
New Policies and New Goals for Changing Times

Recognize that things change and that we need to change with them, so the mere fact that a set of practices has been successful or comfortable in the past is not an argument for its maintenance into the future.

—Bradford DeLong¹

The European economy was one of the great postwar success stories. Today the eastward-expanding European Union will become the world's largest economic region. More countries would like to join the European Union and emulate the current member states—not surprising since most Western Europeans today are living comfortably and are protected from economic losses. Yet today's affluent European economies face serious challenges if they are to maintain their current standard of living, while the newly entering countries of Eastern Europe will be able to catch up economically only if they avoid the growth-limiting policies that exist in some of the Western European economies. Transforming the European economy is a necessity. Preparing it for the challenges of the 21st century will require painful adjustments; many existing companies will fail, and many workers will lose their jobs.

Not surprisingly, there is great political resistance to serious reform efforts. Yet a transformation of the European economy—indeed a *radical* transformation—is exactly what European leaders agreed was needed at a meeting in 2000 in Lisbon. The leaders reiterated their commitment to the Lisbon goals at the March 2004 EU Council meeting in Brussels. The time has come to actually implement the reforms and achieve those goals. As the Council itself stated in March: “The challenge now is follow-up:

1. One of five lessons learned from David Landes' *The Wealth and Poverty of Nations*; see www.j-bradford-delong.net.

real progress towards more and better jobs must be made over the coming year.”

A positive message that performance in Europe can be improved—substantially so—can drive economic reform in Europe. Europe can create an economy that combines both strong growth and a solid social safety net, though it will not be easy. Indeed, many sacred cows of social policy, labor-market policy, and product-market regulation will have to be slaughtered along the way. These changes will not be costless. But the promise of better performance does not have to be taken on faith. There are several examples within Europe of reforms that have already worked. Denmark, the Netherlands, and Sweden have made labor-market reforms that raised employment and lowered unemployment. Britain, France, and Germany all have industries that were privatized or deregulated and where productivity increased rapidly.

Positive messages are more appealing than negative ones, but economic reform in Europe also has to be driven by a stick. When the going gets tough on reform and protests abound, it is important to remember that Europe cannot simply maintain the status quo. To do so would mortgage the future of younger Europeans, who would pay the price of present-day political inaction. But even apart from the issue of generational equity, the current system is not sustainable. The days when workers stayed in the same job or with the same firm until retirement (which might begin at age 55) have gone. The world today is radically different from the postwar period, when the cornerstones of Europe’s present economic and social institutions were laid. It is not just the impact of technology. It is not just the impact of trade, globalization, and the new countries entering the European Union. It is not just shifts in consumer tastes or in demographics. Rather, it is the combination of all of these. These forces inevitably will affect Europe—indeed, they have already. Europe must not only respond positively to future forces of change, but also reverse some of the adverse trends that started in the 1970s.

The book’s purpose is twofold. First, it presents an analysis of economic performance in Britain, France, Germany, and—to a lesser extent—Italy. We examine how these large European economies reached their current situations and the challenges they face going forward. In addition, the book reviews labor-market developments in Denmark, the Netherlands, and Sweden to evaluate the success of their reform efforts and see what lessons they can provide to the efforts now under way in France and Germany.² The book also analyzes the policies of the European Central Bank (ECB) and the impact of the Stability and Growth Pact (SGP), and offers recommendations for their continued role in solving the economic challenges facing the region.

2. Britain’s economic situation is somewhat different, while Italy has not yet undertaken a major social reform effort.

Second, the book builds on this analysis to suggest specific policies that—if adopted—would increase the core European economies’ rates of productivity growth and job creation. Improved performance in these areas is the key to improving living standards, meeting the future demographic challenge of the retiring baby boom generation, and—crucially—mitigating the social exclusion that occurs with persistently high levels of unemployment and underemployment.

The most important theme of this book is that workers, companies, and policy-makers must be able to adapt to change. This idea has not been accepted on either side of the Atlantic and fighting against it causes many economic battles and policy distortions.³ As important as it is to enact new reform policies in Europe, it is even more important to alter workers’ view of the economy and to articulate their role in it—and consequently their own—prosperity.

Structurally, the book sets out the factual analysis first and follows up with policy recommendations. However, this first chapter jumps the gun by providing an overview of the main policy proposals. The reason for this is obvious, but there are two dangers involved. The first danger is that the policy proposals and the priorities placed on them as presented will stand alone since the later chapters provide analysis and support. We ameliorate this problem by giving summaries of why the proposed policies are important.

The second danger occurs because many of the specific reforms proposed are designed to improve the economic incentives facing individuals and companies—we are suggesting market-oriented reforms. Since a main purpose of this book is to contribute to the policy debate in Europe, it would be unfortunate if its findings were dismissed because of a belief that they simply suggest that Europe become more like the United States. We fully understand the antipathy of Europeans toward self-congratulatory US commentators who preach the virtues of the free market while conveniently ignoring the serious economic problems facing their own country—some of which stem from US policies not following good market principles. While economic and policy problems in the United States are not addressed in this book, we are well aware of them.

At the same time, we are also impatient with European commentators who argue that the region does not face serious economic problems and therefore existing policies are adequate and major new reforms are unnecessary. We also disagree with a variation on this theme that says that Germany is the *only* economy in Europe with problems. The European

3. The 2004 US presidential campaign is influenced by fears of offshoring US jobs. In Germany, Chancellor Schröder has described any company that moves jobs offshore as unpatriotic, which is something of an irony since the country has run a large trade surplus for years. Many German jobs depend upon the willingness of other countries to offshore their jobs.

economies are diverse, and we acknowledge that some of these economies are performing very well. However, a number of European economies—notably the four largest—clearly need to sustain existing reforms and enact additional economic reforms.

The title of this book, *Transforming the European Economy*, is actually a modification of a landmark statement made at the 2000 Lisbon Council meeting where European leaders called for a “radical transformation of the European economy.” They also argued that “an average economic growth rate of around 3 percent should be a realistic prospect for the coming years. . . .” Subsequent meetings set ambitious targets for increasing employment: Over 20 million jobs would be created in the European Union by 2010.⁴ However, these goals should be reached while preserving an effective social safety net and sustaining the region’s environment and historical legacy.

The reform proposals in this book are intended to help national policymakers and EU-level policymakers figure out how to reach the goals they have set for themselves.

The Need for Sustained Economic Reform in Europe

For most of the postwar period, Europe outpaced the United States and caught up to the US level of labor productivity (output per hour worked). After experiencing an economic slowdown in 2002–03, Europe is expected to make at least a modest recovery in 2004.⁵ But reform is needed if Europe is to return to full employment and to achieve its maximum growth rate, given the pace of worldwide advances in technology and business practices. European policymakers should use neither concerns about social inclusion nor the environment as an excuse for inaction. Furthermore, they should not protect special interests at the expense of those who could be employed in a more flexible economy. Welfare systems and labor laws must provide the right incentives to Europeans to participate in the economy and not divide the population into two groups: the well-protected *insiders* who have jobs and an unsustainably large number of *outsiders* who do not.

4. See Presidency Conclusions, Lisbon European Council, March 23–24, 2000, <http://ue.eu.int/Newsroom/LoadDoc.asp?BID=76&DID=60917&from=&LANG=1>. See also European Commission (2002e, 1–3). Many additional targets for specific policy areas have since been set at the biannual European Council Summits. For an overview, see the European Commission’s Lisbon Agenda Web site, www.europa.eu.int/comm/lisbon_strategy/index_en.html.

5. Although Europe did not experience the same level of job loss after 2000 that occurred in the United States, the region did suffer a significant slowdown. Hours worked per capita are down in all the major economies. To the extent that the number of jobs has increased, this is mostly from part-time work or increased job sharing.

