

**Economist Conferences**  
**Economic background and perspectives for 2004-2005: The track towards a dynamic  
economy**

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*Session II: Alternatives for stable economic growth: increasing productivity, greater  
competitiveness and entrepreneurial innovation*

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It is a privilege to be here today to discuss both timely and important issues with Spanish friends and colleagues. This afternoon, my duty is to give an assessment of Europe's ability to improve its economic performance and the policy requirements that are needed to do so.

But some of us in the audience today may legitimately ask whether economic performance in Europe has in fact been poor compared with the U.S and other OECD economies. The Economist magazine posed this question in a recent article<sup>1</sup> and essentially concluded that the differences in growth were much smaller than widely perceived. And where differences remained, they reflected personal choices for more leisure and lower incomes.

This 'new', benign view of Europe's economy is radical. If accepted it implies that structural reforms are not needed. Governments can simply plan for a future based on extrapolating past trends. I don't adhere to this reasoning. Rather, I believe in the 'old' school, whose diagnosis concludes it is crucial for Europe's future to remove the obstacles that are hindering its growth performance.

To be fair, The Economist's assessment makes a number of important and valid arguments. It is true, for instance, that demographic differences account for a good part of the weaker GDP growth in the euro area. Nonetheless, even if we look at GDP per capita, marked divergences in performance remain (Table).

The exact magnitude of differences depend on the time periods chosen, whether comparisons are in terms of total output or business sector output and the choice of country

aggregation within Europe. It is obvious, for instance that if the weakest growing economy (Germany) is excluded from the euro area that the average growth in the remainder of the area rises. Likewise, it is obvious that the opposite occurs if the fast growing 'catch-up' economies of Ireland, Portugal, Greece and Spain are excluded.

The important point here is that broad-brush aggregate comparisons of euro area performance do not always make much sense and conceal that some extraordinary success stories have taken place in Europe. In Ireland average annual per capita output growth through the 1990s expanded by almost 6 ½ per cent, the fastest pace recorded in any OECD country. Greece, albeit from a low rate, the Netherlands and Luxembourg also managed to boost per capita output growth over the 1990s, as did Finland and Spain over the second half of the decade.

What is not possible based on an honest presentation of the statistics is to conclude that economic performance in Europe's three large continental economies (Germany, France and Italy) has been anything other than sub optimal over the past decade. Already GDP per capita stopped converging to U.S. levels in the 1980s. And during the 1990s it back-tracked: annual per capita output growth in the United States was almost 1 percentage point above what was achieved in the 3 large euro area economies.

As a result of these trends, per capita incomes in 2002 were almost 30 per cent lower in the large euro area economies than in the United States (Graph). Sadly enough this is a slightly larger gap than that prevailing in 1970. If, on the other hand, the rate of convergence recorded during the 1970s had been maintained, the major 3 euro area economies would almost have by now similar levels of output per capita. Looking ahead, if the gap in per capita incomes vis-à-vis the U.S. is to narrow, it will be necessary not just to match U.S. performance, but to exceed it. No large European economy has managed to do this for a sustained period in over two decades.

Understanding why our growth performances are so uneven and searching for the sources of growth to close the gaps has therefore and justifiably gained a lot more importance for policy makers in Spain and in Europe at large. The OECD has a long tradition in this area and has recently completed a vast research effort, empirically examining the drivers of long-term growth.<sup>2</sup>

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<sup>1</sup> See *Mirror, mirror on the wall* in *The Economist* June 17 edition.

<sup>2</sup> See OECD (2003), *The sources of economic growth*, Paris.

The main message from our work is that structural policies that foster a high degree of labour utilization together with strong productivity play a fundamental role in determining economic performance. Many continental European economies have been found to be wanting on both these fronts, with high unemployment, weak job creation and a secular decline in the number of hours worked per employee. Against this background, reforming labour markets and social institutions is a necessity, in our view, if Europe is to return to stronger growth.

This diagnosis has gained force in the past few years, but is evidently still not broadly shared. Those in The Economist camp validly point out that there is nothing wrong in principle with different growth rates, provided they reveal a kind of social optimum. Indeed, an argument could be made that Europeans have a greater preference for leisure. In other words, when you become wealthier Europeans prefer to trade lower income levels against more leisure time. It is true that hours worked per employed person have gone down over the past couple of decades in many continental European economies, while they have remained broadly steady in the faster growing OECD economies.

