G20 Finance and Central Bank Deputies Meeting
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Structural Reform in a Crisis Environment

Note by the OECD

Structural reform is an essential ingredient to achieve sustainable and balanced growth. Recent developments in structural policy reform in G20 countries are mildly encouraging, though, as always, some may consider the glass half full and others consider it half empty.

It was not a priori clear how much structural reform activity we should expect to see in current circumstances. Empirical evidence shows that crises or very weak activity tend to boost structural reform activity. But it also shows that large budget deficits discourage structural reform, possibly because there is no fiscal space to buy off the losers from reform. At any rate, many G20 countries face both weak activity and sizeable budget problems.

The OECD has recently examined countries' progress up to end-2011 on structural reform priorities, in the framework of its 2012 issue of *Going for Growth*, to be released in Mexico City in the margin of the G-20 meetings. The latest issue for *Going for Growth* compares recent progress on structural reform with past progress, and therefore the exercise was confined to countries for which longer time series of reform are available. Progress in all cases refers to action on the policy priorities to boost economic growth that were set out in previous issues of *Going for Growth*. The main conclusions can be summarised as follows (see Box for further details):

- *First*, as depicted in Figure 1, the pace of structural reform slowed down over the years 2008-9, as countries were preoccupied by the immediate crisis firefighting. But over the years 2010-11, structural reform re-accelerated and the pace of structural reform was actually considerably higher than before the crisis.

- *Second*, on the cross-country pattern of reform a main finding is that in general over the whole period of 2007-11, reform progress was stronger in countries with a lower initial level of income (Figure 2). So the relative pace of reform tended to help convergence.

- *Third*, it is also found that the harder countries were hit by the crisis in the form of rising unemployment, the more they progressed on structural reform (Figure 3, Panel A). Another result is that unlike the general historical pattern it is the countries that have done most budget consolidation over the past couple of years that have also progressed most on structural reform (Figure 3, Panel B).

These latter results are driven to some extent by euro area programme countries and more generally by countries on the European periphery. It suggests that the relative pace of structural reform as between core and peripheral Europe is helping to reduce the economic imbalances at the origin of the debt crisis.

Box. The main reform patterns since the start of the crisis

Countries have sought to raise labour utilisation especially by cutting labour taxes, delaying effective retirement ages and strengthening active labour market policies (ALMPs). At the onset of the recession, most OECD countries sought to improve the safety net for job losers by boosting unemployment benefit generosity and expanding coverage to new groups of workers. At the same time, more than two-thirds of OECD countries raised resources for job-search assistance and training programmes in order to facilitate re-employment and re-deployment. To stimulate labour demand, work-sharing arrangements were introduced or expanded in two-thirds of OECD countries, labour taxes were cut and new job or hiring subsidy schemes were introduced, often targeting marginal job seekers such as youth, older workers, or the long-term unemployed. As the recovery gathered momentum, some temporary measures were phased out, and difficult labour market reforms were implemented in the areas of retirement schemes, job protection, minimum wages and wage bargaining systems, especially in the context of the European debt crisis.

Regarding priorities aimed at boosting labour productivity, countries have been especially active in improving the design of their innovation policies and reforming their education systems, while much less progress has been achieved towards reducing agricultural policy support and removing barriers to foreign direct investment. The need to deliver both higher growth and credible fiscal consolidation in many OECD countries has also provided additional impetus for growth-friendly tax reforms that reduce impediments to labour utilisation, private investment and entrepreneurship.

The impact of the crisis was both milder and shorter in the BRIICS, but it also made more apparent the necessity of some of the structural reforms recommended in *Going for Growth*. In particular, there is a need in several cases to expand social protection systems in order to support workers in times of crisis and – in a longer-term perspective – achieve more equitable and sustainable growth. Policy responsiveness to *Going for Growth* priorities has been mixed so far. All emerging economies have implemented policies aimed at enhancing the quality and inclusiveness of their education systems, which is a key challenge these countries face to achieve higher living standards. Helped by their generally more sustainable fiscal situations along with their higher growth prospects, most large emerging countries continued investing in physical infrastructure, another specific *Going for Growth* priority in a number of them. By contrast, less has been done to address important productivity-enhancing priorities, both in areas that are also common – albeit milder – challenges in OECD countries (*e.g.* the reduction of barriers to entrepreneurship and foreign direct investment) and in other more specific fields, such as enhancing the rule of law and strengthening governance systems.

