

Weighing up the Growth Dividends from Structural Reforms

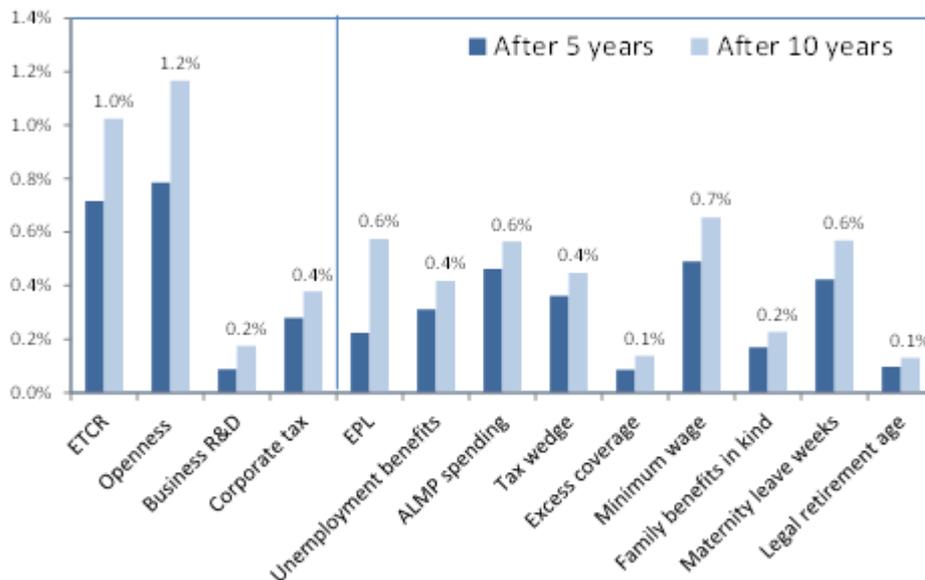
by Balázs Égert and Peter Gal, OECD Economics Department

In many OECD countries, economic growth has yet to recover the lost ground suffered in the aftermath of the financial crisis. In some of them, unemployment has been persistently high, investment rates disappoint, and productivity is extremely sluggish – a “low growth trap”. Put differently, all three sources of sustainable long-run growth under-perform. This jeopardizes societies’ ability “to make good on its promises to current and future generations – to create jobs and develop career paths for young people, to pay for health and pension commitments to old people”. (OECD, 2016). While this partly reflects the persistent weakness of demand in some cases (Mann, 2016), there are policy tools available that affect the long-run productive capacity of the economy, or potential growth. Our recent work takes a fresh view on the relative payoffs in terms of raising future growth (Égert and Gal, 2016). We study how various product and labour market policies and regulations affect per capita income growth over different horizons and through the three supply-side channels: multi-factor productivity (MFP), capital deepening and employment.

We find that product market regulation (PMR) reforms have the largest overall direct policy impact: reducing regulatory barriers to competition induce a cumulative increase of 0.7% of GDP per capita over a 5-year horizon. Other policies with considerable overall effects include increased spending on active labour market policies (ALMPs), a reduction in labour tax wedge, in the minimum wage or in the length of maternity leave with impacts ranging from 0.3% to 0.5%. Typical reforms in other policy areas tend to have a smaller impact on per

capita income (Figure 1).

Figure 1. The impact of reforms on GDP per capita 5 and 10 years after the reforms

