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Competitiveness and structural policies: where does the EU stand?

This paper is a contribution to the project *Globalisation Challenges for Europe and Finland* organised by the Secretariat of the Economic Council. The project is a part of Finland's EU Presidency programme and its objective is to add momentum to the discussion in the European Union on globalisation, Europe's competitiveness policy and the Lisbon strategy.

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Contents

SUMMARY	5
1 INTRODUCTION	7
2 WHERE DOES THE EU STAND ON PERFORMANCE?	10
3 WHERE DOES THE EU STAND ON STRUCTURAL POLICIES?	14
3.1 Labour market policies	14
3.2 Product market policies	18
3.3 Financial market policies	21
3.4 Innovation and human capital policies	23
4 WHY IS IT SO DIFFICULT TO REFORM STRUCTURAL POLICIES?	25
5 SUMMING-UP	29
REFERENCES	30

SUMMARY

Average EU growth performance has been disappointing over recent decades. This picture is not uniform across countries, however, some having done better than others. We argue that EU policy debate, rather than focusing on competitiveness, ought to address the reasons for disappointing aggregate growth outcomes as well as intra-EU heterogeneity. On the whole, weaknesses in growth performance can to a large extent be ascribed to inadequacies in the structural policy framework. The policy shortcomings that we identify based on a substantial body of OECD evidence are not really surprising. Rather, they have been around for a considerable period of time, which raises the question why reform has been insufficient. Based on the emerging empirical literature concerning the political economy of structural reform, we suggest a number of actions governments can take to facilitate the reform process. For example, structural reform may be helped by having scope for macroeconomic accommodation of any negative short-term impacts, which is an added argument for establishing more sound fiscal positions. As well, the tendency for structural reforms to have ripple effects across different markets suggests that trade liberalisation, which is desirable in itself, could help reform in other areas. Finally, we also emphasise the role that analysis by institutions seen as independent and credible can have in terms of unblocking the reform process.

1 INTRODUCTION

Europe is obsessed with competitiveness. Conferences are held to discuss competitiveness. Politicians emphasise competitiveness. Major policy initiatives, such as the Lisbon Agenda, are launched with reference to competitiveness. Yet, the focus on competitiveness makes little sense for a discussion of economic policies. At face value, the notion of competitiveness as a policy objective has a mercantilist flavour. It is suggestive of a zero-sum game whereas, in fact, one country's economic success rarely hampers, and frequently helps, that of another country. A focus on competitiveness may thus lead to strange policy reactions and inter-dependencies across countries. It is easy to imagine an armaments race as countries try to improve or preserve perceived competitiveness, for example by ramping up subsidies to or tax-breaks for various activities.

In order to provide a meaningful policy discussion, while still using the c word in the title, we would therefore interpret the concept of competitiveness differently. More specifically, we think of competitiveness as a gauge of the extent to which policies create incentives and pre conditions for private economic agents that allow them to maximise output. It is a bit of a stretch, but we would contend that most policies favourable to economic growth would also enhance welfare. Recent OECD work has examined the link between GDP growth and welfare and is summarised in Box 1.1.

On this basis, our focus in the rest of the paper is on where the countries of the European Union stand in terms of growth friendly policies.² This involves assessing policies in individual countries, since most of the policies that matter in this regard are national policies – trade policies being an important exception. The focus on national policies in individual EU countries also gives rise to one of the important conclusions of the current paper: there is no single EU story. Some EU countries seem to have policies in place that are friendly to economic activity and competitiveness. This is reflected in their high levels and respectable growth of real income. Other EU countries do less well. Since countries in this latter group often happen to be big, average EU performance tends to leave something to be desired.

² To be more specific, we focus on the EU countries for which there is information in OECD databases which in most cases means the 19 EU countries that are also OECD Members or the 15 EU Members before the 2004 accession wave.

The rest of the paper first reviews how countries are doing on various aspects of economic performance. Subsequently, it discusses the structural policy settings responsible for observed performance. Given that policy inadequacies and corresponding performance weaknesses have often been recognised for years, the third section discusses some factors that influence the process of structural reform and the possibilities for speeding up the process. A brief concluding section sums up the paper.

Box 1.1 The relationship between GDP and welfare

There is not a simple relationship between GDP/capita and well being. At one level, GDP/capita is an imperfect measure of the material resources available to people. At another level, the availability of material resources is only one factor affecting well being. More specifically:¹

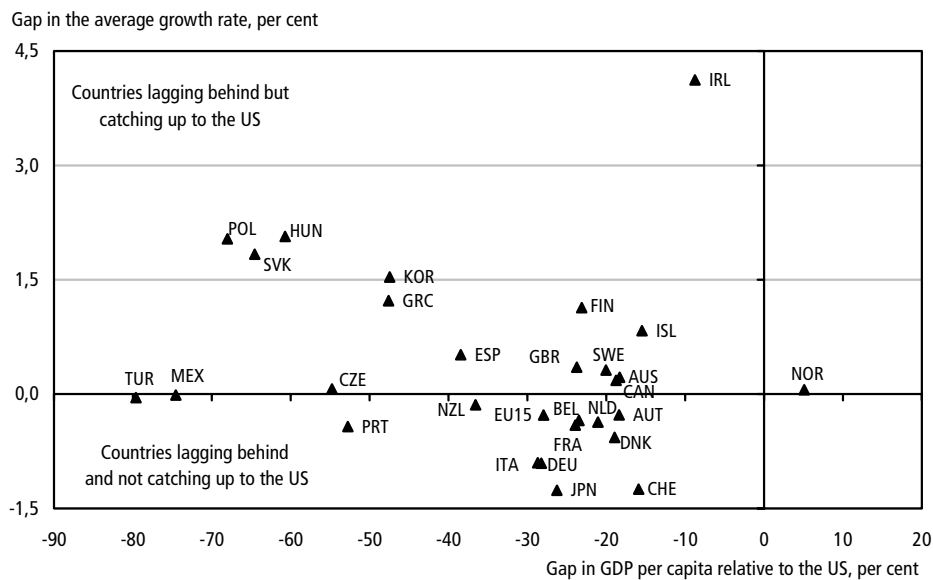
- A number of adjustments are possible within or around the system of National Accounts to move from GDP to concepts that are closer to real income. These adjustments take into account things like depreciation, net income from abroad, and variations in the terms of trade. However, whether looked at in level or in growth rate terms, rankings of OECD countries on these adjusted measures are not materially different from rankings based on GDP/capita.
- Recent Finnish experience is an interesting example of growth being higher on an output basis, such as for GDP, than on a real income basis. The large ICT sector in Finland experiences very rapid productivity growth and, as a result, a tendency for prices to fall. Hence, GDP growth has been rapid but the terms of trade have tended to decline.
- People clearly derive well being from their leisure time but the appropriate valuation of leisure is uncertain. Nonetheless, applying a number of different valuation assumptions, the rankings of countries in terms of leisure adjusted GDP levels or growth rates is not very different from GDP based rankings.
- Many would argue that, in terms of well-being, a dollar at the bottom of the income distribution is worth more than a dollar at the top. Cross country rankings of household income levels under various assumptions about aversion to inequity are not too dissimilar to a GDP based ranking for a low degree of aversion to inequity. However, with strong aversion to inequity a number of countries change positions with, in particular, the United States moving down in the ranking. Rankings of countries according to growth rates are also highly sensitive to the degree of aversion to inequity.
- A different approach to the measurement of well-being relies on considering a wide range of social outcome indicators, stretching from employment and educational achievements over child poverty and life expectancy to suicide rates. As it turns out, however, these indicators do not really tell an alternative story to that arising from GDP/capital levels. It is difficult to assign relative importance to the various indicators and while cross country patterns of some of them are correlated with each other and with GDP/capita, others are not. Nonetheless, the fact that a number of such welfare indicators appear not to be very responsive to GDP developments may signal that welfare returns from growth could be diminishing.
- Subjective evidence on happiness based on surveys shows a positive, albeit noisy, cross-country correlation with levels of GDP/capita but, over time, there is little tendency for people to become happier as they become richer. This may in part reflect that evidence on subjective happiness is better at picking up effects of relative incomes than absolute income.