I certainly agree that people should not be obliged to choose work over leisure. But even though we cannot say much about the relative preferences for leisure on both sides of the Atlantic, we can say, based on our own research and other evidence that government policies are keeping out of the labour force people who are capable of working, and often willing to do so.

Let me elaborate with two concrete examples. First, we have found that large distortions in pension and social transfer programmes make it financially uninteresting to remain in the labour force until the statutory retirement age. The implicit tax in ordinary pension schemes at age 60 of continuing in work and from age 55 from various pathways into retirement created by other social transfer programmes averages about 30 per cent in OECD countries, with marked cross-country differences (Graph). For Spain, the implicit tax embedded in social transfer schemes is well above the OECD average, at close to 60 per cent.

The empirical analysis finds that removing the incentives to withdraw early from the labour force could considerably raise participation rates of older individuals.<sup>3</sup> In Spain, for

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<sup>3</sup> See Duval, R (2003), “The retirement effects of old-age pension systems and other social transfer programmes in OECD countries”, *OECD Economics Department Working Paper*, No. 370.

example, it would boost the participation rate by some 25 percentage points, which would substantially raise economic output (Graph).

The second example relates to female labour force participation rates. While these have increased substantially in recent times they remain relatively low in most continental European countries. To take Spain as a case in point, the female participation rate has risen by about 30 percentage points over the past two decades, but it still remains relatively low by OECD standards. OECD empirical work demonstrates that governments have it within their ability to boost significantly the female labour force participation rate. Progress, for instance, could be made by ensuring second earners were granted more neutral tax treatment and by giving support to families with young children in the form of parental leave. The results are striking, especially for Spain.<sup>4</sup> On average, female participation could be some 10 percentage points higher, and twice that for Spain, than would otherwise be the case if economies adopted the policies of the best performing country in respect of taxes and childcare (Graph).

Europeans should not be too complacent about productivity either. To be sure, on the face of it, there is less scope to improve output in Europe by boosting productivity than there is via raising the employment rate, since in Germany, France and Italy hourly labour productivity is about the same as in the United States.

But this interpretation is too simplistic, because in Europe many persons with below average productivity are out of employment and thus not included in the measurement of labour productivity. In this context, it is thus no surprise that countries with the lowest employment rates are also those where hourly productivity looks the highest (Graph).<sup>5</sup> Moreover, there are a number of other European countries with low measured labour productivity, including Spain, Portugal and Greece. Viewed from these perspectives, it is reasonable to conclude that many EU countries lag behind the U.S. in terms of labour productivity and that a challenge ahead is to implement policies that will close the gap.

The OECD recognizes that governments cannot fine tune productivity. But they can play an important role in establishing a better environment for productivity growth. In the case of

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<sup>4</sup> See Jaumotte, J. (2003), 'Female labour force participation: past trends and main determinants in OECD countries', *OECD Economics Department Working Papers*, No. 376.

<sup>5</sup> Such cross-country comparisons, although very suggestive, obviously do not amount to a fully fledged explanation of productivity differences.

continental Europe, a number of factors have been standing in the way of stronger productivity. Most importantly, product and capital markets are not open enough and therefore not integrated enough to generate the right kind of competitive pressures. This limits the scope for specialization, which brings efficiency gains and productivity improvements. In addition, for a number of continental European economies, the barriers to entrepreneurship manifest by the unfriendly environment for start-ups and relatively high regulatory and administrative burdens are estimated to be among the highest in the OECD (Graph).

The empirical work suggests that the benefits from competitive and open markets can be large. To give an order of magnitude, we find, based on our econometric work using cross-country sectoral data that the liberalization of product markets could increase productivity by as much as 10 per cent in those sectors which lag behind. As a further example, this time based on a firm-level analysis, we have learnt that new firms in the U.S. start small compared with Europe, but the successful U.S. start-ups grow much more quickly. This dichotomy is partly linked to lower administrative set-up costs and relatively light labour regulations in the U.S.

Viewed from this somewhat provocative perspective, the euro area cannot afford to remain complacent. Europe's current problems are clearly linked to structural weaknesses. European governments, as I see it, need to push ahead with vigorous structural reforms to improve economic performance and to meet the fiscal challenges looming in the decades ahead as the population ages.

