productive.**
2) **Rate of change: Why worry? Reforms price marginal groups into the labour market this must reduce average productivity.**

Mr. Pangloss and the employment productivity trade-off in levels

Key fact: When EU citizens work they are (almost) as productive as in the US. They just prefer to work less.

Conclusion: structural reforms not needed since choice of shorter working time (and life) is rooted in preferences.

(If less work is due to higher taxes conclusion changes a bit.)

Mr. Pangloss should look into the future

Key fact: levels change when rates of growth differ.

See next page for a projection which extends current trends to 2010. (Source: Gordon (2004))

Mr. Pangloss should look into the future

	EU productivity per hour as % of US
1973	79
1995	94
2003	85
On current trends: 2010	78

Mr. Pangloss should look into the future

Conclusion: Europe is falling back rather quickly.

Forget about Lisbon: "the most productive knowledge based economy"

Mr. Pangloss and the employment growth - productivity trade-off

Key fact: Employment rates have increased (a bit) over the last years.

Conclusion: Europe is pricing marginal groups into the labour market. Lower productivity growth is a sign of success (of labour market reforms).

Conclusion is wrong because magnitudes do not fit the picture.

Mr. Pangloss should look at the numbers

- Key fact: employment rate has increased by about 0.5 percentage points per year since 1995 (from 60.1 to 64.3 % for EU-15)
- If productivity of new entrants is 90 % of that of the previous work force, this would imply a reduction in productivity of 0.05 % per annum.
- Conclusion: cannot explain loss of productivity growth this way!

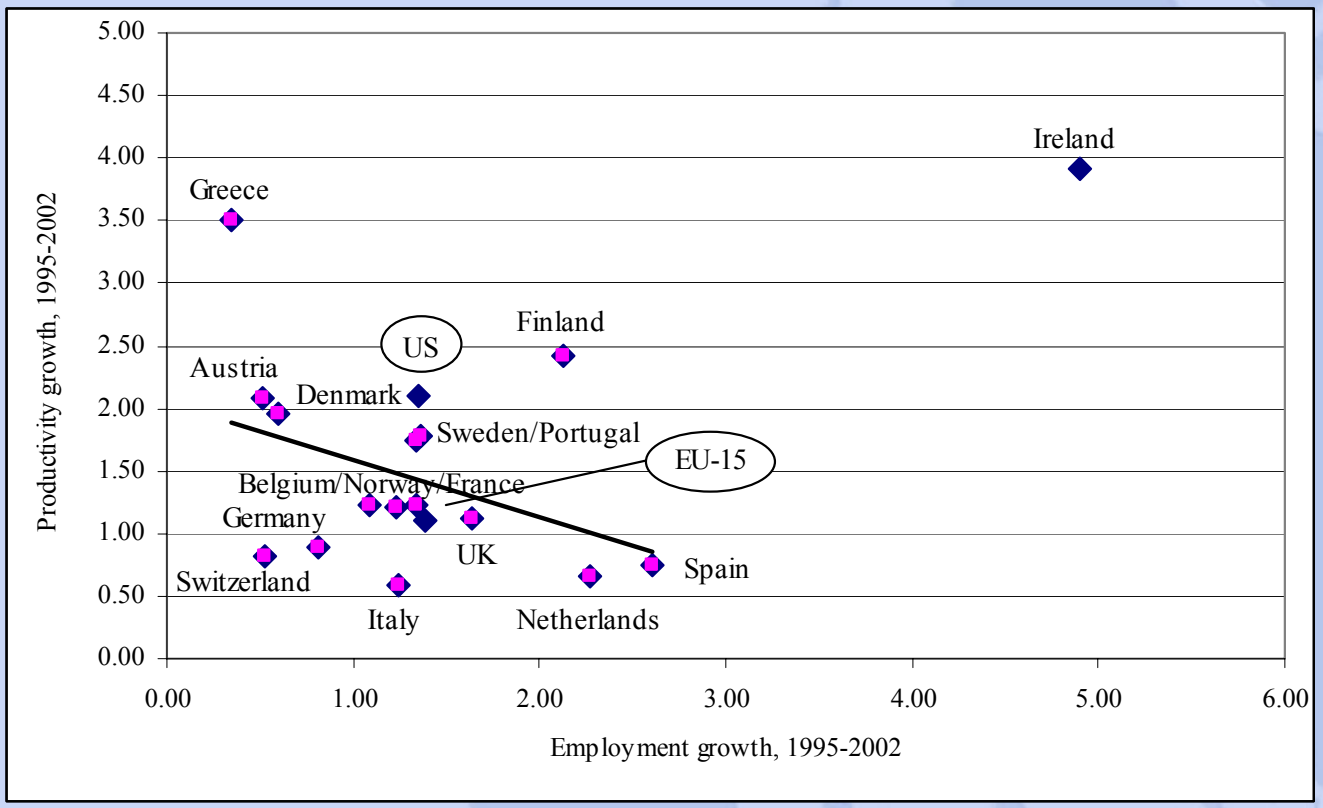
Can marginal groups explain loss of productivity growth?