¹ The following is based on Boarini et al. (2006).

2 WHERE DOES THE EU STAND ON PERFORMANCE?

For most of the period between the end of WW2 and the 1970s, western European countries tended to catch up to the United States in terms of GDP/capita. Since then the EU15 has marked time, with hints that it may even have begun to slip against the United States from the mid-1990s – this is a presumption rather than a definitive statement, given that the difference in average growth is small and that macroeconomic fluctuations may affect the numbers (Figure 2.1). Nonetheless, the EU15 average performance hides considerable heterogeneity, with the three large continental economies falling more clearly behind US growth whereas many of the smaller countries, as well as the United Kingdom, have either held their own or continued to catch up.

Figure 2.1 GDP per capital levels and growth rates: gap *vis-à-vis* the United States¹.

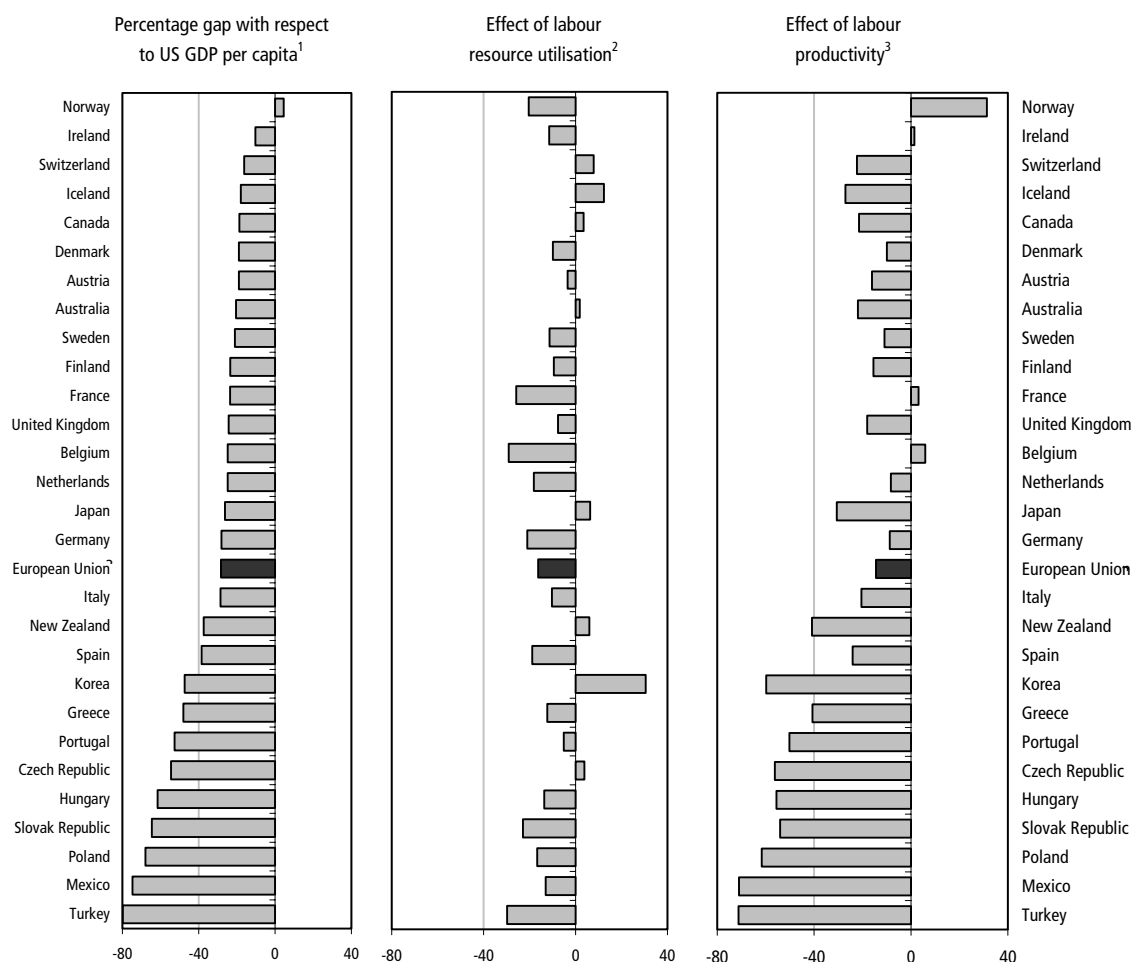


¹ The average growth rate in GDP per capita is calculated over the period 1995-2004 on the basis of volumes data from national accounts sources. The level of GDP per capita is for 2004 on the basis of 2000 PPPs.

Source: OECD National Accounts of OECD Countries, 2004 and OECD Economic Outlook, No. 76.

As a result of these growth patterns, the level of GDP/capita in the EU15 is about a third lower than in the United States (Figure 2.2, left column). Again diversity is large, with the gap for Ireland being less than 15 per cent and the gap for Portugal exceeding 50 per cent. Some of the newer EU Member countries in eastern Europe are even further behind.

Figure 2.2 The sources of real income differences, 2004.



¹ Based on year 2000 purchasing power parities (PPPs).

² Labour resource utilisation is measured as total number of hours worked divided by population.

³ Labour productivity is measured as GDP per hour worked.

Source: OECD, National Accounts of OECD Countries, 2005; OECD, Economic Outlook, No. 78; and OECD, Employment Outlook, 2005.

The gap in GDP/capita with respect to the United States can be accounted for by lower utilisation of available labour resources and by lower productivity of labour. For the EU15, the two components of the gap have almost the same magnitude. Lower utilisation of labour resources is the result of lower labour force participation, higher unemployment and lower working hours for those who work. The gap in productivity could in principle also be broken down into a

number of contributing factors but weak data in practice make it difficult to compare levels of capital intensity and multi factor productivity across countries.