With so many policies influencing growth, priorities are essential and care is needed to ensure they are combined in a coherent manner. If I had to be subjective and selective, I would single out the following challenges:

- Pursuing stability-oriented macroeconomic policies is absolutely necessary, but not sufficient;
- It also requires vigorous efforts to get people back into work. Issues such as perverse incentives favouring early retirement, high costs of unskilled labour, rigid wage formation processes and the balance of employment protection legislation have to be addressed to reduce dualism in labour markets and help those who live at the fringes of labour markets to find a real place in the work force;

- Increasing competition in service and product markets to foster innovation and the diffusion of new technologies. It is also important to raise the level of R&D spending through well designed incentives; and
- Lowering barriers to entrepreneurship. It would be important for instance to improve the business environment for start-ups.

To be sure, progress has been made in recent years, notably tackling early retirement and strengthening competition in network industries. But the implementation of reforms across countries has been uneven and much remains to be done, especially to restore sharper incentives to work and employ. In Spain, reforms could aim to increase wage flexibility, which would also boost productivity performance.

There is no sure way of succeeding, though some strategies appear to work better than others. The adoption of a package of measures, rather than a piecemeal approach to reform seems to work better. It facilitates a coherent reform process and is more likely to result in a better balanced distribution of the costs and benefits of reform across society, thereby serving to strengthen adhesion to change. It is also always important to identify, quantify and disseminate estimates of the cost of maintaining the status-quo. Even if they are sometimes imprecise and tentative, they put into better perspective the short-term costs of reforming against the long-term costs associated with inaction.

On this last point, I am in full agreement with The Economist. It is imperative that both the facts and the analyses based on them provide a sound basis upon which policy decisions and personal choices can be made. In this regard, I think the OECD plays a useful role. Its analyses and data shape and contribute to domestic policy debates, bringing an international perspective and distilling the lessons learnt from both successful and less successful policies in its member countries.

## Euro area dynamism compared

Average growth over the past 10 years

	Real GDP	Real GDP per capita	Real GDP per employee	Real GDP per hour worked
United States	3.3	2.2	1.9	2.0
Selected English-speaking countries <sup>1</sup>	3.3	2.5	1.7	1.7
Euro area	2.1	1.8	1.1	1.4
Euro less Germany	2.4	2.0	1.0	1.3
Euro 3 <sup>2</sup>	1.7	1.4	1.1	1.7
Euro smalls <sup>3</sup>	2.9	2.6	1.0	1.0
Euro 'catch-up' countries <sup>4</sup>	3.5	3.0	1.2	1.1

1. Australia, Canada, New Zealand and the United Kingdom.

2. France, Germany and Italy.

3. Austria, Belgium, Finland, Greece, Ireland, Netherlands, Portugal and Spain. Excludes Austria and Portugal for the Real GDP per hour worked.

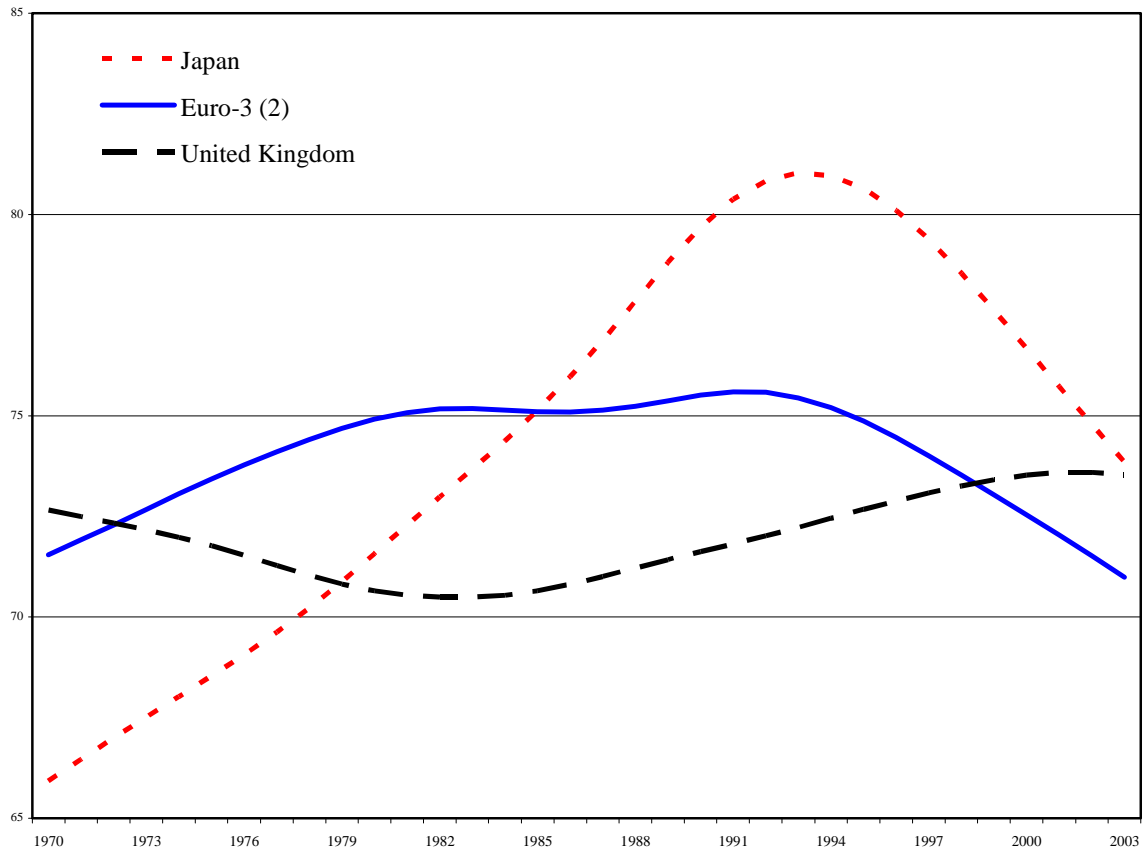
4. Greece, Ireland, Portugal and Spain. Excludes Portugal for the Real GDP per hour worked.

