

PART I  
*Chapter 1*

## **Structural Reform at a Time of Financial Crisis**

*This chapter reviews how the current recession affects the prospect for structural reform and then explores which of the policy priorities identified in the current volume to boost long-term growth are most likely to stimulate demand in the near term. The main conclusion of the chapter is that there are, indeed, growth-enhancing structural policies in nearly all OECD countries that could potentially enhance short-term, as well as long-term, growth.*

The OECD economy is in its deepest recession for at least three decades. The downturn was originally related to the weakening of the sub-prime mortgage market in the United States, but spread to the inter-bank market and other financial markets, and to other OECD and non-OECD countries, with extreme stress in global financial markets on a scale not seen since the 1930s. Difficulties in financial markets have increasingly affected the real economy: GDP contracted towards the end of 2008 in most OECD countries and industrial production collapsed (Figure 1.1).

Figure 1.1. **Industrial production**<sup>1</sup>



1. Production index in total industry, excluding construction. Monthly data are working day and seasonally adjusted.

Source: EUROSTAT and OECD Economic Outlook No. 84, Vol. 2008/2.

StatLink  <http://dx.doi.org/10.1787/533826616320>

The initial policy response to the crisis has been aimed at stabilising financial markets through guaranteeing deposits and bank lending, and providing equity injections. These emergency measures will eventually have to be scaled back once markets and institutions have begun to function normally. Of particular importance for long-run growth, reforms will be required of regulatory and supervisory structures to reduce the likelihood of such events in the future. To the extent that such reforms succeed in improving the functioning of financial markets, they will contribute to raising economic growth and living standards in the long term.

As the scale of the impact of the financial crisis on economic growth and jobs has become evident, authorities around the world have taken unprecedented measures to stimulate aggregate demand. Central banks throughout the OECD area have cut their interest rates sharply; in the United States and Japan, policy rates are now close to zero. At the same time, governments have decided to provide significant budgetary support to

aggregate demand through a mixture of public spending increases and tax cuts. Indeed, most OECD countries have recently announced fiscal measures, amounting to up to 5% of GDP over a two year period, to stimulate growth. While these fiscal packages are primarily intended to boost aggregate demand in the short run, their design can influence growth in the long term through changes in incentives and structural conditions.

This chapter reviews how the current recession affects the prospect for structural reform and then explores which of the policy priorities identified in the current volume to boost long-term growth are most likely to stimulate demand in the near term. The main conclusion of the chapter is that there are, indeed, growth-enhancing structural policies in nearly all OECD countries that could potentially enhance short term, as well as long-term growth. These include:

- Introducing infrastructure projects or improving the quality of existing infrastructure, particularly in education. Provided that such projects can be brought on stream quickly, they are a potent way to stimulate aggregate demand in the short run; greater provision of high-quality infrastructure services will facilitate economic growth in the long run.
- Increasing expenditure on active labour market policies to provide workers with the skills that will be needed as the economy recovers, including through the use of compulsory training programmes. In the short term, this increases the ability to find a job and spending power of those that are likely to have a high propensity to spend; in the long term, to the extent it succeeds in enhancing the skills of participants, it will increase productivity and employment.
- Reducing the tax burden on labour income, particularly for low-income workers. In the short term, this will increase aggregate demand as spending by this group is closely linked to their disposable income; in the long term, the tax cut will raise employment rates for this group with positive effects on GDP per capita.
- Reforming anti-competitive product market regulation, especially entry barriers. In the near term, this may stimulate the creation of new products and businesses with beneficial effects on demand; in the long term, stronger competition will raise productivity and hence living standards.

While country circumstances vary, and thus not all of these policies are appropriate in all OECD countries, those described above are the ones most likely to strengthen both short-term demand in the current economic situation, and long-term growth as well.

### **Do crises facilitate structural reforms?**

While the focus of policy making during a sharp downturn shifts to supporting demand, past experience shows that structural reforms are often initiated in times of economic crises. This is the case even if it is easier to cope with adjustment costs of reform when the economy is strong. Among the reasons for this pattern is that crises unmask weaknesses in existing policies that were hidden by cyclical buoyancy, and the associated mood of public anxiety reduces part of the resistance to change. For example, high unemployment and weak growth in previous crises in the United Kingdom, New Zealand, the Netherlands and Finland triggered strong reform efforts. The current recession, which is likely to be the deepest one in many OECD countries for decades, may also stimulate reforms as countries attempt to regain dynamism.

While presenting opportunities for reform, crises also carry the risk that structural measures are introduced which ultimately undermine growth and living standards.