As with the gap itself, the breakdown into labour utilisation and productivity differs across EU countries. To some extent, there is a general pattern across all OECD countries according to which countries with large gaps in GDP/capita also tend to have large gaps in labour productivity. The eastern and southern EU Member countries fall into this category. However, the picture is much more diverse for those EU countries that have a GDP/capita gap of more moderate magnitude. Two countries, Belgium and France, are even recorded as having higher hourly labour productivity than the United States with the GDP/capita gap more than fully accounted for by lower labour utilisation. The numbers in this area need, however, to be read with care.

One of the influences on recorded labour productivity is the quality of the labour employed. There is evidence for a number of countries with low employment levels, that it is in particular low-productive labour that is either unemployed or does not participate in the labour market. Hence, if employment levels in these countries were boosted to the same level as in the United States or some of the better performing European countries, recorded productivity would tend to decline.³ In this sense, underlying labour productivity may be weaker than apparent productivity in countries with low employment.

With the Czech Republic as the only exception, all EU countries in Figure 2.2 have a lower labour utilisation than the United States. This has sometimes led to the suggestion that Europeans have a greater preference for leisure and that, accordingly, one should not be too concerned about the part of the GDP/capita gap that reflects lower labour utilisation. There is reason to believe that this argument is grossly exaggerated. More than half of the EU15-US gap in labour utilisation is accounted for by a lower employment/population ratio in EU15 countries. Recent OECD work illustrates that low employment numbers to a large extent reflect disincentives to offer, seek and accept jobs.⁴ Hence, along the extensive margin of labour supply there seems to be little scope for a preference for leisure to explain lower EU labour supply.

Along the intensive margin of labour supply, it is also unlikely that lower working hours to a large extent reflect a preference for leisure. In any case, it would have to be a recently developed preference, given that European working hours used to be longer than those in the United States a few decades ago. Furthermore, there is reason to assume that distortions created by policy also

³ Estimates in Boursès and Cètte (2006) suggest that the effect on hourly productivity exceeds 10 per cent of the US productivity level in France, Germany, Italy and the Netherlands.

⁴ See Bassanini and Duval (2006), Duval (2004) and Jaumotte (2004).

play a role in this area (see below). That said, there are also arguments why working hours might be excessive in the United States.⁵ First, there may be positive externalities in leisure consumption which are not easily internalised in the decentralised US labour market.⁶ Second, in a context of asymmetric information working hours may be used to signal commitment, leading to long hours where there are no binding institutional ceilings.

The less than satisfactory growth performance of some EU countries would be less of a concern if there were signs that it would be reversed in the future. That is not the case, however. Ageing will affect many European countries more strongly than the United States. Hence, even taking into account the long-term effects of recent policy reforms on retirement behaviour as well as the tendency of younger cohorts of women to participate in the labour force, projections of GDP/capita growth are significantly lower in the large continental European countries than in the United States over coming decades due to the relative fall in the share of the working age population (OECD, 2006a).⁷ Furthermore, on some accounts the United States is investing more strongly in future productivity growth than are most countries of the European Union. For example, spending on R&D as a share of GDP is higher in the United States and the share of a youth cohort enrolling in tertiary education is substantially higher. In both cases, however, as in the case of the ageing effects, there is no single European story. Nordic countries, in particular, tend to do better whereas Southern countries tend to do worse.

⁵ For further background, see Alesina et al. (2005) and Landers et al. (1996).

⁶ Positive externalities in leisure consumption arise when one person derives more pleasure from leisure if another person at the same time consumes leisure such as is likely to occur within families or among groups of friends. However, with bargaining between individual workers and employers such effects are unlikely to be taken into account whereas collective bargaining may act as a co-ordinating mechanism to integrate these spillovers.

⁷ The projections in OECD (2006a) are based on a common rate of growth of labour productivity across all richer countries so that cross-country growth differences reflect demographic changes and changes in labour force participation and unemployment.

3 WHERE DOES THE EU STAND ON STRUCTURAL POLICIES?

EU countries are not doomed to perform less well than the United States or other leading OECD members in terms of economic growth. First, as described above, some EU countries actually already perform fairly well. Second, performance in those countries that do not can be lifted through appropriate structural policy reform. The links between structural policies and growth have been studied intensely by the OECD, and this section builds on the cumulated evidence.⁸ Four fields of structural policies are considered below (policies in labour, product and financial markets as well as those affecting innovation and human capital) and in each case, the effect of policy on both labour utilisation and productivity is considered.

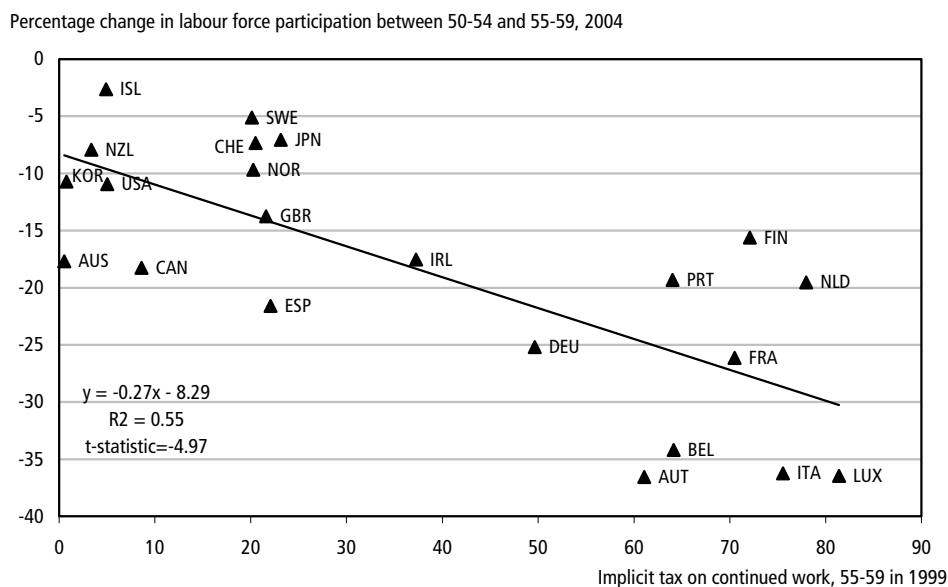
3.1 Labour market policies

As discussed above, about half of the EU15-US gap in GDP/capita can be accounted for by lower labour utilisation. On the labour supply side, the low age of retirement in many EU countries is a major explanation. This again is importantly affected by incentives arising from misguided policies concerning public transfers for early retirement, disability, unemployment and old-age pension.⁹ A measure of older persons' disincentive to supply labour is the so-called implicit tax on continued work. In broad terms, it represents the opportunity cost (in the form of lost public transfers) incurred by a person working an additional year instead of joining, for instance, an early retirement scheme. As illustrated in Figure 3.1, this implicit tax varies strongly across countries for people in their mid-50s, reflecting the specific arrangements for transfer and pension systems. It is also strongly related to retirement behaviour: where the implicit tax is high, there is a sharp drop in labour force participation between persons in the first and the second half of the 50s. It is noticeable that there are EU countries with both high and low implicit taxes, but all the countries with very high implicit taxes are EU countries.

