

# PROMOTING GROWTH AND EMPLOYMENT IN UE

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**Abstract:**

*The euro area has a special interest in the success of structural reform. Stepping up reforms – of course welcome in the EU as a whole – is an absolute must for the euro area. Importantly, improved market responses will pay a double dividend – by boosting growth in living standards over the longer haul while allowing better adjustment to shocks and fostering macroeconomic stability. Empirical evidence from our analysis indicates that structural reforms in countries sharing the single currency have higher "multipliers" than elsewhere: that is, those countries undertaking structural reforms can accrue more benefit while those falling behind may pay a higher price for their inaction.*

**Key words:** *growth, employment, stability.*

**JEL classification:** *F01, F15, F43, F59, O10, O20, O50*

## 1. INTRODUCTION

Economic growth in the euro area has average around 2% per annum, roughly the same as in the preceding ten years. While EMU's primary objective has been to establish macroeconomic stability, it was hoped that trade and financial market integration would, via heightened competition and innovation, boost productivity and output. Financial and product market integration spurred by the single currency, along with increases in labour participation, has indeed acted as a growth driver, and probably more so than expected. But other factors have acted as impediments, most notably weak progress with structural policies. Had there been more progress with structural reform, growth would have been substantially more buoyant.

Looking ahead, a gradual reduction in the fraction of population in working age is expected due to ageing populations. This would lead the contribution of labour inputs to potential growth to first taper off and subsequently turn negative.

This will already be felt in the next decade, with potential growth expected to fall below 2% per annum as growth. Further down the road potential growth could *halve* to about 1% per year, half the rate projected for the US. Such weak long-term growth prospects need to be internalised in EMU policy making now.

Against this backdrop, the first section of this chapter examines the medium and long-term growth prospects for the euro area in more detail.

The next sections then look at the scope for policies to enhance growth via, respectively, higher active labour market participation and stronger growth in productivity.

## 2. LONG-TERM PROJECTIONS

The most salient feature of potential economic growth in the euro area since the inception of the single currency has been the combination of a strengthening contribution to growth from labour – notwithstanding the secular decline in hours worked per person – and a falling contribution from labour productivity. This tendency, which has in fact been in the data since the mid-1990s, is in stark contrast with developments in the United States, where labour productivity accelerated while growth in labour utilisation slowed down (but from a higher level). The bulk of the euro-area

productivity growth gap is due to a divergence in total factor productivity (TFP), suggesting that a slow pace of diffusion of new technology is the main culprit.

Using a production function-based medium term extension to 2012, the euro area would continue to record potential growth of roughly 2-2½ % per annum over the next five years (Table I). A progressive recovery in TFP growth rates in the euro area from an annual rate of 0.8 % at present to 1.1 % is assumed. Even so, the euro area's potential growth rate would decline from 2010 onwards, with rates falling to below 2 % by 2012 as the predicted recovery in productivity growth rates would be more than offset by a smaller contribution from labour inputs as growth in the working age population slows down and structural unemployment and labour force participation rates are not expected to change much.

From "unchanged-policy" projections regarding demography, participation rates, capitaldeepening, and TFP up to 2050 emerges that the area's potential growth rate would be cut by almost half. This will occur in spite of the assumption that TFP growth would "normalise", and is due to the negative labour supply implications of the most recent Eurostat's population projections. The long-term demographic differences between the euro area and the US are stark, with the US continuing to record potential growth rates of around 2½ %. If the recent pattern of slow TFP growth in the euro area do not turn out to be an aberration, potential growth would obviously be even lower in the euro area.

As noted, these longer-term scenarios assume "unchanged policies". Hence it would be useful to examine the scope for policy to push up the utilisation of labour resources further and to address the TFP slowdown in the euro area.

