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COVER NOTE

From:	General Secretariat of the Council
To:	Delegations
Subject:	The economic impact of structural reforms

Delegations will find attached a Commission background paper on the economic impact of structural reforms intended to serve as a basis for the EU and EFTA Ministers of Finance and Economy meeting on 10 November 2015.

Encl.

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

The economic impact of structural reforms

Background Paper

for the

EU EFTA ECOFIN Meeting

10 November 2015

Introduction

The European economic recovery is strengthening. To ensure economic growth is sustained, the implementation of the three-priorities approach is key: structural reforms, stepping up investment and fiscal responsibility. Notwithstanding the improved economic situation, the potential growth rate in the EU has fallen over the last two decades. The slowdown in productivity growth started well before the crisis but the depth of the crisis weighs further on long-term growth prospects. Low growth rates have gone hand-in-glove in many countries with rising unemployment rates and extended unemployment duration. Low growth also hampers debt sustainability and has forced more consolidation measures in vulnerable Member States, which have further reduced growth. All this has provided an impetus to carry out reforms to boost growth.

After giving a general overview of the range of structural reforms and their potential impact, this note focuses on the positive impacts of joint implementation of structural reforms. The analysis is limited to the impact on EU-28 and does not cover the impact on the EEA and Switzerland.

The assessment is made with the help of the QUEST model , applying a benchmarking methodology based on a set of structural indicators covering a wide range of areas. For a description of the methodology and a more thorough understanding of its limitations and interpretation, the reader is referred to the analysis published in ECFIN Economic Papers nr 541 in December 2014 "The potential growth impact of structural reforms in the EU: A benchmarking exercise", on which this note draws heavily.

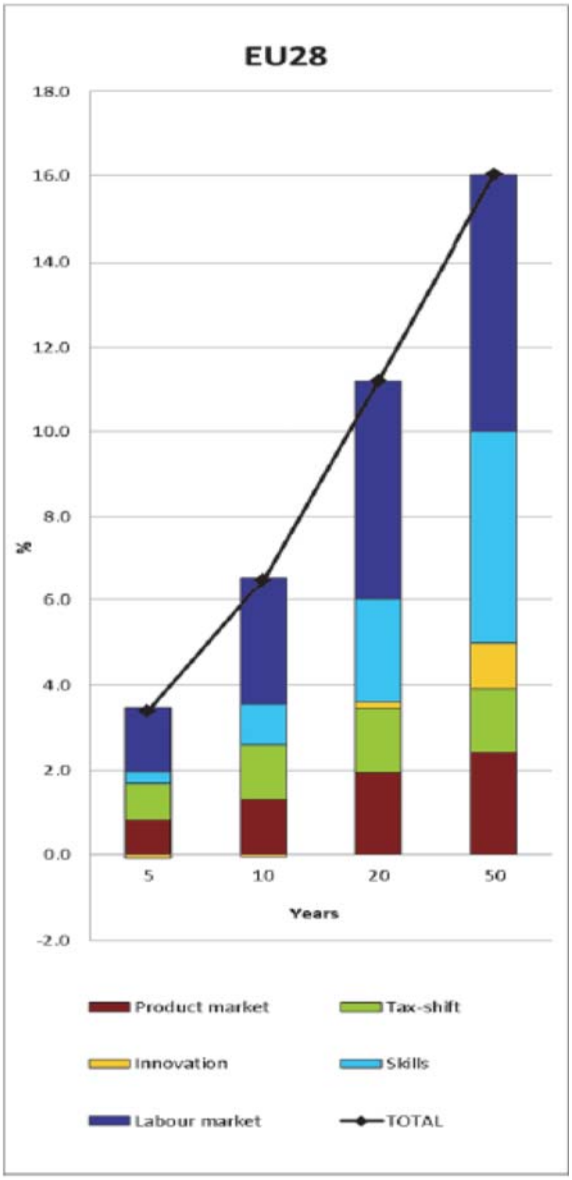
Types of structural reforms and their impact over time

Structural reforms cover a broad range of policy actions that work to enhance the long-term growth potential of the economy. They cover product market reforms, innovation policies, tax-shifts, labour market reforms, and education. The impact of different types of structural reforms depends on the so-called 'distance-to-frontier'. In this 'distance-to-frontier' approach the performance gap of an individual Member State vis-à-vis the average of the three best EU performers is used to quantify the potential for reform by assuming a gradual and partial closure. The performance gap is assumed to be gradually closed by half[1]. Over time the relative effect of different types of reforms changes.

Of the reforms simulated in this paper, labour market reforms, and in particular reforms that raise labour force participation, yield relatively the largest output effects in the short to medium run, followed by tax reforms and reforms raising competition in product markets. The relative contribution of these reforms depends crucially on the identified performance gaps and on the assumed implementation speed. Reforms relating to product markets, stimulating competition in certain sectors, can lead to large output gains, but such effects are likely to emerge only gradually. If reforms could be enacted faster then the effects could also be more frontloaded.

[1] Realistic 'speed limits' are assumed, of mark-up changes not exceeding 1 pp per year, participation rates 0.5 pp per year, tax shifts, entry costs and benefit reforms spread over 5 years, while cohort effects of education and training can take more than 20 years to pass through.

In the short run, labour market reforms (increased participation, active labour market policies, and benefit reforms), tax reforms (shifting taxation towards indirect taxes) and product market reforms (higher competition in services sector and lower entry costs) have the largest effects. Which of these can deliver the fastest growth effects depends on implementation assumptions. But it is clear that education/training (or skills enhancing) reforms cannot be expected to deliver significant growth effects in the short run. In the medium to long run, though, the effects of these reforms become sizeable.



This also holds for innovation reforms (R&D promoting policies), which may not have a significant impact in the short to medium run, but can make a considerable contribution to higher output in the very long run (the final bar in the figure to the right shows the effects after 50 years).