⁸ See in particular OECD (2003).

⁹ For a review of the issues and relevant empirical evidence, see OECD (2005a) and Duval (2004).

Figure 3.1 Labour market withdrawal and implicit tax rate.



Source: OECD, Economic Policy Reforms: Going for Growth, 2005.

Apart from their effect on retirement incentives, where they can act as pathway into retirement, disability benefits are a concern in several countries where large numbers of the working age population are in these schemes. Thus, while the share of the working age population on disability benefits is not higher in the EU15 than in the United States, numbers are particularly high in Nordic countries, in the United Kingdom and in some transition economies.

A number of EU countries, particularly in Southern Europe, have very low female participation rates. This reflects several factors, including incentives arising from tax systems and family policies.¹⁰ As regards tax systems, a more equal taxation of second earners may be called for and, as regards family policies, a greater reliance on child care support than on child benefits may also boost female labour supply.¹¹

Higher average unemployment is another reason for lower GDP/capita in EU countries than in the United States. Again, however, cross country variability is high with EU unemployment rates ranging from levels comparable with those in the United States (in the United Kingdom and some smaller countries) to rates

¹⁰ For a review of the issues and relevant empirical evidence, see OECD (2005a) and Jaumotte (2004).

¹¹ At the same time, however, it should be recognised that child benefits are easier to target to social objectives than is child-care support.

in excess of 15 per cent in some transition countries. The policy drivers of unemployment have been the subject of substantial research, with another effort in the context of the recent reassessment of the OECD's Jobs Strategy.¹² The main upshots with relevance for policy settings in EU countries are:

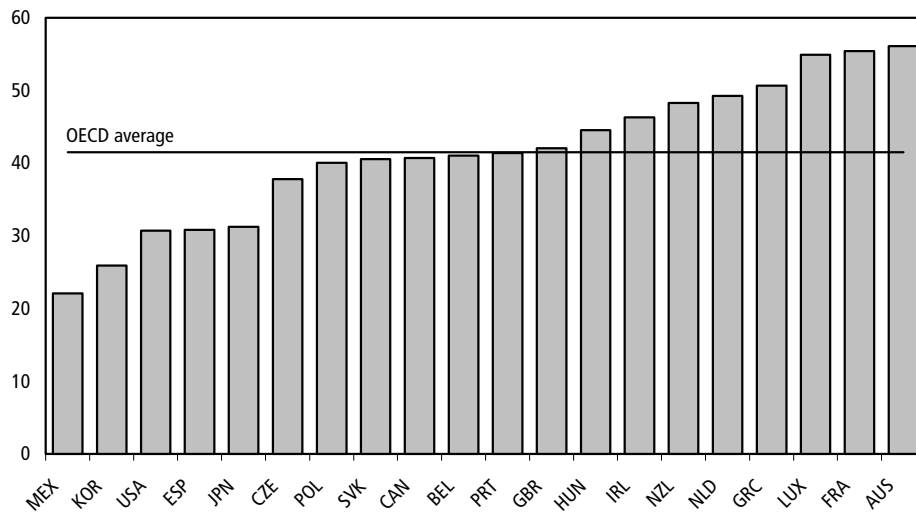
- Where they are not counter balanced by strict activation policies aimed at strengthening job search and availability, high unemployment benefits of long duration boost unemployment. Net replacement incomes tend to be high relative to earnings and of long duration in Europe north of the Alps but some of these countries, notably in the Nordic region, also have more rigorous activation policies. Because replacement incomes pose incentive problems, a few countries have put in place in work benefits to address these. However, if such benefits are sizeable they have to be phased out in order not to be too expensive and this may lead to very high marginal effective tax rates in the phase out range, posing other incentive problems such as weak incentives to improve professional competencies.
- Taxes insert a wedge between the real wages employers pay for labour and the real wages employees receive and thereby raise unemployment. This effect is particularly pronounced when wage floors, for example those created by minimum wages, prevent wage earners from accommodating the tax wedge through lower real wages. The cost of labour at the minimum wage is particularly high in some EU countries (Figure 3.2). This is despite a number of these countries providing reductions in payroll taxes for workers at the low end of the pay scale. More generally, high minimum wages may not be a particularly effective instrument to deal with poverty given that the latter is predominantly a non employment phenomenon in most countries.
- Competitive product markets also help to keep unemployment low. A main mechanism is that more competition means lower mark ups as well as higher output, which again allows for a tighter labour market. In parallel with firms losing market power, real labour incomes tend to rise. The policy settings that are of relevance here are discussed further below.
- There is considerable evidence that job protection reduces job opportunities for certain groups and can lead to increased labour market segmentation and more long term unemployment. It may also sap productivity growth as investment in R&D and physical assets is discouraged because the labour adjustment to draw full advantage of such investment is made more difficult. There is also evidence to suggest that policies to reform job protection by allowing for short term contracts while leaving in place strict protection for permanent contracts may be ineffective or even counter productive. Policies in many

¹² The analytical work to empirically identify linkages between policies and unemployment is described in Bassanini and Duval (2006).

continental EU countries have indeed combined the maintenance of relatively strict protection for permanent contracts with an easing of conditions for short term contracts. Further, the enforcement of job protection by the judicial system can be a source of uncertainty that hampers hiring.

- There is evidence that the structures of collective bargaining play an important role for unemployment, with corporatist structures in some of the smaller EU countries often credited with better unemployment outcomes. In practice, however, it is very difficult to influence bargaining structures through structural policies. In the absence of corporatist traditions, some continental EU countries apply administrative extension of bargained agreements but this may only undermine the representativeness of the bargaining parties while pricing some of the more vulnerable groups of workers out of employment.

Figure 3.2 Minimum cost of labour, 2005. Percentage of labour cost of average worker¹

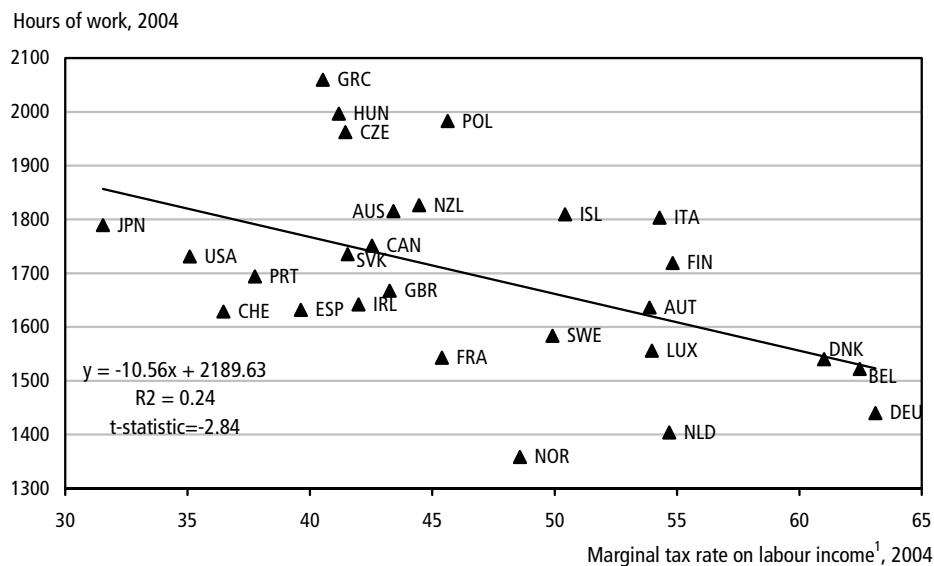


¹ The cost of labour is the sum of the wage level and the corresponding social security contribution paid by employers in manufacturing and services industries.