Germany today seems to be the most troubled of the four large European economies, with unemployment around 10 percent as of mid-2004. Real GDP growth in Germany was only 1.4 percent a year over the 1993 to 2003 period. The German economy has gone from being the leader and driver of European growth to its laggard. France's real GDP growth was somewhat faster than Germany's at 2 percent a year over the same period, but its unemployment rate was also around 10 percent in 2004. In fact, unemployment in France has been chronically high for decades. Italy, at 1.5 percent per year, saw growth almost as low as Germany's from 1993 to 2003 and continues to face arguably the worst demographics of any European country—an unemployment rate close to 10 percent and a government debt to GDP ratio of more than 100 percent. In contrast, Britain's GDP growth was pretty strong from 1993 to 2003, at 2.8 percent a year, and its unemployment rate is around 5 percent. However, this follows many years of very poor performance, and even today, Britain's level of productivity is well below that of the other large European economies and of the United States and shows little sign so far of closing the gap. Despite their differences, Britain, France, Germany, and Italy all have GDP per capita of about the same level, equal to roughly three-quarters of the US figure.

On the productivity issue specifically, it seems that productivity *growth* has slowed in the large European economies in recent years.⁶ This is in contrast not only to the United States, but also to Australia and some of the smaller European economies. If the large European economies could increase their rate of productivity growth they could raise their living standards, lower unemployment, and go part way toward meeting the needs of the retiring baby boomers. *Thus, the goal for Europe is to combine high and rising productivity with full employment.*

Europeans who resist economic reform argue that they are quite willing to trade off higher incomes for greater social equity, but this argument does not justify resistance to reform. First, providing greater employment opportunities is a vital part of an egalitarian society. Second, Europe could achieve many of the same social goals while improving economic incentives and economic performance. Social insurance in Europe could be redesigned to cause fewer perverse incentives for a given level of social protection. The current system in major European countries is fatal for employment. Wage rates for low-skilled workers are inflexible. Payroll taxes are very high and inflate company employment costs (along with other employer mandates). Benefit levels paid to the unemployed and to many others on a variety of social welfare programs are kept high relative to after-tax wages and are paid for prolonged periods. This system discourages employers from hiring and workers from taking jobs.

6. Germany is a special case because of reunification. Reunification caused a large one-time drop in average productivity as East Germany was absorbed into the total. Then growth was boosted as East Germany was modernized. We discuss Germany further in chapter 2.

In fact, the case for reform is stronger even than the above discussion suggests. Europe does not have the luxury of running in place. Inextricably linked to the global economy, Europe is facing large new challenges as rapid technological change continues, countries such as China and India emerge as new competitors in the world market, and Eastern European nations enter the union. We have already mentioned the impending internal challenge from the large aging population.

Europe's economic performance has deteriorated over time because the institutions and policies that were effective in the postwar period of rebuilding and catch-up have become increasingly dysfunctional. The key to economic growth in high-income economies is adaptability and flexibility. Only flexible economies are able to adapt to internal shifts, global developments from beyond their borders, and new technological advances, while generating productivity growth and the new jobs required to achieve true social cohesion.

Reform Progress to Date

Europe's political leaders not only embraced reform in Lisbon in 2000, they have also undertaken specific reform policies, a number of which are important moves in the right direction. Overall progress on reaching the Lisbon goals, however, has been limited. In its own recent review, the European Commission (2004c, 2) noted the following: "Indeed, in certain domains there are significant problems which hold back the entire strategy and which hinder the return of strong growth. What is more, the most important delays have been identified in three strategic domains, which are crucial for growth: knowledge and networks, industrial and service sector competitiveness, and active ageing."

Following the Council meeting in Brussels in March 2004 the leaders issued a statement that acknowledged the validity of the Commission's concerns about the reform agenda's slow progress. However, one of their proposed solutions was to convene yet another study of the situation—a very weak response.

This is particularly frustrating since the European Commission report also highlights the diversity within Europe. Some member states have already achieved many of the 2010 goals, while others have barely begun.⁷ "Catch-up" economies, such as Ireland and Spain, have achieved very rapid growth. Some of the smaller European countries, such as the Netherlands, Denmark, and Sweden, have performed well in recent years, even though they were already above the European income average. These three countries have achieved high employment rates and high degrees of social

7. See European Commission (2003a) for a detailed progress report as of spring 2003.

insurance, and safeguarded the future with sustainable pension systems already in place. As we will show, much progress would be achieved if European countries would learn from each other's policy successes. After all, *European solutions have already been found to many of Europe's problems.*

A Framework for Transforming the European Economy

This section summarizes the specific reform measures that we believe would be most effective in improving employment and productivity growth in Europe—the top priorities for reform. We then point to some policy reforms that have been proposed but in our view are less important or in some cases even counterproductive. One of the common misconceptions in Europe—particularly in Germany—is that the labor market is the only problem. We find that both product- and labor-market reforms are important. We start by highlighting the top three policies to improve productivity and the top three policies to improve labor-market performance, before going into the complete reform framework.

Top Three Policy Priorities for Productivity. First, reform land use policies to give decision makers greater incentives to favor economic development. Second, because European manufacturing is not fully open to global competition, the remaining trade barriers must be eliminated. Third, complete the task of service-sector liberalization and privatization that has already yielded substantial successes.

Top Three Policy Priorities for Increasing Employment. First, sharply reduce the legal and financial barriers that prevent companies from restructuring and discourage new hiring. Second, reform social welfare policies by encouraging people to work instead of encouraging them not to work. Cut back automatic benefits, and either start a wage insurance program or institute the close monitoring of individual social benefit recipients (as occurs in Denmark). Third, facilitate a widening of the distribution of wages paid by employers while preserving social equity through other policies.

Policies to Improve Productivity

To achieve better productivity performance, the level of competitive intensity must be increased. This involves greater openness to global competition, domestic (country-by-country) regulatory reform, and completing the process of privatization and liberalization.

Undertake a comprehensive review of regulations and industrial policies with the goals of increasing competitive intensity and removing barriers to productivity increase. Regulation is a fact of life, whether it involves ensuring transparency to protect the interests of shareholders, or whether it involves implementing health and safety regulation to protect workers and consumers, or whether it involves using a central bank to protect the financial system. However, regulation has become counterproductive in Europe, because it has been taken over by vested interests—regulatory capture. It is not possible here to examine each industry in each country and list all the specific regulations that are hurting productivity. But five examples are provided to illustrate different facets of the regulatory problem and the ways in which regulatory reform should be undertaken. Independent competition agencies in each country (like Britain’s Office of Fair Trading) should be charged with identifying barriers in all industries. This is not currently part of the mandate of the EU competition authority, nor should it be. Since competitive problems inevitably will be country-specific, such assessments are best carried out at the member-state level.

- *Land use policies must be reformed.* Economies cannot change and restructure unless there is flexibility of land use. Restrictive land use policies have discouraged new competitors from entering local markets in retailing, housing construction, hotels, and other industries. These restrictive land use policies thus discourage new companies and new job creation. Zoning is important and can be used appropriately to preserve historical values and the environment. In practice, however, zoning authorities have been captured by local interests, and zoning regulations have been used to protect incumbent companies. Zoning laws and the authorities that enforce them should be reformed so that incentives are better balanced—for example, by ensuring that local entities deciding zoning issues benefit from the new business taxes. The economic development benefits to the society as a whole must weigh more heavily in land use decisions, and these benefits should be reflected in the incentives faced by decision makers.
- *European governments should end the practice of using overt or implicit subsidies to keep low-productivity incumbents operating.* In Britain, despite then-Prime Minister Margaret Thatcher’s free-market rhetoric, large subsidies were paid to sustain low-productivity auto plants. The French government routinely provides financial support to failing companies. In Germany, subsidized funding is provided to many industries, especially manufacturing, construction, and coal. Although EU regulations ostensibly ended these subsidies, they continue. Allowing *companies* to fail is an important part of encouraging *economies* to succeed.