Despite significant structural reforms in recent years, more needs to be done in order to strengthen the jobs recovery in the context of ongoing fiscal consolidation:

- Effective active labour market policies aimed at retraining displaced workers and encouraging return to work can reduce unemployment persistence. There is a case for sheltering such policies from fiscal consolidation efforts, and for complementing them with unemployment benefit reforms once recovery in labour market demand is solid. In particular, crisis-related increases in benefit levels and/or duration could be gradually phased out while some of the recent extensions in the coverage of unemployment benefits could be made permanent.

- Growth-friendly tax reforms could help strengthen the jobs content of a recovery, while also helping fiscal consolidation insofar as they are implemented in a way that raises tax revenue. These include removing tax expenditures and shifting the tax burden towards tax bases that are less harmful to employment and growth, such as immovable property, consumption and environmental taxes.

- Product market reforms are a priority for many OECD countries – in particular in Europe, and could have fairly rapid effects on growth, especially if implemented in certain sheltered sectors such as retail trade and professional services where the potential to quickly create jobs is rather high.

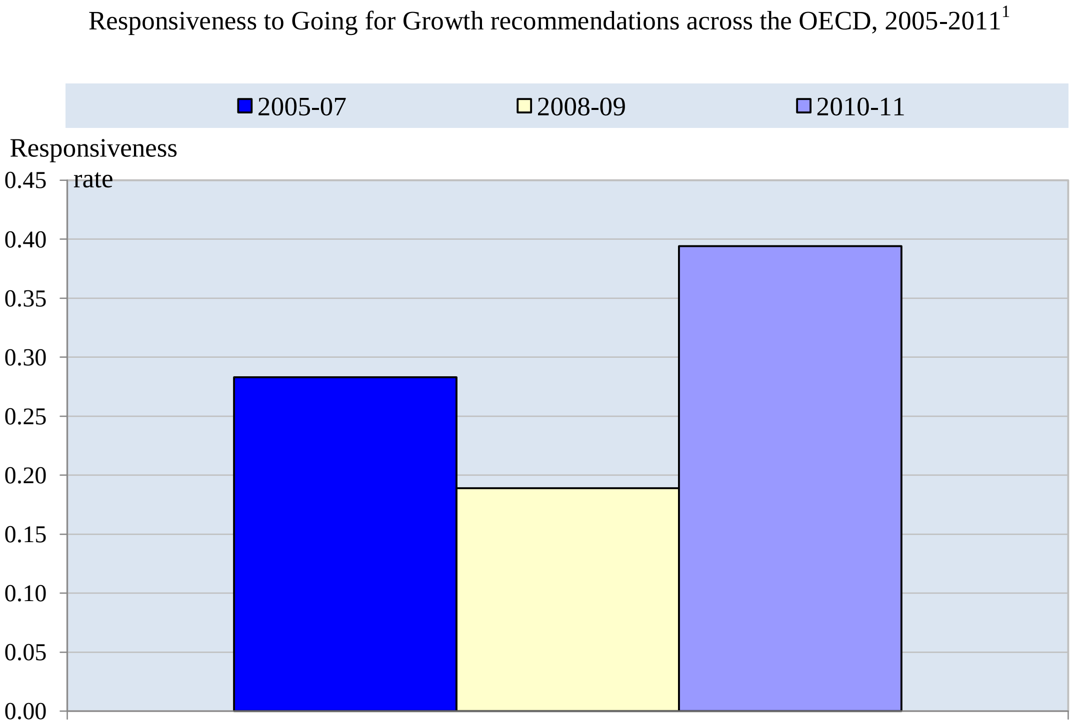
- In economies that experience renewed economic slack, it will be important that the policy response draws on the lessons from the crisis as to what works in terms of cushioning the labour market impact of weak activity, such as making use of short-time working schemes.

Overall, these comparions can be seen as a an illustration of what G20 could achieve if it were to engage in a systematic monitoring process along the lines of the *Going for Growth* process.

An important issue is the impact of structural reform over different time horizons. The new issue of Going for Growth also examines how quickly structural reforms can boost growth. Again, the empirical results were mildly encouraging. In a number of cases positive effects on gowth and employment were found already in the near term. These positive effects would typically increase over a period of 3-5 years, which was the maximum window where the effects of reforms could be traced empirically. On the other hand, there was also evidence that structural reforms, especially in some labour market areas, could have mildly negative short-term effects when introduced in conditions of weak activity. Hence a prudent conclusion is that structural reforms generally do not have the often-feared strong negative short-term effects and that significantly positive effects can materialise over a 3-5 year horizon.

