

# The Agenda for Structural Reform in Europe

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# Reforms in Europe

“France said to be in a Depression both Economic and Spiritual. France’s economic malaise has been gradually accumulative for over a generation.

There is a need for reforms. Recent French Governments have been managed by men who have been understandably unwilling to embark upon the drastic economic reforms that must be carried through.”

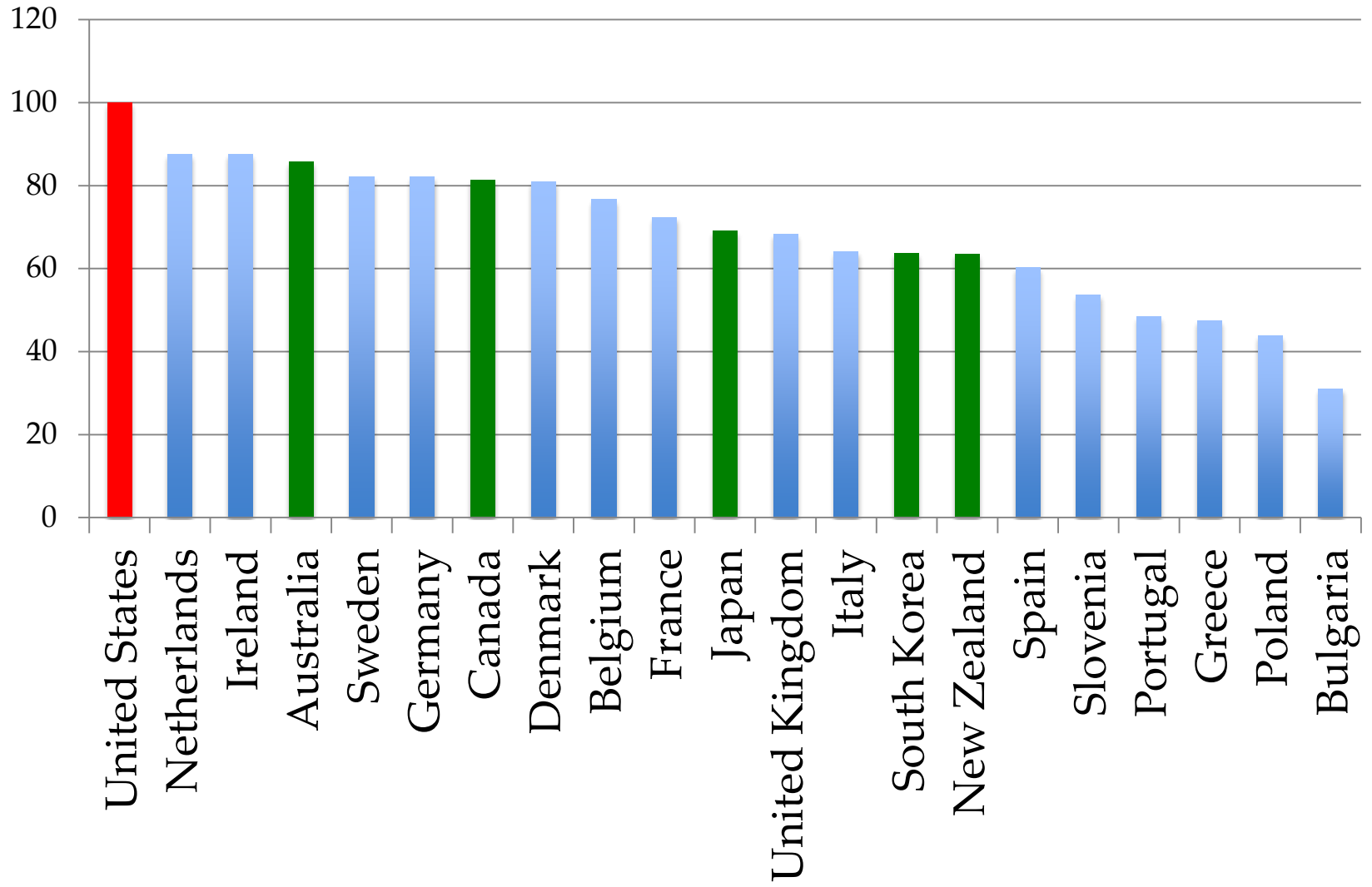
*New York Times, June 25, 1954*

# Outline

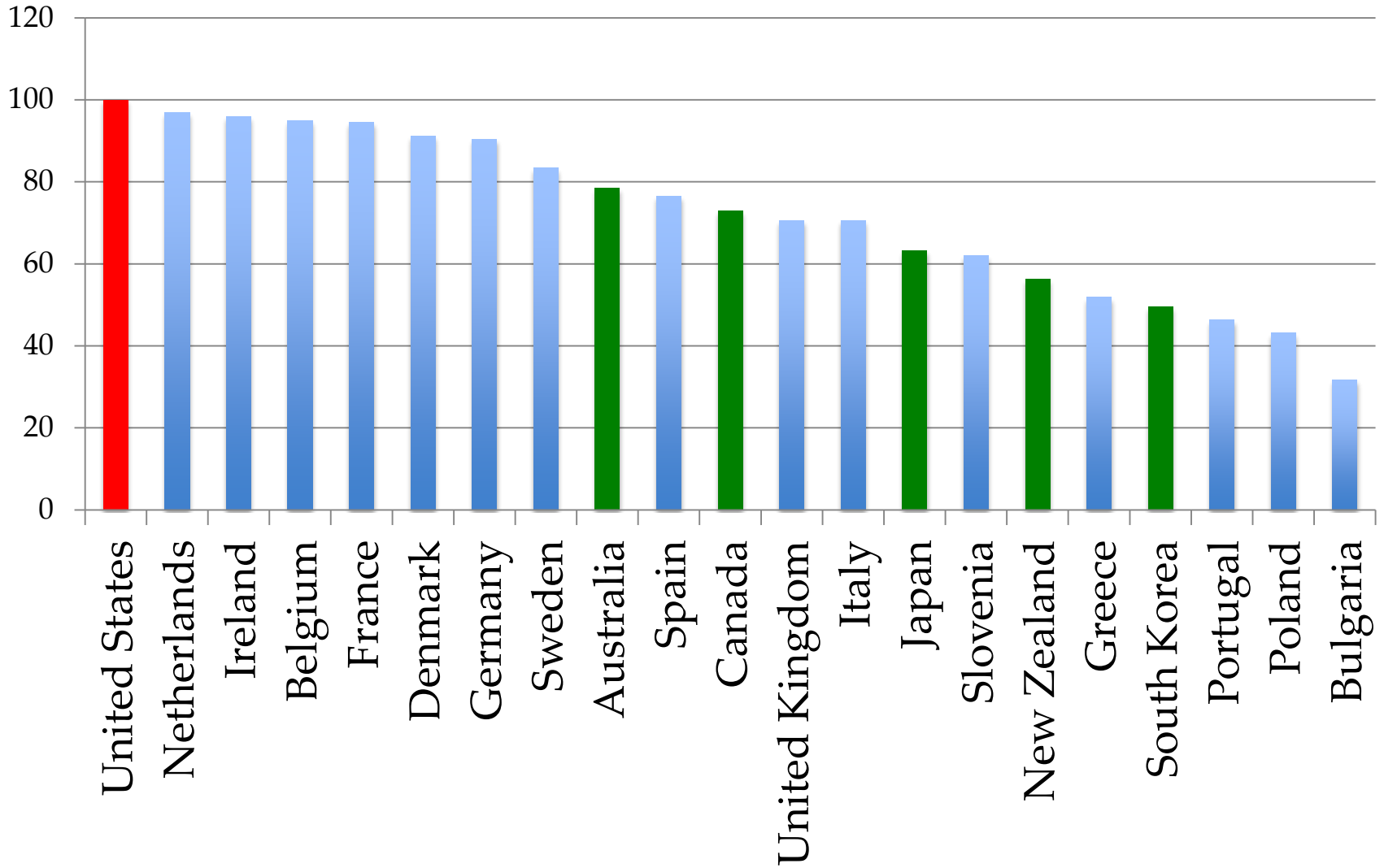
1. The economic performance gap
2. What needs to be reformed
3. The pace of reform
4. The benefits of reform
5. Making reform happen
6. The role of Europe