- *European governments should avoid policies currently being proposed to develop European champions* (related to previous point). The proposed policies are unnecessary because multinational companies headquartered in Europe are already doing well in the global economy. Michelin, Royal Dutch/Shell Group, Olivetti Tecnost SpA, Unilever, STMicroelectronics, Siemens AG, Benetton Group SpA, SAP AG, BMW Group, British and French hotel chains, and many other examples indicate that Europe already has companies with a global presence. Proposals to develop European champions are simply an excuse to continue subsidies to weak companies or to protect local companies from takeovers that could raise their efficiency, scale, and productivity.
- *Narrow, industry-specific regulations that limit competition are common and should be eliminated.* These regulations often have a long-established history and stay under the radar screen of competition policy. For example, German localities regulate the water used in beer production—in the name of purity and the environment. In reality, this regulation protects small local brewers from large multinational brewers that would otherwise take over the market. This is a small industry, but “trivial” policies like these, when replicated over and over, become an important barrier to change.
- *Administrative procedures and regulations should be reformed to encourage new business formation and expansion.* The Organization for Economic Cooperation and Development (OECD) has identified a set of regulatory barriers that discourage the formation and expansion of new firms and productivity increases in existing firms (Nicoletti and Scarpetta 2003). We strongly support their view that the permissions and paperwork required to operate new businesses or change existing ones should be streamlined and many restrictive provisions eliminated. The OECD has shown a positive correlation between low regulatory barriers of this type and productivity performance. A recent World Bank/International Monetary Fund study supports the same idea, showing how entry regulations hamper new firm formation and slow productivity increase (Klapper, Laeven, and Rajan 2004).

Open European manufacturing to global competition. There is a mistaken view in Europe that the manufacturing sector today is fully competitive, but this is not the case. Eliminating trade barriers *within* Europe increased competitive intensity in the 1990s, resulted in a convergence of prices among European countries, and contributed to improved productivity. For example, the French auto industry restructured and sharply increased its productivity as it faced full competition with the German industry. But Europe should go further and eliminate its remaining tariff and nontariff barriers with the rest of the world.

The need to increase competitive intensity in manufacturing is clearly demonstrated by three forms of evidence: (1) Industry case studies have documented the impact of trade barriers on manufacturing productivity in specific industries (see chapter 2). (2) A study of OECD-wide manufactured-goods prices showed that prices are at least 20 percent higher in Europe than those that would prevail with fully open trade.⁸ (3) An Institute for International Economics study by French economist Patrick Messerlin (2001) documents the existence of widespread tariff and non-tariff trade barriers in the European Union. For example, why is there a 10 percent tariff on imported automobiles when Europe is a major exporter in this industry? Messerlin estimates that eliminating existing and identifiable trade barriers in manufacturing, services, and agriculture would add 6 to 7 percent to EU GDP.

The European Union should act on these findings. At present, both EU and US trade authorities have become so caught up with jockeying for position in trade negotiations that they have forgotten that increased openness of their own markets would benefit their economies.

Complete the task of service-sector liberalization and privatization since it has produced positive results so far. The European Union made a commitment to privatize state-owned monopolies and open up Europe-wide competition in services and manufacturing. That policy has resulted in great successes. The road freight industry is becoming pan-European and increasing productivity through greater utilization of its truck fleet and by facilitating long-haul routes throughout Europe. The mobile phone industry in France was introduced as a private, competitive industry (in contrast to the fixed-line system under France Telecom), with sufficient consolidation to allow operation at efficient scale. Labor productivity in the French mobile phone industry in 2000 was twice that of the US industry. The efforts to increase competitive pressure in all service sectors, and in services of general economic interest⁹ in particular, must continue despite arguments that preserving cultural traditions necessitates restrictive policies.

The financial-services industry is particularly important, not only because of its size, but also because it plays an important role in allocating capital. Despite EU efforts to develop a pan-European industry, separate national banking systems are currently preserved by member-state regulations. Unsurprisingly, comfortable oligopolies are common in this sec-

8. See chapter 2 for a discussion of the work by Bradford and Lawrence (2004). Corroborating evidence for their conclusion that manufactured-goods prices are high in Europe can be found in the OECD (2001c) study of the new economy. For example, the OECD reports that computer hardware prices are about 20 percent higher in Europe than in the United States.

9. This refers to economic services, the provision of which can be considered in the general economic interest, for example, postal and telephone services.

tor. Now that the euro and the ECB are firmly established, there is no reason to restrict bank takeovers or prevent the creation of a EU-wide financial-services industry subject to common eurowide regulation.¹⁰ To date, the cost of establishing new retail branch networks creates a prohibitive barrier to entry in this industry. Therefore, it is important to allow or even facilitate mergers and acquisitions in order to develop a competitive European banking industry.

The European Union must move rapidly toward the creation of a unified European standard of professional qualifications. The inability of professional technical personnel to practice outside their national borders is a major barrier to service-sector competition overall.

Improve the market for corporate control by eliminating barriers to mergers and acquisitions. On balance, product-market competition and labor-market flexibility are the most potent tools to encourage companies to innovate, restructure, and improve their productivity. But an active market for corporate control can provide a valuable additional mechanism for increasing competitive intensity. In principle, EU rules encourage the development of a market for corporate control, but in practice many governments have opposed this development and used various tactics to discourage it. German policy is particularly a problem in this area, notably its pivotal role in blocking the original European Commission Takeover Directive in its attempt to protect, among others, Volkswagen from possible takeover. Proposals in France to create national and European champions also suggest limiting takeovers by multinationals from non-European and even other regional countries.

Policies to Increase Work Incentives and Labor-Market Flexibility

One of the reasons that it is difficult politically to actually implement many of the policies described above—even though in several cases they have been among the goals of the European Union for some time—is that restructuring and productivity increase will generate layoffs that could temporarily increase unemployment. In this book, we will argue that rapid productivity growth is good for employment over the long run, but it may involve employment costs in the short run. It is essential, therefore, that policies to encourage employment be a priority for European reform.

In fact, labor-market reform has been a priority of ongoing reform efforts, and important positive steps have been taken in several European economies. Indeed, we argue in chapter 5 that three smaller European

10. Anyone familiar with the inefficiencies arising from the still largely state-regulated and paper check-based US retail banking system will recognize the dangers of maintaining multiple jurisdictions within the same monetary zone.

economies have succeeded in raising employment and lowering unemployment through major programs of reform since the 1980s. Our proposals for labor-market reform in some instances simply support the steps that have already been taken. But some of our proposals go beyond any previous reform plans—at least in the major continental European countries.

The key theme of reform is that the labor market must facilitate and encourage change and job mobility while preserving, as far as possible, the traditional income protections offered in European economies. It is not easy to combine these two attributes, and important trade-offs have to be faced. But, we argue, Europe could achieve a much better point on its equity and efficiency trade-off than the one it is currently on.

Current legal and regulatory barriers to hiring and firing should be sharply reduced. Companies should be required to provide compensation for laid-off workers, but only at a moderate and predictable level.

European companies are unable to restructure their companies to remain competitive because of internal redeployment and layoff restrictions. Small and large companies alike are reluctant to hire because if the business expansion fails they cannot lay off the extra workers they have employed. In many European economies, layoffs and redeployments are subject to review by regulatory authorities or by the courts. Restrictive rules in many EU economies are not consistent with a flexible labor market and are not consistent with the need to adapt to the forces driving markets everywhere.

Companies should be held liable for fair and reasonable separation payments for workers who have been with the same company for an extended period of time. However, this compensation should not be large enough to discourage structural adjustment. Although many economists have supported the policy described above for some time, policymakers in France, Germany, and Italy have so far shown little willingness to embrace this vital policy change.

The duration of automatic benefits given to the unemployed or non-employed should be sharply cut back. But these cutbacks should be combined with programs to facilitate the return to work.

It has been firmly established by economic research that giving unemployment insurance (UI) benefits for an indefinite period encourages long-term unemployment. Several countries in Europe have set or are proposing time limits on the receipt of UI benefits. For example, such limits are part of Germany's Chancellor Gerhard Schröder's Agenda 2010 reform plan, as well as the recent overhaul of France's UNEDIC unemployment insurance plan. But it is not enough to simply cut the duration of benefits. Such a change must be accompanied by one of two additional approaches, or some combination of the two.

