Policy Reform and the Price of Gradualism

The challenges of ageing, migration and globalisation are often perceived as internal and external threats that eventually will transform our socio-economic system. From a dynamic perspective however, every change offers opportunities. As societies and economies can adapt to new circumstances and conditions, policymakers need to decide on how to guide and steer the necessary adaptation processes. Without reforms, the unavoidable adaptation is only postponed and will eventually turn out to be much more expensive. In response to the current reform challenge, Belgian pragmatism has so far favoured gradualism. Several analyses from independent organisations not only highlight the risks from the soft and gradual approach; they show that ambitious reforms bring net-gains for all societal groups.

Structural weaknesses persist

By definition, reform programmes challenge the *status quo* and its associated beneficiaries. The latter will challenge the need for reforms and push forward the alternative of a gradual approach. Gradualism is frequently presented as a pragmatic compromise: reformers can launch a soft version of their initial projects and vested interests will not be impacted. Since the early 1980s, mass unemployment became part of our economic reality. Successive Belgian governments launched a multitude of strategies and action plans of which the devaluation of the Belgian Franc was the most effective. Unfortunately, these efforts could not sustain the necessary growth dynamics. Past reforms targeted many different small groups but apparently had no impact on the essential levellers of economic activity, namely on the attractiveness of working and starting new activities. The structural weaknesses of the Belgian economy persist[1]:

- The Belgian employment rate is among the lowest of Europe (60.3% in 2004) while several other small open economies easily meet the Lisbon target (Denmark 75.7%; Netherlands 73.1%; Sweden 72.1%);
- Belgium has the highest unemployment rate of the EU-15 (13.7% in 2004 and approx. 12.3% in early 2006) and a relatively high long-term unemployment (49.6% in 2004);
- In Belgium, labour costs and tax wedges are the highest of all OECD countries;
- In 2005, total Belgian private employment was still slightly below the level of 1974 when our country counted 2 483 082 private sector jobs (excluding household employment); the strong increase of the labour population over the last 30 years has been absorbed by the public sector and the unemployment statistics;
- Belgium has together with Austria, France, Germany and Greece the highest regulatory barriers to entrepreneurship in the EU-15;

[1] Based on recent datasets from OECD (e.g. OECD Economic Outlook 78 Database), Eurostat (e.g. Labour Force Survey) and the Belgian Planbureau.

- Belgian gross public debt (98.5% in 2005) resulted in net debt interest payments of 4.2 % of GDP in 2005.

Compared to Denmark, Belgium underutilizes 20% of its labour population. Belgium has no other resources than human capital but clearly entered the era of the knowledge economy at a suboptimal level. The gap with countries like Denmark cannot be attributed to quality differences: Belgian students outperform their Danish counterparts in comparative international assessments and all Belgian universities are at least ranked in the European middle group.

The paradigm of gradualism

Belgium's comparatively poor economic record after decades of reform efforts has so far failed to spark a sense of urgency. However, the continuous waste of human capital on a grand scale is both socially and economically unsustainable. Experiences in countries like Finland and Ireland moreover show that growth dynamics can be triggered by ambitious and sustained reform programmes to the benefit of all. Belgium's dire need for an overarching reform agenda has so far been drowned out by adverse public sentiment over timid reform proposals. Paradoxically, while there have not been mass strikes or manifestations against the persistence of mass unemployment; there were indeed strikes against the first moderate measures taken to accommodate the consequences of ageing and to safeguard the interests of the future generations.

In addition, there are strong indications that Belgian policymakers express some degree of reform fatigue even before any structural reforms have been envisaged. In the Joint Employment Report 2004-2005 of the European Commission, the evaluation of recent Belgian employment plans is disappointing. The European Commission defined three main employment challenges: increasing the adaptability of workers and enterprises; attracting more people to the labour market and making work a real option for all; and, investing more and more efficiently in human capital and lifelong learning. Although meeting these challenges is of crucial importance for our economy, the Belgian policy response in addressing the European recommendation has been assessed as 'limited' and even 'insufficient' (Joint Employment Report 2004-2005 – Addendum 1)[2].

Policymakers need to make decisions under uncertainty. Gradualism -or a series of very small steps- in principle offers the possibility to assess the effectiveness of past measures. In addition, more fundamental measures bring the risk of overshooting and triggering economic instability. Independent policy-supporting research can help decision-makers to scale back the level of uncertainty and to implement effective reforms. As it is however obvious that past measures were clearly insufficient, the risk of doing too little exceeds the risk of doing too much. To use an analogy previously presented by Ben Bernanke: a golf player that faces the hole on top of a steep hill needs to hit the ball hard. He can never win the game with a series of soft hits.

Soft and at best gradual reforms that appeal to the short-term interests of particular groups are frequently motivated as essential to safeguard 'social peace'. Applied to the Belgian situation, it is difficult to reconcile a concept of social peace with the

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2 http://europa.eu.int/comm/employment_social/employment_strategy/report_2004/annex1_20045_1_en.pdf

persistence of economic underdevelopment, leaving over 600 000 households in unemployment. Of equal importance, the interests of the future generations were hardly considered in past reforms.

Strong tax increases after 2011?

