Reforming Europe: It’s Time to Accept Differences

By Antonio Fatas , INSEAD Professor of Economics

Reforms are happening where they’re needed in Europe, but their effects are not as big as planned and they’re not always happening fast enough. To accelerate the reform process, national approaches are needed.

Hardly a day goes by without reform being discussed in Europe. Greece and its European partners remain at loggerheads on the need for pension cuts, labour market reforms and ensuring the sustainability of its budget.

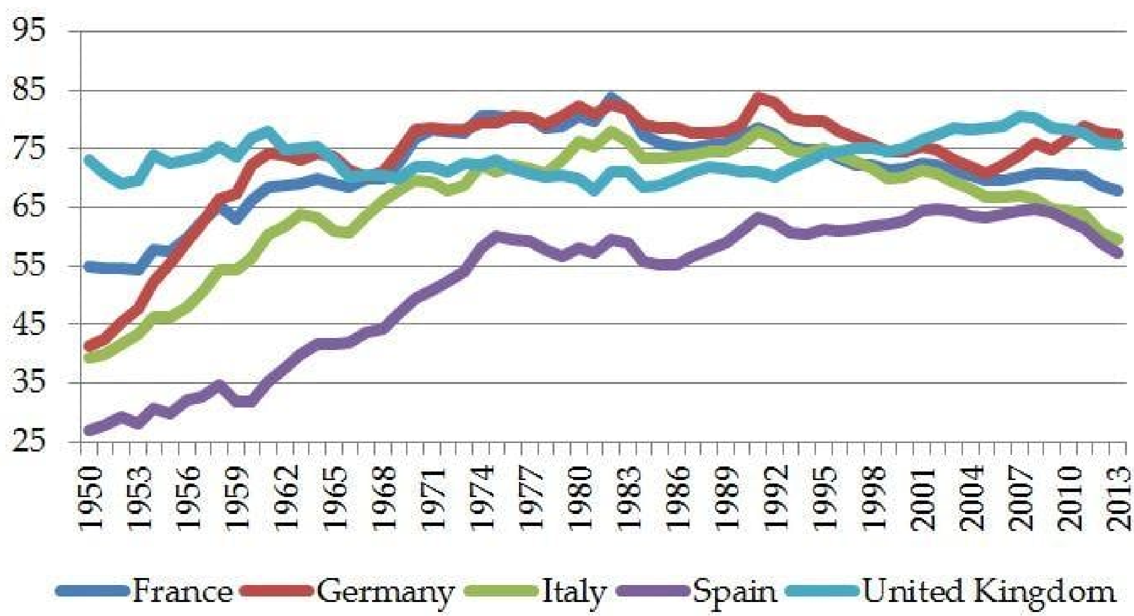
This discussion has been at the centre of the economic policy debate longer than the recent crises and the discussion became more urgent after the 1970s when Europe struggled to adapt to oil price shocks and subsequent recessions. Unemployment remained elevated and Europe’s progress towards U.S.-level prosperity and dynamism slowed down. And the poor performance of Europe during the most recent economic crisis has been yet one more wake up call for the need to find ways to improve growth.

Since 2000, the European Union has made reforms a key priority in economic policy discussions both regionally and locally. But what remains far from clear is whether Europe's reforms are working to improve the continent's living standards and what we should do to improve the status quo going forwards.

How far is Europe from its potential?

In a recent paper **The Agenda for Structural Reform in Europe**, I use the U.S. as a benchmark to demonstrate how most of Europe's economies were on a path of convergence with the U.S. until around the 1980s.

Convergence in GDP per Capita (US=100)