- *Close monitoring of individual workers.* Denmark successfully implemented this approach. Labor-market agencies monitor the actions of the unemployed. Benefit recipients are required to develop action plans for a return to work, and they are offered retraining for new jobs. The unemployed are expected to relocate in order to accept a job that opens up in a different place. They are also required to participate in work crews that perform fairly menial tasks, such as cleanup, if they cannot be placed in a regular job. The sanction for not following these requirements is an immediate loss of benefits. Although very expensive, this program has successfully increased employment in Denmark. The Danish model is effective and is part of the European tradition of helping workers find new jobs and ensuring they have the needed skills—a “third-way” solution. It is rather heavy-handed (as it needs to be for effectiveness), and it may be difficult to administer in large, diverse economies.
- *Wage insurance.*¹¹ Under this plan, workers who lose their jobs would receive automatic UI benefits for only a short period. But they would then be offered a wage supplement if they returned to work at a job that paid a lower wage than their previous job. For example, for two years, a displaced worker accepts a job paying 30 percent less than his or her old job; the worker would then receive a wage supplement equal to 15 percent of the previous wage—enough to close half of the wage loss. The specific parameters of the program could vary, but the crucial argument is that it is better to pay people to work than to pay them to not work. Such a program could also be much cheaper than the cost of indefinite UI benefits.
- *Combine elements of both approaches.* A program that offered wage insurance combined with access to job placement and training services could provide the best of both approaches.

The financial incentive to work must be improved. The previous bullet point described one policy lever to achieve this goal—limiting the duration of UI benefits. But there are other policies that must be adjusted as well.

- *The eligibility and duration of benefits for alternative transfer programs must be controlled.* The Netherlands and Sweden followed policies that were somewhat similar to those in Denmark, and they also succeeded in

11. Robert Lawrence and Lori Kletzer of the Institute for International Economics, with Robert Litan of the Brookings Institution, have been involved in the development of such a program for the United States. See Lawrence and Litan (1986) and Kletzer and Litan (2001). Germany has added a small wage insurance plan to its recent labor reform program. This is an encouraging development, but the plan is very limited at present.

raising employment. However, the availability of early retirement benefits (see further discussion to follow) as well as sickness and disability benefits provided alternative financial support for those not working. Maintaining a humane system for the sick and disabled while avoiding program abuse or overuse is very difficult. Both the Netherlands and Sweden have recognized the problem they face and have tightened eligibility restrictions, but they still face some obstacles. There is a distinct danger that as Germany cuts the duration of its UI benefits, it will end up with increases in the number of persons on alternative income-support programs.¹² As with changes in the UI system, welfare reform should be accompanied by measures to help people get back to work (see next point).

- *Work incentives should be increased by cutting tax rates on low- and middle-wage workers.* In many European economies (and in the United States) low- and middle-wage workers face very high marginal-tax rates¹³ that materially affect their decisions to participate in the labor force. Payroll taxes are generally the biggest problem, and since workers do not pay the taxes directly it is often and incorrectly assumed that they do not affect the decision to enter the workforce. In France, Germany, and Italy the “tax wedge,” reflecting the difference between what employers pay and what workers receive, is around 50 percent for the median worker. Marginal-tax rates can be cut by a general reduction in payroll tax rates (which will necessarily involve cutting the benefits they finance), or such taxes can be made more progressive (as has been done in France). Another option is to offer offsetting financial payments to low-wage workers (negative taxes such as the Working Families Tax Credit in Britain or the Earned Income Tax Credit in the United States). Any of these approaches can be effective—and have been effective when undertaken.

The wage-setting process should be reformed to allow a wider distribution of before-tax wage rates. It is not enough to provide individuals with incentives to work. There also have to be incentives for employers to hire. Wages in many European economies are set to benefit the fortunate “insiders” who have jobs and seniority, while excluding the “outsiders” who remain unemployed or out of the labor force. Wages are set by unions whose bargaining power is enhanced by the regulatory and legal restrictions that reinforce the monopoly power of the incumbent workers

12. The proposal in the German Agenda 2010 to reorganize the Federal Employment Service (renamed the Federal Labor Agency) and combine unemployment and social-welfare benefits for eligible unemployed into the new “Basic Income for Job Seekers” (*Grundsicherung für Arbeitsuchende*) indicates an attempt to address such concerns.

13. A high marginal-tax rate means that workers keep only a small fraction of any increase in income they achieve by taking a job or working longer hours.

and firms. Minimum-wage rates set legally or by agreement are set at levels that make it difficult to achieve the wider wage distribution that would facilitate job creation. Union contract wages are often extended to almost all workers in an industry, reducing the flexibility of the labor market. In the past, many employers preferred the labor-market stability that centralized wage setting brought, but increased competitive pressure necessitates an increased ability to adapt locally to market developments, including wages. The insider-outsider structure of the labor market has been studied for many years, but policymakers in most economies have not been willing to take on the issue. There are two complementary approaches that could be followed to reform wage setting.

- *The rules that encourage or facilitate nationwide bargaining could be modified to encourage wages that are set by local considerations.* Employers that are not party to a major contract negotiation should be free to work out their own deals with their employees and not be constrained by a national contract. Such a step would introduce much greater competition to the labor market itself. Minimum-wage rates should be kept at moderate levels.
- *The steps that were described earlier to increase product-market competition should be implemented. These steps would not only raise productivity, they would also increase wage and labor-market flexibility.* In order to drive product-market competition down to the labor market, it is essential to avoid subsidizing companies that are in danger of bankruptcy. Businesses in Europe argue that they cannot face full global competition, because they are restricted by wage setting and layoffs. This argument should be rejected. Rather, force businesses to take on competition, and they will make the necessary changes on the labor side.

Ideally both of these strategies should be followed. The ability of policymakers to take on entrenched labor-market institutions depends on the strength of their political base and their willingness to face at least temporary unpopularity, manifested by public demonstrations and strikes.

Note that an increase in the before-tax wage distribution does not imply that family incomes must be grossly unequal. A progressive tax system, combined with social support for health care, will mitigate the effect of greater wage inequality. Of course there are limits on the extent to which this can be achieved without eroding incentives, but as we have described above, *some tax provisions can increase equality even as they increase work incentives*—such as wage subsidies, earned income tax credits, or wage insurance. To reiterate an earlier point, the issue of overall equality in a society depends not only on the distribution of wages but also on the availability of jobs. If the wage distribution becomes less equal, but more people can get jobs, then overall inequality will likely have been reduced in the society.

Pension and healthcare reform are essential in order to avoid further erosion of work incentives. By 2030 it is predicted that there will be one worker for each retiree in Italy and about 1.3 workers for each retiree in Germany. Given the pension and healthcare burdens this will involve, and the taxes needed to finance these burdens, there is a danger that work incentives will be sharply reduced even from today's levels.¹⁴ There is wide diversity among European economies as to the severity of their pension problems, so generalizations are difficult, but two principles apply to many economies.

- *The age for normal retirement should be increased.* People are living longer and that means that, on average, there is an increase in the number of years during which they could be active participants in the labor market. However, rather than extending the period of employment, the age of retirement has declined in Europe. This trend should be reversed by raising the age at which full pension benefits are received. Access to various early retirement plans, which lowers the effective age of withdrawal from the labor market, should be restricted to people physically unable to continue working. Government-supported early retirement plans should not be available to the general public without a significant financial penalty relative to a full pension at the statutory retirement age.
- *Growth in the level of government-provided pension benefits should be reduced and fully funded private pension plans encouraged.* Using a gradual process, the real level of state-funded pension payments should be reduced. Unless pension levels are controlled in many European countries they will impose an unfair burden on future taxpayers as the number of retirees increases.¹⁵ It is good policy for government to provide a minimum level of pension support because many individuals, especially those with low levels of income and education, will not save voluntarily for retirement. But beyond that basic level, people should be expected to save for themselves. Government can facilitate private pension plans by ensuring that saving vehicles offering good risk and return combinations are readily available. For much of the postwar period, private financial assets held by European savers (mostly in the form of low-interest savings accounts) earned a negative real rate of return (McKinsey Global Institute 1994).