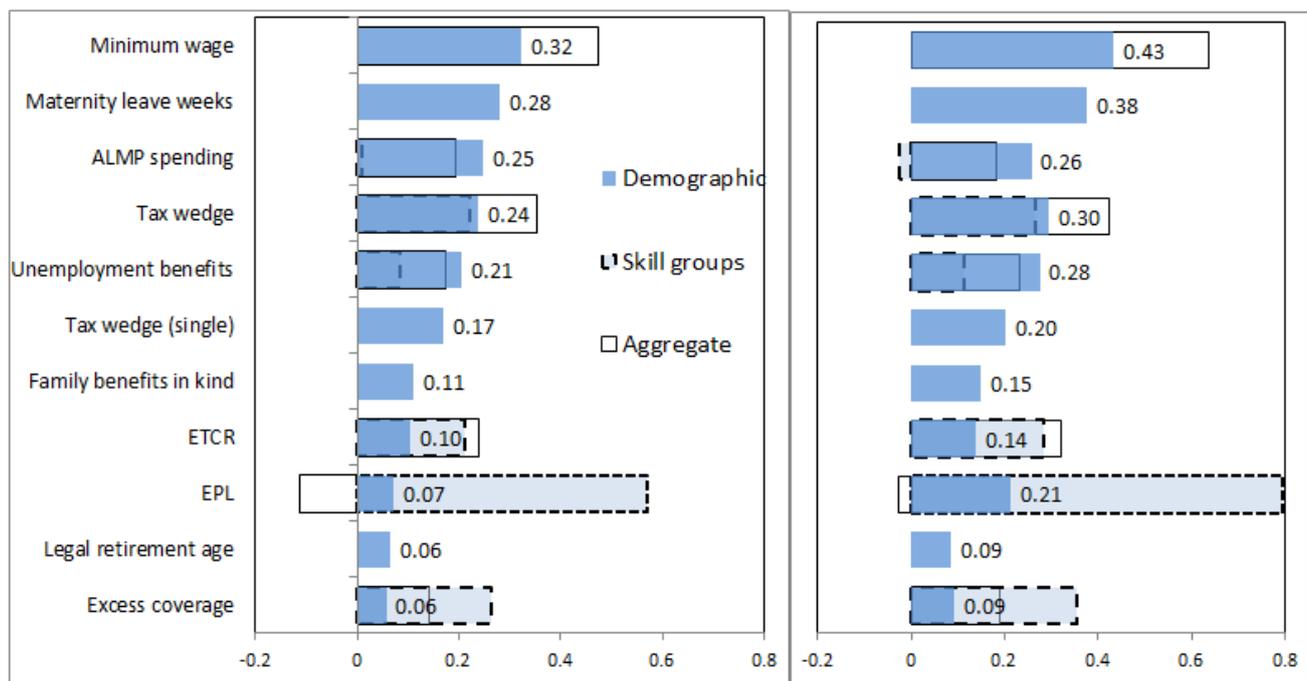


Note: Typically observed reforms are measured here by the average of all beneficial two-year policy changes that were observed over two consecutive years in the sample.

Different policies have different impacts on the separate supply-side components. For instance, PMR affects each of them, while labour market policies tend to impact only employment. Exceptions are ALMPs, which affects both productivity and employment, and EPL, which drives both capital deepening and employment. Finally, the corporate tax has an effect only on capital deepening, while R&D impacts only productivity (Figure 2).

The policy effects differ over longer horizons. For instance, the overall long-term effects on GDP per capita of PMR, employment protection (EPL) and ALMP spending are considerably larger than the 5-year impacts. This is mainly due the fact that MFP and capital are slower to react to reforms, compared to employment (Figure 1).

These results are based on past policy changes and assume that the impacts are uniform across countries and various institutional settings. But the estimation results shown in Figures 1 and 2 could be used as a starting point to provide



Note: *Typically observed reforms are measured as the average improvements in the policy indicators over all two year windows that show improvements in both periods (see Table 5, column 4). The employment rate effects use all three aggregation approaches, and the size of the effects is indicated by numbers for the aggregation using demographic groups. See details in Egert and Gal (2016)

Source: Égert, B. and P. Gal (2016), “The quantification of structural reforms in OECD countries: a new framework”, OECD Economics Department Working Papers, No. 1354, OECD Publishing, Paris.

References

Égert, B. and P. Gal (2016), “[The quantification of structural reforms in OECD countries: a new framework](#)”, OECD Economics Department Working Papers, No. 1354, OECD Publishing, Paris.