Source: OECD.

## Real per capita GDP relative to the United States

Trend indices, based on 2000 PPPs and 2000 prices <sup>1</sup>

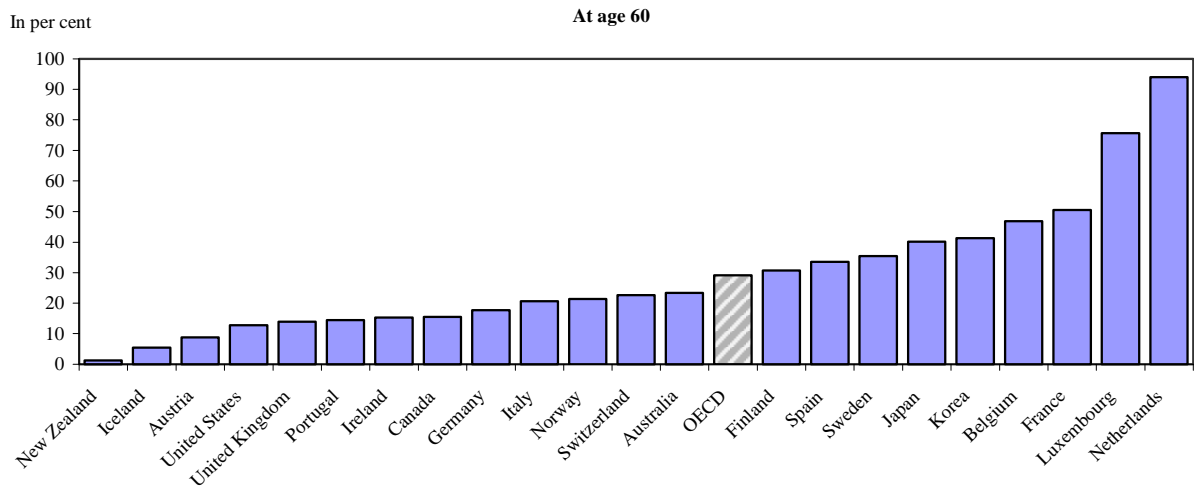
Index US GDP per capita = 100



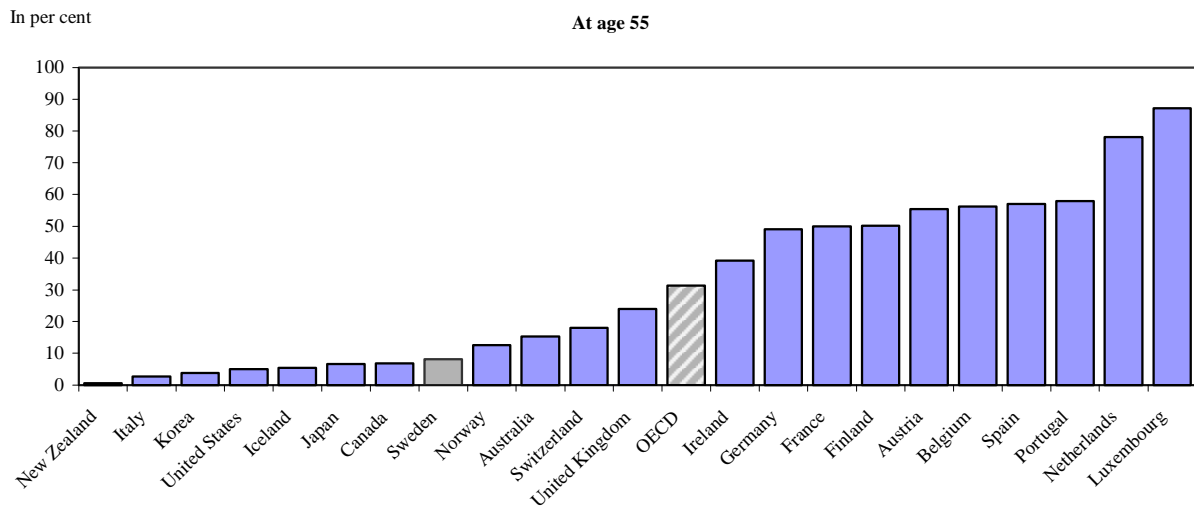
1. The trend is calculated using a Hodrick-Prescott filter (smoothing parameter set to 100) over a period which includes projections through 2010.
  2. Euro-3 refers to Germany, France and Italy.
- Source: OECD *Annual National Accounts*.

## Implicit tax rates in old-age pension systems and social transfer programmes

### Implicit tax rates on continued work over next 5 years in current old-age pension systems<sup>1</sup>



### Implicit tax rates<sup>2</sup> on continued work over next 5 years in current social transfer programmes<sup>1</sup>



1. Single worker with average earnings.

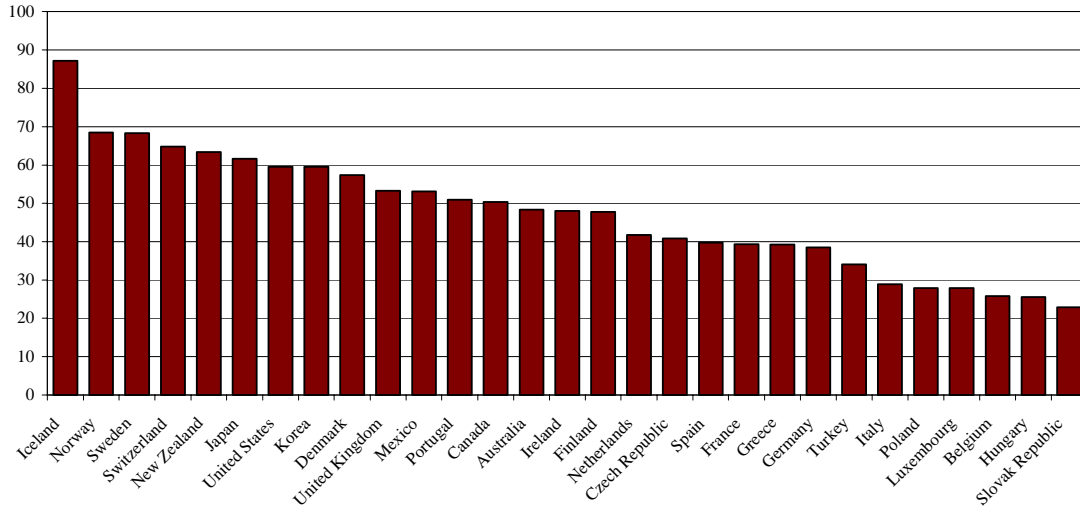
2. The implicit tax rate on continued work refers to an "early retirement route". The latter is modelled as the unemployment benefits / assistance pathway into retirement with the exception of Ireland, where the modelling refers to the pre-retirement allowance, and Luxembourg, where disability benefits were considered given their widespread incidence among pensioners. In those countries where it is considered that no early retirement scheme can be widely used to withdraw from the labour market before the minimum pensionable age (Australia, Canada, Iceland, Italy, Japan, Korea, New Zealand, Norway, Sweden, Switzerland and United States) the retirement scheme considered in the chart is simply the "regular" old-age pension system. Similarly, at those ages when people are entitled to an old-age pension (e.g in France at 60), the retirement scheme considered in the chart is the "regular" old-age pension system rather than an early retirement scheme.

