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The Contribution of Labour Market Reforms, Macroeconomic Policy and Growth Drivers to Economic Growth

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Europe in a Low Growth Trap

Europe has a severe problem of insufficient growth. Three years of meagre growth at about 1% is the famous smaller part of the iceberg to be seen at the surface. Europe underperformed in the nineties relative to the US in growth, productivity and employment creation. The difference in growth performance maintained during the crisis, which had started and was caused by US problems. The latest figures for 2003 again show the US well ahead of Europe in growth of output and productivity. I believe that the growth differential will also exist in the future: Europe is on a growth path of at best 2%, while the US posts a 3% growth perspective over the next decade.

The Importance of Growth

The importance of economic growth for welfare has to be fully evaluated at another occasion. Here it matters that in Europe employment rates are 8 percentage points lower than in the US and the Lisbon target of a 70% employment rate seems to be out of reach. Unemployment is sticky at 8%, which is quite high, even if it is good news - as Jean-Philippe Cotis told - that it did not climb higher in the current slow growth period. The costs of the European retirement systems will become unbearable if there is no growth, and European enlargement will not work smoothly if economic growth does not accelerate. There are strategies to increase the employment content of given low growth rates, but they are neither nice nor easy to implement. The easier of them have been implemented. Growth is important for employment, pensions, budget, and enlargement. All these reasons together may explain why Europe has to try to reach the Lisbon target of a 3% growth path.

The Main Culprit for Low Growth in the EU: Market Inflexibility

In looking for the reason of low growth in Europe and for the growth differential towards the US, the main suspect usually is - and specifically was in the presentations of Karl Pichelmann and Jean-Philippe Cotis - the market inflexibility in Europe. Inflexible labour and product markets decrease employment and consequently economic growth. Higher utilization of labour would guarantee higher output. Labour utilization is understood as limited by regulations, high costs, high taxes, high welfare, and big government. There is a whole family of explanatory attempts along this line, the two papers choose the following variants:

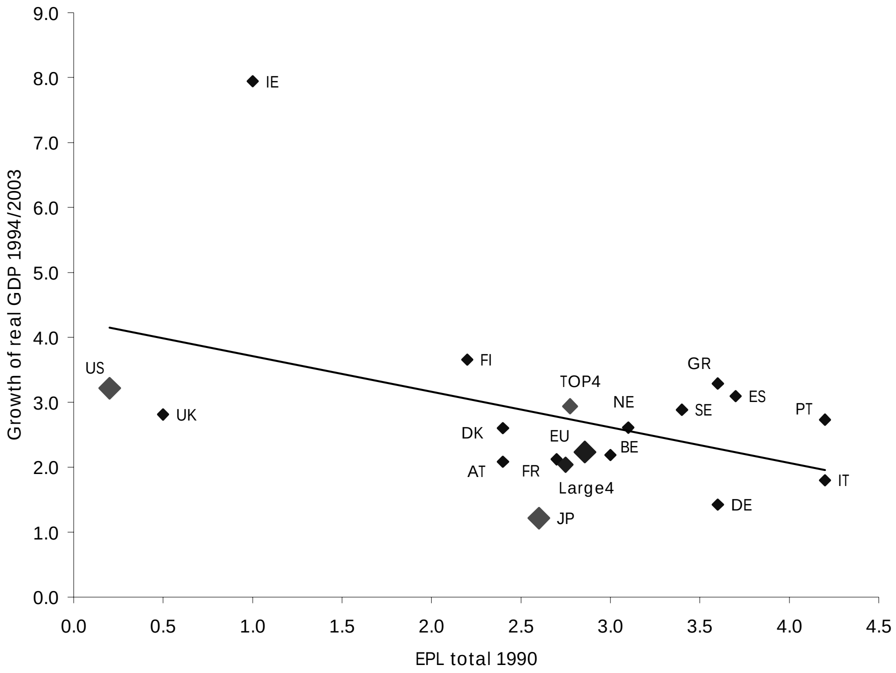
In the wording of OECD: key policies to raise labour utilization are well known: to reform tax and benefit system, specifically unemployment support and tax wedge, to ease labour and product market regulation (OECD, 2003, chapter 5). Or in the wording of Jean-Philippe Cotis: "reforming labour markets will create jobs and stimulate growth" (Cotis, 2003, p. 7) or "a recent study on the sources of growth has shown...low utilization of labour is the main reason why GDP per capita in Europe lags that in the US" (Cotis, 2003, p. 3).

