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Structural Reforms and Fiscal Sustainability

1 Challenges Ahead

The central challenge common to all EU Member States over the next few years is to safeguard the sustainability of welfare systems and government finances in conditions under which the economic environment is changing rapidly. These changes relate to the ageing of the population, technology and globalisation. Each of these factors of change is a big challenge in its own right – in combination they impose strong demands on Europe's economic performance and policy.

As the population ages, the labour force in Europe is heading into a pronounced and prolonged decline. The elderly dependency ratio, i.e. the number of labour force outside employment to those with jobs, is weakening substantially in many EU countries. Concurrently life expectancy is lengthening and the old-aged portion of the population is growing. To offset the negative impact of ageing populations on labour force, a substantial rise in the employment rate and productivity in Europe is necessary in order to finance the welfare expenditure without jeopardising the sustainability of government finances.

Rapid technological development means that productivity growth will be based more closely than ever before on human capital. New technology has strengthened the importance of high competence and lifelong learning as key factors for productivity growth at the expense of traditional capital investment. Achieving benefits from technology does not only require more investment in education, research and development but also calls for the flexible allocation of resources. An economy with flexible structures fosters economic growth and higher productivity by facilitating the transfer of resources to new and fast-growing fields. Great demands are placed on the functioning of labour markets in particular as jobs are created and destroyed at a fast rate.

Globalisation can be broadly defined as the integration of national markets into a large interdependent global economy. Globalisation has accelerated, particularly in the 1990s, hand in hand with technological development but also as a consequence of deliberate political choices. As in the case of technological development, the importance of human capital and competence has grown in the global economy. This has also changed the pattern of globalisation significantly from the past. For industrial countries globalisation has meant to a great extent the rise of multinational companies investing in low cost countries in low-skilled production mainly for export markets. Today emerging markets compete with very low costs, high skills and rapidly-growing domestic markets.

In many respects the ongoing phase of globalisation can be characterised by quantitative and qualitative change which poses new challenges to industrial countries. The quantitative change derives from the fact that five giant countries – China, India, Brazil, Mexico and Russia – have joined the global open market economy during the last two decades. These countries have a combined population of over 2.5 billion, which in itself represents a considerable impact on the development of the world economy, competition and balance of power.

The shift in the balance of power in industrial production can be illustrated by East Asia's becoming the industrial workshop of the world. Its contribution to the world's industrial production has risen from 15% to 35% over the past few decades. At the same time, Europe's contribution has fallen from around 20% to 13%. The flow of direct investments to East Asia has also burgeoned, increasing by a factor of five between 1990 and 2000. These developments have increasingly spurred discussions about a new phase of globalisation implying rapid outsourcing and offshoring of industrial activities, flight of jobs to China and India and deindustrialisation of Europe.

The qualitative shift in globalisation can be illustrated by the relocation not only of industrial production but increasingly also research and development, corporate information management, product design and services to emerging economies. This is supported by the emergence of complex corporate networks where traditional way of producing goods and services in a particular location is increasingly translated into coordination and management of component and service production in different regions.

This new phase of globalisation poses significant challenge for industrial countries to adapt to a changing environment. At the same time, with good adaptability growing markets in large emerging countries provide increasing opportunities. The main challenges facing Europe as well as other industrial economies involve adapting to the fact that today's global market and rapid technological advances have brought changes in the relative standing of production factors. Labour with the highest level of competence is becoming the most important resource. Countries and regions compete for this kind of labour, which has also become more mobile. The capacity of economies to create, attract and retain competent labour is crucial to their long-term growth and prosperity.

In March 2000, Europe's leaders committed themselves to a ten-year programme, designed to make the European Union "the most competitive and dynamic knowledge-based economy in the world" by 2010. The strategy was intended to deliver "an average growth rate of around 3%" in the years following 2000, and to re-establish the conditions for full employment, reflected in a 70% EU employment target and increased participation rates by 2010.

When the Lisbon strategy was launched, the need to ensure long-term fiscal sustainability in the face of population ageing and growing expenditure pressures as well as Europe's lagging productivity and employment growth relative to the USA were regarded as major factors underpinning the necessity to raise Europe's growth potential and competitiveness. Even though the Lisbon strategy has not yet delivered the success Europe's leaders hoped for, its implementation has became even more crucial in the new phase of globalisation. Structural reforms that improve the capacity of European economies to adapt better to changing environment are unavoidable for the governments in order to be able to provide high quality welfare services to their citizens and deliver the promised long-term obligations for the greying population.

2 Growing Tensions in the Financing of the Welfare State

The change in the population's age structure puts public finances under strong pressures at least for three reasons. First, increasing pension and health care expenditure lead to higher public expenditures. Second, a decreasing labour force will slow down economic growth potential and tax revenue, if productivity growth and the employment rate cannot be raised enough to compensate its negative impact. Third, international tax competition as well as the need to raise employment rate imply the need to lower tax burden on capital and labour in several EU countries. The pressures for lowering tax burden is hardly compatible with mounting expenditure pressures and the need to keep public finances on a sound footing.

