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It's the productivity, stupid!

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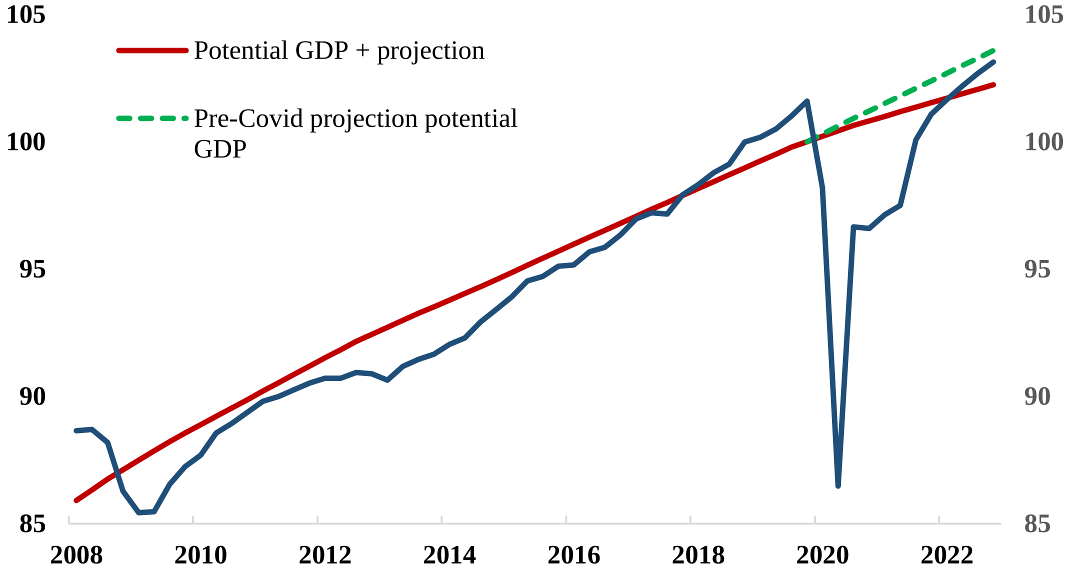
The economic policy responses to the COVID-19 crisis have so far been adequate, but now we need other policies to support the economy and address the long-term economic challenges of Belgium. First, it is necessary to structurally increase the employment rate, which requires pension and labor market reforms. Yet, in contrast to common perception, even a substantial increase in the employment rate does not safeguard public finances in the long run. Most importantly, our welfare state can only be maintained if we manage to substantially increase the growth rate of productivity compared to previous decades. This includes policies that stimulate investment, improve mobility, augment human capital, enhance labor market dynamism and increase domestic competition.

To minimize the permanent economic losses of the COVID-19 crisis, it is crucial that the capital stock of the economy remains intact at the end of the crisis; that is, productive firms should not go bankrupt. In addition, employees who have lost their job should not permanently leave the labor market or become permanently unemployed. Accordingly, it is possible to pick up activity and quickly return to the pre-crisis trend once the situation has normalized. As can be observed in Figure 1, the government has been successful to realize this. According to the most recent OECD projections, potential output will only be 1.3% below the pre-COVID projection by the end of 2022, which can be considered as the permanent losses caused by the crisis. In addition, it is projected that real GDP will already reach (and even be higher than) its potential level by the beginning of 2022. Overall, we can conclude that the fiscal and monetary policy responses to the crisis have been adequate.

Figure 1: OECD projection of Belgian real and potential GDP (2019Q4 = 100)



Source: OECD

The return of actual GDP to its potential level, however, implies that expansionary fiscal policies, such as government consumption or measures to increase purchasing power of households (e.g. a rise of minimum pensions), can no longer stimulate the economy.[1] In particular, when firms produce at full capacity and unemployment is at its natural rate (all inactivity is structural or voluntary), which is the case when output reaches its potential level, such policies only lead to a rise in import and/or higher inflation. From 2022 onwards, economic activity can thus only be stimulated by increasing potential output, which requires alternative policies. As explained below, a rise of potential output is also crucial in the long run.

