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Are Current Reform Efforts on the Right Track?

We must be the change we wish to see in the world.

—Mahatma K. Gandhi

A growth-oriented agenda for economic reform was set out in chapter 1, and the economic analysis of this agenda has been the subject of subsequent chapters. This agenda was based on improving work incentives (for employers to create jobs and for workers to accept jobs); increasing competitive intensity in product and labor markets; and providing supportive macroeconomic policy. This book has recognized that stable but expansionary macroeconomic conditions are a prerequisite for growth, and chapter 6 discussed the monetary and fiscal policies and institutional arrangements that would create these conditions. The main focus of the book, however, has been on structural policies to improve incentives and increase competition, and these policies will also be the focus of this concluding chapter. Specifically, we will look at the reform efforts now under way in Europe to increase competitive intensity and make labor markets more flexible.

One of the European Commission's (Commission) main initiatives is to increase competitive intensity by creating a competition authority with the power to enforce EU-wide procompetition laws with companies that engage in cross-border activities in the region. The chapter starts, therefore, with a description and assessment of competition policy at the EU level. Although there is considerable value in having an EU competition policy, we argue that the broad reform agenda in Europe—encompassing social policies and product-market regulations—must be implemented at the national or member-state level since they have the power to bring about change. Throughout the book we have examined a number of reform policies and recommended proposals that should be followed. We have also assessed the extent to which the large European economies are on track to implement these reforms. It is valuable to summarize this information so we recap the highlights of Britain, France, Germany, and Italy in this last chapter. We then look at the issue of whether reform should be undertaken all at once or incrementally, before ending with a short conclusion.

Where Does EU Competition Policy Stand Now and What More Is Needed?

EU competition law is implemented at the EU and the member-state level, with the European Commission enforcing EU legislation and national competition authorities enforcing national laws. The national authorities may also be used to enforce EU regulations where these preempt national legislation.

Competition policy is an area in which developments at the EU level have driven progress at the member-state level. In some cases it has established new national legal frameworks and enforcement institutions where none previously existed—an important and positive effect.

European competition policy can be divided into four distinct areas: mergers and acquisitions, antitrust, liberalization, and state aid.

Mergers and Acquisitions

Since 1990, the European Commission has had exclusive power to approve European mergers and acquisitions of a certain size, removing the requirement for companies to seek approval at several national competition authorities. The exclusive power of the European Commission covers mergers where the aggregate worldwide turnover of all the undertakings concerned is more than €5 billion or where the aggregate EU-wide turnover of each of at least two of the undertakings concerned is more than €250 million—unless each of the undertakings concerned attains more than two-thirds of its aggregate EU-wide turnover within one and the same member state.

Competition policy's focus, therefore, is on large, cross-border mergers and acquisitions, and the first criterion is explicitly extraterritorial, which gives the Commission authority over non-EU companies operating in the European Union. Since 1990, the Commission has been notified of 2,508 mergers and acquisitions cases (as of June 30, 2004), and has cleared about 90 percent of these. Most of the remaining 10 percent of cases have been referred to member-state authorities. The European Commission has blocked a total of only 18 cases to date.[1] However, some of these have been very high-profile cases, for which the European Commission has received significant criticism—especially in the cases of Volvo/Scania (2000), GE/Honeywell (2001), Schneider/Legrand (2001), and Tetra Laval/Sidel (2001). The parties involved in the latter two cases undertook legal proceedings in the European Court of Justice (ECJ) against the European Commission, and in both cases the ECJ subsequently annulled the European Commission's decision and harshly criticized the basis for the Commission's ruling (the GE-Honeywell case still awaits an ECJ decision).

In response to the criticisms of its actions and the legal defeats it has suffered, in December 2002 the Commission made changes in its merger decision-making process. It increased the level of communication with the corporate parties hoping to merge in order to allow due opportunity for them to defend their proposed action. The Commission also increased the "economic foundation" of its decisions by appointing a chief competition economist and an internal Commission peer-review committee for all cases. The Commission also split up the centralized Merger Task Force (MTF) into separate sectoral units to facilitate expeditious review of pending cases.