14. The United States faces a similar challenge. Its social security retirement problem is serious but soluble. However, if Medicare costs per enrollee were to continue to rise at the same rate as in the past 30 years, they would reach 18 percent of GDP by 2050 according to the Congressional Budget Office. See chapter 2 for a discussion of these issues and sources of data.

15. Not all European economies face the same challenge. The Netherlands has a solvent well-funded pension plan.

- *When restructuring overstaffed companies the emphasis should be on finding new jobs for displaced workers. Strict limits should be placed on subsidized early retirement programs.* We noted earlier that the French auto industry had restructured and raised productivity. The gain to society from this was limited, however, because many of the displaced workers were put on early retirement. The Renault plant in Vilvoorde, Belgium was closed, releasing about 4,000 workers, of which about 1,000 took early retirement. These workers were as young as 48. Policies to encourage reemployment have already been described.
- *Continue with the steps already introduced to limit the growth of health costs.* In many ways the European economies are better positioned than the United States to deal with the exploding healthcare costs of the baby boom generation because they already work actively to control prices. In addition, steps have been introduced to increase copayments and require individuals to bear the cost of nonessential treatments. These should be continued and extended.

Healthcare payment provisions ought to impact retirement decisions. Individuals, as they decide whether or not to retire, should take into account the funds they will need to pay their share of healthcare costs after retirement.

- *The cost of health care could be reduced by placing the right economic incentives on providers—doctors and hospitals.* One disadvantage of having heavily regulated and controlled healthcare systems is that healthcare provider incentives are often not aligned with efficient service provision.¹⁶ For example, doctors and hospitals in Germany have an incentive to keep patients too long. Healthcare providers within individual countries generally believe that treatment protocols are determined by best medical practice and not by financial incentives. This is incorrect. Protocols vary widely by country in ways that reflect economic factors, so that improving incentives can reduce costs without significant adverse effects on health outcomes. In fact, sometimes outcomes are actually improved.¹⁷

Pension and healthcare reforms are already part of Europe's ongoing reform agenda. Under tremendous budget pressure, many countries have made cutbacks, and most politicians are aware of the impending problems from the retiring baby boom generation. Given the unpopularity of

16. In a more market-oriented system such as the US system, there are different inefficiencies, such as heavy administrative costs.

17. Chapter 5 discusses this issue further. Remaining bedridden for an extended period can slow recovery from illness. In addition, hospitals are dangerous places where infections are passed among patients. Releasing patients from hospitals sooner could improve their health.

these reforms, however, and the short time horizon of many politicians, it may be hard to keep the reform effort moving forward in these areas. To acquiesce to short-term political pressures would be a costly mistake, because the problems will only get worse with time.

Policies to Improve Macroeconomic Conditions

Even the most successful program of structural reform in Europe will not generate growth if the macroeconomic conditions are not right. Weakness in aggregate demand can ruin any economic party. The SGP, which was intended to provide a framework for long-term fiscal stability, now seems to be in shambles. France and Germany have said they will not abide by, at least, the letter of the SGP rules. The European Council has refrained from imposing sanctions, and its decision has been upheld by the European Court of Justice. Problems with the SGP suggest that it is in need of reform, but thus far suggested reforms have been ignored.

The ECB is in one important respect a great success. The euro has been launched and after falling against the dollar for some time, it has turned around and is now seen as a solid and established currency. By another metric, however, the ECB has not done so well. Economic growth in the euro area has been weak over the past three years, especially in Germany, its largest economy. The ECB has not moved aggressively enough to stimulate demand, even though inflation has been low, the world economy was weak, and the euro leveled off and then strengthened. In addition, the ECB has not adequately explained its goals and actions to the world at large, resulting in a confused public image. Perhaps this noncommunication is deliberate given that the bank has clearly violated the goals it stated when it was set up.

The discussion of macroeconomic policies is contained in a single chapter in this book—chapter 6—and consists largely of a critique and discussion of the SGP and the ECB. Three policy conclusions about these institutions are worth presenting here.

- The SGP is in urgent need of reform, and the European Council should drive the reform process, preferably as part of the ongoing progression toward a Constitutional Treaty. *The European Commission has proposed reforms, which should be used as the basis for changes in SGP rules. The SGP's enforcement mechanisms should also be strengthened by including progressive penalties for violators, which will signal its commitment to enforcement. However, we also recommend greater short-term flexibility in budget targets to accommodate cyclical downturns.*
- Both European and world economic performance would have been helped by more aggressive ECB countercyclical policies since 2000.

Presumably, the ECB's past efforts were focused on establishing itself as both a credible fighter of inflation and defender of the strength of the euro. Given its success, *in the future the ECB can afford to move more quickly and forcefully to counteract economic weakness in the euro area.* We are confident the ECB will act quickly to counter inflationary pressures if they appear.

- Since the countries joining the euro have given up independent monetary policies, they need alternative forms of adjustment to weather economic shocks that affect only one or a few of the economies. We noted above that fiscal policy provides one such adjustment mechanism, but this is not enough. If the price level in one country gets too high, then there is likely to be prolonged employment and demand weakness in that country before it brings down its price level relative to the rest of the euro area. Adjustments in relative price levels within the euro area would be easier if the overall rate of inflation were not too low. *Either (best option) the ECB should raise its inflation target (currently less than, but close to, 2 percent), or it should (next best option) demonstrate its willingness to tolerate above-target inflation for a period of time to allow member economies to adjust their relative price levels downward as needed.*

Lower-Priority or Counterproductive Policies

There are areas of overlap between the reform proposals given above and the ideas developed in the Lisbon agenda that emerged from the European Council meeting in 2000. This book offers evidence to support the implementation of these reforms and suggests variations on and additions to the Lisbon proposals. Another important issue for reform is prioritization. The Lisbon agenda and subsequent Council statements have proposed policy reforms to stimulate European economic growth that we conclude are not high priority and may actually be counterproductive.

- *Broader tax reform to lower tax rates on high-income taxpayers is a desirable goal but not a top priority for Europe.* If undertaken, however, it should be based on improving incentives rather than providing political payoffs to supporters. In general, we did not find that high taxes on the rich were a key barrier to economic or employment growth in Europe. Britain has a relatively low tax rate on high incomes, but it is the country that suffers the most from a shortage of skillful managerial and technical personnel—except in the financial sector—among the major European economies.

In most countries it is possible to undertake revenue-neutral tax reform that eliminates shelters, exemptions, and loopholes in addition to lowering tax rates for all taxpayers. This is the standard approach

of broadening the base of taxable income while lowering tax rates, and several countries have adopted such measures—the United States in 1986, for example. This type of tax reform would benefit Europe as long as it does not become the centerpiece of policy and distract from overall reform efforts. Beyond revenue-neutral changes, cutting the very high tax rates levied on upper-income taxpayers may become possible in Europe provided stronger growth materializes, transfer payments or other forms of government spending are reduced, and revenue constraints are eased.

The issue of tax harmonization among EU member states is frequently brought forward as a required remedy against “beggar-thy-neighbor” tax policies. In theory, some countries could offer very low tax rates and very low levels of social services to the poor. This would encourage wealthy individuals to move into their country and encourage poor people to move out and be supported by taxpayers in other countries. This danger does not seem a major one, however, as economic migration remains limited within Europe. The greater danger is that tax harmonization will force every country to move its tax rates to the very high levels of some of the economies, which would be counterproductive. Based on the starting point in most European economies, some tax competition would be a positive move.¹⁸

- *Large-scale infrastructure spending is not the way to stimulate economic growth in Europe.* Infrastructure investment seems to be needed in several of the less developed economies of the European Union, including the Eastern European economies, and also Britain, which has neglected its infrastructure. However, none of the industry case studies (even in Britain) found that a lack of infrastructure was a significant barrier to best-practice performance. Increases in government spending—with corresponding tax increases—would likely have adverse effects on private-sector employment and investment. Additional stimulus to aggregate demand in Europe, as needed, should be provided by monetary policy or tax cuts.
- *There is no good case for rapid increases in overall government spending on education and training.* As in the case of infrastructure, with the exception of some less developed economies and of Britain, we did not find the weakness of labor skills to be a barrier to economic growth in Europe. In general, skills in Europe for the bulk of the labor force are as good as or better than in any other economic region. More than likely

18. This should not be seen as an endorsement of policies that extend tax holidays to companies by local governments to lure investment into the area. Frequently, the size of such offers is dictated by political considerations rather than the potential gains from a given project to the local area. For examples of excessive use of incentives to lure investment, see McKinsey Global Institute (2003).

there is a case for improving the way current education expenditures are allocated and managed for all educational levels, although that is not a focus of this book.