While the positive effects on growth and employment are large, it should be borne in mind that this exercise shows the *potential* effects of structural reforms[2].

Although some implementation lag is allowed for, a successful introduction of structural reform measures may take longer than assumed here and delays in implementation would lead to smaller effects in the first few years. In the current environment, with private and public deleveraging, and tight credit conditions in many countries, the short-term impact could be lower, as financing constraints are more binding.

In addition, possible distributional effects may require that some groups in society are compensated and this may have budgetary implications. However, while large output gains can probably not be expected in the short term, growth effects are significant and could help boost the nascent recovery. Higher growth potential can also stimulate investment demand and help to restore investment to pre-crisis levels. The output and employment effects in the medium/long term are sizeable.

[2] It should be noted that this analysis is based on the most recent available indicators and may exclude the impact of measures (e.g. pension reforms) adopted in recent years but only taking effect in the future.

The power of joint implementation

Structural reforms undertaken by each Member State separately can boost GDP levels (compared to the "non-reform" baseline) in the EU by some 3% after five years, some 6% after 10 years and 10% after twenty years.. These macro-economic effects are significant , taking into account that the reforms simulated are not over ambitious. When considering simultaneous efforts in all EU Member States, positive cross country spill-over effects add up to 10% to the gains in output in the long run. The effects of joint implementation come through four channels:

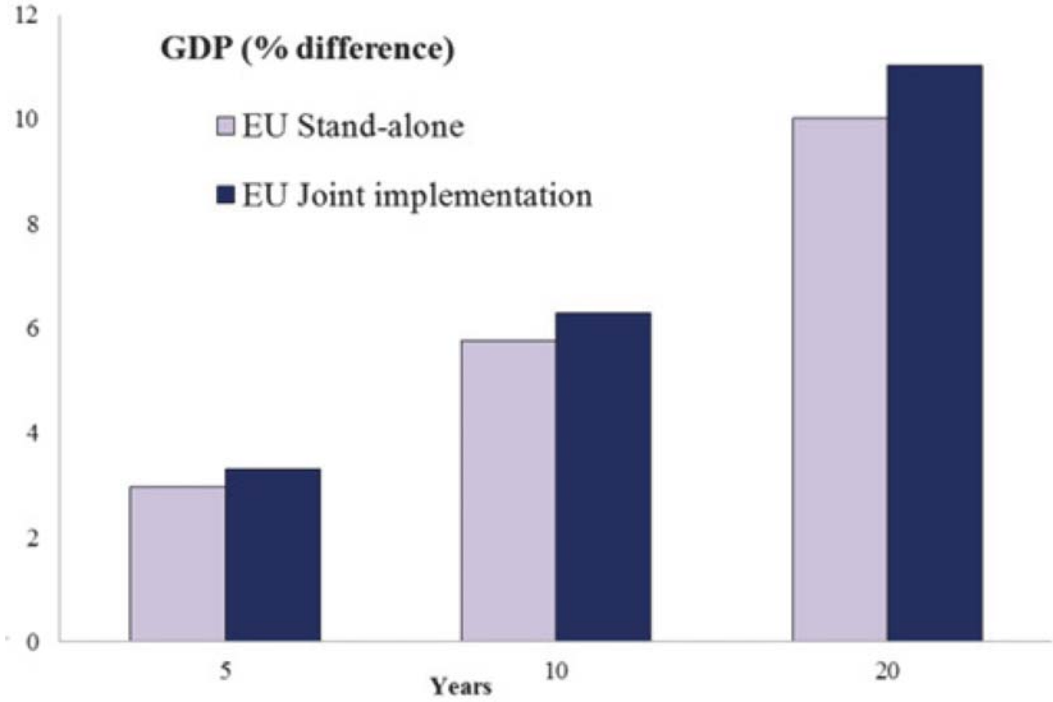
1. *Demand spill-over effects* whereby policy action in one country (e.g. growth-enhancing structural reforms) influences import and/or export flows with partner economies. As structural reforms boost growth and domestic demand, reforms in one country lead to positive demand spill-over effects on others.

2. *Competitiveness effects*, e.g. resulting from measures that reduce labour costs or mark-ups in one country and improve its competitiveness. As these measures make other countries relatively less competitive, these effects reduce the positive demand spill-over effect.

3. *International financial flows* caused by reforms in one country can have effects on others. For example, reforms which increase the rate of return on capital can lead to capital inflows until rates of return are equalised internationally. Exchange rate changes associated with international capital flows can induce further trade flows.

4. *Knowledge spill-over effects* resulting from the international diffusion of innovations will generally lead to a positive transmission of reforms that foster intangible capital formation. While these spill-over effects do not play a significant role in the short term, they become important in the longer term, in particular for reforms that promote R&D. Based on empirical studies, domestic knowledge production (intangible capital) is modelled as resulting from domestic R&D efforts plus knowledge gained in the rest of the world and the latter channel captures spill-over effects.

The demand effect boosts imports and supports trading partners' growth, though this is partly offset by the competitiveness effect. Trade balance effects are relatively small and can turn negative where the demand effect dominates the competitiveness effect. In the case of simultaneous reforms, long-run productivity effects are larger. The figure below summarizes the impact on GDP for both stand-alone and joint-implementation.



Conclusion

Reforms lead to significant improvements in fiscal positions and can yield sizeable reductions in debt-to-GDP ratios in the medium/long term, alleviating the need for further consolidation measures and contributing to long-term debt sustainability. Joint implementation of structural reforms increases the impact of structural reforms for the EU and for individual Member States. The sizeable growth effects and the positive budgetary effects provide a strong rationale for the impetus to reform given by the country-specific recommendations in the European Semester.

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