Or in words of Karl Pichelmann: "A coherent strategy with the goals of non inflationary rate of growth...basically requires deep comprehensive reforms of the product, capital and labour markets. .....Growth is sluggish since labour utilization is low in Europe" (Pichelmann, 2003).

Labour Market Flexibility Is One out of Three Differences Between the US and Europe

Comparisons between the faster growing US economy and the slower growing European economy show three sets of differences (with many sub items in each): The first is market flexibility, the second are differences in investment into growth drivers and the third set comprises differences in fiscal and monetary policy. Labour market reforms (and related reforms of product market, keeping costs in line with productivity, investing in a favourable environment for business) are – I completely agree here with Jean Philippe Cotis and Karl Pichelmann - important for increasing employment and output. Their growth enhancing effects may probably not come that quick and may not be that robust, that labour market reforms automatically generate growth. If macroeconomic policy is restrictive and if the economy does not invest into its future, the upcoming blossoms of liberalization may not find the sun and the water they need for growth and expansion. Functioning of market is the *necessary* condition for growth, but investment into the determinants of long run growth is the *sufficient* condition for growth. Without investment into the long-term determinants of growth liberalization does not create long-term growth.

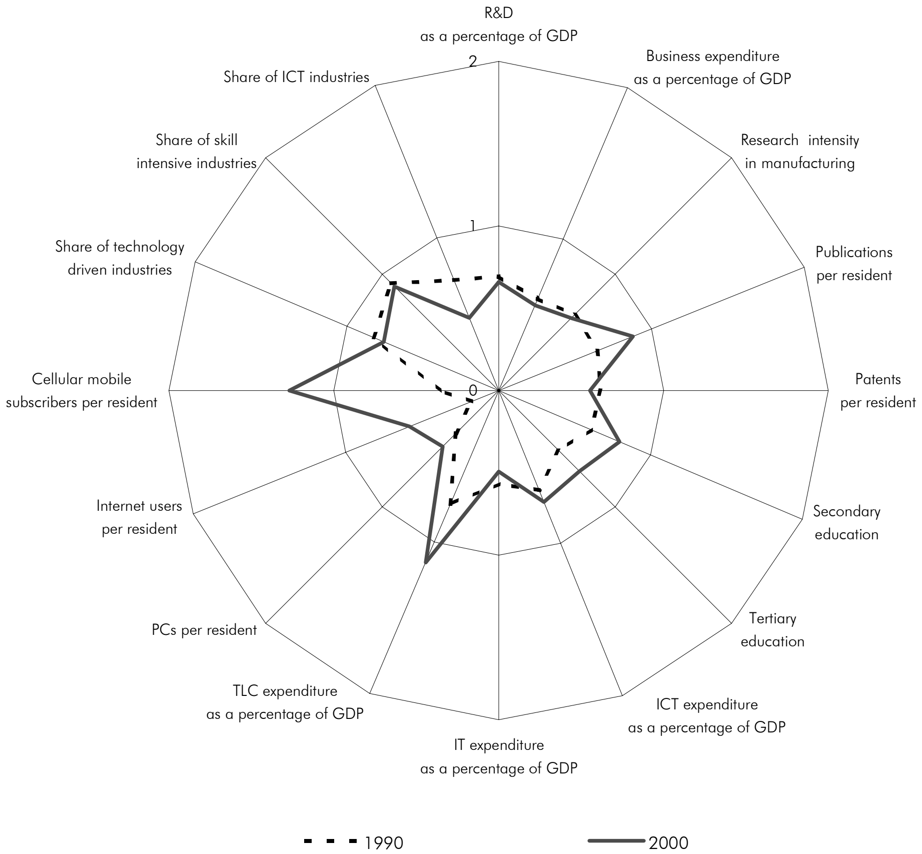
Figure 1: EPL 1990 and Growth of GDP



Deficit No. 1: Underinvestment into Growth Drivers

Economic growth in developed economies depends on research, education and the diffusion of new technologies. Europe underperformed in investment into the future at least to the same extent as in market perfection. In a set of 16 indicators measuring input and output of research, input and output of education, production and consumption in ICT, Europe shows inferior performance in 14 indicators.