- *Major government spending programs intended to encourage greater use of information technology (IT) are not needed.* While we did find that Europe lagged the United States in IT use, the gap was smaller than had been thought at the 2000 Lisbon meeting. Moreover, the collapse of IT spending in the United States since 2000 has signaled the dangers of overinvestment in the sector. There may be facilitating policies that would increase access to communications and computer technologies. But in general, regulations and lack of competitive pressure are the main obstacles to greater use of and benefits from IT in the business sector. Another barrier to IT use is its high equipment cost, which is yet another example of the broader problem of high manufacturing prices noted earlier.

Summarizing the Nature of the Reform Proposals

The reforms proposed in this book are designed to increase flexibility and improve economic incentives—incentives for individuals to work and incentives for companies to operate productively, expand business, and create jobs. Improving incentives for companies generally means increasing the level of competitive intensity they face.

Striking the right balance of incentives for the business sector not only involves encouraging competition, it also involves allowing companies and industries to evolve as technologies and tastes change. It is detrimental to protect a fragmented industry where most of the participants are below minimum efficient scale and are not using the most productive business practices. It is also bad policy to offer subsidized loans to favored companies to keep them operational. As far as possible, competition should be played out on a level playing field where new companies are allowed or encouraged and where both old and new companies are allowed to fail.

Getting the incentives right, however, means recognizing that not all industries are alike. In fact, in some industries it may be difficult or impossible to rely solely on market competition. There are a few industries (or subindustries) where there are natural monopolies, and there are sectors where there is a danger that an unregulated market will create monopolies. Finding the right *degree* of regulation, and finding the *best way* to regulate, therefore, present two of the most important challenges facing any modern economy. But it can be done. It is possible to regulate monopolies in ways that create strong performance incentives. For example, productivity growth in Britain's electricity distribution system has been rapid

even without competition, because regulators put strong downward pressure on prices. Productivity growth in the US telecom industry was also rapid when AT&T had a virtual monopoly. This was not because of the monopoly, it was because the opportunities for productivity increase were large and the regulatory system in place provided an incentive to AT&T to take advantage of those opportunities. In other cases the existence of antitrust policy can be helpful by discouraging predatory practices.¹⁹

Germany and other European economies can overregulate the market (as Japan does) in a way that limits competition and slows change. If European policymakers are serious about reform, they will have to risk hurting established companies and workers as well as possibly making structural unemployment worse in the short run in order to achieve long-term growth. With the right set of macroeconomic and reform policies that risk can be minimized.

If striking the right balance of incentives for individuals were based on a very narrow concept of market efficiency, then people would have to face the full economic consequences of their actions. In many European countries, where people can collect substantial unemployment benefits or welfare payments indefinitely and retirement benefits are largely unrelated to private savings, the link between income and individual responsibility has been severely undermined. The right incentives mean that people are given emergency assistance and covered by insurance against catastrophic loss or injury. The existence of such social protections improves the welfare—improves the market outcome—of everyone in the society in the face of economic uncertainties. But having the right incentives also means that people should face a significant economic penalty when they choose not to work, and they should shoulder some responsibility for protecting themselves against economic setbacks through private savings.

Finding the right trade-off between equity and efficiency is indeed very difficult. However, many European countries have gone too far in the provision of social insurance. This book explores the possibility that if work incentives are too low, an unstable decline in employment could occur. Benefit levels paid to those who are not working are financed primarily by taxes on those who do work. If the benefits are too generous or are provided for too large a segment of the population, then the number of willing workers will decline over time. This will raise the tax burden on those still working and reduce even more the incentive to work. The possibility of such a downward spiral of work effort may help explain the 1970s and 1980s in Europe, but more important is the concern about the future. With the number of retirees rising rapidly and the number of persons of work-

19. According to Crandall and Winston (2003), however, it is hard to find evidence that specific antitrust actions have actually been helpful.

ing age declining, there is a real threat that in some European countries work incentives could erode much more and threaten a gradual collapse of the labor market.

Choosing How Many Hours to Work

There is general consensus that it would be helpful to create greater employment opportunities and thereby reduce unemployment and increase labor force participation. A more controversial idea is that full-time employees should work more hours—either longer hours per week or fewer weeks of vacation. There has been a decline in hours worked per year by full-time employees in Europe, and this can be interpreted as purely a voluntary choice.

We do not believe, however, that Europeans are freely choosing the number of hours they work in a year based on the right economic incentives. First, heavy taxes and high benefit and transfer payments affect individual choices. In particular, health and retirement benefits are not closely linked to income, while the tax burden on additional income is very high—conditions that will incline individuals to work fewer hours. For example, if the government supports college students by using tax revenues, parents of those students have no incentive to work extra hours to pay for tuition. It is not clear that such choices are optimal (or even egalitarian when low- and middle-income workers are taxed to support students from wealthy families).

Second, the number of hours per week and number of weeks per year are generally not determined on an individual basis. Instead, they are negotiated in collective agreements or dictated by policy. It is unlikely that such collective or policy decisions are made in a way that yields the best outcome for the economy overall. Policymakers mistakenly believe that shortening the number of hours per worker will raise total employment. Individuals often mistakenly assume that they can work fewer hours with no loss of real income—shorter hours are presented to them as costless so why not vote in favor of a policy to cut work hours.

Third, life expectancy is steadily increasing. If faced with the true economic consequences of this increase in longevity, individuals would likely combine higher savings with an increase in the number of hours worked. So far, Europeans have not reacted this way. Rather, earlier retirement, lower labor force participation, and lower hours worked per year have been the norm. If individuals were to face the right incentives, we judge they would likely change all three dimensions of their work choices, including choosing somewhat longer hours worked per year.

Fourth, as recently as 1973 workers in the large European economies worked nearly as many hours per year as those in other developed econo-

mies such as Australia, Canada and the United States, whereas by 2003 they were working 300–400 fewer hours.²⁰ This suggests that differences in economic conditions and policies may have induced the divergence in outcomes, rather than a sudden shift in deep-seated European preferences.

We are certainly not recommending policies that will force people to work longer hours per week or per year. But we do recommend that people be given the option of working longer hours. We oppose mandating shorter hours for everyone, whether through policy or collective agreements. In addition, we believe that policies that distort incentives in ways that shorten work hours, relative to optimal individual choices, impose significant costs that should be weighed against their benefits.

The Literature

There is an extensive library of literature dating back over 20 years advocating European economic reform, and many of the themes presented in this book exist in this earlier literature. The 1980s literature on “Eurosclerosis” and the barriers to European growth presented many of the relevant issues for reform.²¹ However, there is substantive new material in this book that goes beyond prior literature. It is based on our own analysis as well as on a range of studies since the 1980s. We have tried to present a comprehensive analysis of the economic issues facing Europe, building on facts and supported by aggregate, economywide data and detailed case studies of individual industries.²²

There have been major developments in productivity in recent years with faster growth evident in the United States and a few other countries. Most of Europe, however, seems to have missed the revival of productivity. Understanding what drives productivity improvement—including the role of IT—is an important task and an important element in any reforms intended to increase long-run growth in Europe. This book tries to avoid economic jargon and clearly present the forces that have shaped the European economy, the principles that should support structural reform, and the priorities for reform.²³ This is an ideal time to discuss reforms, be-

20. Data from Groningen Growth and Development Centre and The Conference Board, Total Economy Database, February 2004. www.ggdc.net.