Source: OECD.

## Employment rates of older workers

Employment of men and women age 55-64 as a percentage of the population age 55-64, 2002

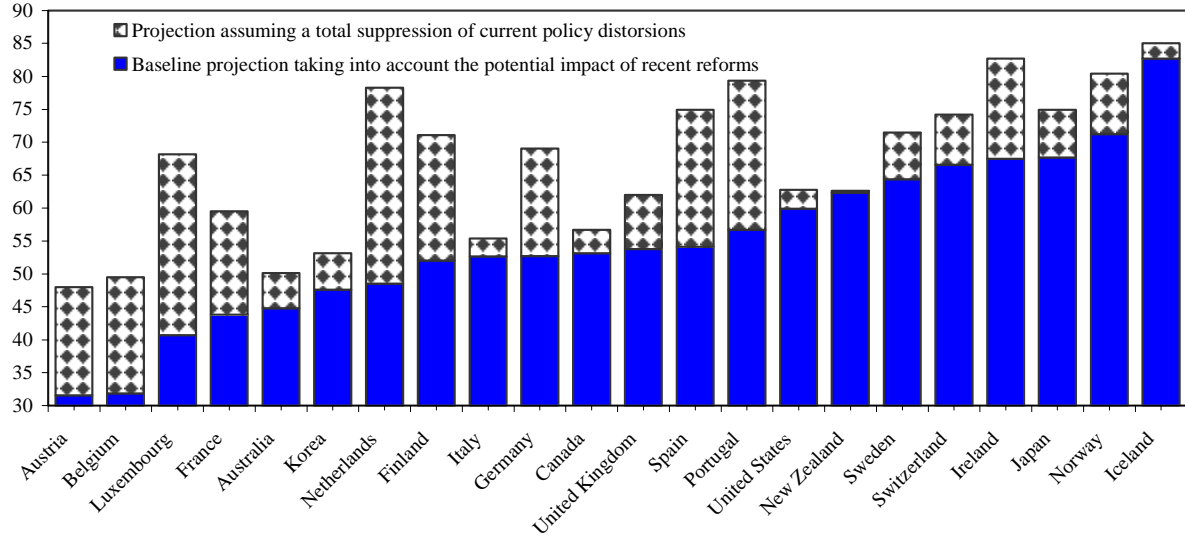
% of population age 55-64



Source: OECD.

## Removing implicit taxes on older workers would raise participation

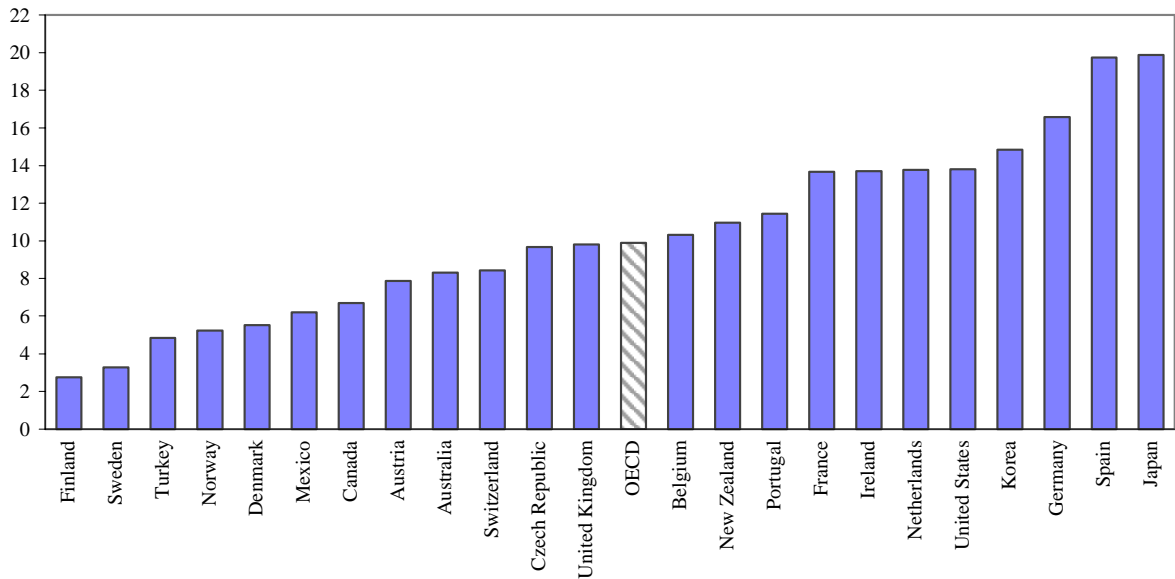
Potential impact of pension reforms on labour force participation of older workers (projected labour force participation rates of the 55-64 age group in 2025 under different scenarios)



Source: OECD.