Table I  
Long-term potential Growth Rates and their Components

	Potential Growth (%)	Labour Input (%)			Hourly Labour Productivity (%)		
		Total	Employment	Hours Worked	Total	Capital Deepening	TFP
<b>Euro Area</b>							
1989-1998	2,3	0,3	0,7	-0,4	2,0	0,7	1,3
1999-2008	2,2	0,8	1,2	-0,3	1,3	0,5	0,8
2009-2012	2,1	0,4	0,8	-0,4	1,7	0,7	1,0
2013-2020	1,9	0,1			1,8	0,7	1,1
2021-2030	1,3	-0,4			1,8	0,7	1,1
2031-2050	1,2	-0,5			1,7	0,6	1,1
<b>US</b>							
1989-1998	3,1	1,6	1,6	0,0	1,5	0,3	1,2
1999-2008	2,8	0,8	1,2	-0,4	2,0	0,8	1,2
2009-2012	2,4	0,5	0,6	-0,1	1,9	0,8	1,0
2013-2020	2,2	0,3			2,0	0,8	1,1
2021-2030	2,0	0,2			1,8	0,7	1,1
2031-2050	2,4	0,7			1,7	0,6	1,1

Source: European Commission.

### 3. RAISING EMPLOYMENT RATES

In the first ten years of EMU, labour productivity growth slowed down while labour utilisation accelerated. The expansion of employment observed since 1999 was based both on reductions in the unemployment rate and increases in the labour market participation rate. As well, changes in the working age population still added about half a percentage point to overall employment growth.

Based on the recent experience, the following sections examine the role that policies could play in boosting participation and cutting unemployment. It also looks at the determinants of hours worked and how policies impinge on them.

Participation in the labour market is determined in part by social, cultural, institutional and demographic factors, such as the duration of education, the roles of men and women, the decline of fertility rates, the age structure of the population and the normal age of retirement.

Economic factors also play a role, in particular employment expectations, household income levels, the share of part-time employment in total employment and the share of the services sector in the economy.

A more precise account of the change in the aggregate participation rate, including a longterm projection consistent with the growth projection, is reported in Table I, based on a "shift-share" analysis .

From Table II. can also be inferred that:

- Almost two-thirds of the increase in participation since 1999 is explained by a sharp increase in the participation of female prime-age workers. The increase in female labour market activity has been particularly sizeable in countries where their participation rates were initially low, which is an indication of convergence. This is driven by socio-economic and cultural changes while also policies and changes in labour market institutions played a role.
- The increase in the employment of older workers has been marked as well, explaining more than a third of total job creation since 1999. Reforms in pension systems have been instrumental in this regard, lifting the statutory retirement age in some cases and reducing the incentives for early retirement.

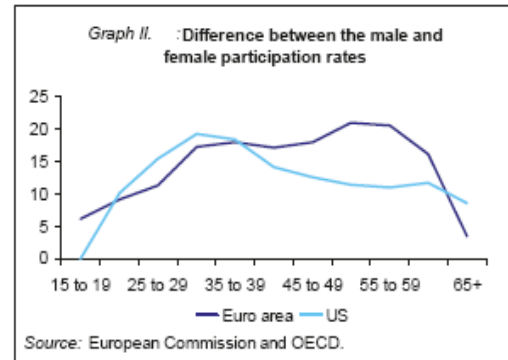
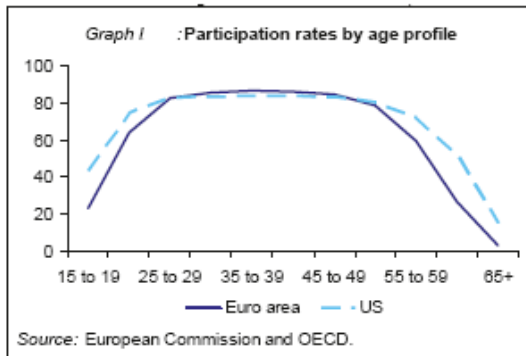
Table II

<b>Decomposition contributions to participation rates</b>			
	<b>1995 - 1998</b>	<b>1999 - 2006</b>	<b>2007- 2050</b>
Participation rate and of period	66,6	70,6	75,6
% change	1,1	3,3	4,9
Contribution from shifts in employment rates of:			
TOTAL	0,8	3,1	5,9
Young (15-24)	-0,1	0,0	0,0
Prime age (25-54)	0,7	1,7	2,8
Older (55-65)	0,2	1,3	3,0
MALE	0,1	0,6	1,9
Young (15-24)	0,0	0,0	0,0
Prime age (25-54)	0,0	0,0	0,7
Older (55-65)	0,1	0,5	1,2
FEMALE	0,7	2,5	3,9
Young (15-24)	-0,1	0,0	0,0
Prime age (25-54)	0,7	1,7	2,1
Older (55-65)	0,2	0,8	1,8
Contribution from demographic effect:			
TOTAL	0,3	0,2	-1,6
Young (15-24)	-0,4	-0,4	-0,2
Prime age (25-54)	0,6	0,5	-3,2
Older (55-65)	0,0	0,1	1,9
Interaction effect	0,0	0,0	0,6

Source: European Commission.

