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ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

The Role of Structural Reform for Adjustment and Growth

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Summary

Structural reforms to labour and product markets help to improve economic growth prospects and the ability of economies to adjust to shocks by expanding flexibility and improving the efficiency of how and where productive factors are used.

The recent financial and economic crisis prompted EU countries to undertake considerable reforms, which are now starting to show tentative results.

Their full benefits, however, may take years to materialise, which means that governments must avoid the temptation to give up on them now that the economic situation is somewhat more comfortable.

1. Introduction

The EU's approach to fighting the economic, financial and sovereign debt crisis can be described as a combination of fiscal consolidation, financial sector stabilisation, and profound structural reforms in labour and product markets. This approach is reflected in the priorities set by the Annual Growth Survey and in the European Commission's country-specific policy recommendations to Member States in the framework of the European Semester, the EU's annual cycle of economic policy coordination.

Immediate action to strengthen government finances and stabilise the financial system were necessary in the midst of the crisis to avoid further instability and contagion.

Now that we seem to have arrived in calmer waters, policymakers are increasingly focusing on the longer term challenge of how to strengthen our economic fundamentals so that our economies can grow sustainably and raise our living standards. Strengthening our economic fundamentals will require further reforms in labour and product markets, beyond those carried out during the crisis to restore competitiveness and correct imbalances.

2. The relevance of structural reforms for adjustment and growth

Let us be a bit more concrete about what we mean by structural reforms and why they are relevant for growth and adjustment. Growth is not so much about working harder; it is about working smarter. In other words, it is about using productive factors as efficiently as possible. The average productivity of a country gives only limited guidance in this respect because productivity levels differ greatly across and within sectors. Reallocating resources efficiently can bring significant gains and this is the aim of structural reforms.

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Product and labour market reforms should promote more efficient use of scarce resources. Reducing barriers to the reallocation of capital and labour across firms helps ensure that the most productive firms can achieve their growth potential and that less efficient ones get restructured or leave the industry.

Start-up difficulties, such as entry regulations, protect incumbent firms against competition from newcomers, which can lead to excessive prices and/or lower quality products/services and/or less innovation. This harms consumer welfare and has damaging macroeconomic implications.

The scope for reducing unnecessary regulation appears to be especially relevant in the EU's service sectors. Deregulation could generate additional indirect benefits in the sense that services constitute an important intermediate input to downstream sectors such as manufacturing.

Reforms to labour markets that increase labour utilisation and boost output potential are vital to reducing structural unemployment, improving activity and employment rates, and boosting potential growth and welfare.

In order to weather economic shocks, prices and wages must be allowed to adjust and production factors to reallocate.[1] This is particularly true for the euro area, in which participating members need to be able to adjust to shocks and competitiveness pressures without the help of a domestic monetary policy or exchange rate policies.

3. Recent reform efforts

3.1 Product market reforms

One way to track progress in structural reforms is through global country rankings. Despite their limitations, rankings can shed some light on actual and perceived strengths and weaknesses of a country's business environment. They also attract a lot of attention and are likely to influence investors' perceptions, the debate among policy makers, and public opinion about reforms and reform priorities.

First our analysis looks in more detail into reform efforts in selected euro area countries that have been hit particularly hard during the crisis, namely Greece, Italy, Portugal and Spain, through the lens of the publicly available information underpinning global country rankings. Since rankings do not capture distance between countries, the values of the indicators per se are used instead. Progress is then measured by comparing recent information with the situation before the crisis.[2] Key global country indicators, mainly in the areas of business environment, are used to benchmark the progress against EU countries. The selected indicators cover the following areas: easiness of doing business (from World Bank); quality of regulation, rule of law and corruption (World Bank); business regulation and property rights (Fraser Institute); goods market efficiency (World Economic Forum); late payments (Intrum Justitia); efficiency of judicial system (CEPEJ). Finally, an indicator directly measuring reform effort (Product Market Regulation indicator from OECD) is also included.

The results are depicted in the form of a heat map (Figure 1) where red and orange are synonymous of bad and weak performance, respectively; and light green and dark green represent good and strong performance, respectively. Arrows indicate the direction of the change between the two years considered. An arrow pointing upwards (↗) implies that the considered country indicator improved in recent years, and an arrow pointing downwards (↘) that the indicator deteriorated in recent years. A horizontal arrow (→) indicates no relevant change. Colours reflect a country's relative position to EU average. The evolution is proxied by the arrows which are the result of absolute changes in the indicators of each country. For example, the situation regarding starting a business has improved in the four countries.