Antitrust Policy

The European Commission must, under Article 81 (1) in the EU Treaty, act to prevent any agreements or practices that may affect trade *between* member states and that have as their objective or affect the prevention, restriction, or distortion of competition within the common market.[2] EU Treaty Article 82 states that the European Commission should prevent any abuse by one or more companies of a dominant position within the common market (or in a substantial part of the market). Such abuse must be prohibited if it affects trade *between* member states.[3] Thus, the mandate of the EU antitrust policy applies only to cross-border antitrust issues—roughly the equivalent in the United States of rules that apply to companies engaged in interstate commerce. Note, however, that EU Treaty Article 81 is intended to prevent price discrimination agreements within the European

1. So-called Article 8 (3) decisions. The Commission has also approved conditionally—i.e., with particular conditions and/or obligations attached for the parties involved, a little fewer than 200 cases. For specific data, see www.europa.eu.int/comm/competition/mergers/cases/index/#by_decision_type.html.

2. EU Treaty Article 81 (1), available at www.europa.eu.int/comm/competition/legislation/treaties/ec/art81_en.html.

3. EU Treaty Article 82, available at www.europa.eu.int/comm/competition/legislation/treaties/ec/art82_en.html.

Union. Companies cannot legally stop imports of low-price goods or services from one EU country into another EU country where prices are higher.

In May 2004, European companies were freed from their obligation to notify and seek clearance with the Commission for relevant business agreements that they enter into. Obviously, companies must still ensure that their agreements do not violate EU or national competition law, but removing the automatic necessity of notification should ease the administrative hurdle of many particularly smaller European mergers and acquisitions and must therefore be welcomed. It should also free Commission resources to pursue serious competition offenders, rather than process frequently routine filings. To some degree it is testimony to the raised level of knowledge of (though not necessarily adherence to) competition policy issues among European businesses that authorities can now to a greater extent rely on businesses knowing where the red lines are themselves, rather than require them to file a notification no matter what.

On the other hand, the Commission also on May 1, 2004, got increased powers of inspection and the power to intervene against all types of anticompetitive mergers (within its jurisdiction). It can annul any agreement it deems violates EU competition laws (with possible recourse to the ECJ) and fine companies involved in anticompetitive behavior up to 10 percent of global turnover. While the Commission has possessed antitrust powers since 1962, it is only in recent years that significant action has been taken this field. In 2001 and 2002 fines of €1.8 billion and €1 billion were imposed, respectively.[4] In addition, since 2001 the European Commission has taken action against at least three companies—Deutsche Post, Michelin, and DSD—for abuse of a dominant market position. Microsoft was fined €497 million and ordered to unbundle its media player from Windows. Microsoft has appealed the verdict.

Significant sectors of the European economy[5] are partially covered by the so-called block exemptions, which grant immunity for some types of collusion between firms, if they are deemed to improve overall competition through, for instance, improved distribution or technology transfer. As part of the changes in applications of Article 81 on May 1, 2004, older block exemptions were replaced with new regulations. Instead of imposing on companies positively the things they could do (under the old block exemptions), the new rules create a "negative list" of prohibited violations—such as price fixing, market sharing—as well as a safe harbor for all other agreements. According to EU Competition Commissioner Mario Monti, the aim of these reforms to block agreements is to limit market distortions and allow more freedom for businesses to make desired com-

4. Data available at www.europa.eu.int/comm/competition/citizen/cartel_stats.html.

5. Including, for instance, transportation (road, rail, sea, and air), telecommunications, and insurance.

mercial decisions. While it is still early days, we support the intent and direction of these reforms to competition policy.[6]

On balance, European competition policy has strengthened antitrust enforcement in recent years, despite the effective gaps remaining from excluded sectors. At the same time, national authorities have gained a more prominent role as their regulatory capabilities have increased. This development is foreseen to continue after May 1, 2004, with the new European Competition Network (ECN), comprising both the Commission and national authorities in an informal though institutionalized group (informal in that one actor cannot force a decision on another). In part, this reflects increased capabilities among national authorities and healthy decentralization of decision-making authority, but given the political sensitivity of many antitrust cases, attempts at member-state "power grabs" cannot be ruled out. Such attempts, however, must be resisted, as too wide a disparity of competition policy enforcement among entities in a single market—seeking, for instance, to protect national champions—would cause significant market distortions and harm overall levels of competition.

Liberalization of Former Government Monopolies

Traditionally, many European economies had placed large industrial sectors under state-controlled companies, especially industries deemed essential or those with significant economies of scale and high fixed costs—telecommunications and electricity, for example. As a result of changing technologies that allow efficient operation at smaller scale and changing attitudes, there has been a shift toward privatization and competition. The sale of government-owned assets has also been a source of revenue to fill budget gaps.