The participation of the young has shown no increase since 1999. This is not necessarily problematic for those who are in education, but in several countries the share of the young that is neither in education nor in employment is high -- above 20% in Italy and Greece, and above 10% in France, Germany, Ireland, the Netherlands and Spain (Quintini *et al.* 2007). This is symptomatic of a need to reduce school drop-out

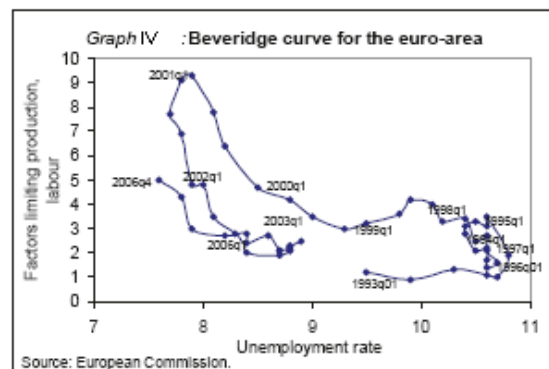
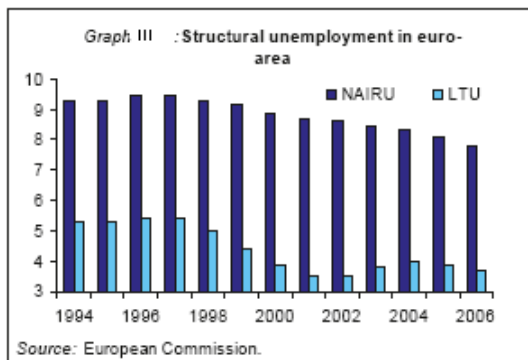
rates and promote a smoother entry of the young in the labour market. The participation rate of primeage men has shown no increase since 1999, but this is already relatively high in the euro area, also compared with the US. (as can be inferred from Graphs I and II).



Although it has reportedly significantly risen, female participation in the euro area is still relatively low. Low participation is largely concentrated among women above 40 years and probably reflects a combined effect of persistence of social habits, difficult transitions from inactivity to work after a period of child care and disincentives to work created by the interaction of tax and benefit systems. While policies could usefully focus on this group, there

may be scope to raise the labour market participation of females also at younger ages as well. Young women's labour market entry decision strongly depends on factors such as access to institutionalised childcare (Del Boca and Vuri 2006), government support for families with children, parental leaves, flexibility of working-time arrangements, preferences regarding choice of reduced working hours to care for children (Kramarz *et al.* 2006, Jaumotte 2003). On all these fronts progress is feasible.

The decline structural unemployment since 1999 has been sizeable. It has been accompanied by a fall in the long-term unemployment rate (Graph III) and a better qualitative match between supply and demand on the labour market as suggested by a downward shift of the "Beveridge curve" (Graph IV). The introduction of more flexible working arrangements, the strengthening of incentives to work embedded in tax and benefit systems, a greater link with activation policies and a stronger reliance on preventive and targeted active labour market policies, the (modest) reduction of the tax burden on labour, especially for the low-skilled, and more generally, widespread wage moderation, are all factors that have contributed.



However, unemployment rates remain high and strongly persistent in certain regions, pointing to a tendency towards "polarisation", as would be predictable for an economic environment where product and financial market integrate while labour markets remain spatially segmented.

Specialisation and agglomeration effects induced by EMU may reinforce these tendencies and policies to encourage the adjustment of real wages and facilitate labour mobility would thus be beneficial.