[1] Main channels for labour market adjustment include working time organisation, nominal and/or real wages, mobility across different jobs and labour market status and commuting. In the longer run, investment in human capital is crucial to improve the adjustment capacity of an economy.

[2] Based on the report 'Product market reforms in vulnerable countries', European Commission, DG ECFIN (forthcoming), in which the economic impact of a variety of structural reforms in vulnerable member states is studied.

Figure 1: Heat map business environment

	Year: Before the crisis	Year: Recent	Greece	Italy	Portugal	Spain
DB Dealing with construction permits	2008	2013	↗	↘	↗	↘
DB Enforcing contracts	2008	2013	↘	↗	↗	↗
DB Getting credit	2008	2013	↗	→	→	→
DB Paying taxes	2008	2013	↗	↗	↗	↗
DB Protecting investors	2008	2013	↗	→	→	→
DB Resolving insolvency	2008	2013	↘	↗	↗	↗
DB Starting a business	2008	2013	↗	↗	↗	↗
DB Trading across borders	2008	2013	↗	↗	↗	↗
FI Business regulation	2008	2011	↘	↗	↗	↗
WB Regulatory quality	2008	2012	↘	↘	↘	↘
WEF Goods markets	2008	2013	↘	↘	↘	↘
IJ Business late payments	2008	2013	↘	↘	↗	↘
IJ Public late payments	2008	2013	↘	↘	↗	↘
FI Legal structure and property rights	2008	2011	↘	↗	↘	↗
WB Rule of law	2008	2012	↘	↘	↗	↘
CEPEJ Clearance rate	2008	2012*	↘	↗	↗	↗
CEPEJ Disposition time	2008	2012*	↘	↘	↗	↘
PMR State control	2008	2013	↗	↗	↗	↗
PMR Barriers to trade and investment	2008	2013	↗	↗	→	↗
PMR Barriers to entrepreneurship	2008	2013	↗	↗	↗	↗

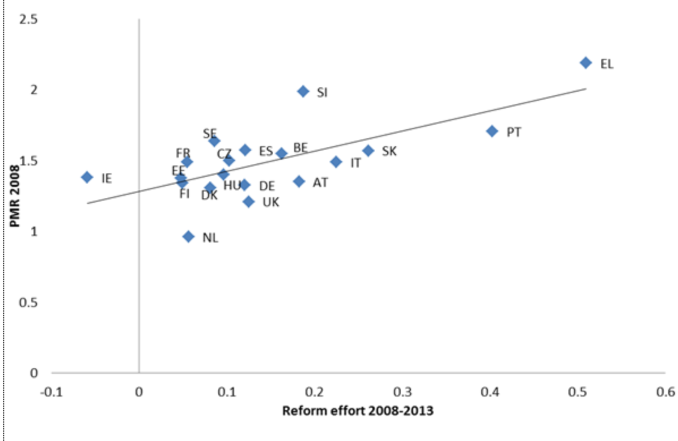
*Spain information refers to 2010

Notes: CEPEJ clearance rate and disposition time are computed for total non-criminal cases. Sources: World Bank and International Finance Corporation Doing Business, World Bank Worldwide Governance Indicators, OECD, Fraser Institute, World Economic Forum, Intrum Justitia, CEPEJ.

The heat map shows that overall progress, evaluated in terms of "moving into green", is observed in Portugal, Italy and Spain (although there are some areas showing deterioration such as disposition time and enforcing contracts in Italy and Spain). Progress has been more limited in Greece.[3]

Figure 2 illustrates the relationship between the OECD's PMR indicator in 2008 and the reform effort (defined as the reduction in the PMR indicator between 2008 and 2013). This figure shows that countries with relatively restrictive product market regulation in 2008 tend to exhibit on average an intensified reform effort afterwards.

Figure 2: Product market restrictiveness in 2008 and subsequent reform efforts



Note: OECD's Product Market Regulation indicator ranges from 0 to 6, where 6 stands for very restrictive.