# The Gap in Economic Performance

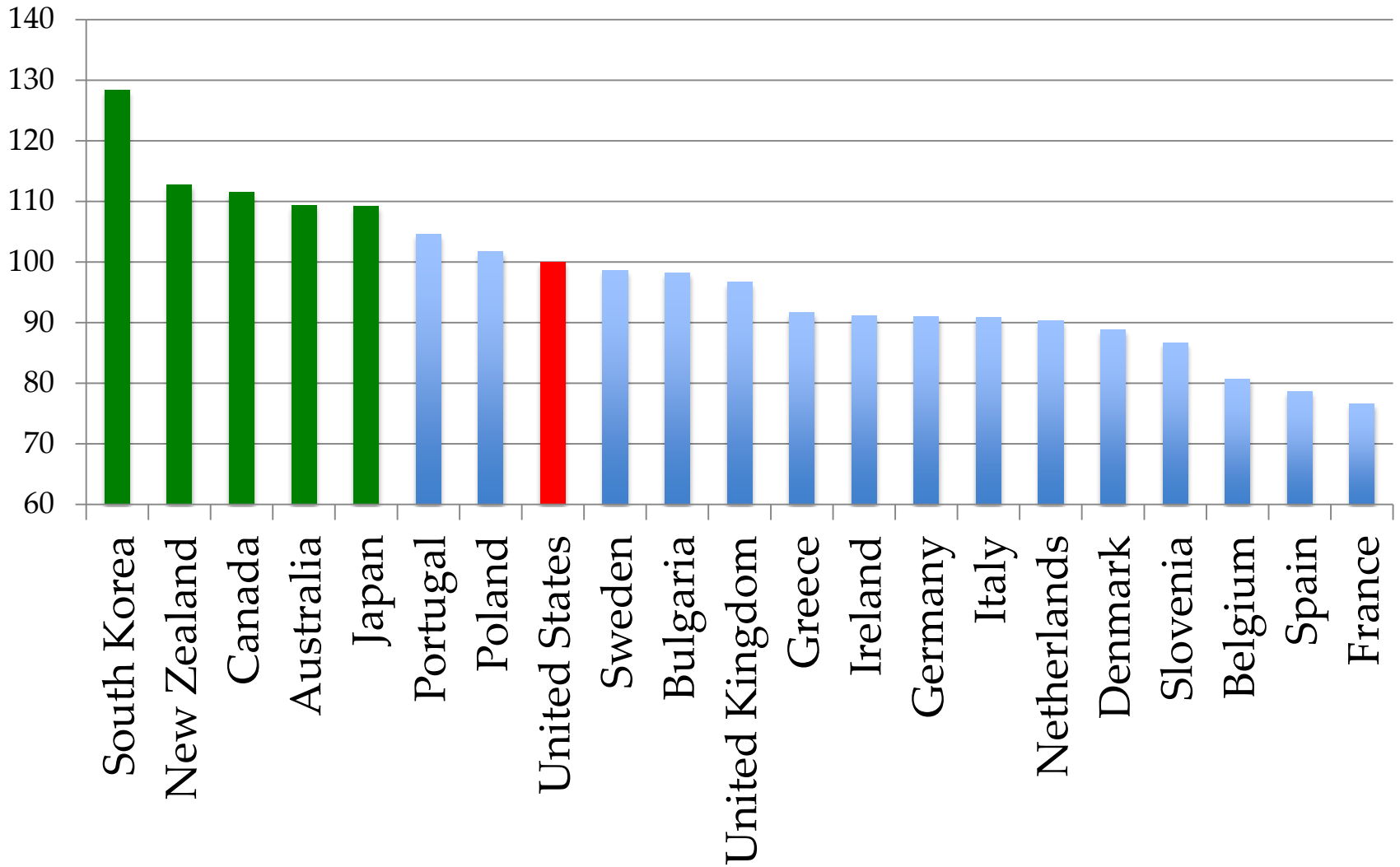
# GDP per Capita



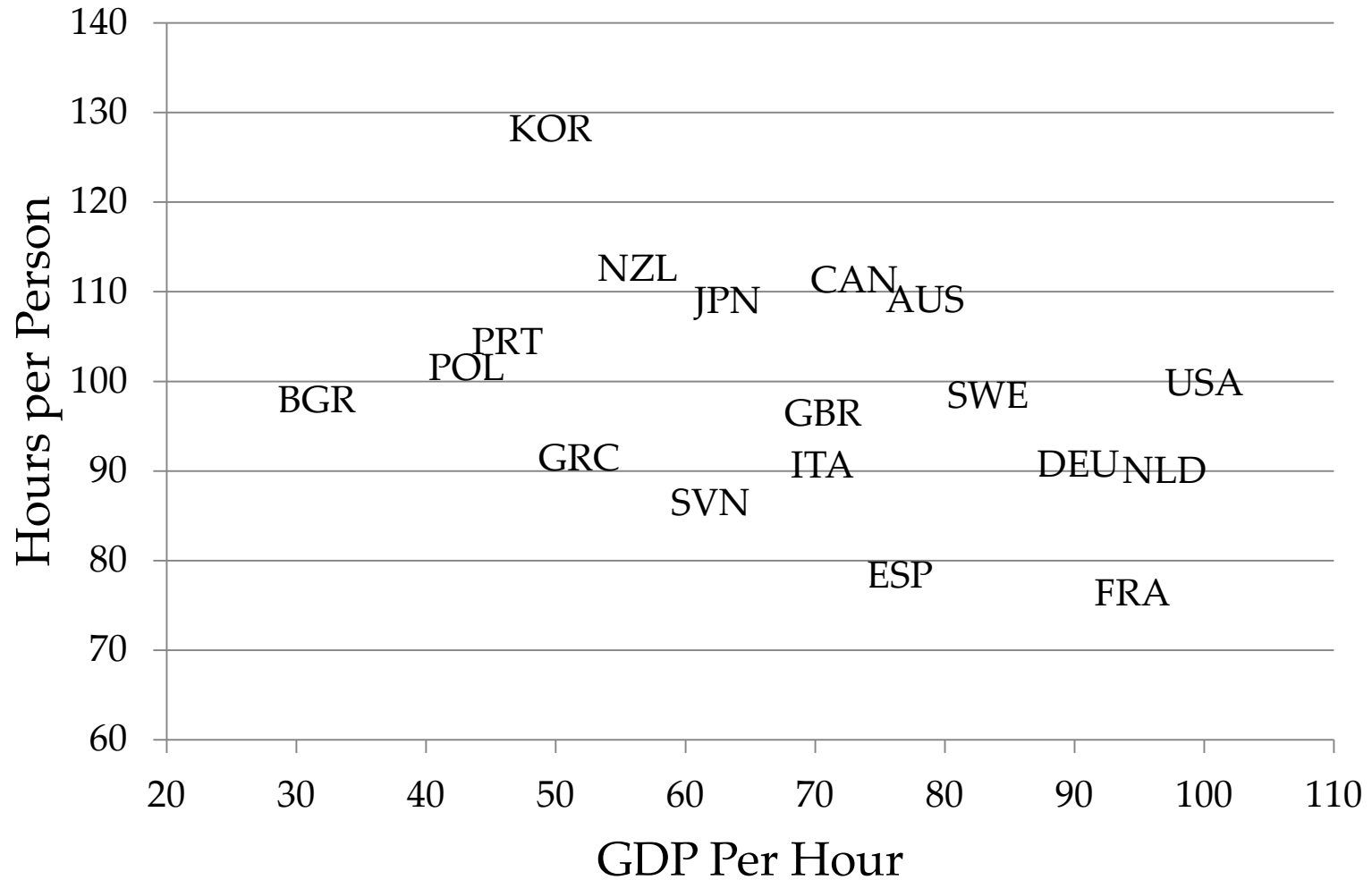
# GDP per Hour



# Hours per Capita



# Productivity vs. Employment





# Demographics, Labor Market and Productivity (Gap to the US)

$$\frac{GDP}{Population} = \frac{GDP}{Hours} \frac{Hours}{WorkingAge} \frac{WorkingAge}{Population}$$