Average hours worked per employee have been falling in most developed economies, but the fall has been particularly sizeable in the euro area. A proximate explanation is a compositional effect implied by the rising incidence of female employment, as this is often part-time (OECD

2007b). However, the deeper explanation may reside in the distortions created by the tax and benefit systems (Prescott 2004). Labour market rulebooks and institutions constitute another explanation, and some argue that this is driven by unions' preference that would be biased in favour of prime-age male workers (Alesina *et al.* 2005). Another explanation points to a revealed preference to convert productivity gains into leisure (Blanchard 2004, Gordon 2007).

However, these different explanations are not mutually exclusive. High marginal tax rates influence the decision to enter the labour market on a part-time basis mostly for non-working

spouses (OECD 2007). Wage compression, which is comparatively pronounced in the euro

area, is found to have a negative effect on hours worked (Faggio and Nickell 2007) and may also weaken the incentives for women to work fulltime.

Policies could thus usefully aim to create proper incentives for women to supply more

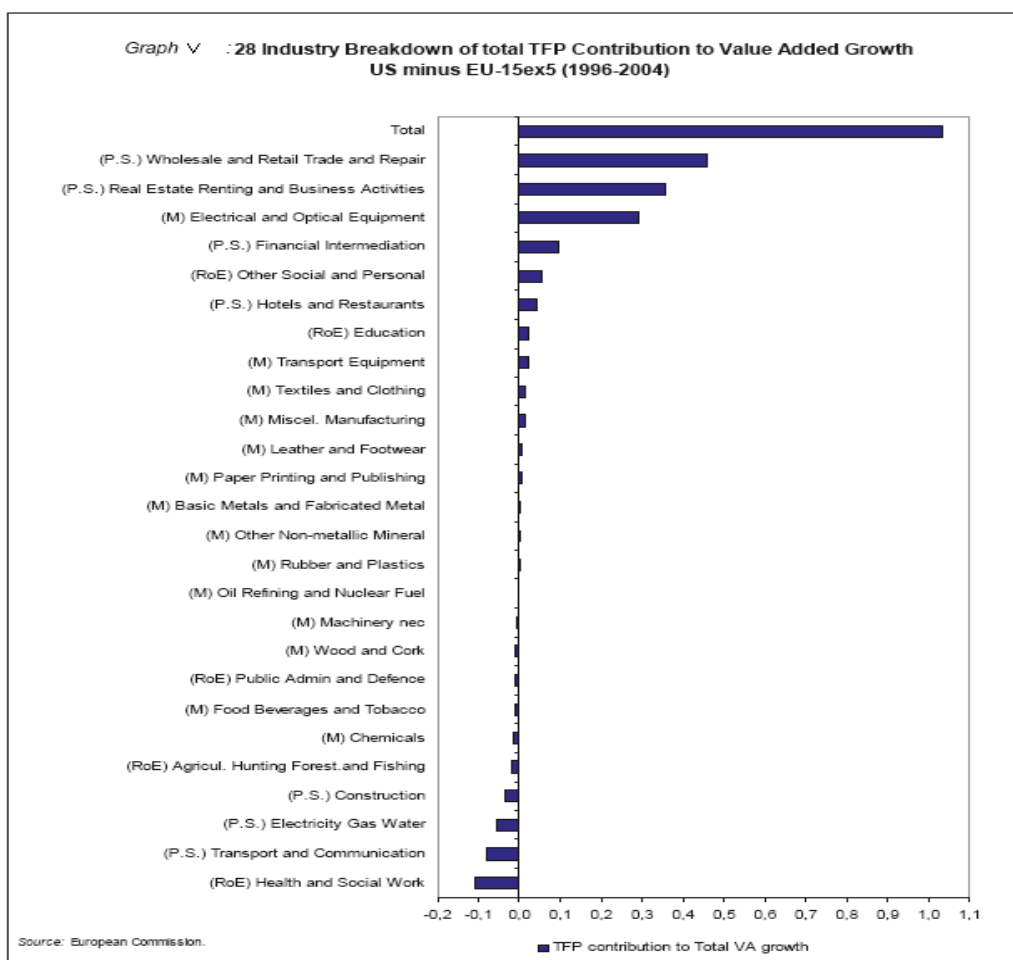
hours of work, thus reinforcing the call for heightened female labour market participation.