Politicians come under intense pressure to do “something” during economic crises, and hasty responses may involve measures that are simple and popular but fundamentally flawed. A classic example of this is the erection of import barriers in the 1930s which contributed to transform a downturn into the Great Depression. Another is the introduction of early retirement schemes in many European countries in the wake of the crisis in the 1970s which were intended to reduce unemployment by making room for employing young people. This policy proved to be a failure, but it took many countries years to withdraw it.

Politicians will come under pressure in the current crisis to adopt measures that are unsuitable to raise living standards in the long term, or even growth in the short term. Giving in to such demands, notably protectionist pressures, would seriously damage living standards over time. Policies targeting particular sectors in the current situation risk delaying necessary adjustment to new circumstances and creating a costly dependence on public support. If nonetheless taken, such measures should be phased out quickly. Generally, any government sectoral support should be confined to sectors that are of systemic importance to the functioning of the wider economy.

The crisis should not be allowed to delay decisions on climate change. The international community has started to discuss objectives and policies that could replace the Kyoto Protocol. Decisions are required in the near term about measures that will be mainly implemented only after 2012 to moderate global warming in the long term. Such reforms will increase welfare, though not necessarily GDP per capita.

## The selection of appropriate structural policies

What does the current crisis imply for near-term structural policy priorities and what demand-management policies can be applied that would also strengthen productive capacity in the long term? As outlined in Box 1.1, countries with growth-friendly structural policy settings have tended to recover relatively quickly from a downturn. Whether the current slump may prove different is too early to tell but, at any rate, it is probably too late for other countries to strengthen their resilience to the current shock. However, structural reforms that increase aggregate supply may also affect short-term demand, and those that boost rather than depress demand should clearly be given greater emphasis in the context of the current crisis.

### **Demand effects of structural policies**

Structural reforms may create slack in the economy as capacity expands, without a commensurate increase, or even sometimes a temporary contraction, in demand. In normal circumstances, such induced slack can be offset by the wealth effect resulting from the incorporation of higher growth prospects in asset prices (see below) and by expansionary macroeconomic policies. For instance, monetary policy aimed at price stability would react to reforms that threatened to open up a negative output gap and push inflation below target. However, at present when the capacity of macroeconomic policy is stretched, such reactions may not be feasible. This suggests that now may not be the right time for structural reforms that could have adverse short-run effects on aggregate demand, and that those reforms with possible beneficial effects on aggregate demand should be prioritised at present.

### Box 1.1. **Structural policy and resilience to shocks**

The structural policy settings that have tended to be most supportive of high GDP per capita are generally the same as those that are usually most helpful for economies to rebound swiftly after negative shocks.<sup>\*</sup> However, these settings have also been found to amplify the initial impact of shocks. Such policies allow for a more rapid adjustment in prices and wages that enable a more rapid recovery in aggregate demand, reducing the cumulative losses in output and employment that might otherwise arise. This is because where policies encourage strong competition in product markets, slack in demand will induce producers to cut profit margins, and lower prices will help to support demand, including by allowing monetary policy to respond more strongly to the downturn (provided that it has scope for reducing interest rates). Similarly, where structural policies foster flexibility in wages, an increase in unemployment will swiftly show up in lower wages, which in turn will raise employment prospects. Also, well-functioning financial markets that permit households and firms to borrow to smooth the consequences of an economic downturn would under normal circumstances help to limit the decline.

In the past, favourable structural policy settings in a number of OECD countries have given them the flexibility to recover relatively quickly from downturns. The United States, in particular, has demonstrated its capacity to bounce back after being hit by sharp cuts in demand, though it remains to be seen how resilient it will be in the current downturn with impaired financial markets. By contrast, Continental European countries have historically had milder downturns but slower rebounds, and their reaction to the downturn earlier this decade showed that recovery can take a long time.

<sup>\*</sup> For OECD evidence, see Duval et al. (2008).

In this context, the fiscal easing that is underway in many OECD countries could, in principle, also facilitate structural reforms. Temporary easing may offer the leeway to initiate reforms that require permanent restructuring of public budgets, such as frontloading cuts in revenue or spending increases, while delaying measures to raise revenue or cut spending until the economy recovers. Also, part of the increase in public spending or lowering of taxes may help compensate losers of structural reforms, and hence reduce their resistance to reform.