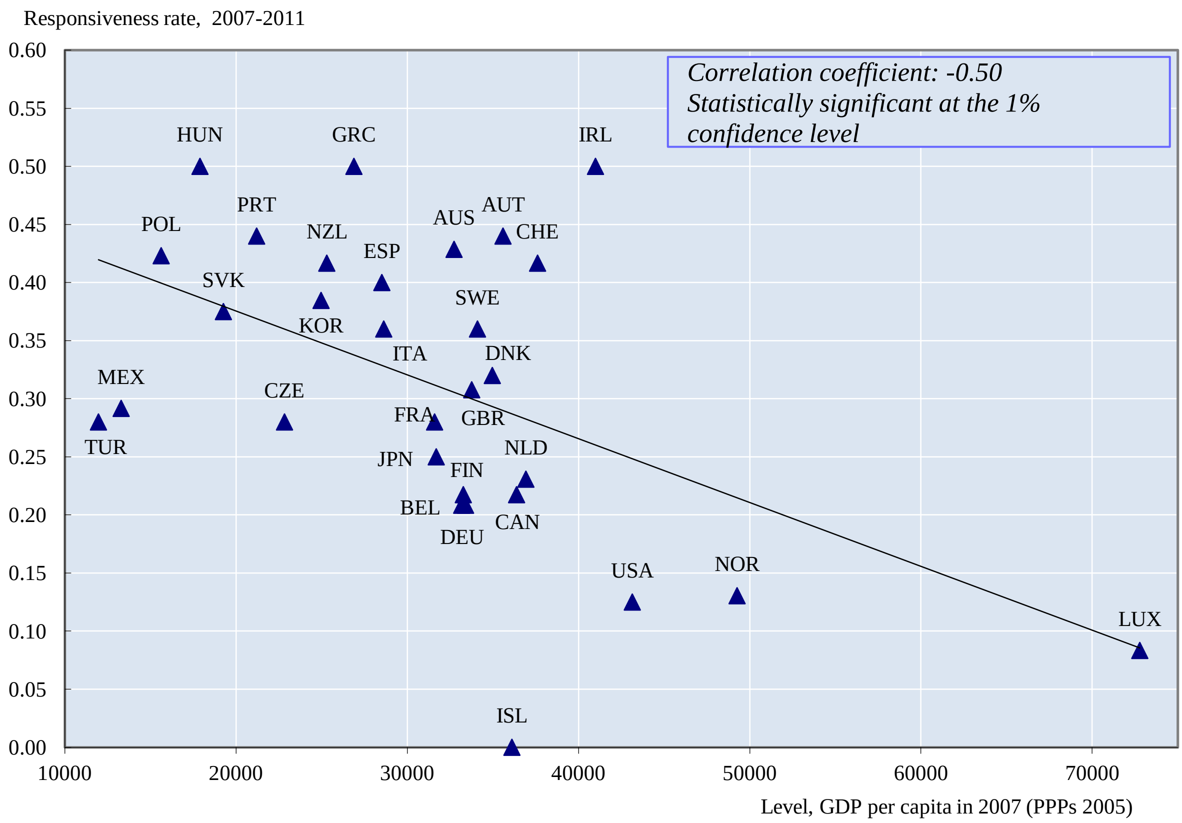
Figure 1 **The crisis has acted as a catalyst for reforms**

Responsiveness to Going for Growth recommendations across the OECD, 2005-2011[1]



Note: The responsiveness rate is based on a scoring system in which each priority set in the previous edition of Going for Growth rakes a value of one if "significant" action is taken the following year, and zero if not.
1. Average across OECD countries excluding Chile, Estonia, Israel and Slovenia.