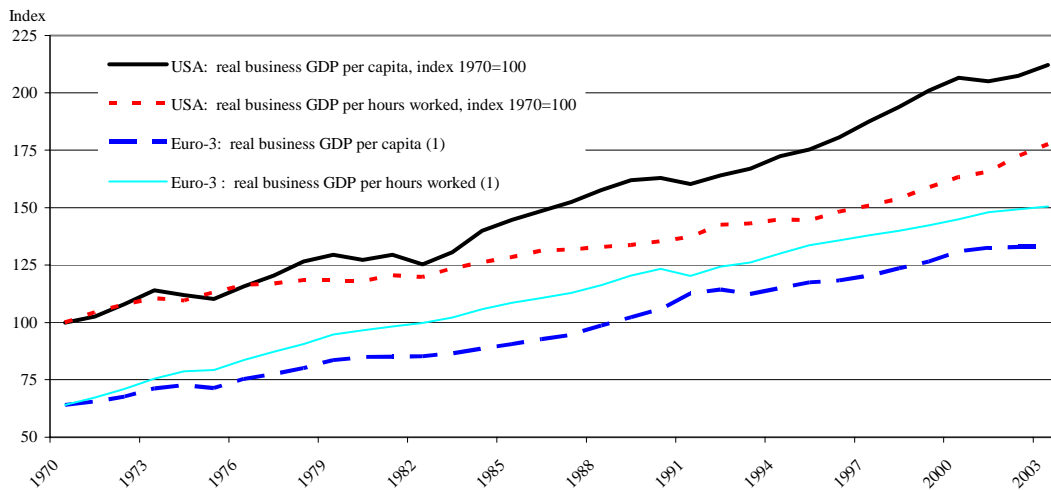
## Lowering work obstacles to females would also raise labour force participation

*Simulations of policy measures to increase female participation*<sup>1</sup>



1. The baseline participation rates are the projected female participation rates for 2025 based on cohort effects and are taken from Burniaux et al. (2003); OECD refers to the unweighted OECD average.  
Source: OECD estimates.

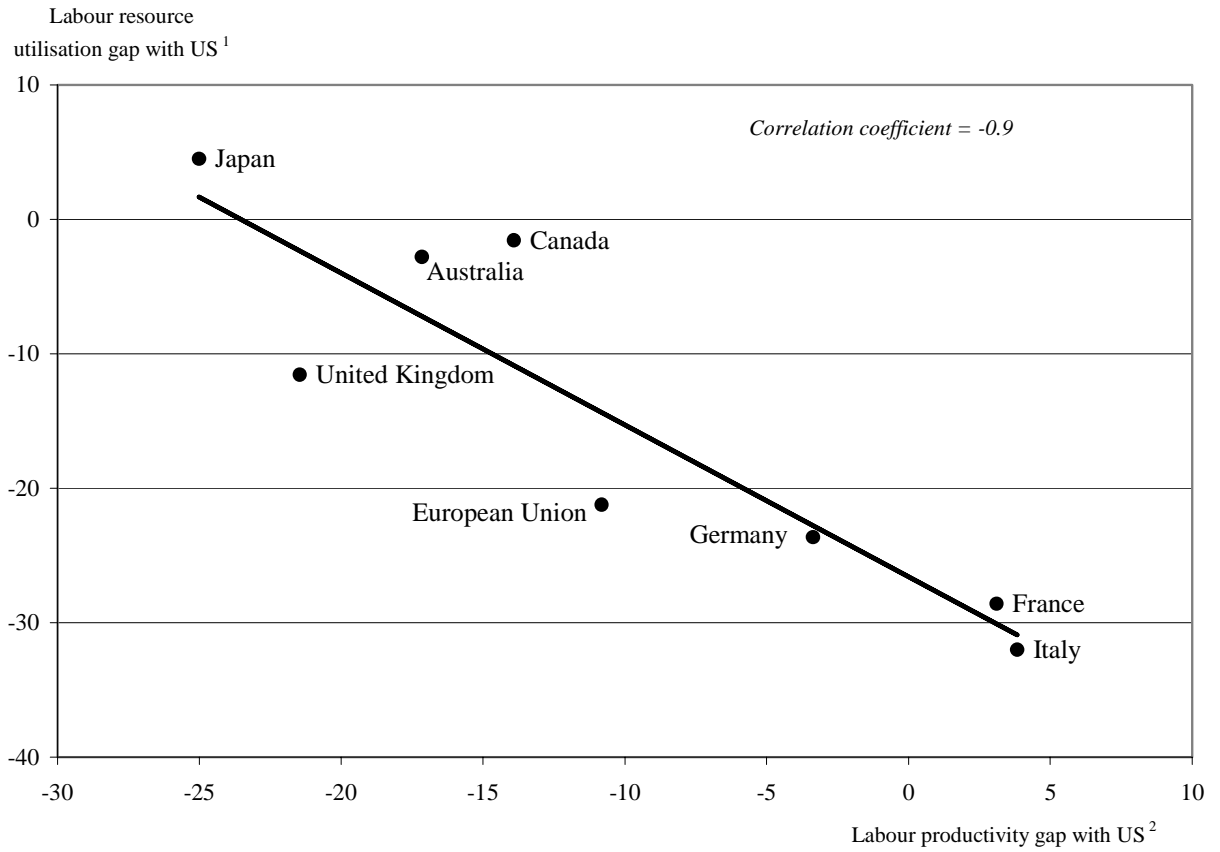
## Euro area labour productivity has converged closer to US levels, but not output per capita