[Mann, C. L. \(2016\), “Deploy effective fiscal initiatives and promote inclusive trade policies to escape from the low-growth trap” ECOSCOPE, November 28.](#)

OECD (2016), “[Economic Outlook](#)”, Vol 2016(1).

Product market reforms under the microscope

by Alexander Hijzen, Senior Economist, Directorate for Employment, Labour and Social Affairs, OECD and Peter N. Gal, Economist, Economics Department, OECD

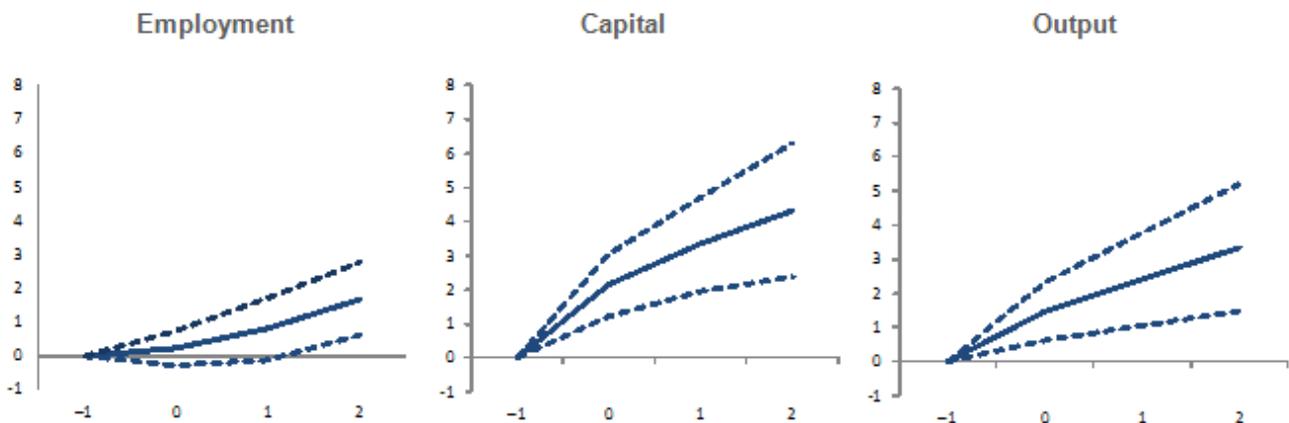
Given the secular decline in productivity growth and the persistent weakness of the economic recovery in many advanced economies, increased attention is being paid to the potential role of structural reforms for restoring economic growth. While structural reforms concern many policy areas (e.g. banking supervision, property right laws and employment-protection rules), product market regulation (PMR) feature particularly prominently on the agenda of many advanced economies (OECD, 2015). Understanding the dynamics effects of reforms in this area may provide important insights with respect to the way such reforms are designed, the political economy of reforms and the potential need for complementary policies. In [a recent paper](#) (Gal and Hijzen, 2016), we attempt to open up the black box of pro-competition product market reforms by providing a comprehensive analysis of their short-term impacts across firms that differ in terms of the main sector in which they operate, the size of their operations and their financial health.

Our main findings on the impacts of major product market reforms are as follows:

- *First, the short-term, firm-level effects of reducing regulatory barriers to product market competition are positive and strengthen over time (Figure 1). The effects are immediate for both output and investment,*

and increase further to 4% and 3% respectively after two years. The effects for employment are considerably smaller and only materialize after two years.

Figure 1. The short-term effects of product market reforms on incumbent firms
 Percentage change in the outcome variable of interest in years after the reform