Figure 2: Growth Drivers: Europe vs. USA



Deficit No. 2: Evidence on Labour Market Inflexibility

Labour markets are more restricted by law, rules, and collective bargaining in Europe than in the US. Using the OECD indicator on labour market regulation which uses a scaling between 0 (= unregulated) to 6 (= regulated) the US labour market is assessed as practically unregulated (0.2 points). European labour market had been assessed as 2.9 in 1990 and this indicator decreased to 2.6 in the average of EU countries in 1998. For regular contracts the regulation did not change much, only the two countries with the toughest regulation (Spain and Portugal) did deregulate standard contracts significantly. Most changes happened for temporary contracts. While this allows flexibility for firms without changing the basic rules for existing contracts, this asymmetry leads to danger of a dual labour market as Jean-Philippe Cotis told.

There have been changes over the last decade. Karl Pichelmann cites "tax and benefit reforms for targeted groups, in work support, more active labour market policy, part-time work and more flexible work contracts". He calculates that the impact of structural reforms might have increased European growth by about half a percentage point. Actual growth was 2.6% between 1996 and 2001, without reforms it may have been as low as 2.2%. Jean-Philippe Cotis calls the reforms substantial progress, with the most difficult part ahead.

Deficit No. 3: Growth Orientation in Fiscal and Monetary Policy

Monetary policy has been focussing - primarily on price stability in Europe. In the US the Fed targeted at inflation free growth. The capacity and determinedness of the Fed to counteract declining demand would have been criticized as ultra-Keynesian by Milton Friedman and many European experts for monetary policy. Fiscal policy in the US had successfully managed balanced budgets in the late nineties and could now out of this position allow automatic stabilizers to run the budget into a high deficit in the downturn, and to announce sweeping tax cuts at the deepest point of the business cycle in addition to an increased bill for security and war. This is not the place for a full evaluation of macroeconomic policies (that will be done at other places in the symposium). And we have to keep in mind that the European Central Bank could not be more supportive to growth before it had established the credibility to be tough on inflation. And we want to stress that countries with deficits above 3% or 4% of GDP are not really in the best position to kick-start their economy by increasing deficits even more. But there had been unused chances over the past ten years to support growth by both policies. This indeed would have been done if the Lisbon target of 3% growth would have been taken as equally earnest as the 3% deficit ceiling. And strictly speeking the first is the goal, the second only an instrument.

Learning from the Best: Choosing Top 4 Countries Performers in the EU

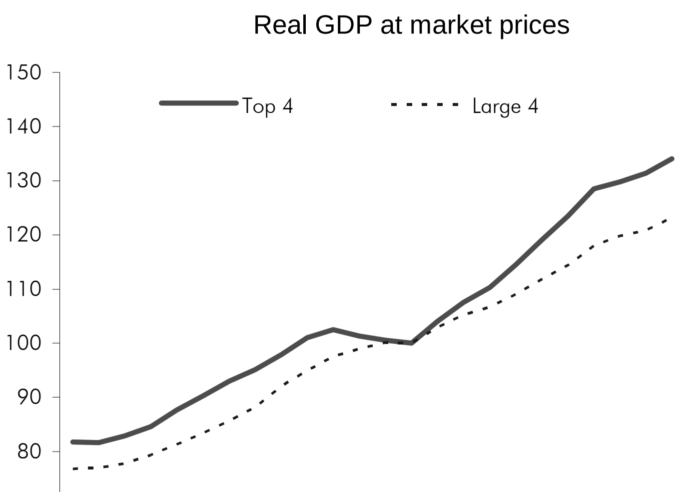
Looking at European countries shows a large diversity in growth and employment creation. Progress has been uneven in the words of Pichelmann as well as of Cotis for labour market reforms. Choosing a broad set of indicators on economic performance, like growth of output and productivity, employment generation, inflation and fiscal stability, we get a group of four best performing countries in the EU, namely Sweden, Finland, Denmark and maybe also the Netherlands. We group these four countries together, independent of some caveats relating to the position of the Netherlands, as the top 4 countries.

This list of top performers is not too different from Jean-Philippe Cotis' top league of performance, which aimed at singling out top performers on the labour markets. We just delete the United Kingdom from the group of top performers, knowing that the UK currently faces the challenge to either leave the country's infrastructure to deteriorate or massively raise taxes to finance education and health and traffic. And we add the Netherlands due to remarkable low unemployment, high employment rate and top productivity (knowing that costs are running high again and the attempt to regain employment out of the one million people in unemployment or disabled schemes proves next to impossible). Where I differ from Jean-Philippe Cotis is that the remarkable success of the Nordic countries is only partly due to labour market policy and to a large extent to growth promotion via research, education and embracing the information and communication technology.