At the EU level, five Commission directives in the telecommunications, transport, postal services, gas, and electricity sectors were intended to introduce competition by separating infrastructure from commercial activities. These directives have come in part out of the EU's Lisbon agenda.

The efforts to privatize government monopolies and introduce competition have encountered enormous political opposition from member states, especially France. This opposition, in turn, is fueled by fierce resistance by the employees of the state companies, who fear the effect of competition on their jobs, wages, and pensions. Because of this opposition, implementing the directives has been slow, and very long transitional periods have frequently been the result.

A key issue is whether the most important step in liberating government monopolies is privatization or whether it is sufficient to create

6. For Commissioner Monti's full comments and additional information, see European Commission Competition Policy Newsletter, Special Edition May 2004. Available at www.europa.eu.int/comm/competition/publications/cpn/special_edition.pdf.

effective competition for a state-run enterprise. In this regard, EU Treaty Article 86 (2), which covers *Services of General Economic Interest*, is of particular interest. It states that:

> Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in this Treaty, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Community.[7]

In principle this article is intended to make sure that state ownership is not used as a way of limiting competition within the European Union. However, in reality the article has been subject to "political interpretation." Some EU governments, notably the French, have argued that it is necessary to provide essential services to isolated and/or poorer regions of their economies, which requires either continued state ownership or limits on competition for formerly state-owned companies. The French government has argued that companies facing the full competitive pressures of a liberalized European utility service market, for example, would face too few incentives to expand service coverage to such poorer regions. They have called for significant exemptions for former state-owned utilities with respect to EU competition and common market rules.

Currently, the European Commission is drafting new legislation, aimed at clarifying the scope of "services of general economic interest" (see European Commission 2003e). Such legislation was a condition for the French government's acceptance of partial liberalization of the European energy markets at the 2002 Barcelona Summit.

Thus, while significant progress has been made in Europe toward privatization and increased competition, much more needs to be done and political resistance is blocking progress. The specifics of liberalizing state monopolies in the bigger EU countries are discussed later in this chapter.

State Aid

In an effort to create a level playing field for competition, EU Treaty Article 87 prohibits any state aid that distorts competition in the European Union, and tasks the European Commission to enforce this ban. There are exemptions to this ban, however, allowing state aid for small- and medium-sized enterprises (SMEs) and for the provision of training. In addition, the Commission can grant exemptions on a case-by-case basis, provided aid does not adversely affect the "common interest."

7. EU Treaty Article 86 (2), available at europa.eu.int/eur-lex/en/treaties/dat/C_2002325EN.003301.html.

Despite the good intentions of Article 87, state aid sparks frequent debates, and the overall level of state aid remains high in the European Union. The Commission estimated that between 1996–98, the total level of state aid in the European Union was €93 billion, or €250 per capita (European Commission 2000b). The European airline industry has been subject to clashes between the Commission and member states aiding their national flag carriers. Air France, Alitalia, Sabena, and Olympic Airways are examples of companies ordered to repay illegal aid to their national government. However, the stubbornly high overall level of state aid in the European Union illustrates the persistence of this problem to EU competition policy.

Companies that are not meeting the competitive test should either restructure or improve their operations, or they should be taken over or closed down. State aid slows down the process of restructuring that is a vital part of overall productivity improvement.

Hostile Takeovers

The discussion so far has been about European competition policy on mergers and acquisitions and on agreements among companies. These cases focus on preventing the formation of anticompetitive dominant companies or anticompetitive practices by groups of companies. Of course the opposite problem may be of as great or even greater concern. Some industries in Europe have failed to consolidate, leaving a fragmented structure where companies neither achieve minimum efficient scale nor use information technology (IT) effectively. In other cases an entrenched management may be incompetent but they hang on to their jobs because shareholders do not have access to relevant information on company performance, which makes it difficult for them to act. In such situations, the capital market's ability to mount hostile takeovers may be important to improving productivity. Even the threat of such takeovers may be enough to force managers to improve their operations.