Source: OECD, Taxing Wages database and OECD Employment Outlook.

It is not only the number of persons employed that is likely to be unfavourably affected by policies in EU countries. Low annual working hours are also likely to be a result of distortions created by policy. A prime suspect in that regard is high marginal tax rates (Figure 3.3). Northern European countries have particularly high marginal tax rates on labour and also tend to have lower annual working hours.

Figure 3.3 Hours of work and marginal tax rate, 2004.



¹ Marginal income tax rate plus employee contributions and indirect taxes, single person with no children, earning the average wage.

Source: OECD, Taxing Wages; Analytical database, 2004.

3.2 Product market policies

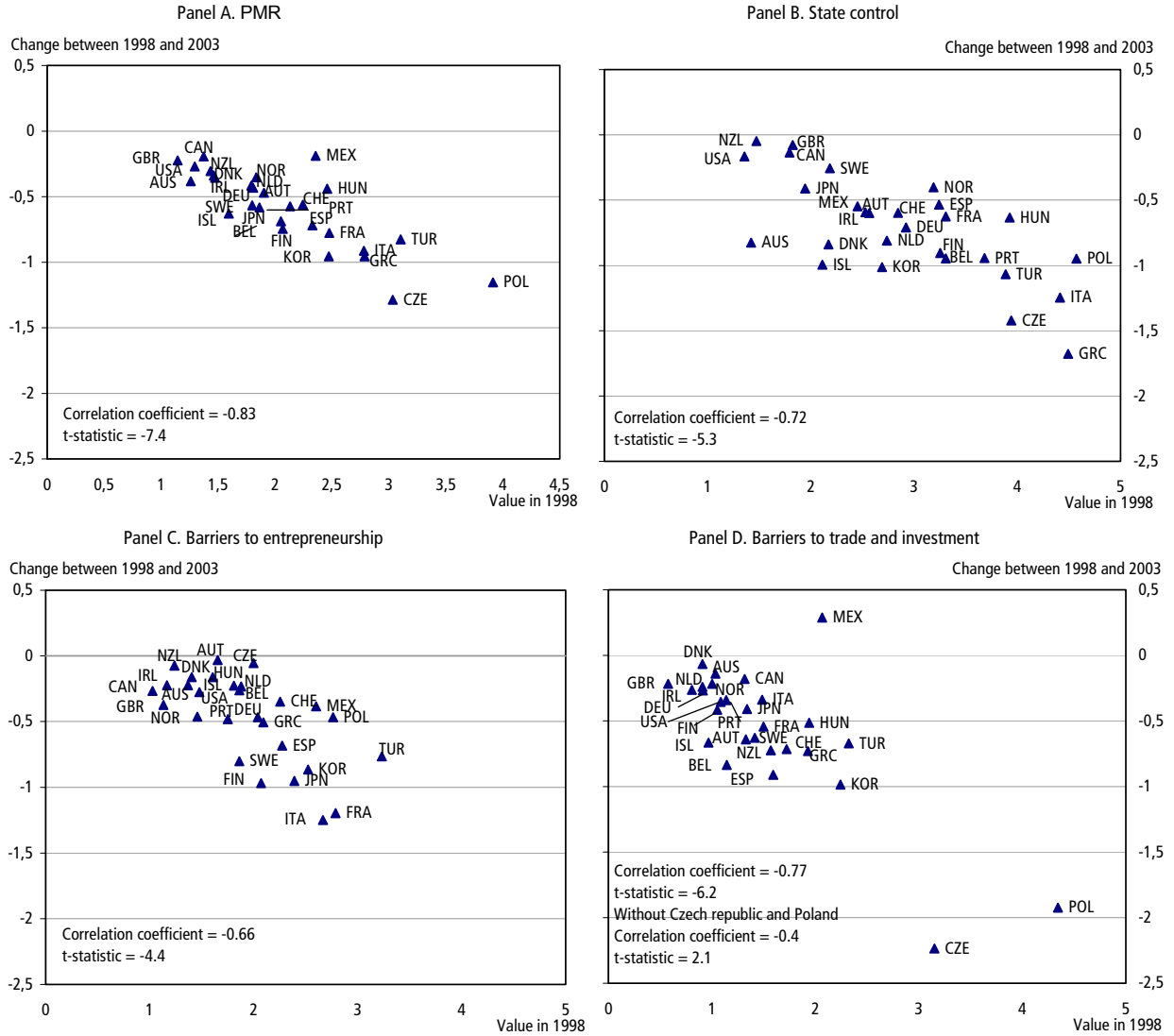
A rich empirical literature supports the notion that more competitive product markets tend to boost productivity.¹³ This happens through a number of channels including the pressures that competition puts on inefficient enterprises to either close or shape up. It could be feared that too intensive competition might quickly erode the profits associated with the introduction of new products or production processes as best practice would spread very rapidly but in practice this fear appears unfounded, at least at currently existing levels of competition and given appropriate protection of intellectual property. Indeed, there is convincing evidence that competition may act as a spur to innovation effort. In a European context, where increased R&D investment is seen as a priority for virtually all countries, this suggests that measures to enhance product market competition are a first best approach to reaching (sometimes arbitrary) targets for R&D investment (see further below). Even if the effect on innovation were limited, greater competition would still improve the allocation of resources across the economy and the efficiency they are used with.

¹³ See the references quoted in OECD(2005b), which also quantifies the beneficial effects of further liberalisation.

Overall, anti competitive product market regulation has declined throughout the OECD area over the past three decades. At the same time, available indicators suggest that there has been some convergence of regulatory stances across OECD countries, also over the more recent past (Figure 3.4). EU countries generally started out with the most heavy handed regulation and the internal market programme may be among the explanations for not only absolute but also relative progress since then. That said, EU countries are still among the most heavily regulated. It is in particular eastern and southern European countries that maintain a more restrictive regulatory stance, with the former group not yet having overcome the historical legacy despite substantial progress.