3.2 Labour market reforms

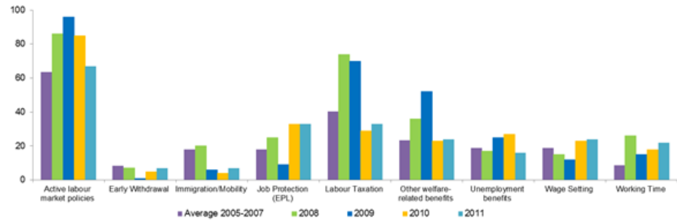
Similarly, labour market reforms carried out since the start of the crisis broadly reflect the need to modernise existing policy and regulatory settings, with a view to improve the resilience and flexibility of European labour market. Because the crisis has hit countries differently and because fiscal positions vary, the policy response of every country has been quite different, with the hardest-hit countries undertaking the greatest reforms.

A simple count of measures by policy area using the LABREF database on labour market reforms,[4] allows broad reform trends over recent years to be captured. As Figure 3 shows, after a first phase during which Member States concentrated on fiscal stimuli in order to contain the short-term impact of the crisis on labour markets, from 2010 onwards, attention turned to the need to enhance the adjustment capacity and to favour the rebalancing process in those countries that had accumulated large current account deficits. In line with EU recommendations, reforms tended to be more macro-structural in nature, focusing on employment protection legislation (EPL), the design of automatic stabilisers and wage-setting frameworks. The number of reforms in labour taxation and benefit-related domains were highest in the early years of the crisis, while the frequency of EPL and wage-setting reforms increased mainly after 2010.

[3] This assessment is necessarily partial as the heatmap only covers progress in selected areas.

[4] Database available at: http://ec.europa.eu/economy_finance/db_indicators/labref/index_en.htm.

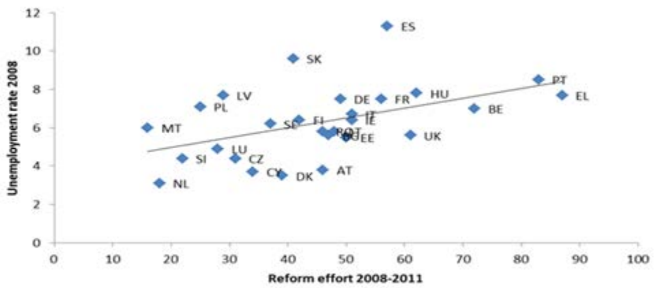
Figure 3: Average number of labour market measures by policy domain in the EU-27 countries



Source: DG ECFIN LABREF database.

Figure 4 illustrates the relationship between the unemployment rate in 2008 and the reform effort undertaken between 2008 and 2011. The figures shows that countries with relatively higher unemployment rates in 2008, such as Greece and Portugal, tended to make the most intense labour market reform effort in the following years.

Figure 4: Unemployment rate in 2008 and subsequent labour market reform efforts



A number of Member States launched important reforms to modernise employment protection regimes with a view to encouraging job creation while tackling labour market segmentation between types of contracts (i.e. Portugal, Czech Republic, Estonia, Netherlands, France, Italy, Greece, Slovenia, Slovakia, and Hungary). Figure 5 shows the OECD EPL indicators on strictness of laws on individual dismissals for permanent contracts. It compares values for 2008 with values for 2013 and shows that only in Denmark and Ireland did an increase in the degree of protection take place. In the majority of the other countries, EPL either remained constant or fell as a result of reforms carried out in the post-crisis period. The reduction in the EPL indicator appears to be particularly strong for Portugal, starting from a high degree of protection, but reductions are visible also for Estonia, Greece, Spain, Italy and Slovakia.

Figure 5: EPL indicators, individual dismissals, permanent contracts

Source: OECD

A number of high-unemployment countries have also taken steps aimed at decentralising and rationalising the wage-setting system and easing the adaptation of wage conditions to the economic environment (e.g. France, Italy, Portugal, Spain). Social partners played a key role in this process in most countries, both in the preparation of new legislation and by concluding bipartite or tripartite agreements and social pacts detailing the application of existing legal frameworks. These adjustments have been important components of the adjustment in countries which needed to restore cost-competitiveness and have translated into a greater convergence of unit labour costs within the euro area in recent years.

The quality and effectiveness of active labour market policies and the efficiency of public employment services are also essential to fight unemployment, as shown by the number of measures adopted in this field in recent years. Such policies will play a crucial role in fighting high and persistent unemployment and in preventing it from becoming entrenched and turning into structural unemployment.

4. Structural reforms and results

4.1. Adjustment

By adjustment of an economy we mean structural changes that help remove macroeconomic risks and vulnerabilities and set the scene for economic recovery and sustainable growth. Part of this adjustment comes from reallocation of factors across and within sectors, and changing the incentives on the use of the available resources.