Performance Differs Significantly Between Top 4 and Large 4 Countries

The top 4 countries post higher growth (2.7% in 1993/2002), as compared to 1.9% for the large 4 European countries. This holds for productivity increase and output growth in manufacturing. Employment rates are higher, unemployment lower. The most striking difference occurred in the public sector indicators. Public debt had been higher in 1993 and is now lower relative to GDP. While budget deficits which were 5% in both groups at the beginning of the nineties, now the top 4 countries post a surplus and set the target to have surpluses at about 1% or 2% of GDP over a business cycle to cover past debt or future commitments for pensions. At the same time three out of the large 4 countries are dangerously near or above the penalty area of the Stability and Growth Pact. The turnaround of the top 4 countries has been partly the result of discrete budget cuts, partly of self imposed expenditure limits. The higher growth rate then helped to make the reforms self-enforcing, since growing economies post higher revenues at constant or declining statutory tax rates, while the big low-growth countries faced decreased revenues, which called for the next budget cuts and so on (downward spiral).

Figure 3: Differences between Top 4 and Large 4 in GDP Growth



The Top Countries Invested into Economic Growth

The top performing countries lead in any ranking targeted to measure innovation, new technologies or progress towards information society. Specifically impressing is the performance in research and development. The top 4 countries used to invest about 1½% of GDP in 1982; this was less than the 1.9% of the large 4 countries. The top 4 countries overtook the large ones in 1988 and increased their research efforts irrespective of the crisis in the early nineties continuously to 3%. Sweden has with 3.8% the highest share in the EU countries, the average of the top 4 countries is 2.8%. The share in the large 4 countries has peaked in 1987 and is slightly decreasing to 1.9% in 2000.

The top 4 countries are also leading in other indicators on research (business expenditure, patents, and publications), have a higher ratio of secondary and tertiary education and are leading in all indicators on the production and diffusion of information technology. Overall the top 4 countries have today an advantage in 14 out of 16 indicators and improved its position in the nineties relative to the large economies.

Figure 4: The Growth Driver Hierarchy

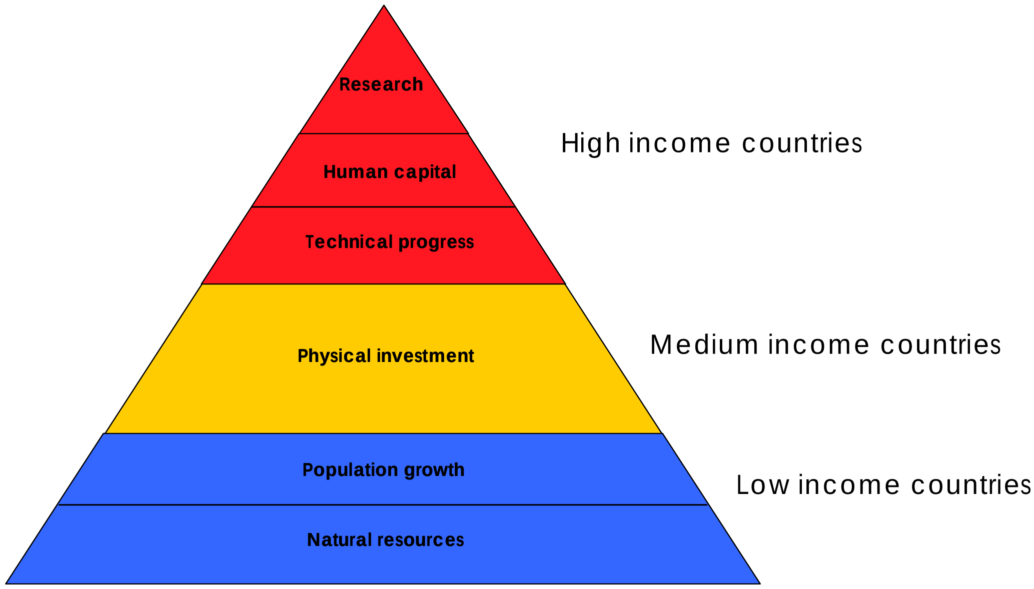
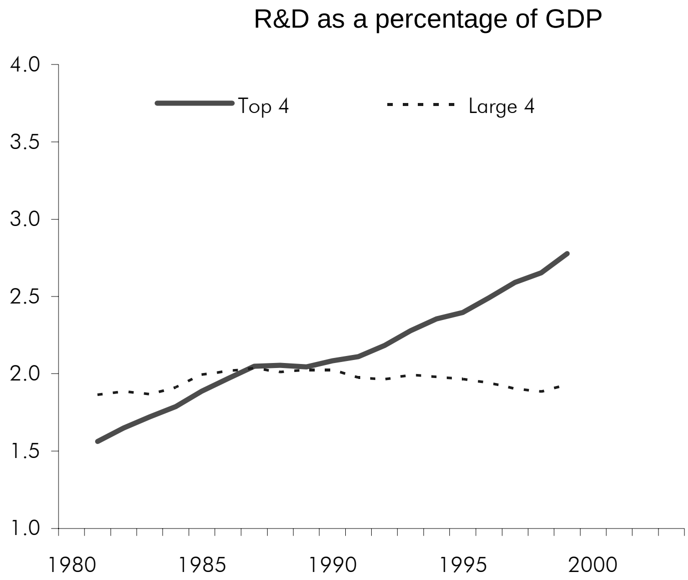