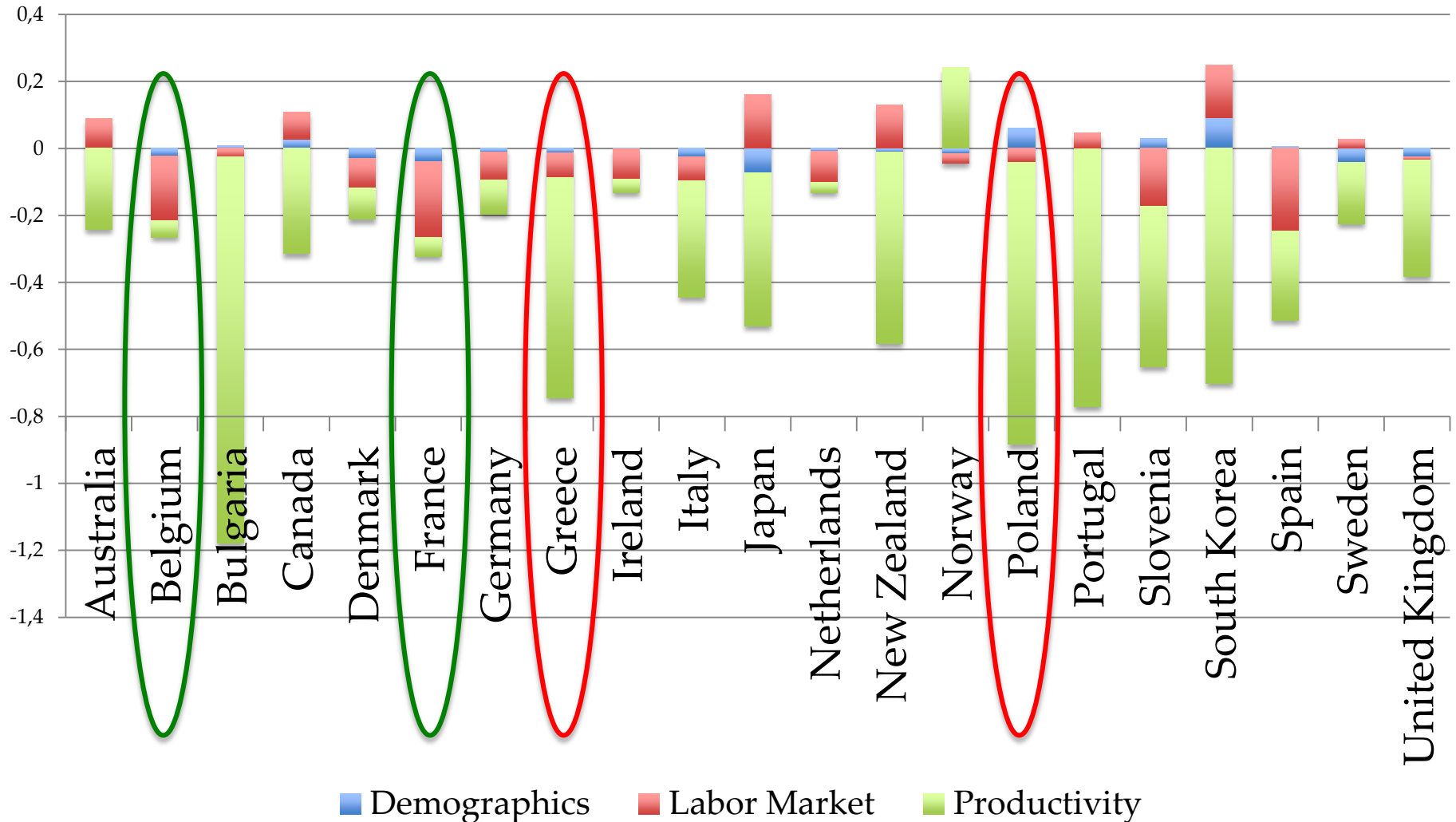
Productivity

Demographics

Labor Market

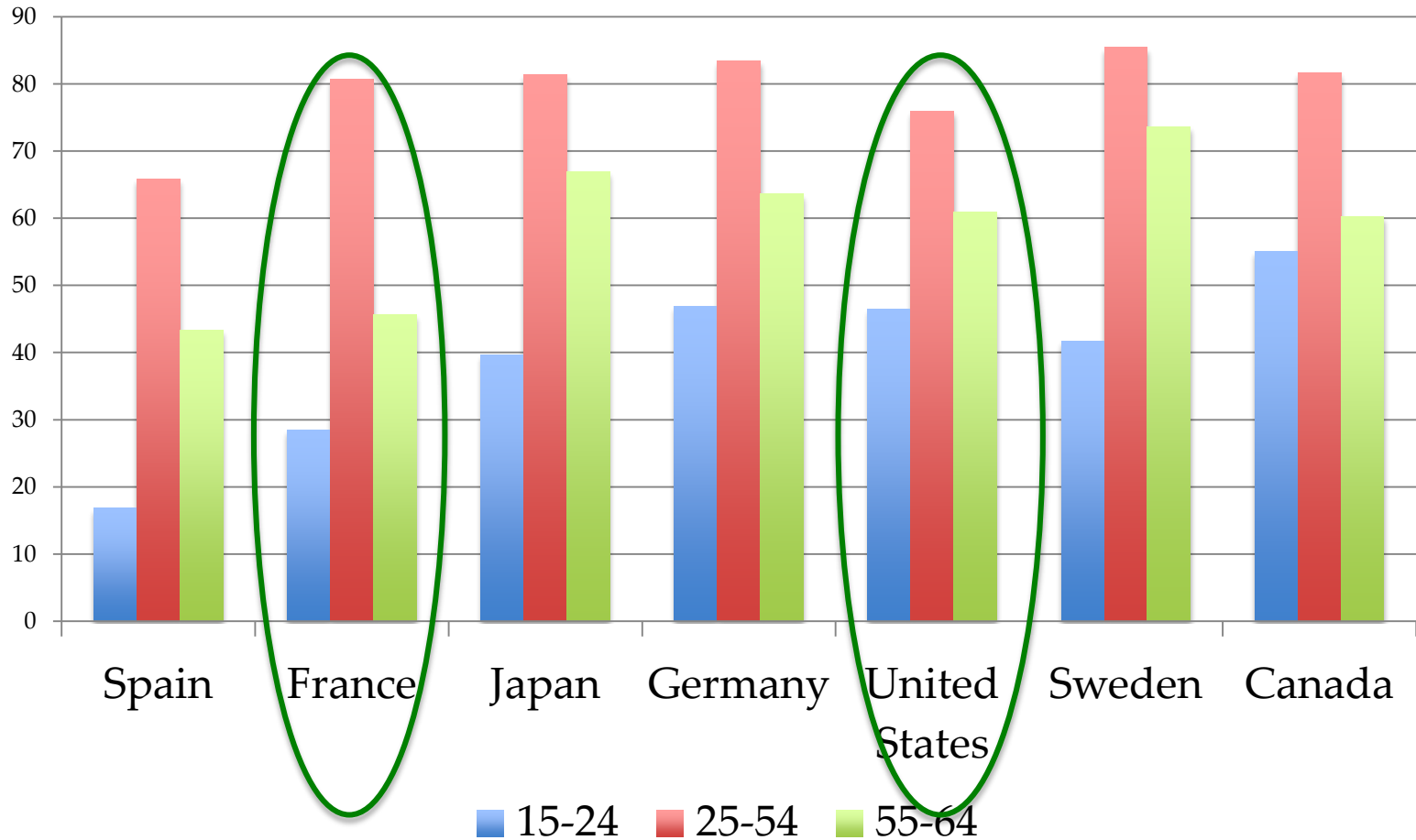
The diagram illustrates the decomposition of GDP per capita into three components: Productivity, Labor Market, and Demographics. The equation is presented as a fraction of GDP over Population, which is equal to the product of three fractions: GDP over Hours, Hours over WorkingAge, and WorkingAge over Population. Blue arrows point from the labels 'Productivity', 'Labor Market', and 'Demographics' to their respective terms in the equation: Productivity points to GDP/Hours, Labor Market points to Hours/WorkingAge, and Demographics points to WorkingAge/Population.