21. For a leading example see Lawrence and Schultze (1987), which also contains many additional references.

22. Most of the industry-level analysis comes from work by the McKinsey Global Institute. Martin Baily is a senior adviser to McKinsey & Company and participated in most of the studies described below.

23. The findings of the Sapir report (2003) contributed to our analysis and are complementary to this effort. A recent study by Bayoumi, Laxton, and Pesenti (2003) strongly supports the benefits of competition in improving economic performance. Olivier Blanchard (2004) takes a relatively optimistic view of the situation in Europe, arguing that reforms already in

cause European policymakers are being forced by the facts to face the need for reform. And based on their public statements, they are committed to developing far-reaching reform programs.

Feasibility of Reform Proposals

This analysis presents the reforms we believe Europe should follow to become more competitive and expand employment. It is an economic analysis rather than a political analysis. If this economic analysis is to be relevant and helpful to the policy debate in Europe, there should be some relation between what is proposed here and what is feasible.

There is a relationship: The policies designed to increase productivity involve expanding trade and competition within Europe and increasing global competition. They involve continued liberalization of sectors previously dominated by state-owned enterprises and the restructuring of industries that have been overprotected. Although these reforms have been part of the policy thrust of the European Union for many years, progress has been limited. Despite setbacks and obstacles, we urge policymakers to keep moving ahead with reform instead of staying motionless or even turning back.

Reform efforts in France and Germany are currently seen as politically unpopular given the losses in French and German regional elections.²⁴ Transforming the European economy will require committed political leaders. Governments in most European countries today enjoy strong parliamentary mandates with time to enact required reforms before a new election cycle. Policymakers should seize this opportunity and not be deterred by the results of regional or local elections or by the actions of protesters.

To be successful, policymakers must “sell” a reform program to the electorate. French and German leaders suffered election setbacks because neither articulated a clear and honest picture of what must be accomplished by reform, the reasons for change, the likely short-term effects, and the large long-run societal payoff. Instead, voters, already discontented by cyclical weakness in their economies, were simply presented with cut-backs in entitlement programs—such as pensions and unemployment insurance—that they believed were safe. The struggle to achieve economic reform will be tough, regardless, but without a clear picture of what is at stake, there is little hope of success.

place, combined with competitive pressure, will make Europe more flexible. For an interesting perspective on reform, also see Baldassarri and Busato (2003). Sinn (2003) looks particularly at Germany’s economic ills and proposes solutions not unlike those in this book.

24. In France, President Chirac’s party, the UMP, suffered losses. Similarly, in Germany, Chancellor Schröder’s party, the SPD, lost in regional elections. Voters are reportedly opposed to the economic reforms these leaders have proposed or enacted.

European policymakers may also balk at the reforms proposed to increase productivity. Incumbents are very involved in maintaining control over land use to protect their position and in retaining other narrow industry-specific regulations that protect them. However, evidence provided in this book demonstrates that when competition is permitted, economies benefit with higher productivity. The evidence to support the productivity-enhancing policies outlined here can be found within Europe as well as from US experience. European policymakers should build on their own success stories.

The same argument also applies to labor-market and social policy reforms. No country has chosen its labor-market and social insurance policies optimally, but an important lesson can be drawn from Denmark, the Netherlands, and Sweden. If major policy reforms are undertaken to increase employment incentives, employment will increase. European policymakers can, therefore, build on Europe's own success stories in this area.

If implemented, the proposed labor-market reforms would represent a significant shift in European policy, since they seek to preserve adequate income protection for displaced workers and include tax reforms to increase the after-tax incomes of low-wage workers. Although these are both market- and incentive-oriented reforms, they also recognize the goal of social cohesion. The dismantling of social welfare is not required.

We have argued that the policy proposals in the book are not modeled on US policies, and we acknowledge that that US policies are far from perfect. To the best of our ability, the analysis in this book is based on economic principles. That said, the US economy has been extraordinarily successful at job creation over the long run, and productivity growth has been strong since the mid-1990s. The US economy is market oriented and provides strong incentives for individuals to work and for companies to be productive. Therefore, it would be foolish, for us as economists or for policymakers in Europe, to ignore the lessons from the US experience if they can help Europe achieve its goals.

On the feasibility of policy reform and its implementation, we would like to draw attention to the forthcoming book on Germany by our Institute colleague Adam Posen. While Posen presents his own perspective on reform priorities, his study of German policy and reform will be very complementary to this analysis.

Chapter Summaries

Chapter summaries are included as a guide to the structure of the book. As chapters 2 through 7 are summarized, there is some inevitable repetition of the themes developed in this first chapter.

Chapter 2 examines Europe's postwar success and subsequent problems. It seeks to answer the key question: If the European economic sys-

tem has severe problems, how did the region grow so strongly for so long? Our answer is that European economic institutions were sufficiently suited to the period of catch-up growth after World War II but are too rigid to succeed or adapt in the current market where flexibility is more important. The European economy had great difficulty adjusting to the effect of declining productivity growth that started in the 1970s, and to the impact of trade and technology on the demand for low-skill workers.

Over most of the postwar period, GDP per hour worked has grown faster in Europe than in the United States. This period of rapid growth shows the tremendous productivity success Europe achieved as it caught up to the US level (Britain is an exception to this statement). However, when productivity slowed this created serious economic difficulties. Not only does such a growth slowdown cause persistent unemployment, it reduces tax revenue growth and thus can lead to budget problems. It lowers real wage growth and weakens profits. It makes it much more difficult to finance the retirement income of pensioners. If Europe could increase its rate of productivity growth, this would ease its transition to a full employment economy and make it much easier to avoid any threat of an unstable employment decline.

Chapter 3 considers how Europe could improve its rate of productivity growth. The key is to increase the intensity of competition in product markets, encourage business and industry restructuring, and adopt regulatory reform to facilitate these. The chapter examines the literature, including a recently completed OECD study (OECD 2003f) of economic growth, and reviews the policy implications of it. In particular, the study found that international competition and globalization spur growth. Another powerful empirical finding is that new start-up companies in the United States are very different from those in Europe. Their employment levels have increased much more. The ability of US companies to experiment in the market is seen as possibly an important reason for stronger job creation in America, while start-up growth in Europe may be hampered by strict employment protection legislation often covering all but the smallest European firms.

Since the issue of IT has been so important to the growth debate, the chapter also explores the role of IT in US and European growth. Looking at comparable business operations across the two regions shows IT use is often quite similar for both. When IT is not used as effectively in Europe as in the United States it is mostly because of the industry structure or other barriers to innovation, rather than because of an intrinsic inability to install IT. IT is one means to achieve faster growth in Europe and does provide an opportunity that Europe should exploit given how it can improve business. But technology policies are often overrated and should not be used as an excuse to avoid more fundamental structural reform.

Europe can draw important lessons from the revival of US productivity growth. The US productivity revival took place in an environment of very

intense competition, with the competition coming from both national and international sources. Therefore, to take advantage of the potential for productivity growth it is essential to allow economic change to take place and for the competitive process to work its way out.

Two major studies carried out by the McKinsey Global Institute used industry case studies and looked at the levels and growth rates of productivity in France and Germany in the 1990s. These studies determined that the nature of regulation in industries had a major effect on their performance. The industries where competition is encouraged generally achieve the best productivity performance. *A good-news story for Europe is that many of the regulatory reforms undertaken so far are working.*

Chapter 4 focuses on Britain. According to the OECD, Britain today has flexibility in both product and labor markets. If our diagnosis of Europe's problems and solutions in chapters 2 and 3 is correct, Britain should have been performing better economically recently than major continental European economies.

Although in some respects Britain has done better than other large European economies over the past few years, its economy continues to suffer from a low level of productivity relative to both other major European countries and the United States.