Within individual regulatory areas. EU countries have achieved a high degree of liberalisation of trade and investment flows though extending these gains to the services area in the context of the services directive proved difficult. Performance is more heterogeneous as regards state control and, to a lesser extent, as concerns barriers to entrepreneurship. While not a direct regulatory shortcoming as such, the tendency for consolidation in the utilities sector to occur within rather than across borders may pose challenges to effective competition going forward. Finally, the common agricultural policy remains grossly distorting even if the weight placed on the most market unfriendly instruments has been reduced.

Figure 3.4 Examining convergence in regulatory approaches¹.



¹ A negative correlation between the indicator value in 1998 and its change between 1998 and 2003 is indicative of convergence in regulation given that the scale of the indicators is 0 to 6 from least to most restrictive.

3.3 Financial market policies

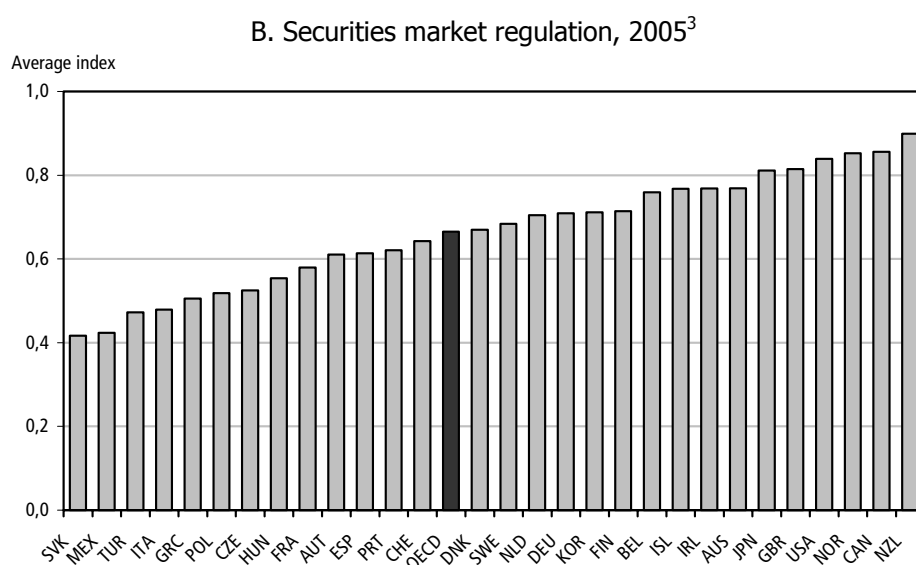
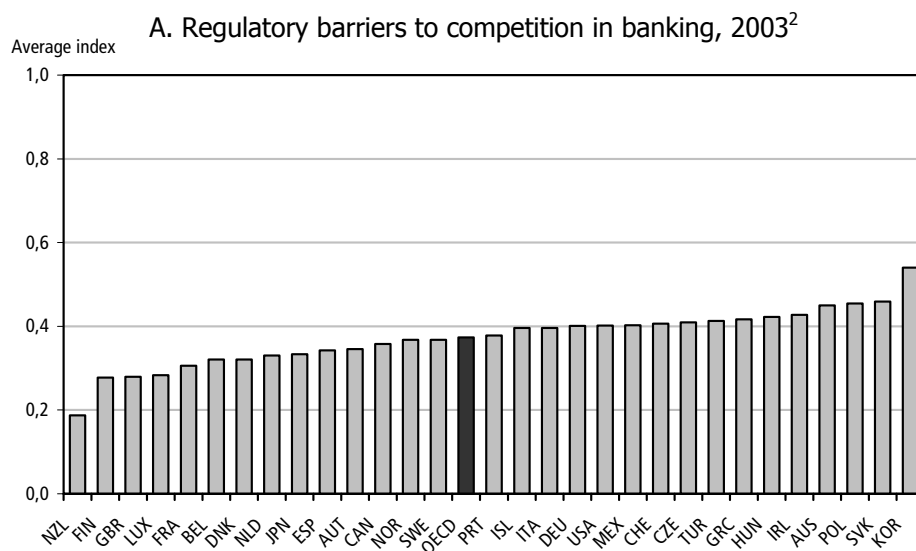
Policies affecting financial markets also play an important role in influencing economic growth. At a theoretical level, financial markets perform crucial roles in mobilising saving, channelling it to the investment projects with the highest returns (including investment in innovation), allocating risk to those who will accept it at the lowest price, and monitoring investment in a context of corporate governance. In order for financial markets to perform these roles, regulation should not unduly constrain competition while, on the other hand, provide for systemic stability.

At the empirical level, there is only limited evidence linking financial regulation with the performance of financial markets and growth.¹⁴ A set of indicators recently developed by the OECD, based to a large extent on information collected by the World Bank, represents an exception. The indicators aim at synthesising the stance of a wide range of regulations with respect to competition and there is evidence that these indicators are actually related to growth outcomes (OECD, 2006b). While this work remains preliminary and therefore not a solid base for strong policy conclusions,¹⁵ the indicators suggest that intervention in the banking sector may act as a brake on growth primarily in eastern European countries, where entry barriers remain significant (Figure 3.5). The same countries, as well as some Southern European countries, also appear to have a less competition friendly regulation of securities markets, reflecting issues regarding contract enforcement, investor protection and efficiency of bankruptcy procedures.

¹⁴ Most of the empirical evidence is concerned with the relationship between growth related outcomes and measures of financial market depth, such as stock market capitalization or bank credit, but not with direct measures of policy settings. This literature has often suggested very large impacts from financial markets on growth, see e.g. Leahy et al. (2001).

¹⁵ Among other things, the indicators do not capture "soft" issues such as the tendency for liberalisation of markets for banking services in Europe to have been accompanied in some countries by substantial concentration in the domestic banking sector with only limited consolidation across borders.

Figure 3.5 Indicators of the pro-competitive stance of financial regulation¹.



¹ The scale of the indicator is 0-1 from least to most restrictive.

² Covers domestic entry, foreign entry, activity and government ownership. A higher value indicates more competition-restraining regulation.

³ Covers contract enforcement, access to credit, investor protection, and bankruptcy procedures. A higher value indicates regulation that is more conducive to financial development.

Source: OECD and World Bank, Bank regulation and supervision database.

3.4 Innovation and human capital policies

Innovation is obviously a main driver of growth over the long term.¹⁶ At the same time, innovation is affected by market failures that, in principle, may justify government support. This is the background to a range of government policies to support private R&D (either directly or indirectly, through tax breaks) or perform R&D in the public sector. As always in connection with public intervention, however, there is a risk of supporting activities that would have taken place anyway or of support not being given where the return is highest but where political influence is greatest (or in areas that at the political level are seen as representing technologies of the future). Risks of wasteful spending are probably particularly large in EU countries given the aim of raising R&D spending to the arbitrary level of 3 per cent of GDP - with the implementation of this target apparently aiming for a uniform application across countries including those where such a target does not obviously make sense.

In any case, and as mentioned above, innovation is positively affected by structural reforms in labour, product and financial markets. For such reforms, positive effects on innovation come on top of beneficial primary effects. In this sense, such reforms are a no-regrets way to boost innovation. By contrast, government support to R&D will have budgetary costs and may in some cases crowd out privately funded R&D.