Potential output and the costs of ageing

One of the greatest economic challenges for our country is the ageing of the population. Without a substantial increase of potential output, it will be impossible for the government to service future social expenditures (including pensions and health care). This can be illustrated by the fact that social expenditures are measured as a percentage of GDP: $\frac{social\ expenditures_{2019}}{GDP_{2019}} = 24.6\%$, and the projected evolution of both components in the table below.

Table 1

	2019	2030	2050	2070	2070bis
Evolution real GDP	100.0	113.9	150.2	206.0	249.5
Social expenditures	24.6	32.3	45.2	61.4	61.4
% of real GDP	*24.6%*	*28.4%*	*30.1%*	*29.8%*	*24.6%*

Note: evolution real GDP and social expenditures are the baseline scenario projections of the *Comité d'Étude sur le Vieillissement* (report 2021). The column 2070bis represents the required evolution of real GDP to have the same % of social expenditures as in 2019.

The ratio of social expenditures to GDP was 24.6% in 2019. According to the *Comité d'Étude sur le Vieillissement*, social expenditures will be 61.4% of *current* GDP (excluding inflation) in 2070. This is impossible to service. However, since the Comité also projects a rise of real GDP by 106.0% over this period (from 100 => 206.0), the ratio of social expenditures to GDP will "only" be 29.8%. This illustrates the crucial role of the denominator; that is, GDP growth, to accommodate the costs of ageing.

As a matter of fact, a rise of real GDP by 106.0% will not be enough since a rise of social expenditures to 29.8% would be dramatic for public finances. In particular, this would augment the government deficit by 5.2%-points compared to 2019, of which 4.9%-points are expenditures of the federal government. Taking into account that the pre-COVID federal deficit was already 2.0%-points, this corresponds to a structural federal deficit of 7.2% of GDP in the long run, which is not sustainable. The last column of the table shows that real GDP should preferably increase by 149.5% (from 100 => 249.5) in order to

[1] Notice that, due to the substantial build-up of savings during the lockdowns, there is no need to stimulate household consumption in the first place. This will happen automatically.

have the same percentage of GDP as in 2019. Put differently, we need higher GDP growth than the assumptions made for the projections.

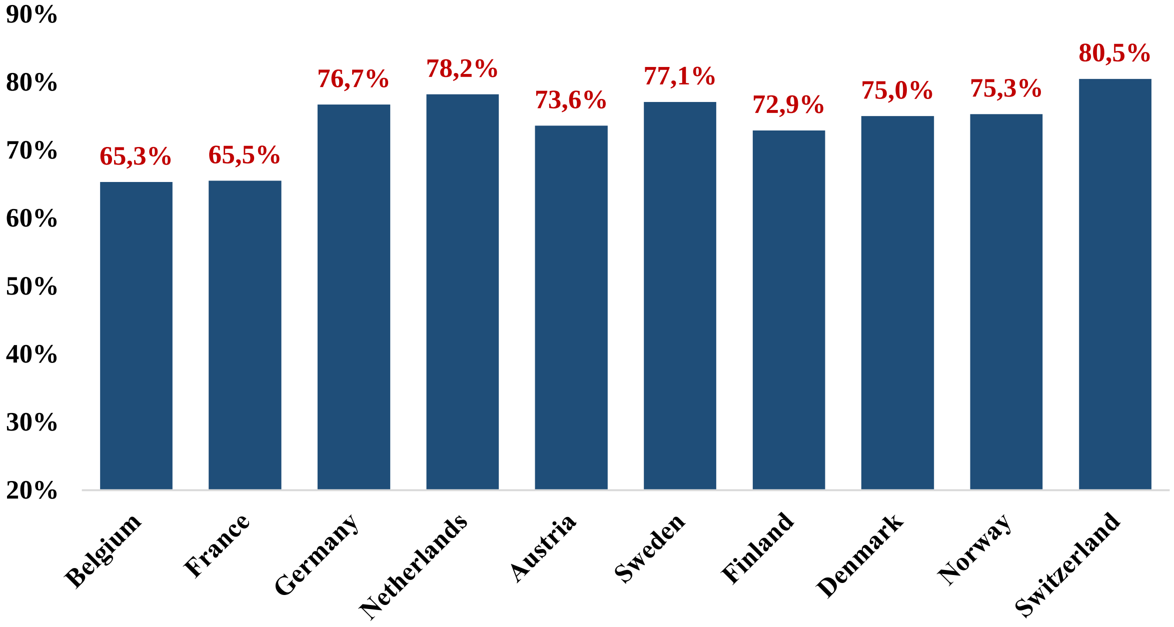
To better understand the substantial rise of GDP that is required to accommodate the rising costs of ageing, it is useful to decompose GDP in its two key components, which we further discuss below:

