

Box 8

STRUCTURAL POLICIES IN TIMES OF CRISIS

In view of the ongoing financial market crisis and the contraction in economic activity in the euro area, this box outlines fiscal and structural policy measures to increase the economy's resilience and stimulate productivity and innovation to sustain long-term economic recovery and growth. Monetary policy, by ensuring that inflation expectations remain firmly anchored in line with the ECB's definition of price stability of HICP inflation being below but close to 2% over the medium term, supports confidence and contributes to economic recovery. However, monetary policy obviously cannot address the situation in individual regions or sectors or create the structural conditions for the efficient allocation of workers and restructuring of firms. Countries with structurally rigid labour and product markets and with relatively large fiscal imbalances and inefficient public administrations are likely to be less resilient to the crisis and more exposed to the global downturn. In the longer run, a country's output growth will also depend, inter alia, on

the degree to which the crisis and economic downturn affects potential output through corporate restructuring, labour market adjustment and the quality of public sector activities.

At the current juncture, it is crucial that governments do not delay, but rather take decisive action to implement the necessary structural reforms in their countries and enhance the quality of public finances in line with the Lisbon Strategy. Such measures are preferable to short-term demand management since they lay sound foundations for a recovery, as well as medium and longer-term growth and employment. In a recent Communication,¹ launched as the basis for a European Economic Recovery Plan to be discussed by the European Council, the European Commission also proposed a number of related fiscal and structural policy measures. In this respect, it is important to maintain discipline and a medium-term perspective in macroeconomic policy-making. Experience has shown that policy activism has only led to the accumulation of fiscal imbalances and has not helped to solve the underlying economic and structural problems.

Measures to stimulate the labour market and productivity growth²

In the labour market, measures are needed which help to contain the impact of the financial crisis and ensure that the economic recovery gets under way without a structural deterioration in the unemployment level and reduced longer-term labour participation rates. These are:

- (a) Measures to support flexible wages and moderate wage growth: These include the abolition of wage indexation schemes, helping to reduce upward wage and cost pressure on firms, thereby facilitating competitiveness and supporting employment. In an environment where sectors are affected differently by the crisis, institutional features of the wage bargaining system that could help ensure that wages reflect local level productivity developments, the unemployment conditions and firm-level competitiveness would be beneficial. In particular, in those sectors and countries affected most severely by the crisis, lowering prices and costs per unit of output supports demand and employment. In addition, in discussions on minimum wage legislation, the focus needs to be on the support of employment and the avoidance of job losses, as these would primarily affect the low-skilled and weaker parts of society.
- (b) Measures to support (re)employment: Reforms to enhance the effectiveness and efficiency of active labour market policies and public employment offices would assist in the (re)training of the unemployed and help them to find new jobs. For employed workers, the greater flexibility of working hours could give firms the additional margin of reducing working hours over specified periods in line with production needs, without losing valuable firm-specific human capital through lay-offs. Greater flexibility in the renewal of temporary employment contracts may also help support employment within the crisis.
- (c) Measures to facilitate economic adjustment over the medium term: Other measures can help to promote the medium-term adjustment capacity of the economy and set the stage for recovery, avoiding a ratcheting up of structural unemployment. These include measures to enhance geographical (both within and across countries) and occupational labour mobility, such as ensuring the portability of pensions and the international recognition of educational attainments, which would support the redistribution of activity across sectors. Reforms to the

1 Communication from the European Commission to the European Council – A European Economic Recovery Plan, 26 November, 2008.

2 See, for example, ECB (2008) “Labour Supply and Employment in the Euro Area Countries”, 2008 Structural Issues Report.

unemployment benefit system stipulating the appropriate level and/or the duration of benefits avoid disincentives to increase labour supply and additional upward pressure on labour costs. A reduction in tax wedges on employment through a shift of taxes and social security contributions may help to support labour supply and employment by reducing contributions for employers and the gap between salaries and actual take home pay for employees. Making permanent employment protection legislation more flexible reduces disincentives to firms of hiring new workers. Finally, steps to enhance the transferability of skills and to change the skill structure through better education activities improves employability in the medium to long term.

In product markets, measures which ease the regulatory burden on existing business operations, raise competition and stimulate innovation are required. These include:

- (a) Measures aimed at further increasing resilience: Policies which reduce the regulation on existing business operations and increase competition are beneficial for consumers in terms of lower prices, thus boosting households' purchasing power. This is particularly the case in the services sector (such as network services and the retail sector) and the agricultural sector. Together with associated productivity gains from the shift in supply to the most efficient firms, such measures are likely to stimulate medium-term aggregate demand and increase the resilience of the euro area economy in coping with adverse shocks.
- (b) Measures stimulating productivity and innovation: In countries with budgetary room for manoeuvre, increased public Research and Development (R&D) spending could be advocated to stimulate aggregate demand and long-term productivity and competitiveness through innovation activity. Moreover, within a sound regulatory environment, an adequate market for venture capital ensures that start-ups and small and medium-sized enterprises (SMEs) find adequate sources of funding. Private-public partnerships may also help in the case of particularly complex or financially demanding projects. Barriers to entry as well as regulatory barriers on setting up new businesses should be eased or eliminated to facilitate the restructuring of the corporate sector through the emergence of new firms.

Quality and growth-enhancing fiscal measures

Measures aimed at enhancing the quality of public finances, and affecting both the level and composition of government revenues and expenditures, aim to achieve longer-term economic benefits from a more effective and efficient allocation and use of budgetary resources for identified strategic priorities. Productive expenditure has a positive effect on the growth potential of an economy by means of increasing the marginal productivity of capital and/or labour or total factor productivity. In this regard, "core" government spending may be as important to longer-term output growth as private capital and labour.³ It can raise the human and physical capital stock and technical progress in the economy either directly or indirectly by creating synergies for private activities. Moreover, public services must be delivered in a cost-effective way. Finally, taking a certain level of "high quality" government spending as given, it is important that the corresponding financing structure minimise tax distortions and provide for simplicity and transparency in tax rules and administration.

³ Core spending may include spending for internal and external security, essential administrative services and justice, basic research, basic education and health, minimum social security, public infrastructure.

Available evidence points to negative growth effects of larger governments, in particular if associated with high tax burdens on labour and capital and inefficient expenditure.⁴ Furthermore, empirical studies on the efficiency of public expenditure also find substantial room for improvement in the euro area and Europe in general.⁵ Good governance practices regarding public finances (e.g. fiscal rules), besides promoting fiscal discipline and sustainability, can also help the redirection of public spending towards more growth-enhancing spending items through the use of fewer budgetary resources for other purposes.

Overall, fiscal policies are of high quality and support growth if they fulfil the following requirements:

- provide an institutional environment supportive to growth and sound public finances;
- limit commitments to the essential role of government in providing goods and services;
- set growth and employment-promoting incentives for the private sector;
- make efficient use of public resources;
- finance government activities and, where appropriate, private sector activities with an efficient and stable tax system;
- support macroeconomic stability through stable and sustainable public accounts.

Such measures should be in line with the principle of an open market economy with free competition to avoid a situation whereby government support to domestic companies discriminates against foreign firms.

4 A. Afonso, W. Ebert, L. Schuknecht and M. Thöne, “Quality of Public Finances and Growth”, European Central Bank Working Paper No. 438, 2005, and European Commission, “Public finances in EMU – 2008”, European Economy, 4 July 2008.

5 S. Deroose and C. Kastrop (eds.), “The Quality of Public Finances: Findings of the Economic Policy Committee-Working Group (2004-2007)”, European Commission Occasional Papers 37, 2008.