Figure 5: Differences between Top 4 and Large 4 in R&D



Top 4 Countries Did Reform Institutions

Looking at the indicators on product market and labour market regulation, the surprising result is that the top 4 countries are not really outliers with higher regulation (as one would suspect from their position in welfare costs and taxes). Product market regulation[1] is approximately on EU average (or slightly below, with 1.5 for the top 4 countries and 1.6 for EU average). It is marginally higher in Finland due to remaining state control and government ownership, but slightly below EU average. As far as liberalization of markets is concerned, top 4 countries had been less liberalized in 1988 and are now all more liberalized. Measured by the decline in regulation in the network industries the top 4 countries are the champions in liberalization. Average regulation is now 2.65 in the top 4 countries versus 2.96 in the large 4 countries and 3.26 in the EU (on average), but still far from 1.02 in the UK and 1.36 in the US.

As far as labour market regulation[2] is concerned, the top 4 countries had been in the average position in 1990, with lower regulation in Finland and in Denmark and higher in Sweden and the Netherlands. Looking at the change in the nineties three of the top 4 countries did reduce labour market regulation strongly (Denmark, Sweden, and the

[1] The data set supplies an overall indicator on product market regulation for 1998, which contains 17 data on the state control over business enterprises (e.g. size public sector, voting rights, legislative control, and price control). Demand and control regulation in general, barriers to entrepreneurship, and barriers to international trade and investment (non-residents discrimination, regulatory burden, and tariffs).

[2] The OECD data set on regulatory indicators contains 15 indicators of strictness of employment protection grouped into worker with regular contract and workers with fixed term contracts or temporary work agencies.

Netherlands) and Finland reduced its less strict regulatory scheme marginally. The labour market regulation of the top 4 countries is now below that of the EU and of the large 4 countries. The change did come mainly from deregulation of temporary contracts, were the regulation indicator dropped from 3.1 to 1.6[3]. For regular contracts only a few changes were made, like reductions in the replacement ratios[4], stricter obligations to accept job offers and to upgrade qualification.

Summing up the top 4 countries had – despite of being considered as countries with an elaborate welfare system - a system of regulation of product and labour markets which was not significantly tighter than that of other countries. In the nineties they managed to fine-tune their system in the direction of better incentives: they enforced part-time work, activation of unemployed through qualification, they intensified their active labour market policy, and enforced liberalization in network industries. They maintained the key elements of a comprehensive welfare system, but circumvented its negative incentives for work and leisure decisions. These countries however also realized that they can afford their high costs only if they strive for high productivity and if they stimulate economic growth. They increased their investment into research, education and promoted the diffusion of new technologies. Consequently they performed better than European average in the nineties (and in the current three years of slow growth).

Which Labour Market Reforms Are Specifically Attractive?