The vulnerable countries in the EU were until recently typically characterised by large current account deficits and are still burdened by large foreign debts. In order to repair these imbalances, these countries need to expand their tradable goods sectors, increase their exports and replace their imports with domestic production. European Commission[5] data show that in Spain, and to a more limited extent Greece, the size of the tradable sector has increased while the share in total employment in the non-tradable sector has decreased.

Some structural changes are driven by automatic adjustment of the economy (e.g. the downsizing of an oversized construction sector), but structural reforms are needed not only to facilitate and smooth this process but also to create new, better and sustainable business opportunities. A low degree of regulation in product markets is associated with a better, more efficient allocation of resources within sectors. The Box provides some examples of work by the European Commission to quantify the impact of specific product market reforms.

BOX: Empirical assessment of the impacts of selected reforms

Reform of regulated professions[6]

The 'liberal professions' are generally defined as occupations requiring special training in the arts or sciences, such as lawyers, engineers, architects and accountants. Some of these professions are closely regulated by national governments and professional bodies which limit the number of entrants into the profession, set the rates that can be charged, determine the organisational structure of businesses providing professional services, and protect exclusive rights enjoyed by practitioners. Such intensive regulation can hold back the performance of these sectors, with significant costs for consumers and downstream businesses. A more flexible and transparent regulatory framework would facilitate the mobility of qualified professionals within the Internal Market, the cross-border provisions of professional services and, at a more microeconomic level, through enhanced competition, improve resource reallocation within sectors and decrease mark-ups. Large-scale reforms of regulated professions are taking place in a number of Member States (e.g. Poland, Portugal and Slovenia). In a forthcoming publication of European Commission staff, the impacts of reforms of regulated professions are quantified, using a novel 'two-step' approach in order to analyse the various transmission channels through which reforms affect performance. This exercise shows that reforming regulated professions can generate substantial gains for consumers and firms.

The first step investigates the impact of reforms in regulated professions and the entry, growth and exit of firms in the selected sectors. The second step quantifies the relationship between entry, growth, and exit of firms on performance indicators For example, it is found that a reduction of the Product Market Regulation indicator of the OECD by 1 point (on a scale from 0 to 6, where higher numbers are associated with increased restrictiveness) increases the birth rate of new companies in the relevant sectors by 0.8 %-point, which in turn correspond to a reduction of the profit rate by 5.4 %-point.

Reform of judicial systems[7]

A well-functioning civil justice system is an essential requisite for an effective business environment. Predictable, timely and enforceable judicial decisions contribute to trust and stability, creating favourable conditions for entrepreneurial activity and investment choices. A broad number of areas can be found where efficiency and effectiveness of civil justice are important for the functioning of a market economy. These include the enforcement of property, credit and intellectual property rights, as well as labour, insolvency and administrative law.

In the aftermath of the crisis, a number of Member States have undertaken civil justice reforms, in line with the European Semester recommendations. These reforms which are mostly aimed at reducing the length of civil and commercial trials as well as the backlog of pending cases, aim to improve the efficiency of judicial procedures, while preserving the independence of judges and fair access to justice.

A forthcoming work by European Commission staff provides an econometric investigation of the impact of structural reforms affecting the civil justice system on selected economic outcomes, such as business dynamics and foreign direct investments (FDI).

The findings highlight that a 10 % decrease in the number of courts as a ratio to population (e.g. as a result of a reorganisation of judicial geography aimed at achieving economies of scale) is associated with an increase in FDI net inflows as a ratio to GDP by 0.05 percentage points, through an increase in judicial efficiency measured by a reduction in backlog ratio by 4.6 % (while keeping the number of judges constant).

The analysis shows that civil justice efficiency (measured by disposition time and the ratio of pending civil and commercial cases to population) is the main transmission channel linking judicial reforms to economic variables. The findings support the growth potential of judicial reforms rationalising the organisation of courts, fostering investment in in-court ICT and reducing excessive litigation rates (for

[5] European Commission DG ECFIN (2013): 'Stylised facts on employment reallocation in Italy, Greece, Portugal and Spain', staff note for the attention of the LIME Working Group.

[6] Based on E. Canton, D. Ciriaci, I. Solera Lopez (forthcoming): 'Impact of product market regulation on the efficiency and profitability of legal, accounting, architectural and engineering services', European Commission, DG ECFIN.