Until now the rate of hostile takeovers in the core European economies has been very low. A study by Rossi and Volpin (2003) examines all the mergers and acquisitions announced between January 1, 1990 and December 31, 1999 and completed as of December 31, 2002. The study reports (table 7.1) that the volume of takeovers over this period is pretty high for most of the developed economies but varies across countries. Volume is defined as the percentage of traded firms that are targets of successful mergers or acquisitions over this decade, and the figures include: 65.63 percent for the United States, 53.65 percent for Britain, 56.40 percent for France, and 35.51 percent for Germany. Turning to hostile cross-border takeovers, the differences by country are much greater. The figures are 6.44 percent for the United States, 4.39 percent for Britain, 1.68 percent for

Table 7.1 International mergers and acquisitions by target country (percent)

Country	Volume[a] (percent)	Hostile takeovers[b] (percent)	Cross-border ratio[c] (percent)
Australia	34.09	4.60	27.16
Austria	38.14	1.03	51.55
Belgium	33.33	0.56	45.14
Britain	53.65	4.39	23.46
Canada	30.05	2.73	22.66
Denmark	24.03	0.81	38.26
Finland	45.45	0.91	22.67
France	56.40	1.68	33.81
Germany	35.51	0.30	26.05
Greece	12.66	0.00	23.13
Ireland	28.90	4.62	52.73
Italy	56.40	3.04	36.13
Japan	6.43	0.00	13.25
Netherlands	26.49	1.32	43.43
New Zealand	49.82	0.70	46.15
Norway	61.24	5.86	36.76
Portugal	31.37	1.96	40.00
Spain	15.72	0.17	37.55
Sweden	62.06	3.74	35.48
Switzerland	38.48	1.43	43.59
United States	65.63	6.44	9.07

a. Volume is the percentage of traded companies targeted in a completed deal.
b. Hostile takeover is the number of attempted hostile takeovers as a percentage of domestic traded firms.
c. Cross-border is the number of cross-border deals as a percent of all completed deals.

Source: Rossi and Volpin (2003).

France, and 0.30 percent for Germany. In other words, German companies are virtually immune from hostile cross-border takeovers and French companies face only a very low rate of such takeovers.

In order to clarify European competition policy, all EU members endorsed a "Takeover Directive" in late 2003, after 14 years of negotiations. Although the directive generated EU-wide guidelines for company takeovers, especially hostile ones, it was a failure. Instead of providing an EU-wide level playing field that would facilitate outside pressure on company management, the new EU rules preserved the use of multiple voting shares and "poison pills" by incumbent managers as "options" against hostile takeovers without prior shareholder approval.[8] Managers seeking to pre-

8. See European Parliament Press Service, Takeover Directive Adopted, December 16, 2003, available at www2.europarl.eu.int/omk/sipade2?PUBREF=-//EP//TEXT+PRESS+TW-20031215-S+0+DOC+XML+V0//EN&L=EN&LEVEL=2&NAV=X&LSTDOC=N#SECTION13 (accessed January 13, 2004).

serve the status quo as well as groups maintaining the importance of preserving "national champions" will eagerly exploit these "legal options."

In the presence of strong product-market competition, pressure from the capital market—in the form of hostile takeovers—may not be needed. But many examples remain where all-out competitive pressure is lacking, or where incumbent companies are favored or subsidized by policymakers. In these situations, the case is strong for using capital-market pressure as an additional tool to facilitate industry consolidations and to oust ineffective managers. The European Union has clearly failed to provide this spur to greater competition and higher productivity.

Conclusions on the EU Competition Authority

Policymakers in Europe perceive that the European Union now has a strong force working to add competitive intensity in the region. The EU competition authority's decisions receive extensive coverage and are often of considerable interest internationally since they involve the actions of large multinational corporations. Nevertheless, competition policy from the European Commission so far has been far short of ideal.

Preventing mergers among existing large companies and punishing anticompetitive behavior are sometimes necessary. The Commission is like the policeman on the street corner keeping an eye on things in order to prevent crime. However, the legal setbacks and criticisms suffered by the Commission in the ECJ suggest that, at least until recently, there has not been an adequate reckoning of the costs and benefits of such mergers. Further, industry consolidation is often an important mechanism for improving productivity and creating stronger competitors, and the European Commission must ensure that the changes in its assessment procedures are sufficient to determine when a genuine threat to competition occurs.

The biggest limitation of European competition policy, however, is not that it has been too aggressive in some cases. Rather, it lacks the power to tackle the anticompetitive behaviors and regulations that limit competition in many of the EU economies. Moreover, as noted above, member states are working to undermine the authority of the Commission with regard to opening national markets in a number of industries—notably industries that are described as "services of general interest," which include some utilities but could more broadly be applied to other industries. Governments want to protect from competition. If competitive intensity is really to be increased in the European Union, national governments must change their positions and move proactively to encourage, not limit, competition.