The Surprise of Non-Marginalizing Part-Time Work

The real miracle in the Netherlands was that part-time work is no longer seen as marginalizing. Among the measures used to accomplish this were that part-time earners have got a priority right to become fully employed after two years of part time work, that switching to part-time work and (with some restrictions) changing back to full-time work has recently been legally guaranteed, that part time work is also chosen voluntarily by employees with higher qualification (and even by managers) and is no longer seen as detrimental for the further

[3] Examples for changes regarding temporary contracts are that either or both fixed term contracts and contracts can now be used in a wider range of situation than in the beginnings of the nineties (for example in Denmark, the Netherlands, and Sweden). In Denmark and Sweden, all restrictions on the types of work for which temporary work is legal have been removed (Nicoletti et al., 2002, p. 49). In Denmark the restrictions on the number of renewals have been removed. The maximum duration of successive contracts has been increased in Germany, Belgium, Denmark, Italy, and the Netherlands (Nicoletti et al., 2000, p. 50). France has restricted the types of jobs that could be offered by temporary work arrangements and reduced the maximum number of successive fixed term contracts.

[4] Changes for permanent occurred in Finland, Portugal, and Spain which have significantly reduced regulation for permanent workers, furthermore in Finland both the delay to the start of notice and the notice period itself were reduced, and procedures somewhat simplified (Nicoletti et al., 2002, p. 49).

career. Furthermore social contributions, insurances and benefits are paid pro rata relative to the number of hours worked. These rules limit the upcoming of a dual labour market as feared by Jean-Philippe Cotis. Part-time work is no longer that much a characteristic of a person or a position in the firm, but a voluntary decision for a certain phase in one's life.

In-Work Benefits

Benefits for people working are a very important incentive. However, they can be very expensive specifically if the replacement rates (for unemployment or pensions) are high. The difference between income in work and income out of work may not be as decisive as many advocates of reduced benefits believe since countries with very high replacement rates are leading in employment (Sweden, Finland, the Netherlands, and Denmark).[5] The problem is that in-work benefits can be very expensive for government and that they should be used only for a well-specified time.

"Welfare to Work" with a Human Background (Assistance and Commitment)

Denmark reformed its labour market system first by decentralizing and secondly by dividing the period for which unemployment insurance is paid into different phases. In the second phase efforts to activate the unemployed is increased by raising both the obligations and the intensity of help (up to personal training plans and job offers in the non-market segment). The system has been and has to be fine-tuned, but is an interesting variant of the welfare-to-work system, with less offensive rhetoric and real commitment to help the unemployed.

Retraining and Making Employment Attractive for Older People

Specific attempts are made to make work more attractive for older workers, and in parallel to decrease costs for firms and to learn to use more fully the specific ability and knowledge of this group. Lifelong learning is necessary to upgrade qualifications. Changing work and career pattern for people in different phases of their work life should become available, reducing the steepness of wage schemes is necessary. Keeping the older workers on the job is an essential part of the Lisbon strategy, it reduces the burden of the retirement systems, and provides a valuable human resource, specifically if Europe heads into a period of labour shortage (as forecast for the period from 2010 on).

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5 One characteristic of the top 4 countries is their high replacement ratio for low incomes, replacement ratios for unemployment and pensions are declining for higher income (this is a consequence of the redistributive effect of Nordic type welfare states).

Longing for Empirical Research: "Lump of Labour Fallacy" Versus " Labour Supply Creates Labour Demand"

There are two hypotheses which mark the extreme views on labour markets and which are used by different groups of economists, both without sufficient evidence:

"Lump of labour fallacy": The first extreme view is that labour demand is fixed, and each older worker remaining "in the market" steals away the job of somebody else (maybe a younger). Shifting people into a disabled scheme or into early retirement is consequently seen as a strategy to reduce unemployment. This is one extreme viewpoint, sometimes called lump of labour fallacy. It implies that preventing early retirement aggravates unemployment problems.

"(Labour) supply creates demand": The other extreme is a new variant of Says law, this time for the labour market: each person who leaves the European "pockets of inactivity" and who can be persuaded to enter the labour market increases GDP, even if he or she is less productive than the current members of work force and gets lower wage. For this view see the characteristic statement: "...low utilization of labour is the main reason why GDP per capita in Europe lags that in the US" (Cotis, 2003, p. 3).