	Reduction in measured average productivity growth		
		0.5%	1%
Relative productivity level of new entrants in labour market	0.9	0.05%	0.10%
	0.75	0.13%	0.25%
	0.5	0.25%	0.50%

The employment growth productivity trade-off: The real issue

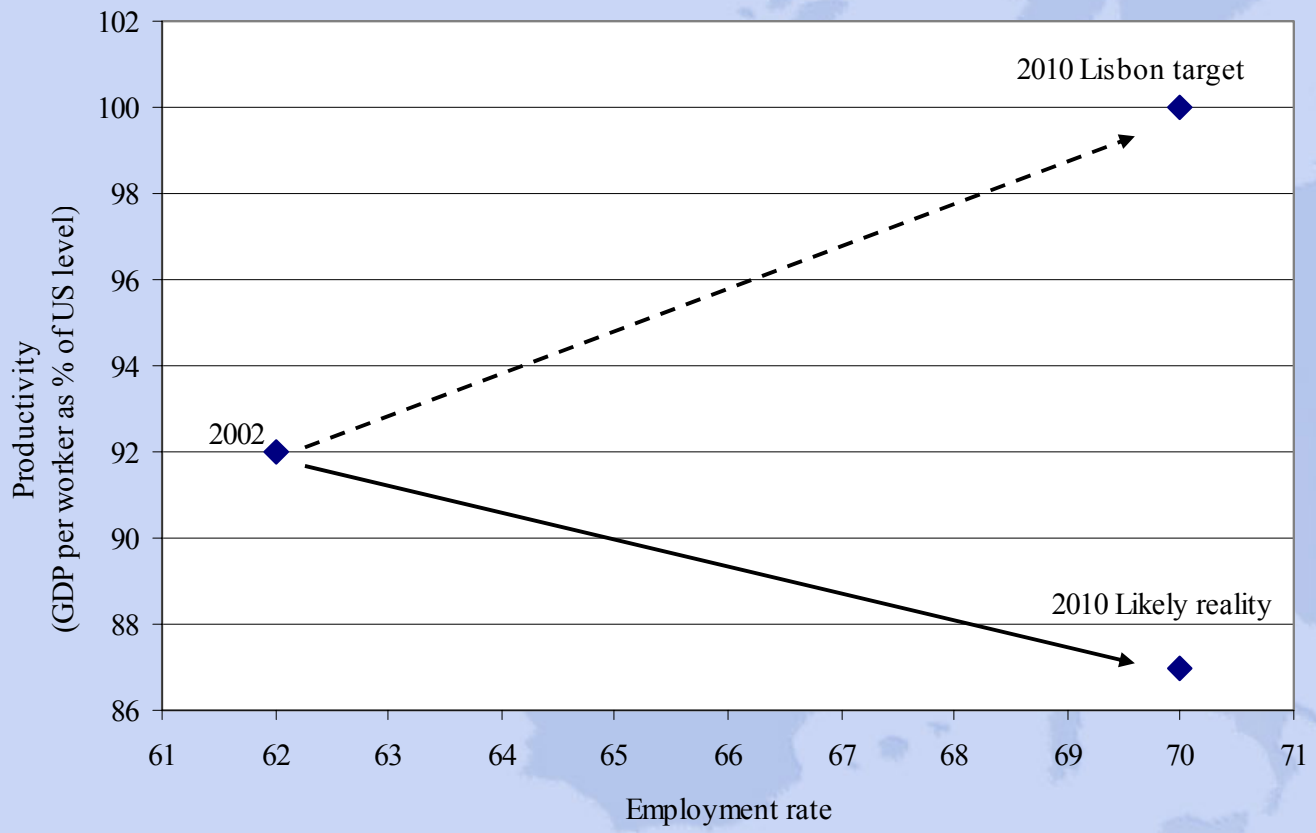
- Higher employment growth implies lower productivity growth if investment does not increase.
- Empirical regularity in Europe.
- Implications for Lisbon goals (cannot have both employment and productivity for the same price (investment)).

Productivity and employment growth in Europe and the US (1995-2002)



Notes: "Employment growth" is the growth rate of total employment; "Productivity growth" is the growth rate of GDP per employed person. *Source*: OECD *Economic Outlook.*

Lisbon: Employment vs. productivity?



How to explain differences in performance within Eurozone

- Same monetary policy.
- Small countries should have been hit harder by global slowdown (more open).
- Large countries had more « expansionary » fiscal policy, but also
- Too much industry?

Small is beautiful? Relative performance of eurozone member countries (%)

	Average of big euro-3	Small euro-8	France	Germany	Italy
Growth	1.93	3.95	2.52	1.53	1.75
Fiscal balance	-2.06	0.13	2.13	1.99	2.07
Labour productivity	0.92	1.75	1.22	0.89	0.67
Share of industry	21.1	17.4	16.8	22.3	23.3

Notes: Big euro-3 = D+F+IT; Small euro-8 = euro-12 minus D+F+IT+ES. All variables average 1997-2002.
Source: European Commission.

Some concluding remarks

- Structural reforms cannot change negative trends (demographics and K/L ratio).
- But can help to make headway.
- Example of smaller euro member countries shows that better performance is possible.

Needed: a structural reform of fiscal policy

- Actual policy decisions determined by short term considerations (political expediency mixed with some primitive Keynesian ideas.)
- Long-term objectives and issues forgotten:
- Deficits crowd out investment!
- Tax smoothing to prepare for ageing

Tighter fiscal policy: the double dividend

1) Ageing makes surpluses today desirable to prepare for ageing.
2) Deficits crowd out investment! Switch to surplus should crowd in enough investment maintain K/L and hence productivity.

Lack of policy leadership makes the ECB a convenient scapegoat. But even so, lower rates are appropriate with reforms.