# Demographics, Labor Market and Productivity (Gap to the US)



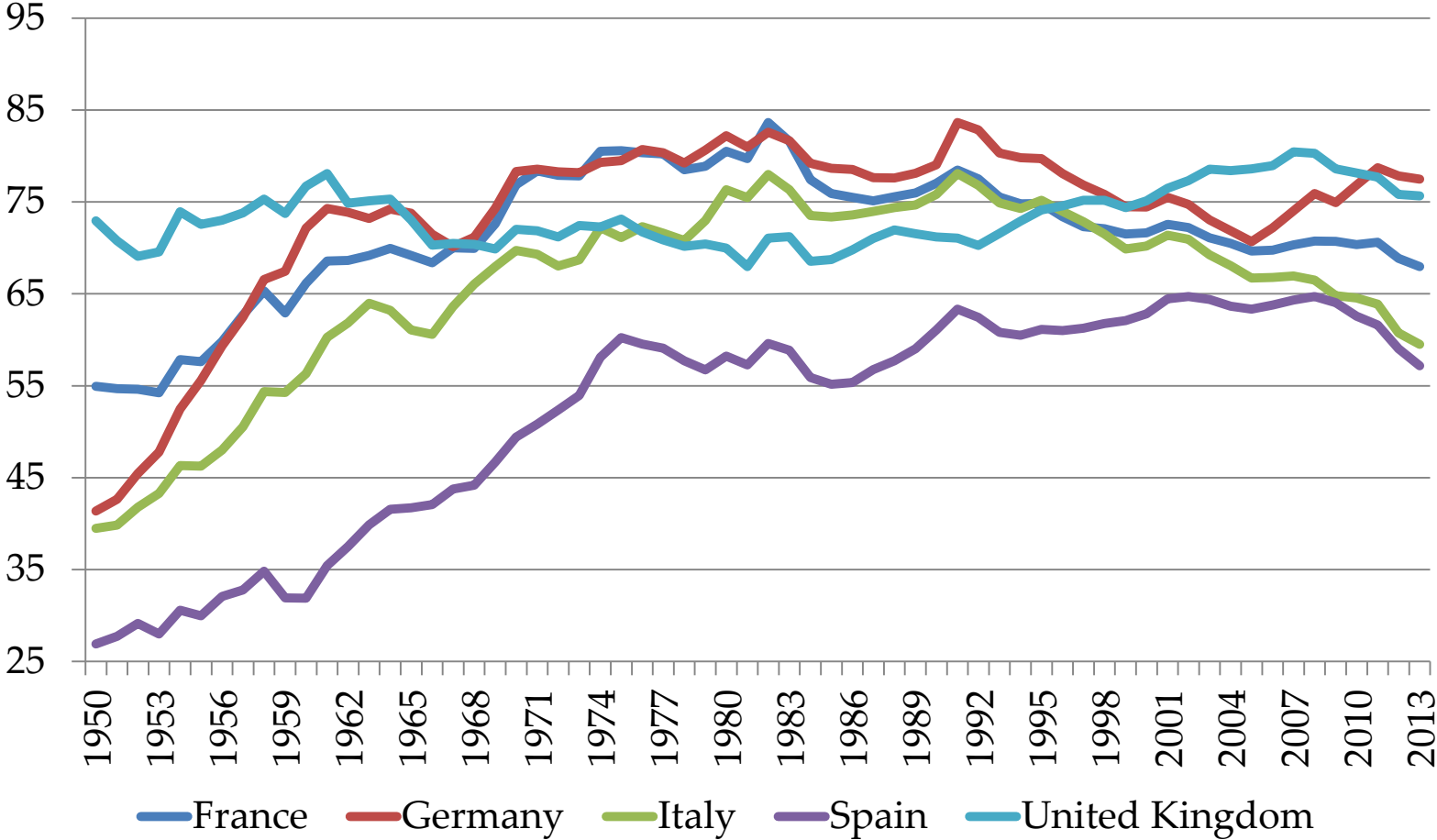
# Labor Market and Demographics

## Employment Rates by Age



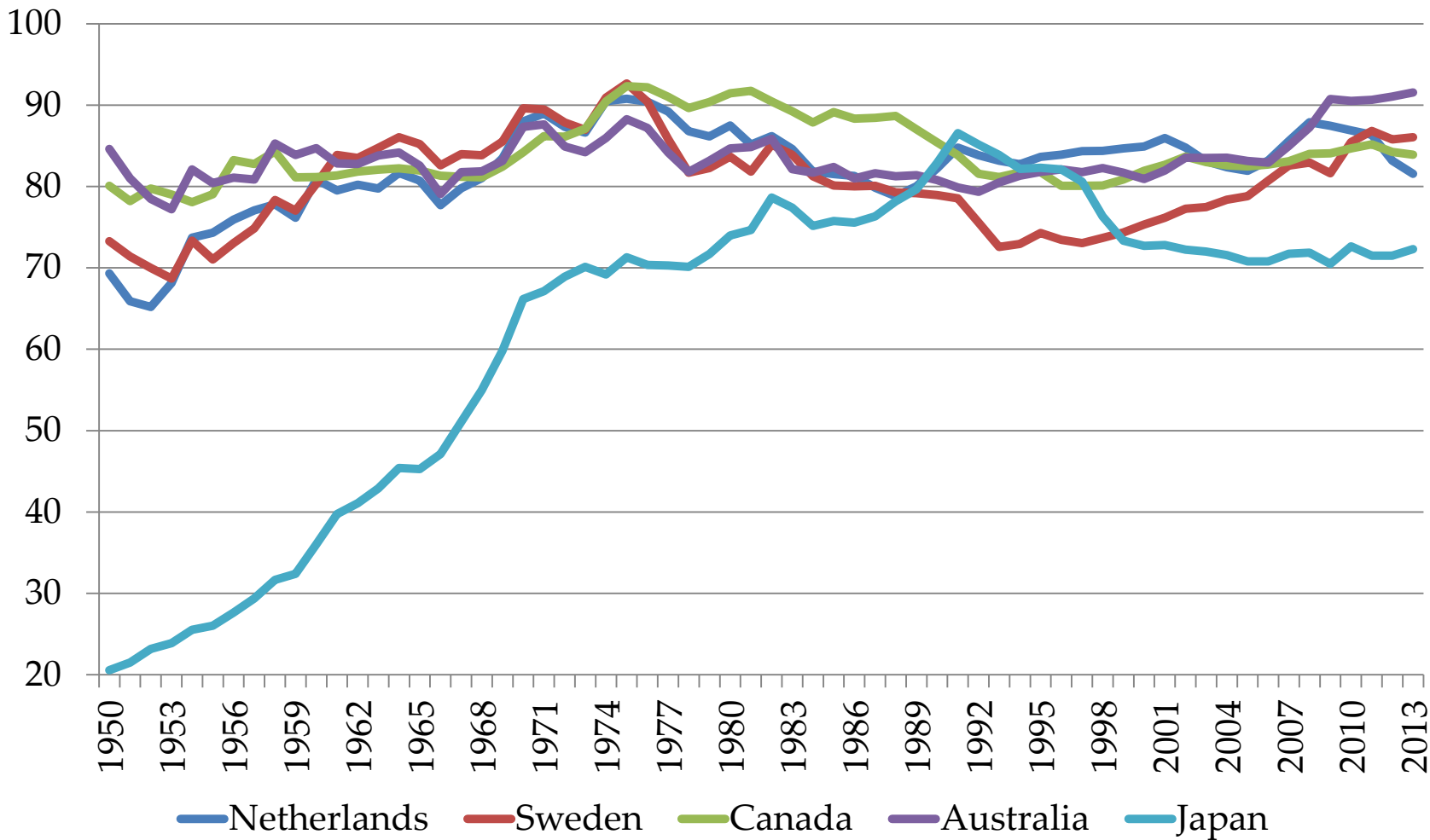
# Convergence

## GDP Per Capita Relative to US



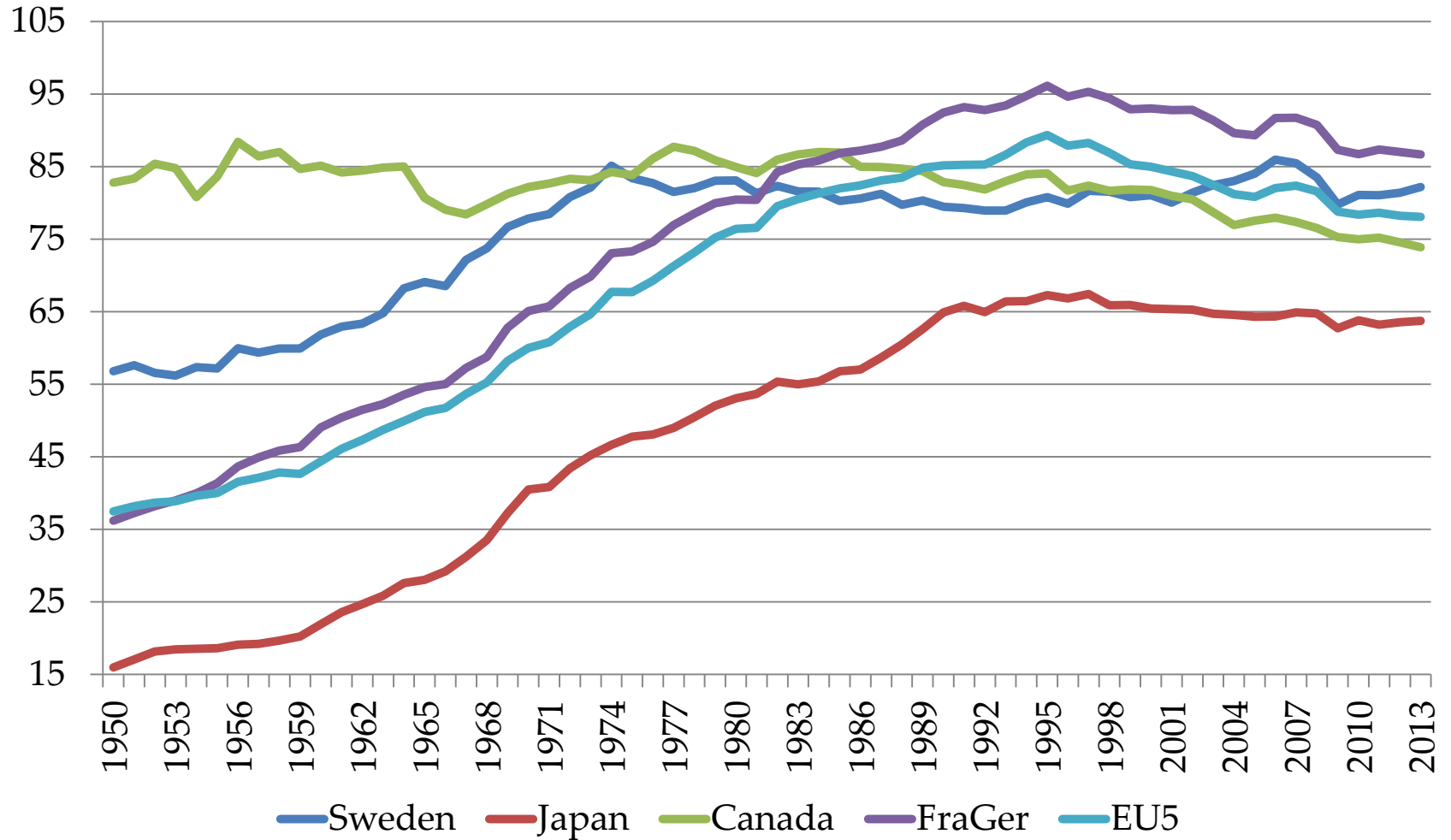
# Convergence

## GDP Per Capita Relative to US



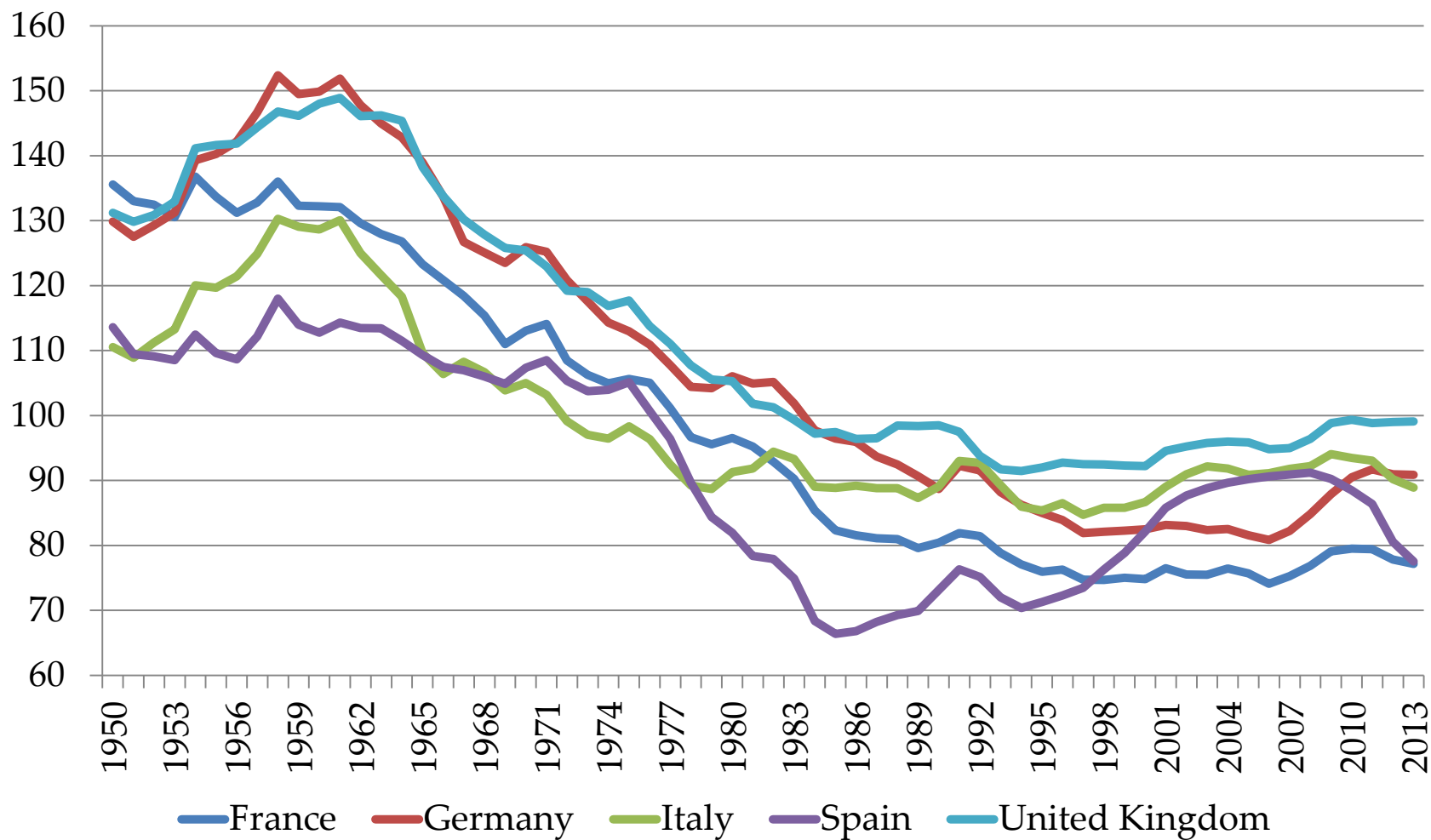
# Convergence

## GDP Per Hour Relative to US



# Convergence

## Hours Per Person Relative to US



# Gaps and Convergence

- Europe (and OECD) < US GDP per capita
- Source of gap = productivity and employment
  - Convergence in productivity stopped and partially reversed
  - Labor (and demographic) dynamics stable
- Lower and declining (?) steady state
- Static or dynamic?