A review of the literature on British productivity leads us to conclude that some special factors are at play in the British economy. In addition, the particular implementation of privatization and deregulation instituted under Prime Minister Margaret Thatcher (and others) in the 1980s and the early 1990s did not immediately succeed in creating truly competitive markets—the British electricity generation market is a notorious example—and this postponed potential productivity gains. Further, Britain suffers from a relatively low-skilled workforce compared to other European countries, while also not possessing the large cohort of educated managers found in the United States.

Thus there are a variety of factors contributing to continued low relative productivity in Britain. We are optimistic that faster productivity growth will occur in that economy as the benefits of past reforms play out.²⁵ But we see a need for continued efforts to make product markets truly competitive across the board.

Chapter 5 turns to the issue of social policy reform. The first half of the chapter focuses on some guiding principles that such reforms should follow. These include setting time limits on unemployment insurance benefits and welfare; introducing wage insurance as a substitute for current unemployment insurance; ensuring that disability programs do not become the final inactive parking lot of a large share of the population;

25. Just-released new data from the United Kingdom Office of National Statistics (2004) suggest Britain's productivity growth has been faster in the last few years than previously thought.

maintaining universal health insurance but limiting its scope; shifting gradually over time to a system where pension levels are tied to private saving, beyond a minimum payment; making sure that the minimum income support level provides an adequate incentive to work; and tax rebates or negative taxes to improve the income of the working poor.

The second half of chapter 5 looks in detail at the social system, labor market, and tax reforms implemented in three small European countries—the Netherlands, Sweden, and Denmark—in the last 20 years. These three countries already have implemented national social reforms that embody many of the guiding principles laid out in the first half of the chapter, and have supplemented these with extensive active labor-market programs, such as worker training. The experiences of the Netherlands, Sweden, and Denmark should therefore provide important examples for other European countries that social reforms are possible and do work in a European political environment. None of the three dismantled its programs of social insurance. Instead each found ways within its disparate national institutions to improve the incentives to work and enhance economic performance.

Yet, chapter 5 also highlights the pitfalls of social policy reforms; how the Netherlands today may have a very low unemployment rate, but on the other hand has far more disabled people than almost any other country; how Sweden's employee absentee rate from sickness seems unreasonably high and strongly related to the generosity of sickness benefits; and how Denmark faces a huge bill for its active labor-market programs—a cost that does not seem to fall much even when unemployment is low. The examples of the three small European economies show the dangers of piecemeal reform of individual parts of a welfare state. The appendix to chapter 5 lays out the positive effects of social reforms on the significant unobserved economy in Europe.

Chapter 6 examines macroeconomic policies to support growth and reform. As noted earlier, reforms that increase work incentives will not work if there are no jobs available because of a cyclical contraction. The chapter evaluates the SGP and the performance of the ECB. The SGP contains the ingredients for a good deal of mischief. Given that Europe and the rest of the world are only now coming gradually out of a downturn, forcing fiscal contraction on Europe is a bad idea. It requires that EU countries maintain budget deficits below 3 percent of GDP and imposes fines if that target is missed. In practice the SGP has not been politically enforceable and so, as it stands, the SGP is ineffective at its original and desirable goal of requiring reasonable fiscal discipline of all EU member countries. But more fortunately, it also fails in its unintended impact of forcing a fiscal policy on the region at a time when such a policy could exacerbate the business cycle.

Many economists have set out proposals for reform of the SGP and the European Commission has critiqued these and offered its own reforms. We support the Commission's proposals with some important modifications.

The chapter then turns to monetary policy and the ECB. In practice the ECB has not kept inflation below its target and has even eased policy at a time when inflation was higher than this. Also, it did not keep money supply growth close to the target level. The ECB in practice has responded to real variables and not just to inflation or money supply growth.

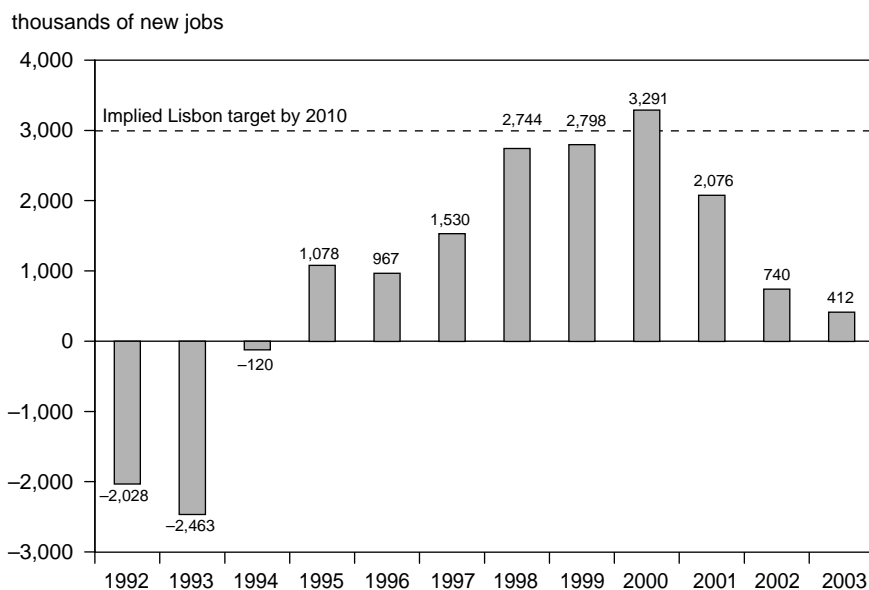
While no one wants to go back to the days of excessive inflation, the world economy does seem to have changed and we have discovered the perils of inflation rates that are either too low or too high. Prices at, and possibly near, deflationary levels create or exacerbate economic problems. The countries that have entered the euro have sacrificed their ability to make independent monetary policy and use the flexibility of exchange rates to respond to country-level economic shocks—adjustments that would have changed the equilibrium exchange rate prior to the euro. Fiscal policy has limited power to offset this problem and Europe has low labor mobility so that migration provides only modest relief. The adjustment of national price and wage levels will have to substitute for the adjustment of exchange rates. This will be much easier to do if it does not require substantial downward adjustments of nominal wages and prices. The ECB should recognize the benefits of modest positive rates of inflation.

Chapter 7 looks at the reform efforts now under way to increase competitive intensity in Europe and make labor markets more flexible. The chapter starts with a description and assessment of competition policy at the EU level. The Commission has responsibility only for companies engaged in cross-border activities, leaving the regulation of many service industries, and even much of manufacturing, still at the national level. Moreover, the Commission does not control many of the regulations that affect competition in practice, such as land use. The conclusion, therefore, is that although there is considerable value in having an EU competition policy, the broad reform agenda in Europe—encompassing social policies and product-market regulations—must be carried out at the national or member-state level. That is where the power resides that can bring about the required change.

Throughout the book there has been discussion of what reform policies should be followed and the extent to which the large economies are on track to carry them out. A summary of recommendations for Britain, France, Germany, and Italy is provided in chapter 7.

The chapter concludes with a discussion of whether reform should be undertaken in one big push or incrementally. The economic case for a big push on reform is clear. Restructuring companies to raise productivity does not improve overall economic performance if alternative jobs are not available, or if workers have no incentive to accept them.

Figure 1.1 EU-15 employment growth 1992–2003 and 2010 Lisbon goals, annual change



Note: Required job growth to reach Lisbon target by 2010: 21.5 million new jobs, or 3.07 million per year.

Source: Eurostat (2004a).

Concluding Remarks

It is clear that progress has been made, but much more is needed. European reforms are not being implemented at the rate that is needed to achieve the Lisbon goals—in fact, the intermediate Lisbon 2005 targets in the area of employment will be missed (European Commission 2004a, 4). Figure 1.1 shows that only in a single year at the peak of the boom in 2000 did the European Union in the past achieve the pace of employment growth that will be required to reach the 2010 goals—namely, 21.5 million additional jobs. But the question remains: Is the reform process on the right track? With some qualifications, the answer is yes. There are now examples of countries within Europe that have instituted social policy reforms and have seen employment rise and productivity increase in response. But there remains much more to do despite the signs of backlash against reform. If this book contributes in any way to sustaining the forward movement of economic reform in Europe, it will have accomplished its purpose.