Reform: Driven by Individual European Governments, Reinforced at the EU Level

Although there are strong common themes to reform that apply throughout the region, the idea of instituting a single European program of reform is not credible. The European economies remain distinct and companies operating in multiple countries continue to face very diverse national business environments. National social security systems still present the citizens of Europe with very disparate conditions, and the national political will to tackle the economic problems is unequally distributed among the continent's capitals. Many of the answers to solving individual European countries' idiosyncratic problems lie in the actions of the individual governments themselves. Some European countries have already enacted substantial social insurance reforms, while others have further to go.

Most of the structural policies required to radically transform the European economy not only to fulfill the Lisbon 2010 agenda but also to preserve European prosperity beyond that (fast approaching) date must be originated and implemented by national governments. Each country must also design, fund, and execute its own social insurance and labor-market policies.

In principle, competition policy is now made at the EU level, but as we have seen, in practice many of the regulations that affect competition are set at the national level. The EU authority applies only to larger companies that operate across borders. Furthermore, only with monetary policy is there a true eurozone decision-making process that applies to all participating economies. Fiscal policies are decided at the member-state level, and the Stability and Growth Pact's influence now seems to be much less than was envisaged when the euro area was formed.

Even though most policy reform actions occur at the member-state level, there are certainly "spillover" effects in one country from economic outcomes in other countries. For the most part, these spillovers are positive. For example, the German economy has been an important engine of growth throughout Europe. If there is successful reform in Germany and that economy achieves rapid economic growth going forward, this will make it much easier for Europe as a whole to grow rapidly. Negative spillovers could occur if some, particularly larger, European economies lag behind the reform process. Investment will flow within Europe to the most dynamic areas and people will also become increasingly mobile. Cultural differences and language barriers continue to exist in Europe, dampening internal cross-border migration, but for the skilled, multilingual segment of (particularly young) Europeans, these matters are less of an impediment to mobility. Hence, some countries or regions could become chronically depressed areas if they become unattractive locations for jobs and investment.

In short, while there are common problems among many of the European economies, the onus is on individual member-state governments to actually carry out the most important reform steps. The EU institutions, like the ECB and the EU competition authority, can only support the reform efforts.

That immediately raises the question of how the individual member countries are doing so far? Many of the answers to that question have been given throughout this book, but it is worthwhile to summarize overall progress in the four largest economies—Britain, France, Germany, and (very briefly) Italy.

A Summary of Reforms to Date in the Four Largest Economies

Britain

Policymakers seem well aware that the central problem in Britain is low productivity. Current Chancellor of the Exchequer Gordon Brown, in particular, together with the Ministry of Trade and Industry, has made productivity improvement a major feature of his economic agenda. Some of the positive steps that have been taken in this area include:

- Policy initiatives have been adopted to address regulatory barriers to productivity change. The Office of Fair Trading (OFT) has been given an aggressive mandate not only to address standard anticompetitive behavior but also to identify regulatory barriers that diminish competition.
- Britain has remained very open to foreign direct investment from around the world, bringing in capital, technology, and managerial capability.
- Brown recently suggested granting visas to managerial and professional talent to come to Britain—in order to overcome what is seen as a shortage of managerial skills.[9]
- The privatization program started under Thatcher has been sustained, and many industries have gradually become more competitive as new entrants have challenged the former government monopolies. (A recent study shows very large productivity gains from privatization.)[10]

9. David Turner and Della Bradshaw, "Doors Thrown Open to Overseas Managers," *Financial Times*, March 18, 2004.

10. Ed Crooks column, "Privatized Industries Show the Way for Reform," *Financial Times*, March 23, 2004.

- The labor market in Britain is much more flexible and less regulated than the labor market in continental Europe. There is an understanding among policymakers that flexibility and worker mobility are essential to a productive economy.
- Efforts to link universities and technology companies have shown some success, notably in the Cambridge area.

A comparison of these positives against the policy framework laid out in chapter 1 and the analysis of Britain in chapter 4 suggests that additional steps should be taken to improve productivity and competitive intensity.