#### **Potential positive short-term demand effects**

Structural policies that successfully increase long-term GDP should have positive wealth effects on aggregate demand in the short run. Thus, reforms that raise company profits over an extended period due to lower costs and/or higher productivity will in normal circumstances show up in higher share prices, which in turn will spur households to spend more and businesses to invest more. However, the mechanisms that allow future benefits to be translated into current spending rely on well-functioning financial markets, which value assets appropriately and permit borrowing on the basis of using these assets as collateral.<sup>2</sup>

With financial markets in crisis, it is doubtful if they can currently carry out these functions in an efficient way. Thus, expected future profits seem to be strongly discounted in current share prices, and financial institutions with impaired balance sheets are likely to be reluctant to lend to households and businesses on the basis of collateralised assets in

the near term. These conditions put a premium on structural reform measures that are not reliant on financial markets to have positive short-term demand effects.

Such reforms include the opening up of markets where latent demand cannot be satisfied because of entry barriers and other regulations. Past reforms of the financial market itself offer an example of how easing of regulations can stimulate aggregate demand. For example, reforms and new products allowed households to withdraw equity from housing and this boosted their spending, although some of the associated borrowing and lending subsequently turned out to be excessive.<sup>3</sup> Another example of demand-raising regulatory reforms was the deregulation of telecommunications in the 1980s and 1990s in many OECD countries, which spurred entry of new companies with new products that appealed to consumers and raised demand. Some countries may still have scope to catch up in this area. Similar developments could take place in other sectors if currently high entry barriers were reduced, notably in retail trade (see Chapter 7).

### ***Potential short-term negative demand effects***

While structural reforms have long-term growth enhancing effects, they may have negative short-run demand effects if they involve costly factor reallocation or increase the risk of job loss and thereby dent households' confidence. For instance, by their very nature, many structural reforms imply turbulence in the labour market:

- The easing of entry regulations and other measures aimed at increasing competition in product markets can result in greater turnover of firms, with corresponding lay-offs in the companies that exit. At the same time, they create jobs in new companies, and the net employment effect may well be positive. In fact, some past reforms of product markets have been associated with greater product variety, higher output, and considerable net employment gains even in the short term.
- Increasing public sector efficiency, and the implied civil service retrenchment, will reduce job opportunities in the government sector. However, a more efficient public sector which allows for lower taxes will encourage employment creation in the private sector, and the net effect on employment may relatively quickly turn positive.
- The relaxation of employment protection legislation (especially on regular contracts) may reduce job security as firing costs are cut. On the other hand, such easing tends to encourage job creation. For example, the easing of restraints on the use of temporary contracts in Italy is widely credited for the maintenance of solid employment gains during the downturn earlier this decade.

While such structural reforms could have a negative impact on confidence and demand in the near term, this is not a given outcome as the reforms destroy some jobs but create new jobs in new firms and often other sectors. Improving public awareness of the benefits of reforms could imply that their overall effect on confidence in the short run would be positive.

Another way in which structural reforms may have adverse effects on demand in the short term is if they threaten income security and prompt precautionary saving. This is probably most relevant for pension reforms but also applies to reforms of other social transfer systems, such as unemployment and invalidity benefit systems. However, reforms in these areas do not necessarily imply a negative response from households. In fact, if confidence in the existing pension system has already been shaken, households may already have adjusted their spending accordingly. Reforms that clarify future pension

arrangements would reduce uncertainty and could even stimulate spending in the short run.

Structural reforms to reduce certain types of distortions in housing markets would not be suitable at present. For example, removing tax privileges for owner occupation has been frequently discussed (see Chapter 5). As tax advantages have increased demand for housing, they have boosted property prices and higher wealth in turn has encouraged the owners to spend. The removal of these advantages at present would put downward pressure on the price of residential property at a time when it is already falling in most OECD countries. To avoid amplifying the decline in household wealth and related spending, such reforms are best delayed until after a recovery has taken hold.

### ***Structural effects of demand policies***

Even if the objective of fiscal policy at present is to support demand, the design of the stimulus can influence the medium and long-term productive potential of the economy. Adjustments to tax structures and spending components will affect the incentives of individuals to work and businesses to invest in a positive or a negative way depending on the specific measures. Temporary measures may not have any permanent effects, but their transitory impact could still be long-lasting.

### ***Public investment in infrastructure and education-related expenditure***

Fiscal spending is likely to have positive supply-side effects if it involves investment in capital rather than government consumption or induced household spending. The government has the option to increase or accelerate infrastructure, maintenance and other types of potentially welfare-enhancing expenditures, such as environmental investments, that have been identified after a careful cost-benefit analysis.