1. France, Germany and Italy. Data are indexed by the difference between US real business GDP per capita and the Euro-3 real business per capita in 1970.  
Source: OECD.

## Labour utilisation and productivity gaps

Percentage gap with respect to the United States level, 2002, 1995 PPP

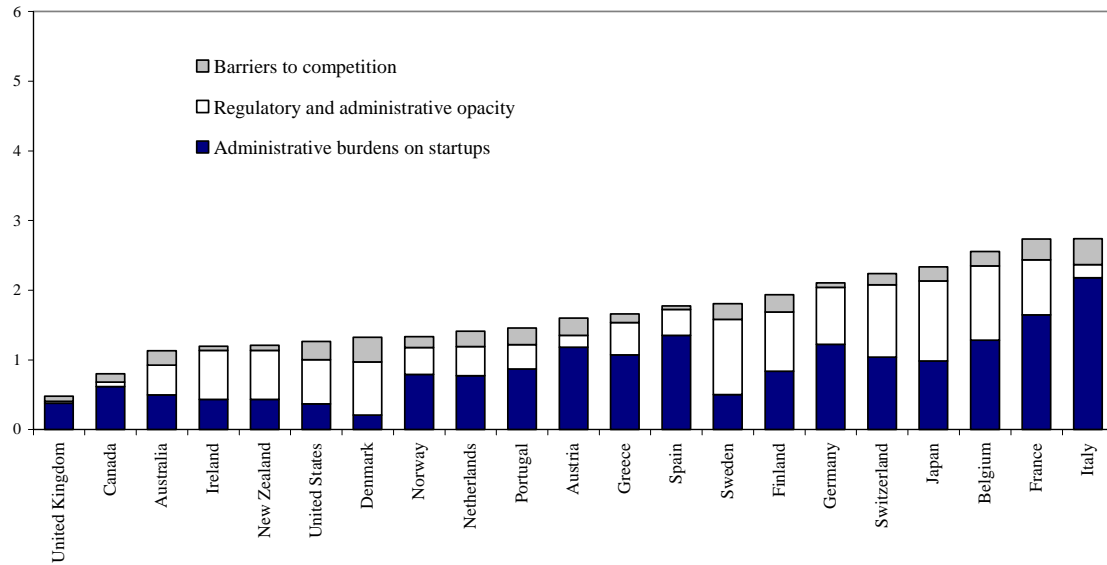


1. Labour resource utilisation gap is measured as trend total number of hours worked divided by population.

2. Labour productivity gap is measured as trend GDP per hour worked.

Source: OECD.

## Barriers to entrepreneurship in euro area countries are high<sup>1</sup>



1. The scale of indicators is 0-6, from least to most restrictive.

Source: Nicoletti, et al (1999), "Summary indicators of product market regulation with an extension to employment protection legislation," OECD *Economic Working Papers* no. 226.