- Land use policies and the regulations to protect historical buildings create a major obstacle to investment and economic growth in Britain. Political resistance to change has prevented the development of a more rational land use policy that would combine economic development while preserving the best of historical and rural Britain.
- Despite much talk about loosening regulations that limit competition and the mandate given to the OFT, the reality is that deregulation has been limited in scope. The OFT needs the resources to conduct a serious analysis of regulatory barriers to productivity increase and the government then needs to act on these conclusions.
- The high prices of manufactured goods and the continued existence of low-productivity manufacturing establishments indicate that British manufacturing is not fully open to global competition. Formal and informal trade barriers should be eliminated as far as possible under EU tariff rules.
- Part of the productivity gap in Britain has been attributed to lower usage of IT. The Organization for Economic Cooperation and Development (OECD) has documented the relatively high prices of IT hardware in the European Union generally, including in Britain.[11] Policymakers should aggressively seek out the reasons for the relatively high IT prices and deal with them. The problem may lie in the retail distribution channel or with manufacturers taking advantage of small market differences to set prices at a higher level in Britain.

11. As a check on this result, we conducted an Internet search of PC prices in the United States and Britain and found that comparable PCs were 25 to 100 percent more expensive in Britain at the prevailing exchange rate. Research assistant Gunilla Pettersson conducted the search. The value-added tax has been removed from the figures given above. Given the rather high rate of value-added tax relative to sales tax rates in the United States, price differences will actually be even greater. The price differentials may be smaller for corporate buyers, but it is absurd that an economy that is trying to raise productivity and increase IT use should allow such high computer prices to persist.

In terms of social and labor-market policies, the welfare state is not very generous in Britain, and its National Health Service is a bare-bones operation. Work incentives are strong enough in Britain that, once the macroeconomic situation improved in the 1990s, employment increased and unemployment fell to moderate levels. Creating jobs is an area of comparative success in Britain in recent years. The Working Tax Credit[12] was introduced to provide additional work incentives for low-wage workers and to provide them with higher net income. Assuming that Britain will continue to grow and improve productivity, it should evaluate how to improve its social services without undermining work incentives.

- There are policies proposed or enacted to improve educational quality in Britain, and we support the goals of these policy initiatives. (This book has not looked specifically at educational policies, so we will not comment on whether these initiatives are the right ones.) The lack of workforce skills should not be overstated or blamed solely for low productivity in order to avoid taking the needed steps to improve product-market competition. The industry case studies for Britain suggest there are many ways in which productivity can be increased with the existing workforce.
- Basic levels of income support are relatively low in Britain. Provided the economy grows, it may be possible to provide a stronger safety net for the poor or unemployed. If so, then wage insurance, or an expansion of the Working Tax Credit, should be implemented rather than increasing support for those who choose not to work.
- Historically, Britain has underinvested in social services. In health care underinvestment was a method of rationing treatment and overall cost control, but this approach introduced inefficiencies in treatment protocols.[13] It will be important to keep health costs under control in the future, especially given the demographic trends. However, cost-effective investment in technology and equipment can actually be cost saving as well as beneficial to patients.

France

France faces low employment, short work hours, and chronically high unemployment. Thus, improved incentives for job creation and acceptance

12. In April 2003, the Working Families Tax Credit program was replaced by the Working Tax Credit program, which was qualitatively similar but extended benefits to people without children.

13. For example, because advanced screening equipment and medical techniques were only slowly introduced, Britain's doctors were unable to determine which patients could be helped by different treatment protocols. Doctors used conventional surgery, which is more expensive and dangerous, rather than laparoscopic surgery to treat colon cancer patients.

are very high priorities. Productivity issues are also important, and in some cases the policies that would help productivity would also help job creation. But first a review of the positive steps France has undertaken in the labor market and its social programs.

- Payroll taxes were reduced for low-wage workers in 1993, and this plan was expanded throughout the decade. As noted earlier in this book, France experienced substantial employment growth in the late 1990s, part of which was attributable to the payroll tax policy.
- Public-sector pensions are very generous in France. The pensions previously allowed individuals to retire with virtually full pay after 37.5 years of service. The French government changed this benefit by extending the years of service to 40 years, which is in line with the pensions available to private-sector workers.
- In 2003, France implemented changes to its unemployment benefit system as part of agreed upon reforms by employers and unions (three of the five national ones) to the UNEDIC (Union Nationale pour l'Emploi dans l'Industrie et le Commerce) unemployment insurance (UI) program. The reforms drastically cut entitlement periods by up to two-thirds, from 15 or 21 months to 7 months (or to 23 months from 30 months).[14] Similarly, in January 2004 the French government cut the entitlement period for the "specific solidarity allowance" (*allocation de solidarité spécifique* [ASS]), which is available to people who have exhausted their unemployment benefits.[15] In addition the French government is acting in cooperation with other actors in the labor market to prevent people from moving among the different social programs and to actively seek a comprehensive overhaul of the incentives presented by the French social security system.