[7] Based on D. Lorenzani and F. Lucidi (forthcoming): 'The economic impact of civil justice reforms', European Commission, DG ECFIN.

instance by enhancing alternative disputes resolution procedures), which are all found to positively affect the efficiency of civil justice. Through increased judicial efficiency, these reforms can potentially enhance entrepreneurial activity (as measured by firms' entry rates) and FDI.

4.2 Growth simulations with QUEST

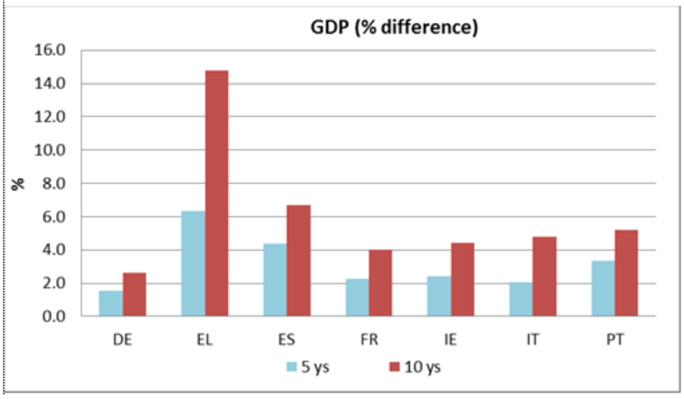
The potential impact of structural reforms on economic growth was calculated in a recent study by the Commission.[8] This model-based exercise used a benchmarking approach based on structural indicators of labour and product markets to quantify the potential for reforms by assuming a gradual and partial closure of the gap vis-à-vis the average of the three-best EU performers. To avoid setting unrealistic and/or unattainable targets, it assumed only half of these gaps would gradually be closed (more ambitious reforms closing the full gap would double the effects).

The gains in output and employment if countries would narrow the gap relative to best performance could potentially be large. GDP could be raised by 1.5 % to 4 % after five years and between 2.5 % and 6.5 % after ten years. In the case of Greece the effects could be even larger (6 % and 14 % respectively, see Figure 6). Some of these effects may actually be already in the pipeline, as the structural indicators of labour and product markets used were mainly based on 2012 data, and recent reforms have partially closed these gaps. Simultaneous reforms in all countries would raise the GDP of each individual country more than reforms undertaken alone, as higher demand effects help to support growth in other MS.

Product market reforms that lower mark-ups and increase competition reduce the costs of goods and services for consumers, boosting consumption and investment, as well as employment, but these are likely to emerge gradually.

Labour market reforms reduce the cost of adjusting employment, making it easier to reallocate labour across firms and sectors, and increasing productivity. Incentives to raise participation rates among women and/or older people and to improve skills can yield larger gains in the medium to long term. These reforms boost growth, lead to higher tax revenues, and contribute to long-term debt sustainability. Structural fiscal reforms that shift the tax burden away from labour towards less distortionary taxes could be implemented relatively rapidly and boost employment and growth.

Figure 6 Potential GDP gains from structural reforms



Note: Reform shocks are based on a set of structural reform indicators covering a wide range of areas, including market competition and regulation, R&D expenditure, skill structure, tax structure, labour market participation, unemployment benefit 'generosity' and active labour market policies.

5. Policy considerations

European countries have shown an increased commitment to tackle the structural weaknesses built-up over the last decade. Although the reform effort undertaken in programme countries and in vulnerable Member States has been impressive; more work still needs to be done, and progress has been more limited in other countries. Structural reforms in product and labour markets are largely about regulation, which can be implemented without substantial additional government expenditures, so there is no excuse not to undertake such reforms from a budgetary or fiscal point of view. Political will is required to overcome vested interests, especially in areas where inefficiencies are deeply entrenched and rent seekers are well-organised.

Structural reform is unfinished business, and there is a risk of complacency and reform fatigue now that economies are recovering.[9] Initial evidence supports the view that effects of structural reforms go in the right direction, and the full benefits of the reforms will take years to materialise. The scale of the challenges at hand, as well as the time needed for the positive effects of reforms to show results, makes it essential that countries persevere and show patience.

[8] 'The growth impact of structural reforms', Quarterly report on the euro area, Vol. 12, Issue 4. December 2013.

http://ec.europa.eu/economy_finance/publications/qr_euro_area/2013/pdf/qrea4_section_2_en.pdf.

[9] See M. Buti and P.C. Padoan (12 September 2013): 'How to make Europe's incipient recovery durable: End policy uncertainty', VOX.