# Gaps, Convergence and Reforms

- Saving rates, technology/efficiency, population growth, institutions/policies... determine convergence and steady state
- Less consensus for countries close to the frontier
- Low steady state interpreted as static inefficiencies
- “Faith” in reforms as a determinant of level differences (and growth rates?)

# Policies, Institutions and Economic Performance

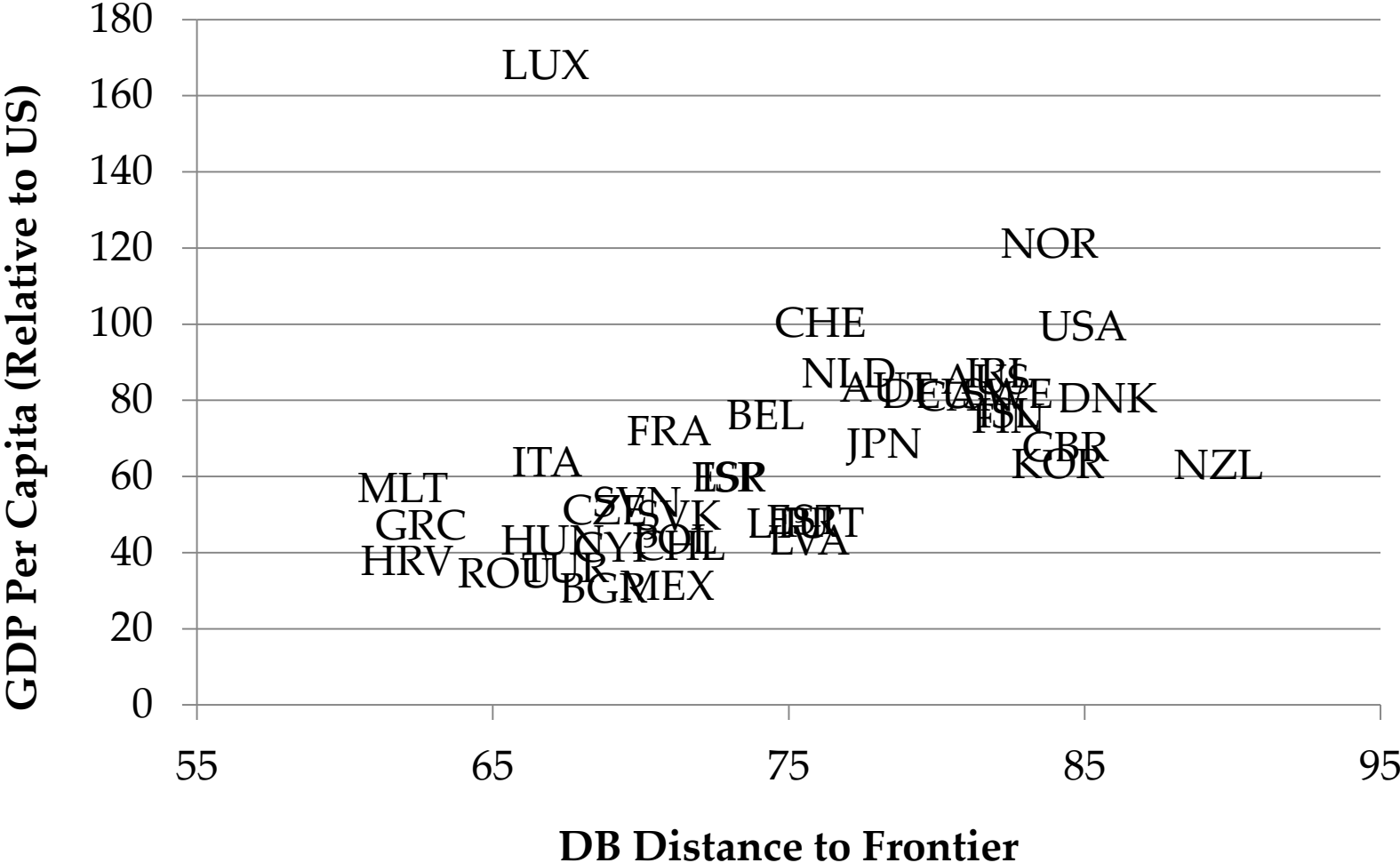
# Gaps in Policies and Institutions

- Macro policies: corruption, accountability,...(e.g. Governance Indicators)
- Micro Policies
  - Doing business (WB)
  - Regulations in product and labor markets (OECD)
- Other: fiscal sustainability, human capital, innovation and diffusion of technologies, financial system,...
- All likely to be highly correlated

# Do Policies Matter? (in the cross section)

- Yes
- Across all measures there is a strong correlation between economic outcomes and policies
- Europe looks similar to other OECD economies

# Do Policies Matter?



# Do Policies Matter?

VARIABLES	GDP Per Capita	GDP Per Hour	Hours Per Capita
Doing Business	2.026*** (0.380)	1.727*** (0.482)	0.558** (0.242)
Constant	-88.58*** (27.90)	-64.72* (35.70)	57.10*** (18.24)
Observations	40	39	39
R-squared	0.462	0.276	0.103

Robust standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

# Do Policies Matter?

VARIABLES	GDP Per Capita	GDP Per Hour	Hours Per Capita
Product Market Regulation	-35.57*** (7.014)	-37.46*** (8.630)	1.792 (8.476)
Constant	116.6*** (11.05)	120.9*** (13.38)	96.53*** (11.92)
Observations	40	39	39
R-squared	0.247	0.222	0.002

Robust standard errors in parentheses

\*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$

# Do Policies Matter?

VARIABLES	Hours per Capita			
	Employment	-7.328**		
Protection	(3.388)			(3.712)
Tax Wedge		-0.738***		-0.819**
		(0.188)		(0.335)
Social Security			-1.021**	0.301
Taxes			(0.448)	(0.611)
Constant	117.6***	119.3***	108.5***	117.4***
	(7.322)	(5.835)	(4.436)	(5.797)
Observations	35	33	29	29
R-squared	0.076	0.399	0.132	0.404

Robust standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1



# Do Policies Matter?

VARIABLES	Employment Rate		Employment Rate	
	25-54		55-64	
Employment Protection	-0.552 (1.602)		-11.21*** (3.196)	
Social Security Taxes		0.0975 (0.202)		-1.596*** (0.334)
Constant	79.28*** (3.190)	76.85*** (2.258)	80.34*** (6.834)	68.83*** (3.651)
Observations	33	29	33	29
R-squared	0.002	0.004	0.188	0.318