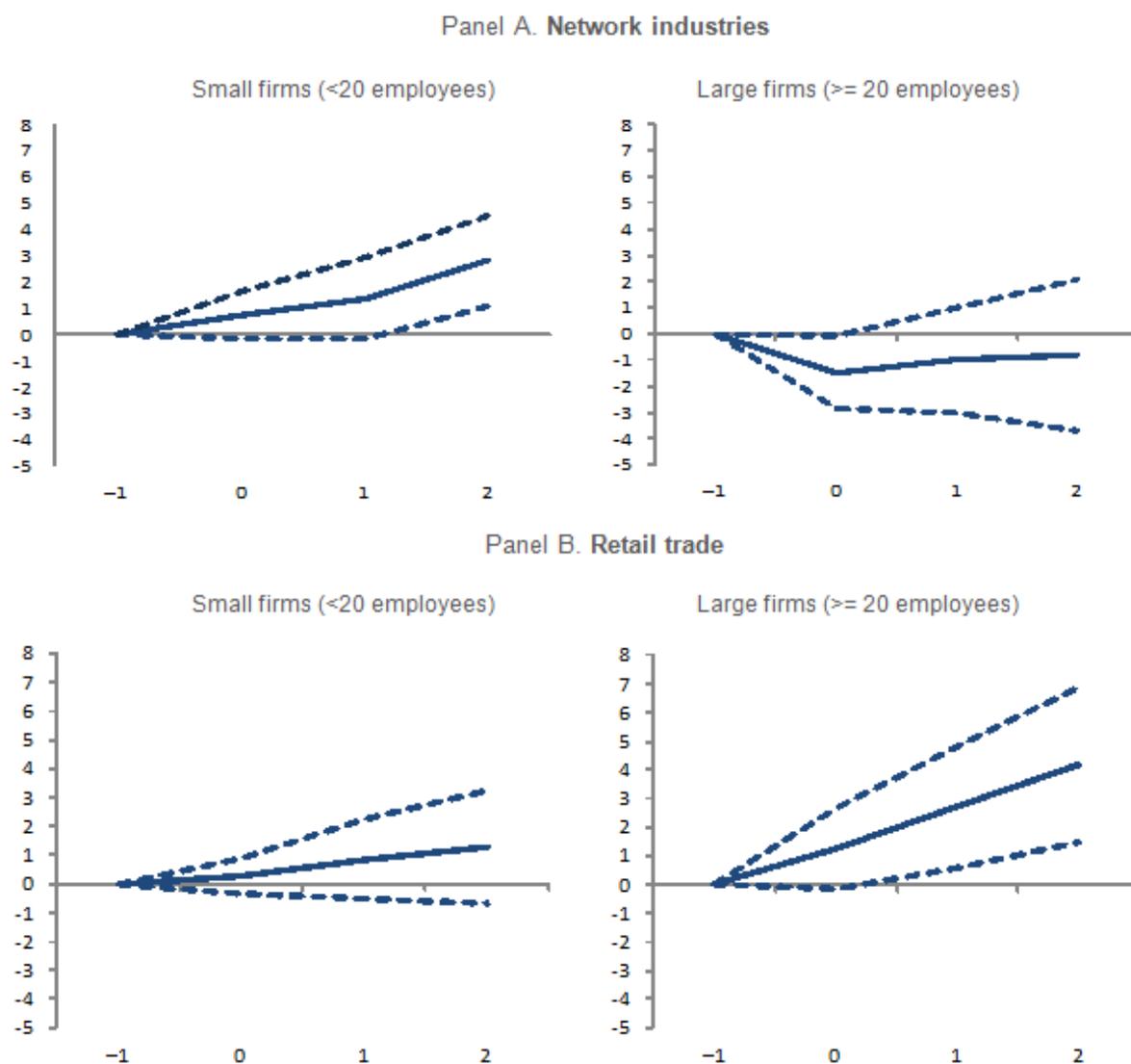


Solid lines represent impulse response functions based on the estimated coefficients of major product market reforms; dashed lines represent 90% confidence intervals. Major reforms are defined to be those that correspond to absolute changes in the extended OECD PMR indicator larger than 0.5, which roughly capture the 5% most intensive changes. See Gal and Hijzen (2016) for details.

