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Structural reforms and investment

Companion note to Discussion Paper: Promoting Investment

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Business environment encompasses a wide range of factors that influence a company's operations such as tangible and intangible infrastructure (transport and distribution, information and communication technologies, judicial system, research, development and innovation, *etc.*), corporate tax system and regulation, quality and cost of labour force, market trends and macroeconomic conditions. Favourable business environment is a crucial determinant for investment decisions.

The potentially positive impact of structural reforms on business environment has been widely recognised – suffice it here to recall the OECD's *Going for Growth* programme (2014), the IMF survey and recommendations[1] and the European Commission (*e.g.* Canton et al. 2014). Structural reforms may yield a better business environment both directly (*e.g.* through reducing red-tape start-up and operational costs) as well as indirectly (*e.g.* through more efficient resource and product markets), albeit typically with a lag.

Successful implementation of structural reforms in product and labour markets will improve productivity, competitiveness, job creation and therefore potential growth. Higher and sustainable economic growth will, in turn, help reduce fiscal burdens and lead to long-term debt sustainability. Moreover, the European Commission's simulation results (Varga and in't Veld 2013) suggest that effects of structural reforms on GDP growth will be even greater if reforms are implemented simultaneously in all countries than in a situation in which each country is acting on their own[2].

In order to maximise benefits, reform actions need to be prioritised and streamlined. Under the current situation of high unemployment and low investment in the EU, priority should be given to those structural reforms that can be expected to reduce burdens on businesses and enhance job creation. High administrative costs and complex legal procedures are often found to be serious obstacles to SME and venture start-ups, especially for cross-border investment. Shifting the tax burden away from direct taxes is likely to stimulate private investment and reduce unemployment relatively quickly, particularly for the youth. Loosening restrictions on the use of temporary labour contracts has also the potential to enhance investment.

Over the past years, a series of programmes have been launched both at national and European levels to improve corporate regulations by reducing administrative burdens and

[1] In Article IV Surveys and policy recommendations for various emerging and developing countries as well as for certain advanced economies.

[2] The study presents a quantitative assessment of the potential impact of structural reforms in four largest euro area countries (Germany, France, Italy and Spain) and three "programme countries" (Greece, Portugal and Ireland). While gains in competitiveness are smaller under the simultaneous reform scenario, higher demand effects offset to support growth. Overall, GDP spill-overs are positive, highlighting the potential benefits of policy coordination.

simplifying administrative procedures. Examples of such initiatives at the EU level are represented by the following: (i) the Small Business Act (2008), comprising policy actions to support SMEs and entrepreneurs; and (ii) the Commission study (2011) on "Business Dynamics", measuring the impact of the legal provisions and administrative procedures on start-ups, business transfers and bankruptcy, with particular attention to SMEs. Similarly, a number of Member States have been engaged in important labour market reforms, with a view to modernising and increasing flexibility of employment contracts and encourage job creation. Such efforts should continue, possibly in a more coordinated and harmonised manner among Member States.

In terms of sectors, several areas have been identified by the European Commission and European policy makers where more reforms and investment could substantially improve business environment in Europe. Examples of such sectors are: energy; telecommunication (especially broadband networks), and transport infrastructure. Policy initiatives targeting resources to these flagship areas are likely to enhance productivity and help demonstrate that structural reforms produce tangible results.

Proper timing and sequencing of reforms is important. Some measures, such as tax reforms, can be expected to produce results more quickly and enhance the effectiveness of further reforms. While others, for instance certain product market reforms, may even temporarily depress investment and output via reduced capital spending by incumbents. Short-term benefits/losses of structural reforms may be lower/higher in recessions, particularly when growth is below potential (on the dynamic impact of structural reforms: Bouis et al. 2012). Long-term commitment and determination is in any case necessary to obtain the substantive benefits of structural reforms, as these fully materialise only in the medium to long term, while in some cases they entail significant frontloading of costs.

Potential benefits would be further enhanced if structural reforms are accompanied by other policies which could have more immediate effects on stimulating investment. Insofar as structural reforms raise potential output in the face of insufficient aggregate demand, investment has the potential to crowd-in their effects, which would otherwise be lagging. Moreover, in the current macroeconomic environment characterised by too low inflation, boosting investment would offset the deleterious downside impact of reforms on prices and wages.

Policy credibility plays an important role, as it affects households and firms' current decisions and expectations. A study by the IMF staff (Anderson et al. 2014) on the euro area points out that the speed at which gains from structural reform implementation could be realised depends on the extent of credibility of the announced policy: *i.e.* if households and firms in the euro area are immediately convinced by the planned reform package, the expected increase in real GDP would be faster than in a scenario in which households and firms' confidence only build up slowly over time[3].

Considering that "confidence" is becoming increasingly important not only in the financial sector but also in driving macroeconomic performance, policy credibility is highly relevant also in this respect, so as to avoid markets and consumers' over-reactions and resulting instability (for more details: Padoan, Sila and van den Noord 2012).

A joint action by the EU is therefore necessary for delivering clear message to the public for its intention and commitment in promoting higher potential growth through structural reforms and enhanced investment.

[3] The long-term outcome of both scenarios will, however, be the same if the reform is successfully implemented.

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