$$\boldsymbol{GDP = employment * labor\ productivity}$$

Employment

In its projections, the *Comité d'Étude sur le Vieillissement* assumes that the employment rate in 2040 will be 6.5%-points higher than the pre-COVID level in 2019, and stabilizes at this level afterwards. Overall, this corresponds to 533000 extra jobs by 2070. Note that this rise also takes into account the increases of the legal pension age in 2025 and 2030, a rise of the labor force and favorable migration effects. Put differently, the employment rate has to rise by more than 6.5%-points if we want to reduce the costs of ageing. As documented in Figure 2, it should be possible to do this. Especially at the end of the careers, there is a lot of room for improvement. To be clear, since employment is currently at its natural rate, a rise in the employment rate is only possible with structural labor market reforms, as well as fundamental pension reforms (and not by stimulating consumption or demand-side policies). It is obvious that the government should now focus on such reforms, which are well known and have been intensively discussed in the public debate recently.

Figure 2: Pre-COVID employment rate (15-64 year) in Belgium and other European countries

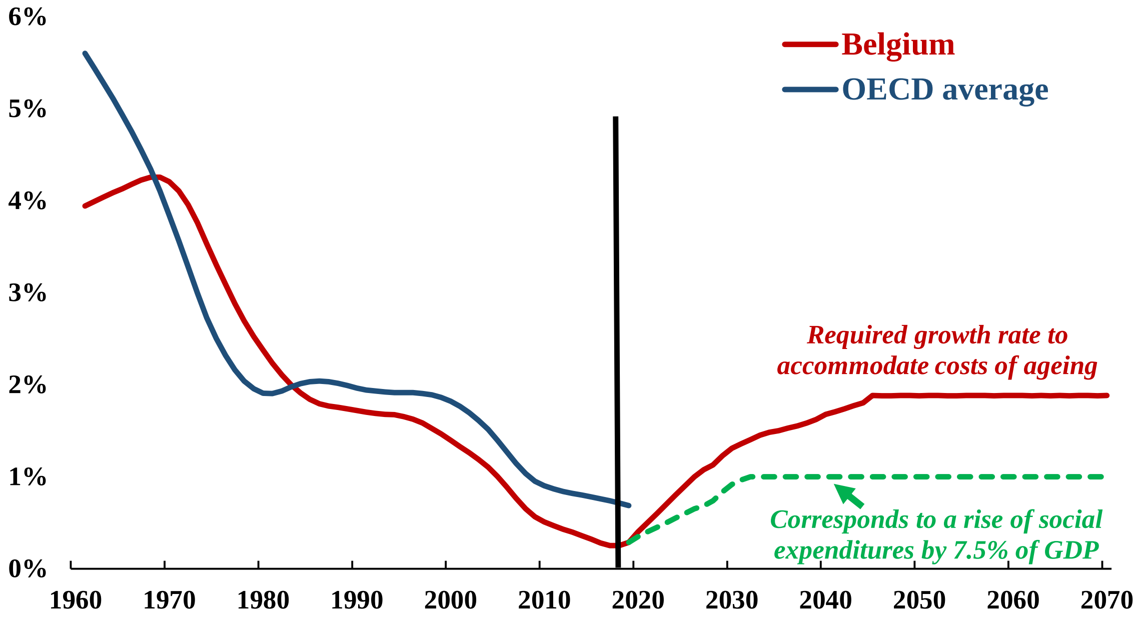


A caveat is that the contribution of a rise in the employment rate to the required increase of real GDP and sustainability of public finances is very modest. More specifically, when the employment rate effectively increases by 6.5%-points over time, this only covers one-ninth (11%) of the required GDP growth by 2070 (which should increase from 100 => 249.5 to keep the percentage of social expenditures to GDP constant).[2] Even if we manage to increase the employment rate by more than 6.5%-points, the impact remains modest. Another caveat is that measures to increase employment often also involve a "cost" for the government budget (e.g. reduction of labor taxes), which lowers the "net" benefits for the budget. Finally, the projections