Robust standard errors in parentheses

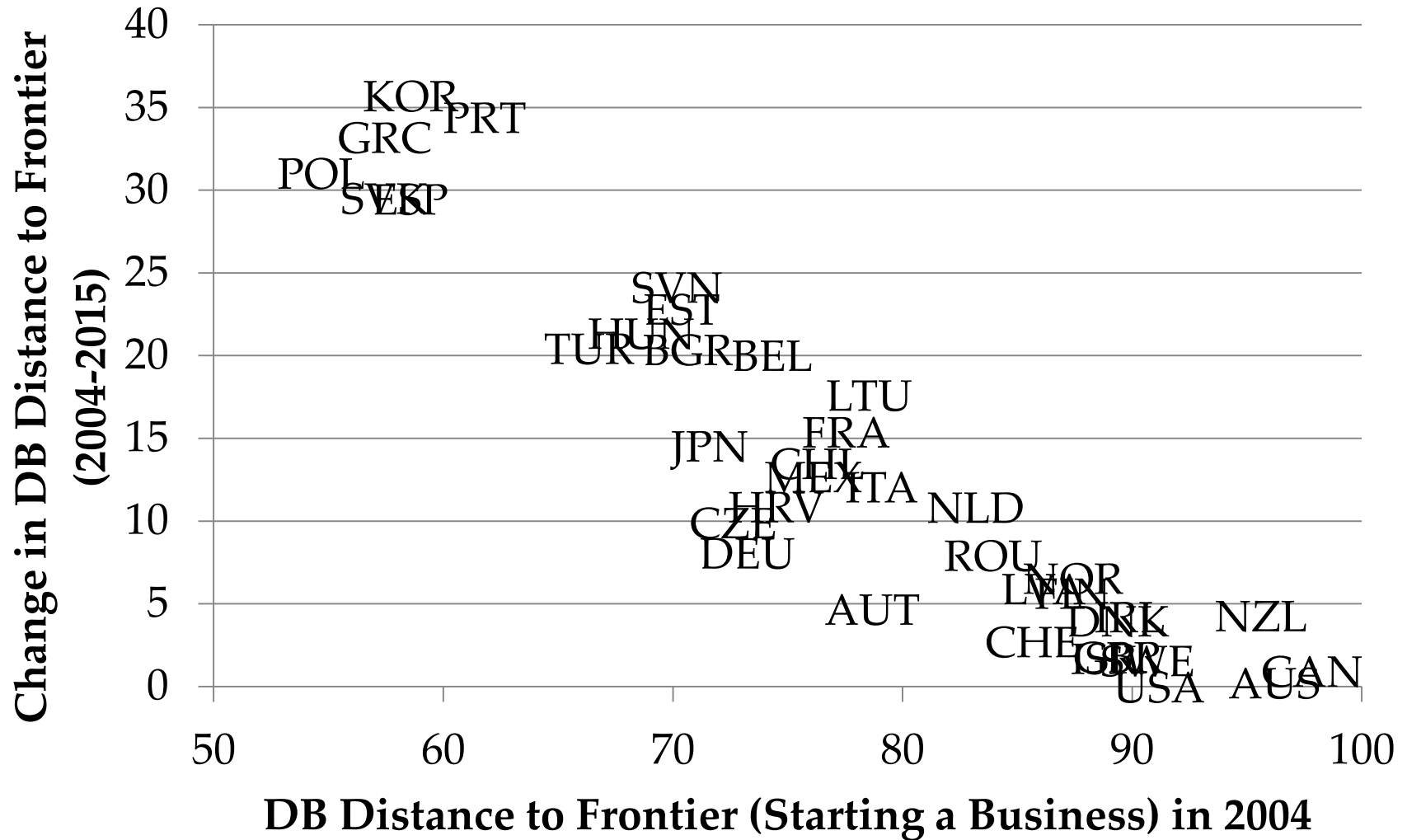
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# Which Policies Matter?

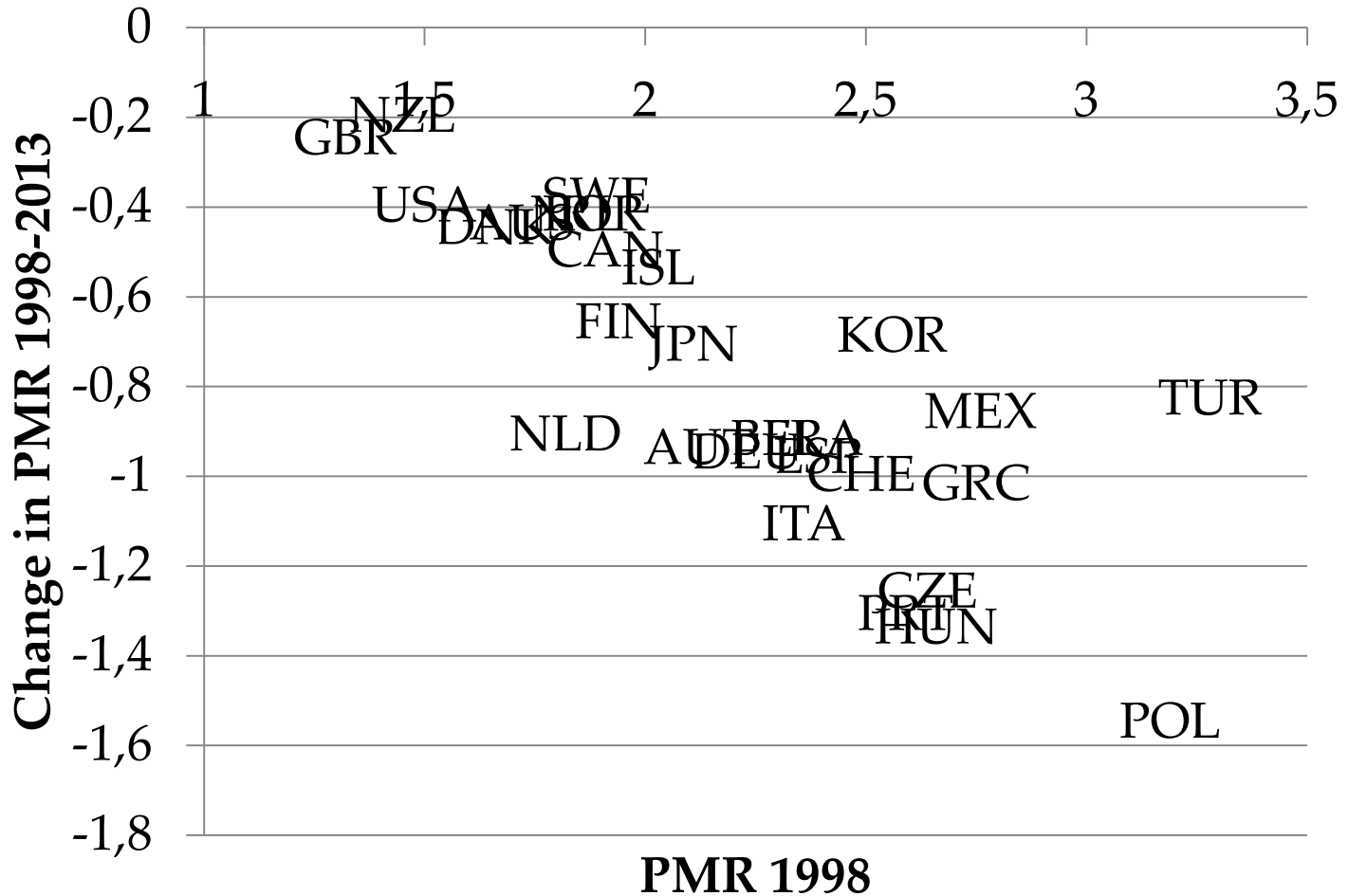
- All aggregate indicators matter
- Many individual indicators matter but are all highly correlated (and potentially correlated with many omitted variables)
- The challenge of designing reform based on microeconomic policies in the context of a macroeconomic gap

Is Reform Happening?