Long-term projections based on demographic change show that largest increases in public spending on pensions, health care and long-term care will occur between 2010 and 2030 in most EU countries. The projections of the Economic Policy Committee indicate that the ageing of population will lead to an increase in public spending of between 3 and 7 percentage points of GDP by 2050, if no corrective policy action is taken (Economic Policy Committee, 2003; see also OECD, 2001 and 2003, Dang et al., 2001). These projections also show that expenditure increases are largely driven by the increase in old-age dependency ratios. Potentially offsetting savings in education and unemployment expenditures are likely to be small (relatively).

On the basis of the expected population change McMorrow and Roeger (2003) estimate that ageing is expected to reduce the annual average growth rate by around 0.40 percentage point for the EU and Japan and by around 0.25 percentage point for the USA. Potential growth rate over the period from 2000 to 2050 is expected to fall to 1.3% for the EU and to slightly below 1% for Japan. This is markedly less than in the USA, where annual average growth rates of 2½ percent are predicted over the next 50 years, driven by continuous growth in the working age population contrasted to the declines in the EU and Japan.

Finally, and independently of the population ageing, pressures for higher public expenditures stem from the so called Baumol disease, the impact of which is usually ignored in the long-term expenditure projections. The question here is that long-term calculations are often based on the assumption that productivity growth in the private and public sectors are more or less the same and that real wages in both sectors increase at the same pace determined by the average productivity growth. However, since the productivity growth in the public sector tends to be much lower than in the private sector while real wages tend to grow at the same pace in the long run, public consumption expenditures are bound to increase much faster than the total output of the economy. This implies ever growing share of the public sector and increasing pressures for financing public services, even in the case where the volume of services is kept unchanged.

3 Pension Reforms and Sustainability of Public Finances

Reducing public debt and maintaining sound fiscal positions in accordance with the requirements of the Stability and Growth Pact (SGP) are necessary for the fiscal sustainability. Long-term projections show clearly that the risk of unsustainable public finances increases considerably if EU countries do not achieve and maintain their budgetary positions of “close to balance or in surplus” as envisaged in the SGP in the coming years. As the budgetary impact of ageing starts to take hold between 2020 and 2030, there is a limited, but fast closing, window of opportunity to reduce debt levels.

To contain expenditure pressures several EU countries have undertaken reforms in their pension systems. In many countries these reforms are still lacking or have not been ambitious enough to ensure the sustainability of public finances and pension systems (Casey et al., 2003, European Commission, 2004).

When assessing the adequacy of pension reforms from the point of view of fiscal sustainability, the EU simulations (Economic Policy Committee, 2003) on the budgetary impact of certain types of parametric reforms to pension systems provide a useful starting point. Three areas of parametric reforms are considered: indexation of pensions, increase in life expectancy and effective retirement age.

Since there is no unique definition for long-term sustainability of public finances, a pragmatic and narrow definition used in the context of the EU is followed here, i.e. sustainability is defined as the ability to meet the EU Treaty reference values for general government gross debt (60% of GDP) in the short and long term without raising the overall tax ratio. However, in a broader sense sustainability is not just a question of meeting the EU Treaty reference values but also whether the current tax ratio is sustainable in the long term taking into account international tax competition and objective to raise employment rate.

According to the simulation results, a reform where indexation of pensions is reduced by half a percentage point per year would decrease on average 30% of the expected increase in pension expenditure by 2050 in earnings-related pension systems. In flat rate systems the effect of indexation is even greater. The adjustment to benefits in line with expected increase in life expectancy at the age of retirement would, on average, reduce 45% of the expected increase in pension expenditure. These types of parametric reforms would contain expenditure pressures, but they would also mean that the benefit ratio gradually decreases.

Finally, the simulations show that raising the effective retirement age by one year would on average decrease around 20% of the expected increase in pension expenditure by 2050. This type of a reform has also a positive impact on the labour supply and economic growth.

Unlike the reduction in indexation and adjustment to benefits in line with expected increase in life expectancy, the increase in the effective retirement age would not reduce the benefit ratio and thus would help to maintain adequacy of pension income. In order to offset the impact of expected higher life expectancy on pension expenditure without reducing benefits, the effective retirement age would have to rise on average by two to three years.