Against the backdrop of a historically high public debt, the gradual approach to policy reform has primarily focussed on fiscal consolidation, *i.e.* a sustained improvement of the budget deficit/surplus. Fiscal consolidation efforts are part of a strategy to mitigate the cost of ageing: a strong reduction of public debt will save on future interest payments. In 2002, it was envisaged that this strategy of fiscal consolidation could succeed on the condition that a budget surplus of 0.7% and 1.5% of GDP in 2007 and 2010 respectively will be achieved (IMF Country Report No.05/76). The latter surplus would then have to be maintained to generate the required public debt run-down. In 2005, the IMF however concluded that '*time for accumulating the required fiscal savings is running out* (p.3)' and this makes the need for effective employment-enhancing policies all the more pressing.

Under gradualism, a balanced budget rather than maintaining budget surpluses became the pragmatic approach towards fiscal consolidation, It is very useful to project the long-term impact of the current balanced budget strategy. This exercise is done in the IMF country report of March 2005 and is based on a 'baseline' growth scenario devoid of labour market reforms but with a long-run annual rate of productivity growth of 1.56 % (based on the average productivity growth between 1975 and 2002). The IMF model then rather optimistically assumes that these productivity gains will lower the unemployment rate to 7.9% in 2009 and thereafter. The development of age-related spending is based on the Belgian official projections[3]. Against these optimistic baseline macro assumptions, the IMF concludes that even if the budget was balanced through 2011, fiscal dynamics would be unsustainable. Balancing the budget would bring the debt ratio to 75% of GDP in 2011: annual interest payment would fall by ¾ of a percentage point of GDP. '*While these savings would cover the projected increase in social spending over the same period, they would fail to provide for the subsequent decades in which social outlays are expected to rise at a much faster rate than at present* (p.5)'. After 2011, a deficit would re-emerge at constant rates to GDP of revenues and discretionary spending. Without tax increases or cuts in government spending, the future debt and budget deficit dynamics would result in the explosive rise of public debt after 2020. By 2050, public debt would have reached a level of more than 190 % of GDP and the budget deficit would have deteriorated to over 13 % of GDP[4]. The prospects of these catastrophic consequences are likely to trigger tax increases or spending cuts long before 2050. Hence, we can expect tax increases between 2011 and 2020 since so far it proves extremely difficult for Belgian policymakers to enforce significant cuts in government spending.

[3] For Belgium, the budgetary cost of ageing between 2000 and 2030 is estimated at 5.6% of GDP (Studiecommissie Vergrijzing 2005) while especially additional health care costs already lead to a short-term impact between 2000 and 2010 of 1.7% of GDP. For the EU-12, total ageing-related expenditures will increase from 17.6% of GDP in 2005 to 23.4% of GDP in 2050 (Oksanen, 2003).

[4] Although in a completely different context, the strong rise of Japanese public debt from 87% of GDP in 1995 to 158.9% of GDP in 2005 illustrates the consequences of postponing fundamental reforms.

Fortunately, the modelling work by the IMF confirms that Belgium has the tools to solve its fundamental problems without tax increases. Other model runs that start from the same baseline scenario show how the combination of fiscal adjustment and labour market reforms will make it possible to control the consequences of ageing, as well as to drastically reduce public debt and to restore the unemployment rate to 3.2% in 2030. One can only conclude that the price of gradualism is extremely high. The gradual approach delays the needed reforms and prepares an economic disaster with either an explosive growth of public debt or even higher taxes. Which social consensus is supporting this scenario?

Job creation as a realistic option

Fundamental reform efforts are not welcomed by those who only focus on possible losses. A more balanced view is needed. Past reform efforts could not avoid that private employment was in 2005 still below the level of 1974. The fundamental economic challenge for Belgium is to facilitate the expansion of the private sector. Only private job creation will align the low Belgian employment rate to the Lisbon target. Although several stakeholders and policymakers adhere to the lump-of-labour paradigm with a fixed supply of jobs, most OECD countries prove that it is possible to create new jobs. Between 2000 and 2004, civilian employment increased by 4% in the Eurozone[5]. Over the same period, the supply of jobs in Spain increased by 15.9%. In Europe, job growth was also spectacular in Luxembourg (13.9%), Ireland (9.9%), Greece (8.5%) and Italy (6.1%). The job growth of Ireland is especially remarkable since this economy was already close to full employment in 2000. In Belgium, the growth rate of civilian employment was only 1.1%. One can only conclude that job creation policies can make a difference and reduce unemployment.

Conclusions

Past reforms have not eliminated or reduced the relative structural weaknesses of the Belgian economy. The gradual policy response to economic challenges favours the *status quo* as if there were a social consensus supporting mass unemployment and the underutilisation of our human capital. There are even indications that Belgian policymakers express some degree of reform fatigue even before a comprehensive reform programme has been envisaged. A balanced budget strategy gradually replaced former fiscal consolidation strategies to tackle the challenge of ageing. IMF models with rather optimistic macro-economic assumptions however show that without fundamental reforms, a balanced budget strategy will lead to an explosive growth of public debt or strong tax increases between 2011 and 2020. The same models however confirm that reforms will make it possible to control the consequences from ageing and stabilize unemployment at an acceptable level. Compared to the latter alternative, the price of gradualism becomes simply unacceptable.

Belgium has invested too much energy in timid and piecemeal reform measures that invariably bring stiff resistance from incumbents with only a short-term perspective. Proposals for short-term gradual reforms are often isolated and cannot benefit from an overall perspective. Reform is better construed through a consistent and broad strategy that is

[5] OECD (2006). Main Economic Indicators, February 2006 (p.18)

developed on a wide societal consensus where the narrow interests of the few can indeed be balanced with the long-term interest of all.

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