Investment in electricity, transportation and telecommunication networks is the traditional mode of injecting demand into a weak economy. Provided that this can be done in a timely way and bottlenecks can be avoided, it is an effective tool for this purpose. Moreover, it may also be effective in raising employment in the short run, given that infrastructure activity is relatively labour intensive. As is discussed in Chapter 6, past infrastructure investment has raised GDP per capita in the long term, though the extent of such effects varies across different types of spending and different countries. However, there is some evidence that the impact declines as infrastructure investment deepens, and, with the high level of infrastructure provision in most OECD countries at present, the gains will be smaller than in the past. In general, new infrastructure spending projects will have stronger supply-side effects if they are carefully chosen on a project-by-project basis with the help of a cost-benefit analysis where benefits include positive externalities for the economy as a whole.<sup>4</sup> But even in cases where external effects have been exhausted, infrastructure spending may well have more positive long-term supply effects than many other instruments to stimulate demand. Nonetheless, there may be a dearth of new infrastructure projects with reasonable returns that can be implemented at short notice. Accelerating necessary maintenance expenditures is probably the surest immediate way to improve infrastructure where profitable new projects cannot be launched readily.

Increased public spending on education and training could raise potential output, though the effects are generally realised only over a long horizon. However, a focus on infrastructure for education could provide some short-term stimulus and also enhance longer-term growth by helping to improve the support facilities for better education.

Perhaps a more promising area for public expenditure is to focus on short compulsory training courses in the context of active labour market policies (ALMP). Participation in such training can increase skills and re-tool workers with new skills,<sup>5</sup> which may facilitate reallocation of workers between sectors and firms in the short run and raise GDP. Also, it may support activation policies and serve as a test on the work-availability and willingness-to-work requirements in unemployment and other benefit systems, thereby countering work disincentives embedded in such programmes. However, for such ALMP programmes to have favourable supply-side effects, they have to be carefully designed.

### ***Tax reform***

Fiscal expansion can also be used as a first stage in a tax reform to reduce the efficiency cost of taxation. As discussed in Chapter 5, there is evidence of a “tax and growth” ranking, whereby corporate income taxes are most harmful for long-term growth, followed by labour income taxes and then consumption taxes, with taxes on immovable property the least harmful to long-term growth.<sup>6</sup> Unfortunately, this hierarchy is unlikely to provide guidance to short-term prioritisation of tax measures because the most harmful taxes from a long-term perspective do not typically have particularly large demand-side effects. Thus, cutting the most distortive taxes, on corporate income, may not be effective in stimulating demand in current circumstances, as companies may already pay little or no tax due to a sharp reduction in income and savings on future tax bills might not be reflected in share prices due to the turmoil in stock markets. However, one potential shift of taxation that could be of help in the short run is to reduce the income and social security taxes on lower-income workers, who are more likely to spend the additional income they receive than those with higher incomes. Also, time-limited fiscal support to encourage energy efficiency is likely to stimulate demand in the short-run and have beneficial environmental effects in the longer term.

### ***Benefits***

Focusing fiscal reflation on increasing the generosity of benefits to households runs the risk of undermining the supply potential of the economy in countries where such policies are already prominent. For example, lengthening the maximum duration of unemployment benefits and raising benefit levels (especially for low-income individuals) may raise aggregate demand, but the evidence shows that unless they are temporary such measures will delay the return to work of unemployed individuals and have adverse effects on labour market performance in the long term. Easing entitlement conditions to disability or early retirement benefits, as has often been the case when labour participation fell in the past, would similarly increase demand in the short run but at the high cost of permanently reducing the supply potential of the economy.

### ***Subsidies***

Introducing or increasing government subsidies to producers may also undermine the long-term production capacity of the economy if these go beyond limiting adjustment costs and postpone necessary restructuring, even if they increase aggregate demand in the short term. If subsidies to individual sectors or companies are made conditional on progress in industrial restructuring, the economic cost of such programmes will be reduced. However, such subsidies can act like protectionist measures, and may provoke retaliation in other countries and a global reduction in growth potential. To avoid the

potentially damaging effects, it is therefore necessary for any sectoral support to be accompanied with a clear exit strategy, outlining the maximum duration of support and how it will be scaled back.

### Notes

1. See Chapter 7 of the 2007 issue of *Going for Growth*. The political economy of structural reforms is discussed in greater detail in Duval and Elmeskov (2005), Høj *et al.* (2006), IMF (2008) and Duval (2008). It is also the subject of ongoing work at the OECD.
2. In principle, reforms that increase human capital might also make families more willing to increase their current spending, but in practice using future human capital as collateral is difficult.
3. Indeed, future reforms may put some restrictions on asset-backed lending to households.
4. For example, an assessment of the benefits of investment in information and communication technologies should incorporate secondary benefits (*e.g.* via on-line education and teleworking) and tertiary benefits (*e.g.* more efficient organisation).
5. See *OECD Employment Outlook 2006*.
6. In the long run, the tax mix will also have an impact on the degree of automatic stabilisation provided by public finances.

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