assume that all additional jobs that are created have the same labor productivity as average workers. This is very optimistic and unrealistic. At the margin, employees typically have lower levels of productivity. These are, for example, low-skilled workers or part-time workers. In sum, it is necessary to substantially increase the employment rate over time. However, in contrast to common perception, it is not the solution to maintain the welfare state and safeguard future public finances.

Labor productivity

A famous quote of Paul Krugman is *"Productivity isn't everything, but in the long run it is almost everything"*. This also applies to the costs of ageing and the future of our welfare state. 89% of the required GDP growth to accommodate the costs of ageing over time should come from a rise in labor productivity. The challenge is illustrated in Figure 3.

Figure 3: Trend annual growth rate of labor productivity



There are several observations worth mentioning based on the figure:

- Whereas the level of labor productivity has historically been quite high in Belgium (we were amongst the top in the world in the early eighties), the growth rate of labor productivity has been much lower than the OECD average since the mid-1980s. Cumulative, the rise of labor productivity has been ±20%-points lower than the OECD average. In other words, if we had the

[2] For the baseline projections of the *Comité d'Étude sur le Vieillissement* (GDP from 100 => 206.0), the contribution of an increase in the employment rate by 6.5%-points would be 14%. For each percentage point extra increase of the employment rate, there is 2.7 extra GDP in 2070 (i.e. GDP will be 208.7 instead of 206.0).

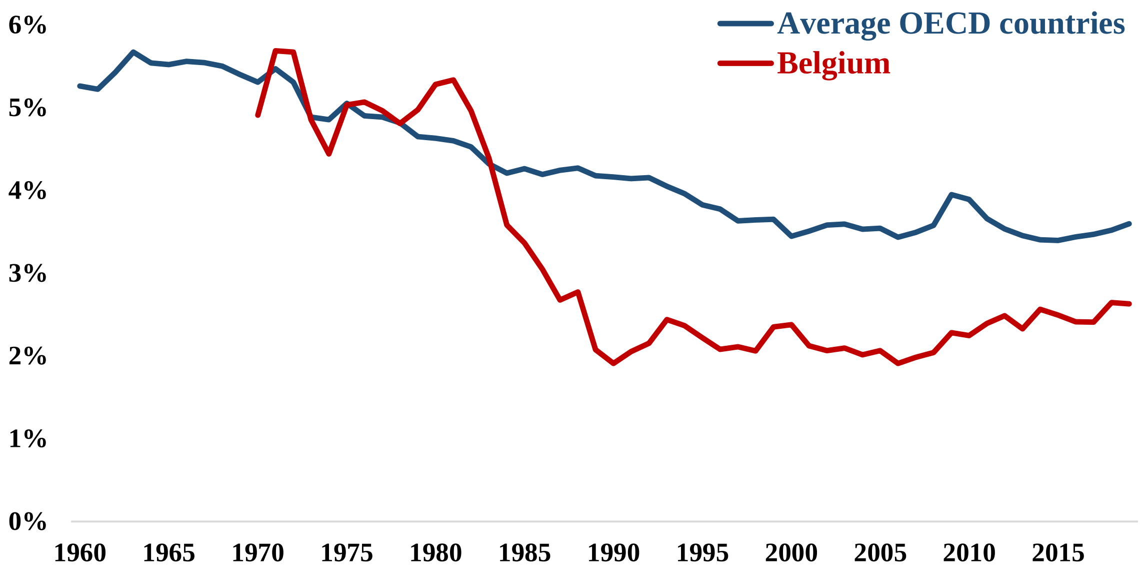
same productivity growth as the OECD average, real GDP today would be roughly 100 billion euro higher. This corresponds to more than 20000 euro per family per year. Overall, the low productivity growth has been the major macroeconomic weakness of our country over the past decades.