#### **4. RAISING PRODUCTIVITY GROWTH**

In several places in this Report the importance of decisively addressing the euro area's relatively poor TFP performance is highlighted, which is key to offset the adverse impact of ageing on growth. The orientation of policies in this regard needs to be rooted in a proper analysis of the forces shaping TFP growth. Several issues stand out: the role of industry structures, catching-up versus growth at the frontier, the impact of product market competition and the role of education and R&D.

The analysis of industry level TFP trends shows that the bulk of the EU-US TFP growth differences over the last decade have been confined to a small group of industries: wholesale and retail trade, other business services, electrical and optical equipment and financial intermediation. suggests that the euro area is not suffering from a generalised TFP slowdown across all industries but rather from difficulties in shifting resources to areas where TFP growth is high, notably ICT, and to a comparatively weak performance in reaping TFP gains in some private services sectors.

A number of studies have examined what part of aggregate TFP growth can be accounted for by TFP taking place within firms or sectors and what part is instead associated with resource reallocation towards more productive activities. Bartelsman *et al.* (2006) using firm-level data for 24 countries quantified that the size of the reallocation effect could amount to up to half of aggregate productivity growth. Interestingly, it appears that market exit of low-productivity enterprises matters more for aggregate productivity performance than market entry of new firms. Moreover, the bulk of the contribution of reallocation effects to TFP growth appears to take place within rather than between sectors. While somewhat speculative, these findings suggest that lack of firm mobility are a main culprit of slow TFP growth in the euro area.



There is also a growing consensus that while catch-up countries would gain from institutions and policies favouring the cost efficient adoption of existing technologies, countries operating at the technology frontier would profit instead from policies that promote excellence in higher education and R&D, financial markets that reward risky projects, and regulations that do not put an excessively heavy burden on either incumbent firms or on potential entrants. The European productivity slowdown could thus be understood in part as a slow adaptation of institutions to a context in which TFP growth is increasingly driven by innovation rather than adoption of existing technologies (Sapir *et al.* 2004).

Various studies have aimed to capture this distinction and generally support the view that catching up and innovation ("growth at the frontier") both contribute to TFP developments in most advanced countries, but at a degree that is largely country-specific and that changes over

time. A recent study carried out at the European Commission (2007a) suggests that since the mid- 1990s TFP growth in Europe was mostly driven by growth at the frontier, with a non-significant impact from the technology gap variable. This finding is thus consistent with the view that across Europe growth is increasingly being driven by innovation activity and less by the adoption of existing up-to date technologies.

TFP growth taking place within sectors and firms is affected by the regulation of *product markets*. Product market regulations and institutions can affect TFP growth via the impact that competition and market structure have on innovation. Recent empirical

evidence suggests that the relation between the extent of competition and innovation is hump-shaped

(Aghion and Howitt 2005): innovation is harmed by either too little or too harsh competition. If competition is too weak, firms have few incentives to innovate and an increase in competition would stimulate innovation. At the other extreme, excessively intense competition reduces the incentives for innovation because the innovating firm would not be able to accrue any rents. There is also evidence to suggest that the relationship between competition and innovation is strongest in countries or industries that operate close to the technology frontier (Griffith *et al.* 2006). Evidence also shows that product market regulation, notably legal entry barriers, and including in network industries, may play a relevant role in shaping the extent to which TFP growth can benefit from resource reallocation. Labour market regulations can also shape TFP growth, not only by affecting the extent of reallocation towards high-growth activities, but also by having an impact on the incentives by firms to innovate. In particular, strict employment protection legislation may discourage the pursuit of risky projects and reduce the likelihood of firms carrying out radical innovation (Saint-Paul 2000, Scarpetta and Tressel 2002).