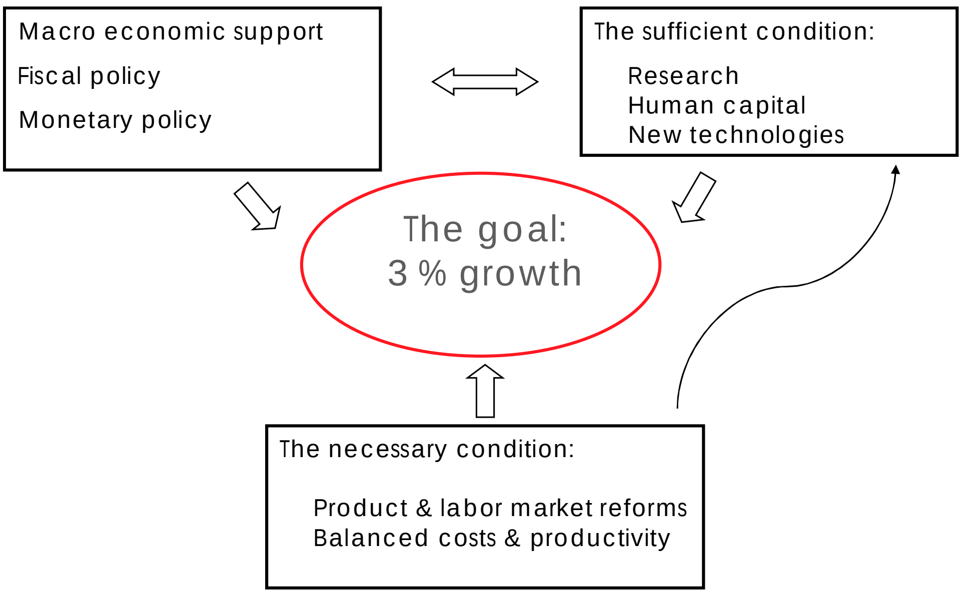
It is evident that the truth lies in between these extremes: increasing effective labour supply increases economic growth and per capita income. The important question is to which extent? Will it be high enough to compensate for the implicit value for leisure, will it be enough to increase net income per worker? Will it be higher if supply comes from disabled, older workers, out-of-workforce people? And from the other perspective: to which extent will the older people which are kept on the labour market add to GDP and to which extent will they only prevent young people to enter? These questions are open to empirical research and should not be solved by statements.

The data presented by Karl Pichelmann in chart 5 indicate that the consequence of increasing the labour content to growth increased economic growth a little bit but to a larger extent reduced the capital content of growth and the rate of multi-factor productivity. Overall growth would not really accelerate, specifically if we extended the chart to 2003. The data for 1997–2002 seem to be the most favourable evidence, since growth accelerated a little bit relative to 1991-1996. But if we take 2003 into account or if we look at the medium-term prospects of a 2% growth, we will not be able to contend that increasing employment by 13 million people (Karl Pichelmann) or 14 million people (Jean-Philippe Cotis) did not accelerate growth. Increasing employment did change the employment content of growth, but reduced the other two components of productivity growth (capital deepening and multi factor productivity). Ceterum censeo only investment in growth drivers is able to increase the long term rate of growth. Flexible labour markets are important, but do not work alone, at least in the short or medium run.

The Conclusion: Labour Market Reforms Are Needed, but Are not Sufficient to Return to Growth

The experience for Europe relative to the US, as well as the strategies of successful European countries versus the big ones, tells us that no single policy set is likely to bring Europe back to a medium term growth rate of 3%. This session of the 31st Economics Conference is about labour markets, and the two papers consequently focussed on labour market policy, attesting Europe "substantial albeit uneven progress" and calculating "a 0.4% contribution" of structural reforms to medium-term growth.

Figure 6: The Three Elements of a Growth Stratgey



My personal view and reading of the evidence is that all three policy sets together are to be used to bring Europe back to a 3% growth path:

- Making markets more flexible and containing private costs (mainly labour costs) and public costs (government expenditures) is the necessary part of the strategy.
- Investing into the future drivers of growth is the sufficient part of the strategy. While the EU and the OECD are hard in fiscal discipline, in liberalization and in labour market deregulation and while the EZB is successfully heading towards repudiation for inflation mindedness, all instances are soft if governments and countries are not investing enough

into the future, if they are violating innovation targets and non investing enough in pan-European infrastructure.

- A fiscal and monetary policy not biased against growth is of great help for the period necessary for structural reforms to translate into higher growth and also for the period long-term investments into the future need to become effective. The economic policy in the US as well as that of the successful European countries have followed a comprehensive approach including labour market reforms, investment into growth drivers and a prudent macroeconomic policy.

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