- To accommodate the costs of ageing (i.e. stabilize social expenditures at 24.6% of GDP), average annual productivity growth in the next five decades has to be 1.6% (in combination with a rise of the employment rate by 6.5%-points). This is considerable. As a reference, annual productivity growth between 2000 and 2019 was 0.7%. Between 2010 and 2019, average productivity growth was even only 0.4%. Furthermore, the (international) trend is declining. In sum, we need productivity growth that is four times higher than in the previous decade.
- If the average growth rate of labor productivity is, for example, “only” 0.9% (which is still higher than the average over the last two decades), social expenditures will in the long run increase by 7.5% of GDP compared to the pre-COVID level (i.e. these expenditures will be more than 32% of GDP). In combination with the existing structural government deficit, this is not sustainable and would imply dramatic (social and fiscal) consequences.

The future of our welfare state will thus be determined by the growth rate of labor productivity. The latter can be augmented by a rise in the capital stock and/or a rise in total factor productivity (i.e. the interplay between capital and labor). Examples of policy measures to realize this are:[3]

- Increase government investment. As can be observed in Figure 4, government investment in infrastructure has been systematically below the OECD average since the mid-1980s. Whereas the share in real GDP was around 5% in the early 1980s, this was only 2 to 2.5% in recent decades.

Figure 4: Evolution of government investment (% of GDP)



[3] For a detailed discussion, see OECD (2019), In-Depth Productivity Review of Belgium, OECD Publishing, Paris.

- Enhance and improve government support for R&D. The latter is crucial for TFP growth, which is the key problem of our low productivity growth.

- Enhance the human capital of employees. This implies a reform of the educational system. It also implies, for example, the encouragement of lifelong learning.

- Employees and part of the capital stock (e.g. trucks) spend too much time in traffic jams, which implies productivity losses. Thus, it is crucial to implement policies that improve mobility.

- Reform the labor market. More precisely, research has shown a negative association between job protection and labor productivity. Hence, it is important to facilitate job mobility of workers from ailing firms towards fast-growing and more productive firms and sectors. This requires, for example, more flexibility for collective dismissals and support for workers to acquire new skills. This also requires more freedom for firms to align wages with productivity at the firm level; that is, give more freedom to firms and workers to set wages because the current wage norm (i.e. the competitiveness law of 1996) does not encourage firms and workers to increase productivity. Finally, improve workers' incentives by reducing the weight of seniority in wage compensation. In sum, we need more labor market dynamism. The challenge is to protect employees, not their jobs.

- Promote competition and make product market regulation more competitive-friendly. Specifically, according to the OECD indicators of product market regulation, Belgium is among the most stringent OECD countries, particularly concerning barriers in services sectors (e.g. e-commerce, retail distribution, retail sales of medicines, telecommunications, lawyers, notaries, accountant, architects and estate agents). Firm entry and exit are low, and companies stay in business longer than in other countries. This lack of competition and barriers to entry does not stimulate firms to innovate and increase productivity; that is, anti-competitive product market regulation is associated with lower productivity growth. Furthermore, the competition authority should become more effective to enforce competition law.

- Improve business dynamism more generally. In particular, strengthen the provision of venture capital to fast-growing young firms, take actions to alter cultural mindsets towards greater risk-taking and reduce the tax privileges for safe assets (e.g. home ownership, saving accounts and life insurance).