Financial markets play a particularly pervasive role as TFP driver. There is abundant crosscountry analysis to show that developed financial markets contribute to growth (e.g., King and Levine 1993; Beck *et al.* 2000) and catching up (Aghion *et al.* 2005). There is agreement arising also that the major contribution of financial development to growth comes from higher TFP growth rates rather than from investment in physical or human capital (King and Levine 1993; Benhabib and Spiegel 2000). Among the reasons why financial development benefits TFP growth there are improved scope for reallocating resources towards activities exhibiting high TFP growth rates, enhanced scope for savings and investment in new-vintage capital and risk diversification allowing carrying out risky innovation activities. Some existing studies indeed confirm that financial development has a positive impact on capital allocation towards sectors with higher growth prospects. Several studies assess the implications of financial markets on the growth performance in the euro area and the EU. Results reported in European Commission (2007a) show that a less burdensome regulation of financial markets is associated with a stronger contribution of TFP growth at the frontier on total TFP growth. The interpretation of the result is that heavy regulations may have anti-competitive effects on market structure or hinder financial innovation, with consequences of the degree of availability of financial resources to carry out risky innovative projects.

While economic growth through imitation requires primary and secondary education, in economies close to the technology frontier, tertiary education and notably graduates in science and engineering are needed to carry out innovative activities. For example, Aghion and Howitt (2005) present evidence for US states that the productivity-impact of an increase in the share of the highest educated members of the labour force is greatest the closer the state is to the technology frontier. European Commission (2007a) finds a positive impact of sectoral shares of high-skilled employment on the contribution given by TFP growth at the frontier to total TFP growth. Similarly, also the impact of R&D on TFP growth is found to be higher in countries at the technological frontier and this is indeed confirmed by empirical research. For example, Scarpetta and Tressel (2002) consistently find that the effects of R&D spending on TFP growth are stronger for leader countries and in high-tech industries.

## 5. CONCLUDING REMARKS

Reform aimed at raising the euro area's labour utilisation and productivity is fundamental to maintain the area's long-term growth potential. In spite of recent progress, employment rates and working hours in the euro area are still low by international comparison. Reforms in labour markets and welfare systems geared to remove distortions in incentives for labour supply would help offset the reduction in labour inputs associated with ageing. Pension reforms increasing the statutory retirement age can be effective in rising participation rates among older workers. Labour market policies improving entry flexibility and supportive welfare systems would contribute to raise participation rates among female workers, while a policy framework encouraging the transition from schooling to the labour market would contribute to raise the participation rates of the young. Regarding working hours, flexible working time arrangements between employers and employees may provide incentives to increase hours worked. Progress on the front of reducing sectorally and regionally-concentrated long-term unemployment pools could be achieved by policies that enhance real wage flexibility and reduce the costs associated with workers' relocation across economic activities and regions.

A key challenge to policy makers in perspective is to create adequate framework conditions to achieve a higher and sustained TFP growth in the euro area. Recent empirical analysis supports the emerging view that the TFP growth slowdown experienced by a large number of advanced European economies in recent years could be linked to lags in the adaptation of European policies and institutions from the post-worldwar- II catching up phase. As convergence leads to a phase in which EU countries join the global technology frontier, a large number of countries are facing growing difficulties in replicating the TFP successes of earlier decades. To face this challenge, the policy response should ensure that the necessary infrastructure for a growing supply of R&D and education, key ingredients to move to an innovation-driven model of TFP growth, is in place. Moreover, developed and wellfunctioning financial markets should ensure an adequate financing of innovative activities and create the conditions for an efficient allocation of resources towards dynamic sectors.

EMU-related financial integration would help in this respect, as suggested by analysis contained in this chapter. In addition, adequate labour market regulations, notably regarding employment protection, could play a role in ensuring an efficient allocation of resources across sectors and firms. As well, regulations in product markets should be supportive of competition, in particular by not deterring the entry of potential competitors and innovators.

Finally, the innovation system in euro-area countries would benefit from improved governance and incentives in universities and research institutions and a better exploitation of synergies among the key players in the innovation system.

In this perspective, a leading role lies with EU policies. In particular, cohesion policy is a key instrument in pushing potential growth and employment while at the same time limiting the emerging regional imbalances and helping countries to keep up with technological change.

Through "earmarking" cohesion policy focuses on growth enhancing investment related to the Lisbon Strategy such as research and technological development, innovation and entrepreneurship, the information society, infrastructure and human capital. On the other hand, it fosters a balanced development path by reducing the gap between the European economies and encouraging the widespread use of advanced engines of growth.



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