- *Second, there are systematic and plausible differences in the effects of reforms across firms of different sizes across different industries (Figure 2). More specifically, in network industries, small firms tend to benefit most from pro-competitive product market reforms, while larger ones downsize to reduce costs and maintain market shares. By contrast, in retail trade, large and potentially more efficient firms tend to benefit more from such reforms.*

Figure 2. The short-term effects of product market reforms on incumbent firms

Percentage change in employment in years after the reform



Solid lines represent impulse response functions based on the estimated coefficients; dashed lines represent 90% confidence intervals. See Gal and Hijzen (2016) for details.

- *Third, financial difficulties faced by firms weaken the short-term impact of product market reforms on investment.* These findings highlight the importance of addressing the problem of weak bank balance sheets when considering product market reforms, and points to the complementary role of financial sector reform more generally. This is particularly relevant in those countries where the flow of credit is still weak and the case for product market reform is relatively strong (e.g. some countries in Southern Europe).

In sum, the present findings confirm the positive effects of pro-competitive product market reforms on economic performance in the medium to longer term, while also providing rich new insights on the way the effects of such reforms materialize over time across different types of firms. More specifically, these findings help to understand why it can be difficult to implement product market reforms in certain sectors, but less so in others. For example, the pace of product market reforms could be slowed down in network industries since large incumbent firms have a tendency to lose out in terms of jobs and profitability. The tendency of financial difficulties to mitigate the impact of product market reforms on investment may also suggest that the effects of product market reforms materialize more slowly in times when the economy is depressed and credit is hard to get by.

These insights can be used to enhance the design of product market reforms and to motivate the need for complementary measures to promote aggregate demand, restore bank balance sheets and to alleviate the social cost of adjustment (IMF, 2016; OECD, 2016).

References

Gal, P. N. and A. Hijzen (2016), "[The Short-Term Impact of Product Market Reforms : A cross-country firm-level analysis](#)", *OECD Economics Department Working Papers No. 1311*.

Also appeared as *IMF Working Paper No. 16/116*.

IMF (2016), *World Economic Outlook*, Chapter 3, April, International Monetary Fund, Washington, D.C.

OECD (2015), [Economic Policy Reforms: Going for Growth](#), Organization for Economic Cooperation and Development, Paris.

OECD (2016), "Short-term labour market effects of structural reforms: Pain before the gain?", in [OECD Employment Outlook 2016](#), OECD Publishing, Paris.

Birds of a feather do business together

by [Jean-Marc Fournier](#),
Economist, Public Economics Division,
OECD Economics Department

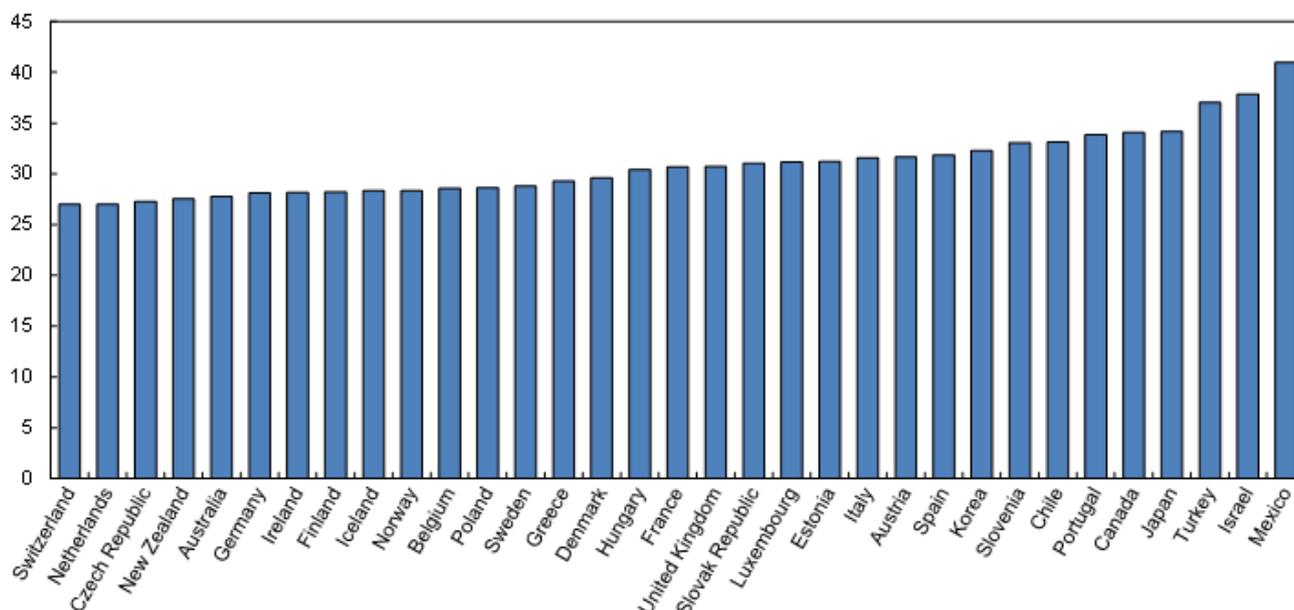
Numerous international agreements and free trade areas have reduced trade and foreign investment restrictions dramatically. This is one factor that has boosted international trade, which has risen about one and a half times faster than GDP since the Second World War. Globalisation has made it possible to reap economies of scale and has given access to cheaper goods.