While these 2003 reforms were a step in the right direction, the government unfortunately backtracked in 2004, following local election defeats. The UI reform was annulled and benefits restored to 256,000 workers who had lost eligibility in January 2004. Much of the positive momentum gained in 2003 has now been lost again.

In addition to the dangers of losing progress previously achieved, some major problems in the labor market, which are not being adequately addressed, are offsetting these positive steps:

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14. See EIRO (2003b).

15. Previously, the ASS benefit, which operates on a sliding scale based on income, could be extended indefinitely every six months, provided that the recipient was actively seeking employment. As of 2004, the entitlement period will become limited to two years (three years for existing recipients). See EIRO (2003f).

- Public-sector spending in France is well over 50 percent of GDP, which means that the overall tax burden is very high. Payroll taxes are very high on average, and the tax wedge is around 50 percent. There is a very large gap between the employer cost per worker and the amount the employee receives. It is likely that this level of taxation has had a negative impact on employment. As the demographics change, it will be hard to avoid increasing this tax wedge even more, creating the danger of pushing more and more people out of the workforce.

- Even though there were changes in unemployment benefit provisions, there are no effective (Danish-style) programs to "encourage" workers to retrain, relocate, or create a plan of action to obtain new employment. The PAP/PARE program instituted in 2001 does not include credible sanctions needed to induce job seekers to obtain new skills and is consequently unlikely to achieve its goals of improving employment and workforce job skills.[16] There is also no wage insurance program or financial incentive for those who take a new job at a lower wage.

- Pension provisions are generally very generous and will generate a huge burden on the working population in the years ahead. Reforms enacted in 2003 are not sufficient to ensure the future financial health of the French PAYGO pension system.[17] French leadership needs to clearly explain to its citizens the future economic situation and the need for change. Restraint in the growth of pension benefit levels[18] is reasonable, together with an increase in the retirement age. The decline in the average retirement age has stopped, but it has not reversed and moved upward.

- Despite increasing the required contribution period for all workers to 40 years, this pension system still provides many opportunities for

16. Started in July 2001, the Return-to-Work Plan (*Plan d'Aide au Retour à l'Emploi*, or PARE) applies to all newly unemployed persons. It includes an in-depth interview for assessing the job seeker's employability, which results in the creation of the Personal Action Plan (PAP). The PAP outlines the set of actions the job seeker must take to successfully find a job. After a six-month period, if the individual has not found a suitable job (defined as corresponding to the skills and professional capabilities of the job seeker), the PAP is updated. Unfortunately, this process is wholly voluntary, and no sanctions are imposed against job seekers without a PAP (Bertelsmann Foundation 2001).

17. The French government and the OECD (2003?) estimate that the proposed reform will cover only about one-third of the expected private-sector pension shortfall by 2020—assuming a halving of the unemployment rate to 4.5 percent in 2020. Similarly, public-pension estimates assume—incorrectly—that state-owned utilities are included in the pension reform, and even then the estimates conclude that only half of the expected shortfall in pensions will be covered.

18. Much has been made of the "equalizing effect" between public and private pension plans in France from the 2003 reform. However, while progress has been made, significant inequalities persist between public and private employees.

French workers to leave the workforce at a very young age. As part of the 2003 pension reforms, it was specifically stipulated that "people with long working lives" should be able to retire at the age of 56, provided that they had paid contributions for fully 42 years. While this is viewed as "required social justice," the direction of the plan is wrong. In principle, government programs in countries such as France—with very low employment—should not encourage people to leave the workforce at an early age. Instead, governments should encourage people to remain in the workforce as long as possible. The national French Old-Age Fund for Wage Earners (CNAVTS) estimates that up to 460,000 (out of 500,000 potential eligibles) will apply for such early retirement before the end of 2008 and add more than €11 billion to the pension burden (EIRO 2003c). In addition, workers in publicly owned utilities (EdF [power], GdF [gas], SNCF [railways], and RATP [Paris metro/buses]) are not included in the reform and, consequently, can retire earlier than after 40 years of work (and contributions).