Another example of general framework policies that may positively affect innovation is education policy. There is evidence that a greater supply of potential researchers increases R&D and patenting.¹⁷ But education is also more generally a driver of economic growth, with OECD research suggesting that over past decades and across countries a rule thumb is that GDP has gone up by some 4-6 per cent for a one-year increase in the average length of education of the population. This result underlines the importance of education even if there are declining returns to investment also in this area. Indeed, results from the OECD's PISA project suggest that, at least beyond certain thresholds, the gains from reducing class size or spending more are, at best, limited (OECD, 2001).¹⁸ Looking across countries, while recognising that international comparisons are difficult in this field, there is a tendency for eastern and southern European countries to drag down average EU performance. At the same time, some of the northern European countries have education systems that, at least in terms of

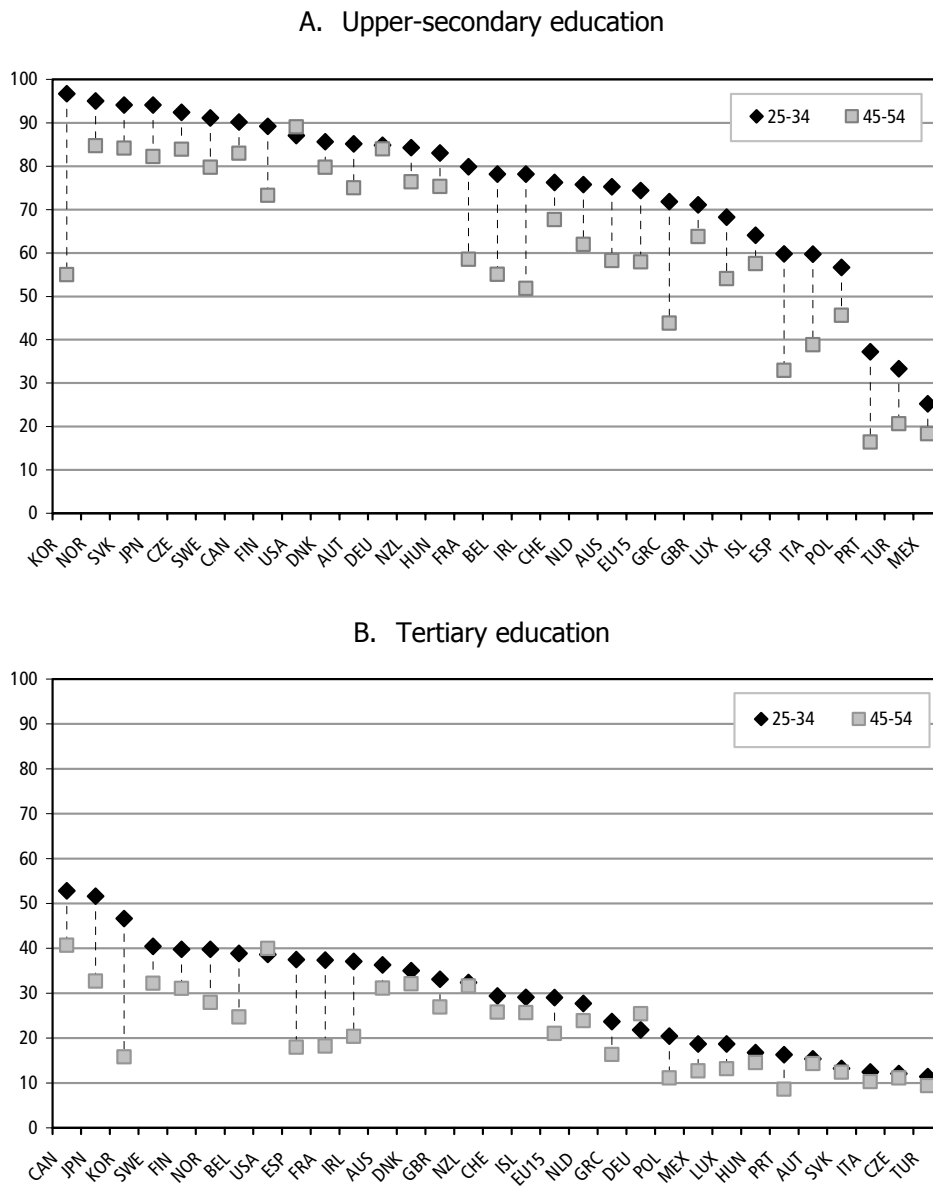
¹⁶ OECD research in the context of the Organisation's Growth Study found a strong empirical link between countries' R&D spending and their growth performance (OECD, 2003).

¹⁷ The mechanism seems to work, at least in part, via the depressing effect of an increased supply of researchers on their real wages and thereby firms' cost of doing research (Jaumotte and Pain, 2005a).

¹⁸ See also the discussion by de la Fuente (2006).

the share of young cohorts with a particular level of education, perform at a level that is similar to those of major non-EU OECD countries (Figure 3.6).

Figure 3.6 Educational attainment, 2003.



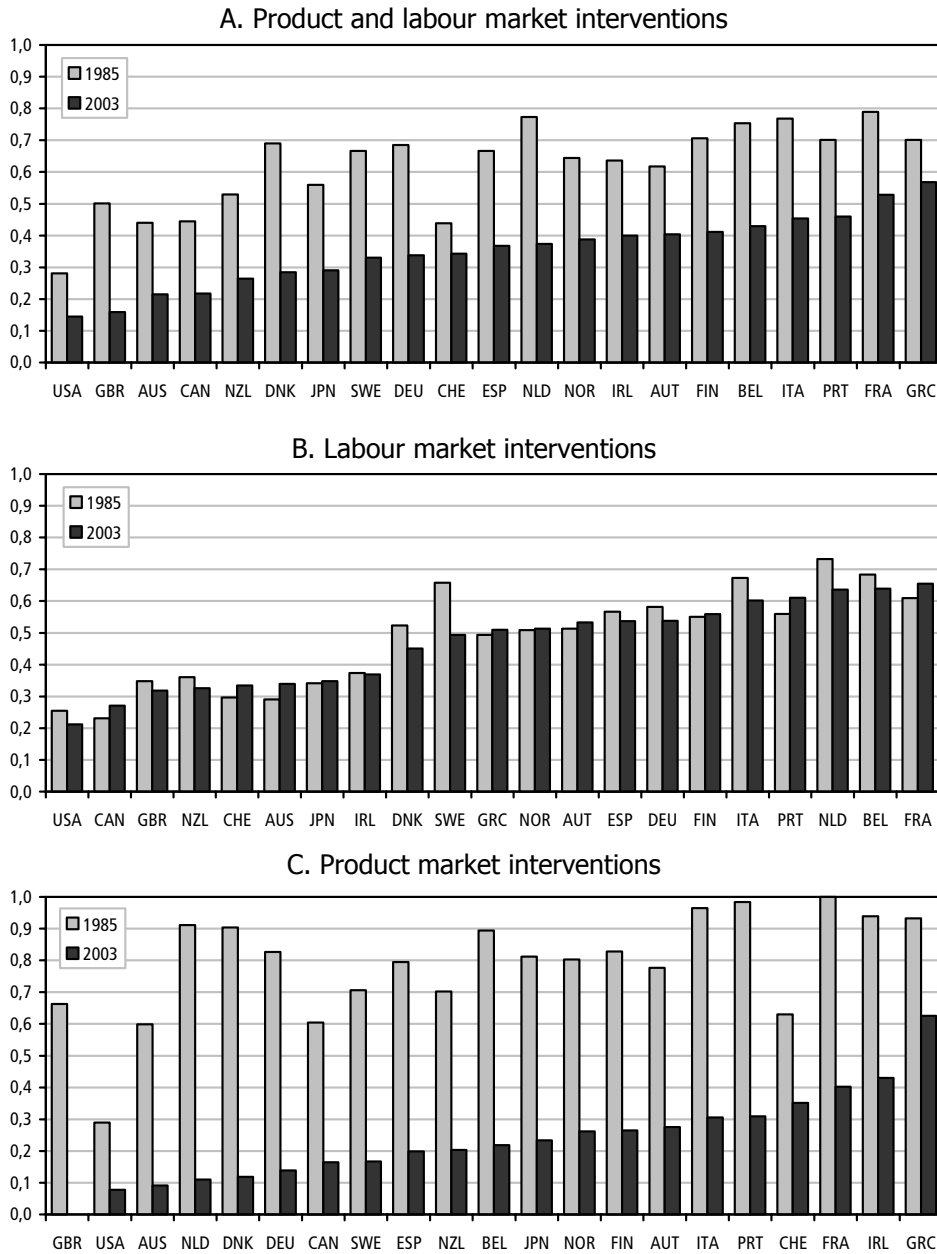
Source: OECD Education at a Glance, 2005.