# Is Reform Happening?

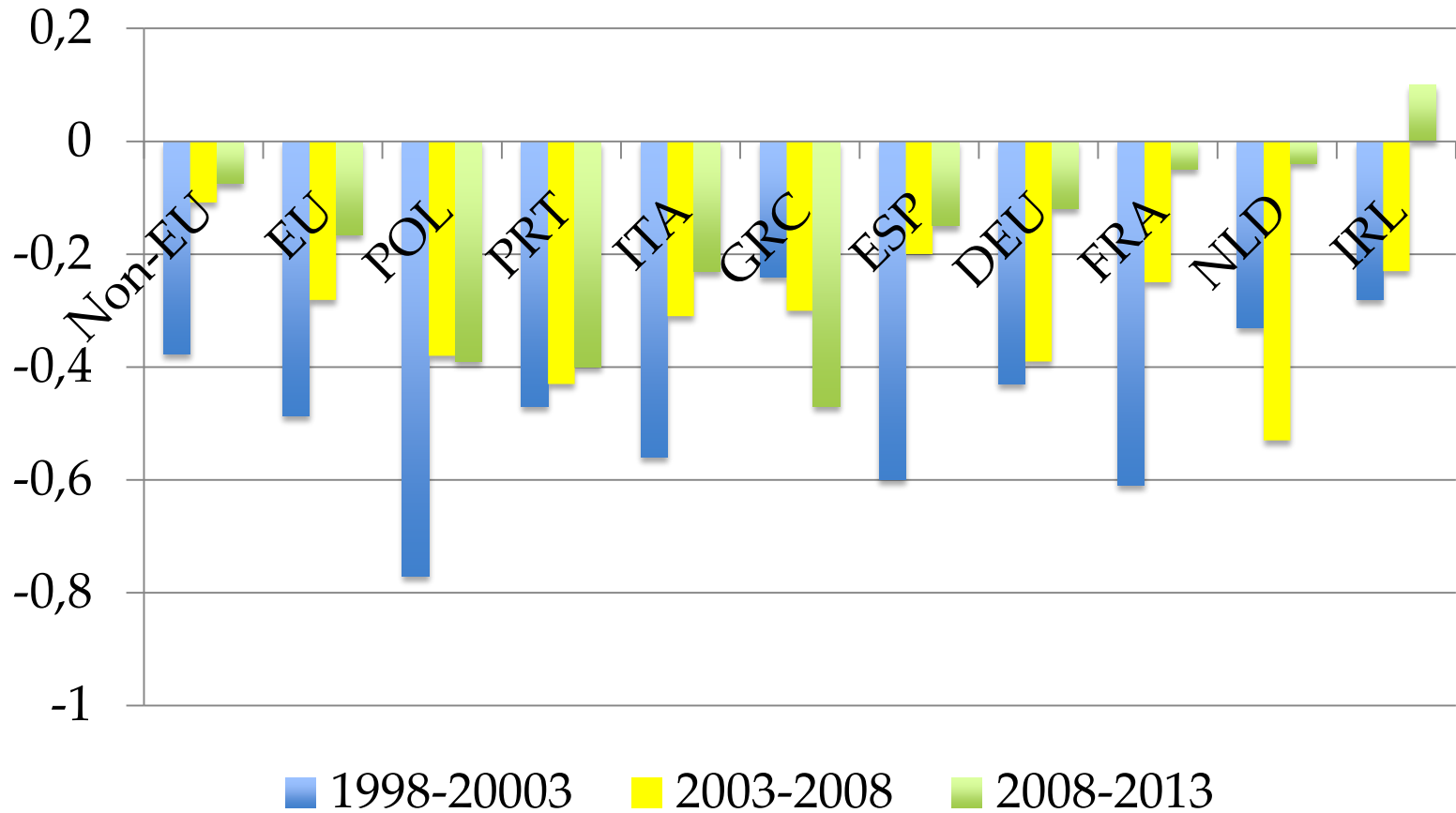


# Is Reform Happening?



# Is Reform Happening?

## PMR Reforms



# The Benefits of Reforms

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VARIABLES	GDP Per Hour Growth 2000-13	Hours per Capita Growth 2000-13
Initial GDP Per Hour	-0.015*** (0.0035)	0.009 (0.0058)
PMR Reform 98-03	0.0051 (0.0060)	0.178*** (0.040)
Interaction PMRx Initial GDP per Hour		-0.048*** (0.011)
Labor Market Reform 98-03		0.0452 (0.126)
Constant	0.067*** (0.004)	-0.023 (0.021)
Observations	27	27
R-squared	0.554	0.676

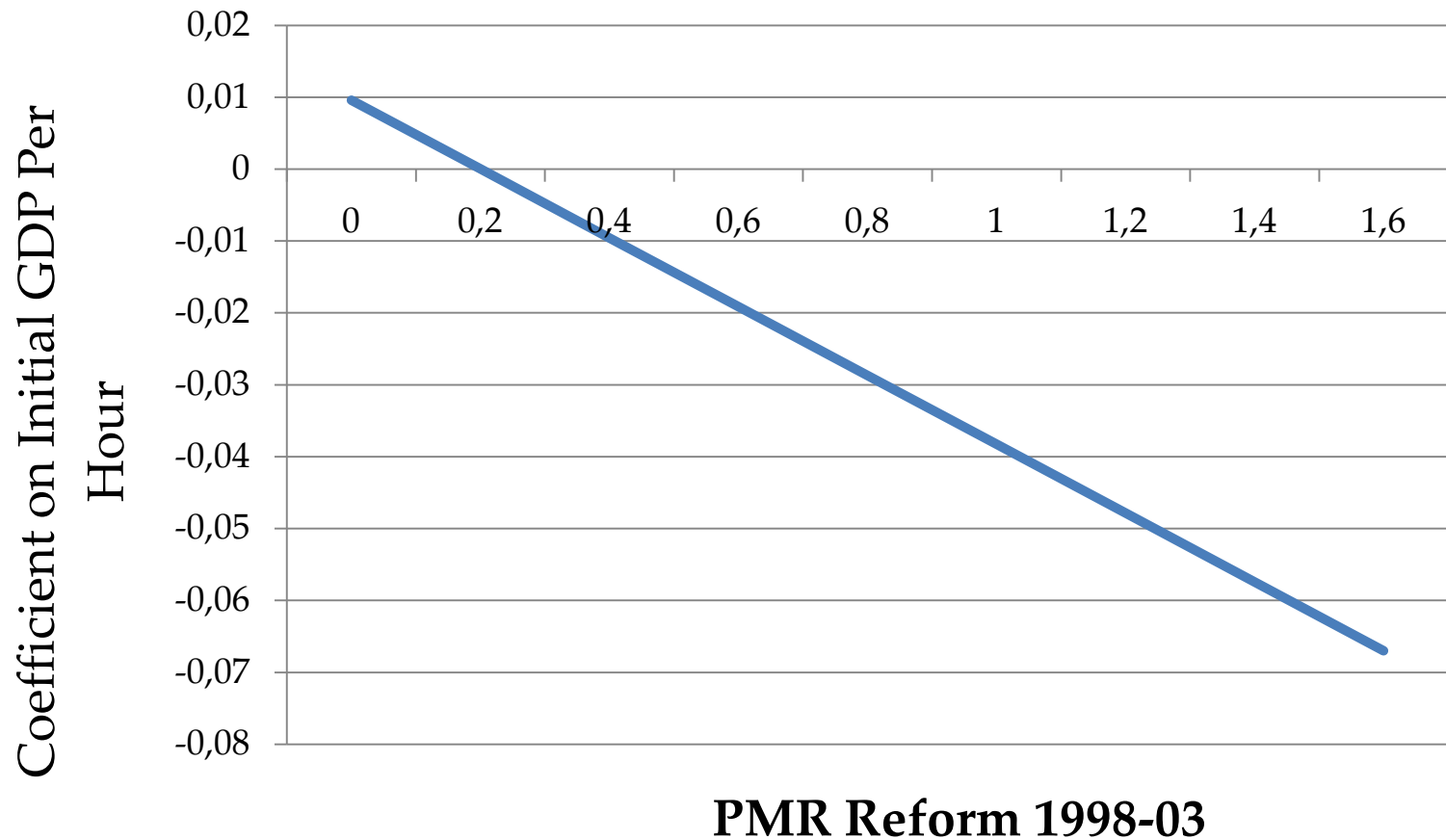
Robust standard errors in parentheses

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# The Benefits of Reforms

Convergence 2000-13 and PMR Reforms 1998-03



# The Benefits of Reforms (Literature Review)

- Limited evidence beyond simulations or calculations on gaps
- Cross-country evidence questionable because of omitted variables and multicollinearity
- Sectoral evidence/time series shows
  - Broad reforms more effective than narrow ones
  - Productivity effects stronger than labor market
  - Effect of reforms are not as strong as effect of other variables (investment or ICT adoption).

# The Benefits of Reforms

- Reform agenda driven by 'faith' on flexibility, competition, deregulation of labor markets,...
- Limited understanding of drivers of technology adoption and innovation
- Likely to be a complex phenomenon (How do you replicate Silicon Valley?)
- Many reforms likely to require more than one policy change (e.g. increasing tax base).

# An Agenda for Reform

- Enough consensus on direction, good and detailed process of setting priorities
- Going faster? Bigger impact?
- OECD (2015), successful reforms require:
  - Urgency
  - Effective communication
  - Strong government leadership and cohesion
  - Persistence and patience

# The Role of Europe

- Catalyst for reforms:
  - Political scapegoat (e.g. EMU)
  - Peer pressure
- Scale and integration as factors for growth (energy, ITC, Financial)
- But role of Europe has its limits (reforms have to be driven by domestic arguments)
- Recent crisis: urgency but connection between Europe and benefits of reforms has broken down
- Need to be realistic
  - Involve a much more transactional approach (feasible?)
  - Do not build institutions that transform a domestic agenda into a supranational (European) one