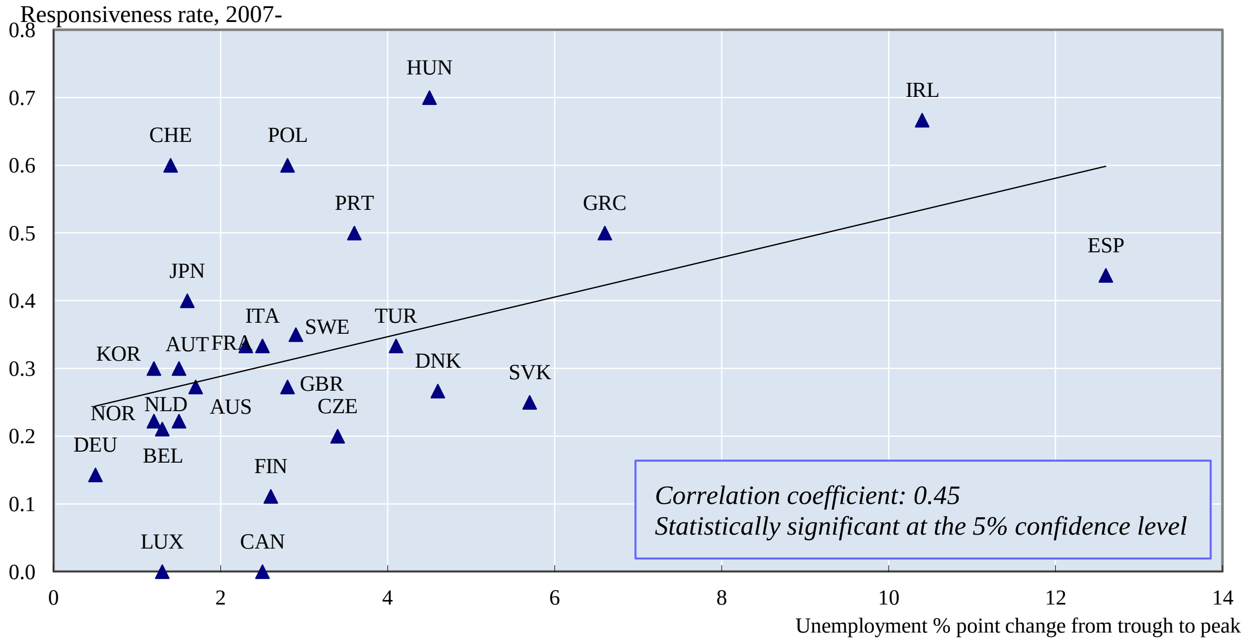
Figure 2. **Reform progress has been greater in lower-income countries**



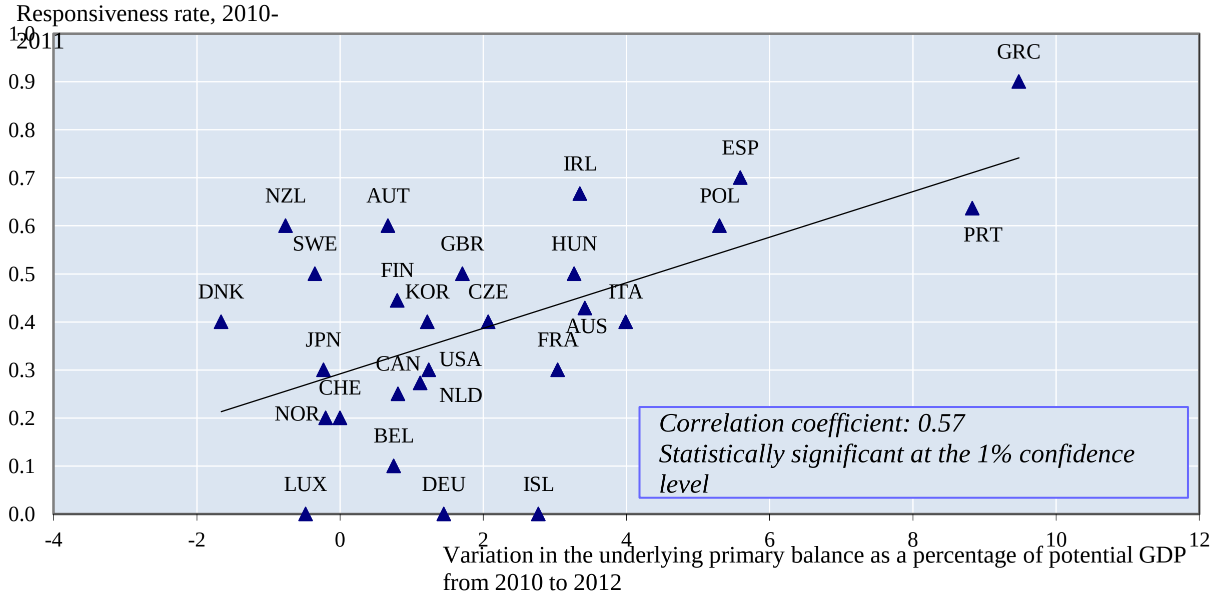
Note: See Figure 1 for the definition of the responsiveness rate.

Figure 3. **The need to address job and fiscal sustainability concerns has given impetus to reform**

A. Responsiveness to labour utilisation-enhancing *Going for Growth* priorities and magnitude of the labour market crisis



B. Overall responsiveness to *Going for Growth* priorities and fiscal consolidation effort



Note: See Figure 1 for the definition of the responsiveness rate.

Source: *OECD Quarterly National Accounts* (for the GDP data); *OECD Main Economic Indicators* (for the unemployment data) and OECD *Economic Outlook 90 Database* (for fiscal consolidation projections).