4 WHY IS IT SO DIFFICULT TO REFORM STRUCTURAL POLICIES?

The shortcomings in performance and policy settings identified above are not really surprising. Progress in policy analysis over the past decade has not so much thrown up new directions for policy as it has reinforced pre existing orientations. But if the problems and their policy implications have been largely well known for many years, the question arises as to why progress in structural reform has not been more pronounced. To some extent it is probably in the nature of structural reform to be an uphill battle. There will almost always be losers and the losers tend to be easy to identify, to suffer significant losses and to do so in the early phases of structural reform. By contrast, the gains from structural reform usually emerge only after some time and are usually spread thinly over broad groups, who are often not very well organised. As well, over and above the hindrances posed by groups who defend their rents, structural reform may sometimes create legitimate concerns about their social implications (though such concerns are also often a pre text for people trying to defend rents).

Set against that background, the progress in structural reform may not be so disappointing. However, it has also been rather heterogeneous. Based on available policy indicators with a (long) time dimension, together with admittedly rough and ready procedures for weighing these together to synthetic indicators of labour and product market policies, it appears that progress has been much better in liberalising product markets than in reforming labour markets (Figure 4.1). As well, progress appears to differ across countries, with some of the (Latin European) countries pursuing relatively interventionist policies two decades ago still being more interventionist than other countries (outside Europe and in Northern Europe).

Figure 4.1 Extent of intervention in product and labour markets, 1985 and 2003¹. Synthetic indicators of product and labour market policies.



¹ All indicators are normalised ranging from 0 to 1, where 1 indicates the highest degree of interventions. The synthetic indicators weigh together a range of indicators of individual policy settings in labour (job protection, unemployment benefits, tax wedges, retirement incentives) and product (regulation in rail transport, road transport, airlines, gas, electricity, telecoms, postal sectors) markets.

Based on the varied reform record across countries and over time, recent OECD analysis has empirically examined the process of structural reform.¹⁹ This strand of work is still in its infancy but the hope is that it will help to identify conditions that facilitate structural reform and that can be influenced by policy. Two issues in particular have come to the fore in this regard:

- The first is the extent to which macroeconomic policies may allow the effects of structural policies to be accommodated. The background is a fear that some structural reforms, in particular liberalisation in the labour market, may have negative effects on economic activity in the short term. Hence, where fiscal and monetary policies have scope to respond to and counteract such weakness it might be easier to get through with structural reform. Indeed, there is empirical support for the notion that a comfortable fiscal position leads to more structural reform and some more limited support for the notion that the pursuit of a domestic monetary anchor has the same effect. In current policy terms, the upshot is that efforts to consolidate fiscal policy may eventually bring an added benefit if they allow more structural reform.
- The second issue relates to the interactions between structural reforms in different fields and the possibilities of using the appropriate sequencing to make greater progress overall. As an empirical regularity, structural reforms in domestic product markets tend to be preceded by at the border reforms while labour market reforms follow at the end. There are a number of arguments why this pattern may be more than a coincidence. In particular, greater openness to foreign competition may lead to more pressure to abolish domestic regulatory constraints than inflate costs and more competition in product markets may make it more difficult to uphold interventions in labour markets. Whether such interlinkages between reforms in different areas can be used to enhance overall structural reform is more unclear, however. Such a strategic approach to structural reform may be too “clever” to work. Nonetheless, at the current juncture it may add an additional argument in favour of overcoming international differences so as to allow a resumption of the Doha Round negotiations with the aim of reaching an ambitious conclusion.

An additional issue relates to the role of institutions. Both supranational and national institutions may play a role:

- There is empirical evidence to suggest that membership of the European Union as well as multilateral trade liberalisations have acted as spurs to structural reform. This raises the question whether international agreement involving mutual obligations can be used as an instrument to enhance structural reform the internal market programme was very

¹⁹ See Høj *et al.* (2006). Related work includes Duval and Elmeskov (2005) and IMF (2004).

successful in this regard. However, the climate has not recently been very favourable to such co-ordinated approaches.

- Some countries have generated momentum for structural reform with independent - and therefore possibly more credible - institutions analysing the costs of structural impediments and the consequences of reform. This can take the form both of *ad hoc* commissions dealing with individual issues and more permanent bodies covering a range of issues.²⁰

²⁰ The discussion by Korkman (2006) suggests that, in the case of the EU, processes of multilateral surveillance and peer pressure may influence the policy debate in individual countries and could help strengthen a process of mutual learning about the benefits of policy reform.

5 SUMMING-UP

This paper has argued that the European focus on international competitiveness may be misplaced and that economic growth might be a more appropriate focus for structural policy. As regards growth and levels of real incomes, EU performance varies across countries highlighting that there is not a single EU "story" of disappointing performance and policy failures. On the whole, differences in performance match differences in structural policy settings though macroeconomic policies obviously also play an important role. The structural policy shortcomings in the various countries are largely well known. However, the well established diagnosis has not always been followed by a decisive cure in the form of structural reform. This fact has led to a renewed interest in the political economy of structural reform but research in this area is not as yet sufficiently conclusive to permit strong conclusions.

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