Beyond the explicit barriers to international trade and investment, firms also face national regulatory hurdles. Firms have to deal with numerous specific rules in other countries which can be complex. This complexity has a cost. Simplification and harmonisation of regulations boost trade and FDI.

The OECD collects detailed data on product market regulations that hamper competition, including, for instance, the involvement of the state in business operations, licencing systems or sector-specific regulations (e.g. regulations of telecommunication firms). Regulations that do not discourage competition (e.g. safety requirements applied to all firms) are excluded. These data allow one to look at differences of regulatory settings between country pairs. This reveals that there is a sizeable heterogeneity in regulatory settings across countries (Figure 1).

Figure 1. Product market regulation heterogeneity

Average bilateral heterogeneity, 2013, per cent



Note: The bilateral heterogeneity is the share of answers to the OECD product market regulation questionnaire that differ between pairs of countries; it is computed for each country pair. The US PMR data are available until 2008 only, and hence the United States is not shown in this figure.

Source: OECD, [Product Market Regulation database](#) and OECD calculations.

[My research](#) shows that firms prefer to invest in a country with a similar regulatory environment. A broad reform package that would cut regulatory differences by one fifth could increase foreign direct investment by about 15%. Such a pace of convergence has been observed between 2008 and 2013 for pairs of countries such as Austria and the Slovak Republic. Regulatory differences in some fields reduce FDI more than others. This is especially the case for antitrust exemptions, regulatory barriers in service sectors, command and control regulations and barriers in network sectors. Belonging to the EU Single Market has a positive effect on foreign direct investment, reflecting the implementation of common area-wide rules. My work also confirms that the stringency of explicit FDI restrictions reduces foreign direct investment, which was

also found in many other studies. Last, the stringency of employment protection legislation and the complexity of regulations also have a large negative impact on foreign direct investment.

Reducing regulatory differences and regulatory stringency also boosts trade as shown in [this working paper](#). For instance, a broad reform package that would align product market regulation to the average of the best performers and, at the same time, cut regulatory heterogeneity by one-fifth can increase trade intensity within the European Union by more than 10%. There is also specific evidence that anti-competitive regulations in network sectors such as airlines and telecom reduce trade.

Find out more

Fournier, J.-M. (2015a), "[The Negative Effect of Regulatory Divergence on Foreign Direct Investment](#)", *OECD Economics Department Working Papers*, No. 1268, OECD Publishing.

Fournier, J.-M. (2015a), "[The Heterogeneity of Product Market Regulations](#)", *OECD Economics Department Working Papers*, No. 1182, OECD Publishing.

Fournier, J.-M. et al. (2015), "[Implicit Regulatory Barriers in the EU Single Market: New Empirical Evidence from Gravity Models](#)", *OECD Economics Department Working Papers*, No. 1181, OECD Publishing.