In sum, the results indicate that all parametric reforms in simulations have a significant impact on expected pension expenditure. It is however clear that individual reforms taken on their own would only partially absorb the expected increase in pension expenditure by 2050. Comprehensive pension reforms are therefore necessary for fiscal sustainability, but also to ensure the adequacy of the future pension income.[1]

[1] *See also simulations carried out for the EU-15 on an aggregate level by European Commission 2001.*

4 Structural Reforms Necessary for Higher Growth and Productivity

Although debt reduction and pension reforms are very important for fiscal sustainability, they do not help Europe to raise its growth potential and competitiveness. Reform areas important for growth involve trade, financial markets, product markets, labour markets, as well as tax and benefit systems (including pensions) and public sector.

Trade liberalisation has been in general the first and most advanced reform area, followed by liberalisation of international capital movements and financial markets. Evidence that membership in the EU in general, and the creation of the Single Market in 1992 and Economic and Monetary Union (EMU) in 1999, in particular, have fostered reforms in these areas is clear.

Despite important progress in trade and financial market reforms, much more needs to be done in order to meet the targets set in the Lisbon strategy. Raising productivity, potential growth and employment in Europe implies structural reforms that reduce labour market rigidities and price inflexibility as well as impediments to competition and innovation. In general, these reforms entail measures that improve the functioning of markets by changing institutional frameworks and regulations than govern market behaviour and performance. Very often structural reforms can be boiled down to various forms of deregulation.

Potential growth is determined by the changes in productivity and labour input. As ageing tends to lower productivity growth additional measures are needed to improve total factor productivity even to keep productivity at the current level. If Europe wants to improve its competitiveness in the globalised world higher productivity growth is needed.

Total labour input depends on employment and hours worked. There has been a long trend in Europe of decreasing working time. So far this has not been a constraint for growth as increasing labour supply has offset the negative impact of shorter working hours. In the future the situation will change for the worse as the supply of labour will decrease when large age cohorts are retiring and smaller age groups are entering the labour market. To combat these two trends reducing labour input and potential growth in the future, reforms that increase average working life and working time are required. Since labour input will diminish anyway, productivity growth becomes critical for potential growth.

A common quest for structural reform and deregulation does not however mean that all regulation is harmful and should be abandoned altogether. Many of the regulations at the national and EU level have been adopted in order to address problems related to market failure and inefficiency or due to consumer protection, health, security and environmental reasons. Government regulations, if appropriately designed to minimise risks of government failure, can prevent harmful market outcomes and are thus beneficial.

Finally, to tackle the Baumol disease and to constrain the pressure for increasing unit costs in the public service provision, the productivity and efficiency of welfare services have to be improved significantly in many European countries. With roughly half of the average projected increase in age-related spending over the next decades coming from health spending, productivity improving reforms in this area are expecially important (OECD, 2003).

5 The Impact of Structural Reforms: Hard to Quantify and Politically Difficult to Justify and Implement

In many cases the impact of structural reforms is not easy to quantify which makes it difficult to communicate the benefits to public at large and thus gain policitical support for reforms. Uncertainty concerning the magnitudes of the dynamic costs and benefits of reforms is usually significant and short- and long-term impact may differ substantially or be of the opposite sign. As uncertainty increases with time, policymakers tend to focus primarily on the expected short-term costs of reforms and heavily discount the long-term benefits, which their political successors are likely to accrue.

Lacking political support is often based on the uneven distribution of the costs and benefits of reforms across the economy and over time. Although the economy as a whole benefits from the reforms over time, some groups in the society will lose at least in the short term.

As product, labour and capital markets are interdependent, simultaneous progress in various areas may lead to complementarities that can alleviate the situation of losers of a particular reform or undermine the case against reform by those benefiting from existing regulatory framework and institutions (Blanchard and Giavazzi, 2003). Reforms in one area may also reinforce the benefits in other areas (see Boeri et al., 2000, Coe and Snower, 1997, OECD, 2002). By reducing short-term economic costs or by reinforcing the benefits, a comprehensive reform package may help in gaining political support for reforms.

The existing empirical evidence supports the view that reforms in-

crease average productivity and long-term growth potential through more efficient allocation of resources, increased factor utilization (labour) and stronger incentives for innovation.[2] Labour, tax and product market reforms typically lower unemployment, but their impact on employment across sectors may vary, as factors of production are reallocated more efficiently as a result of reforms. Overall, very little evidence of adverse effects of trade liberalisation, financial market reforms and product market reforms on wages and income inequality has been found (see IMF, 2004, and the references therein).

6 Concluding Remarks

Although a broad consensus about the objectives and need for reform

[2] *On the positive impact of trade reforms, see Berg and Grueger (2003); of product market reforms, see Nicoletti and Scarpetta (2003); on less distortionary tax systems, see Kneller et al. (1999).*

exists among the EU countries, the lack of progress is visible. The Lisbon strategy has so far produced much more recommendations and talk at the EU level than concrete results in terms of national implementation. To close the widening implementation gap, it is crucial that commitments made at the EU level will be better integrated in the national policy and decision making. ❧

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