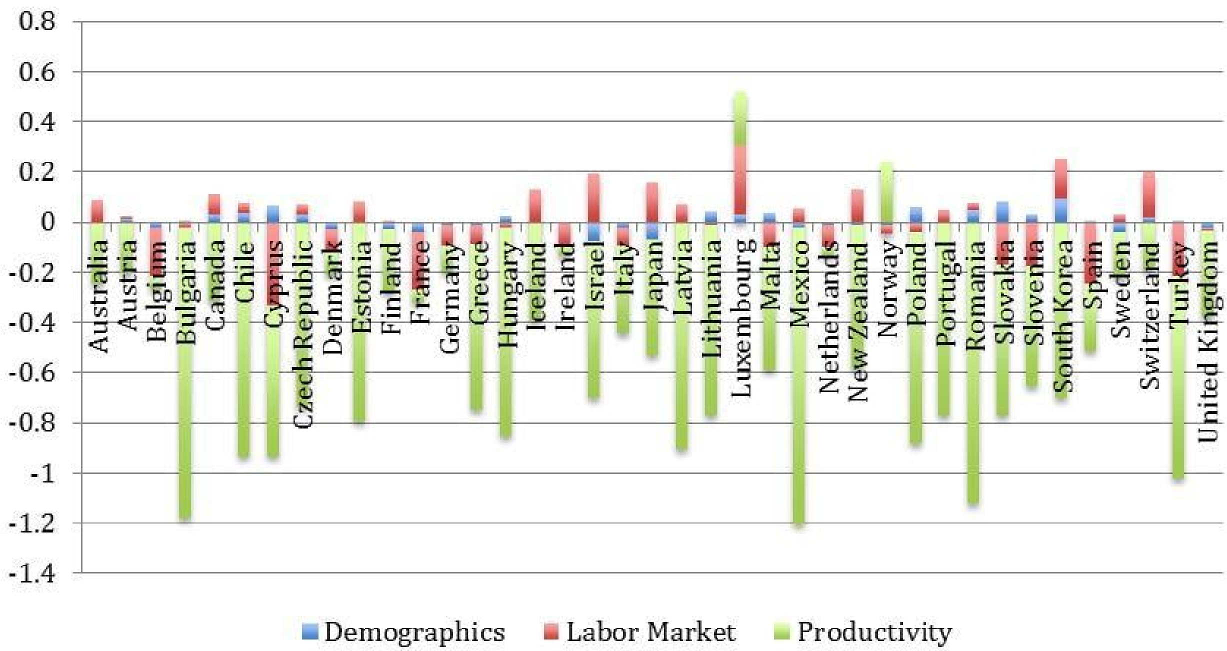


There are two distinct patterns worth mentioning. The U.K. has maintained a gap of about 25 percent for the last five decades. The other four countries (France, Germany, Spain and Italy) were on a very fast convergence process in the early years but this convergence has since reversed. So what is driving this divergence?

If we break down the differences in GDP per capita across demographics, labour markets and productivity, we notice that the gap varies across different European economies, both in terms of size but also origin. While productivity is a large factor for most countries, for a few of them, the labour market is as large or larger, illustrating low utilisation of available workers.

It is interesting to see that Europe is not alone. All other advanced economies also display gaps relative to the U.S. What is interesting is that the productivity gap tends to be smaller for European economies while the labour market gap tends to be larger.

Decomposition of Differences in GDP per Capita



Why Reforms?

So how can structural reforms help to close the gaps? If we look at leading indicators and compare the gaps in labour markets and productivity with them, we can see why reforms are at the centre of economic policy discussions.

I use the World Bank Doing Business database and the OECD's Product and Labour Market Regulations (PMR) index to measure gaps in policies.

The Doing Business database covers variables related to cost of starting a business, regulatory processes or enforcing contracts, which helps us to understand how far each economy is from the "frontier", which represents the best performance. The OECD indicators are very similar in spirit and they look at the flexibility of both product and labour markets under the assumption that more flexible markets and increasing competition are good for growth.

What we find when comparing GDP per capita with the policy variables is a strong correlation between measures of institutions, regulatory processes and policies with productivity and employment.

While the correlation is strong, it is not easy to use this empirical pattern in order to design a set of reforms with a clear set of priorities. The reason is that all indicators seem to matter and they are highly correlated with each other. In addition, we know that there are many interactions between each of the indicators and that some might be very relevant for some countries but not for others. And, finally, there are also many others policies that can be considered as determinants of growth and potentially a target of broader policy reforms, for example:

- Human capital as influenced by both number of years of formal training and quality of the education system.
- Innovation and R&D support via fiscal policy or availability of financing can be beneficial.
- Energy costs can be enablers of activity and responsible for improvements in economic performance.
- ICT drives big differences in productivity among advanced economies.

Because of this complexity, the agenda for reforms tends to be driven by “faith” in labour market flexibility and competition. We understand at the microeconomic level that these are important factors in growth and labour market performance even if the aggregate evidence is not detailed enough to define a set of specific priorities.

Reforms are happening

In our empirical analysis we also show that reforms are happening and they are happening where they’re needed the most. As an example, and contrary to popular belief, this is true in Greece, where reforms in some key indicators have accelerated significantly between 2008 and 2013 compared to the previous 5-year period.

But despite the progress, the results are not there yet. Gaps remain and there is a need to accelerate economic growth after the crisis, in addition to dealing with future demographic challenges that Europe faces. There is a need to either go faster or to implement reforms in a more effective manner by possibly understanding better the true bottlenecks that each economy faces. Just attempting to implant America’s or Switzerland’s flexible labour model in Spain or Greece is not going to work.

An agenda for reforms

Reform is ultimately a domestic political business where trade-offs are being made between economic efficiency, social goals and the way power and income are distributed in society. Europe has played a strong role in reforms both because of peer pressure but also because it has been used as a political scapegoat for unpopular policies. And this is not working anymore, at least in some countries. Constantly making Europe the reason why reforms need to happen is likely to generate unhealthy dynamics between members of the European Union or the Euro area. The current negotiations with Greece serve as a good example.

One way to change these dynamics would be through a much more contractual approach to reforms, such as making rules on entry to the EU more binding. But a contractual approach to European integration and reforms is very difficult to implement. As recent history has shown, countries in the union have already bent agreed rules (such as fiscal policy rules) at times where enforcement was difficult politically.

The only other alternative is to be more realistic and understand that consensus is not always possible. If countries are not willing to establish a common set of policies and institutions then we need to help Europe accept this reality. Forcing “more Europe” into countries that are not ready to commit is a losing battle. This is not what those of us who believe in the political importance of European integration want to hear but it might be the only way forward for the European reform process to be effective.

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