- The government introduced and partially subsidized a 35-hour workweek as the standard, based on the erroneous belief that it would create work sharing and increase employment. In fact, there is no credible evidence to support the view that overall employment has increased as a result of the mandatory shortened workweek. France needs policies to increase the number of hours of work available, not policies to discourage people from working. However, it must be acknowledged that when the shorter workweek was introduced, provisions providing employers greater flexibility over work assignments and scheduling also accompanied it. Although this flexibility was a substantial positive for the French labor market, it was an expensive trade-off.

- Generally, despite the greater flexibility introduced with the 35-hour week, the French labor market remains very rigid both in terms of its wage structure and its difficult hiring and firing processes. Labor protection has become a straitjacket that essentially restricts employment. For example, the burdensome legal structure in France affects the hotel industry: low- and medium-price French hotels minimize the number of employees by eliminating many services available in comparable hotels elsewhere, such as staff to check a guest into the hotel (instead guests use a credit card to enter their rooms). We strongly support enacting the proposed (Virville Report) "assignment and project contracts" (*contrat de mission/projet*), which would enable companies to hire workers only for the duration of a particular project (EIRO 2004b). Such contracts could provide one avenue for alleviating the constraints of job creation in France. Similarly, we support moves under way to change the hierarchical relationships between collective agreements entered at the national, regional, and local levels. Introducing greater opportunities for company-level agreements to deviate from sector-level accords will enhance flexibility and companies' abilities to adjust.

- France uses the courts and the legal system to regulate the labor market, much more so than in other countries. Verdicts favor employees 75 percent of the time. Labor law reform is needed to give employers greater ability to restructure their operations.

- France has a high-quality healthcare system. But, France's public health insurance fund, which pays for the vast majority of French health expenditure (with small participation by private insurance funds) has a rapidly rising deficit. Funding of the system is through a combination of contributions from employers (12.80 percent of wages) and employees (0.75 percent of wages), together with a number of different taxes (European Commission MISSOC Database, accessed May 27, 2004).

  Recognizing the unsustainable path of healthcare finances, the French government in the spring of 2004 presented proposals to reform its healthcare system. A small additional fee of €1 is to be paid by all but the poorest upon seeing a doctor, and specialist treatment without referral penalized by lower reimbursements.[19] While these attempts to raise new revenue and lower costs are welcome, the proposed reforms fail to introduce required financial incentives for both patients and providers to lower overall costs.

France has also made positive, productivity-oriented, product-market reforms:

- France has privatized—or mostly privatized—companies such as Air France and Renault. Such actions have increased productivity and made the companies more competitive.

- The mobile telecommunications industry was structured in a way that created a very productive industry (as described in chapter 3).

- More broadly, many efficient and productive private French companies compete strongly with global best-practice companies. For example, Carrefour has been more successful in Brazil and China than Wal-Mart.[20]

19. See *The Economist*, May 13, 2004, "The Price of Popping Pills," and Agence France-Presse (AFP), May 18, 2004, "France Unveils Plan to Stem Health Spending, Unions Cry Foul."

20. The reasons for Carrefour's greater success are clear. Carrefour entered Brazil's and China's markets earlier than Wal-Mart and was free to choose better store locations. Car-

- The French government has initiated a program to reduce the amount of bureaucratic red tape faced by companies interested in entering the market. The government has also promoted the creation of new firms and their subsequent access to capital.[21]

However, these positive product-market reforms must not overlook some remaining problems. The French government retains control over all major network industries, since this area has not been included in the privatization of state-owned assets since the 1990s. In fact, France maintains a 100 percent government ownership of the former government-run monopolies in electric power (Electricité de France, with a national market share of 95 percent in 2002) and gas (Gaz de France, with a national market share of 90 percent in 2002). Following the European Commission's liberalization directives the electric power and gas markets (for all nonhousehold consumers) will be opened up in the European Union in 2004.[22] In response, France created an official sectoral electricity regulator (*Commission de Régulation de l'Energie*, or CRE). While sectoral regulators offer the possibility of rigorously enforcing competition policy, the reality is that France only opened up its energy markets with the minimum threshold of its commitments to its EU partners. By some measures France has the most closed markets in the European Union and some of the most expensive network access charges for independent producers (figure 7.1). Large government investments in nuclear power have traditionally provided France with plentiful and relatively cheap power, albeit not on commercially viable conditions.

In the gas market there are signs that competition is working for industrial users, where prices since liberalization in 2000 have been below the EU average. The opposite is true in the unliberalized (2007) household market (due to open in 2007).

The French government also remains a majority shareholder (63 percent) in the former telecommunications monopoly, France Telecom, which

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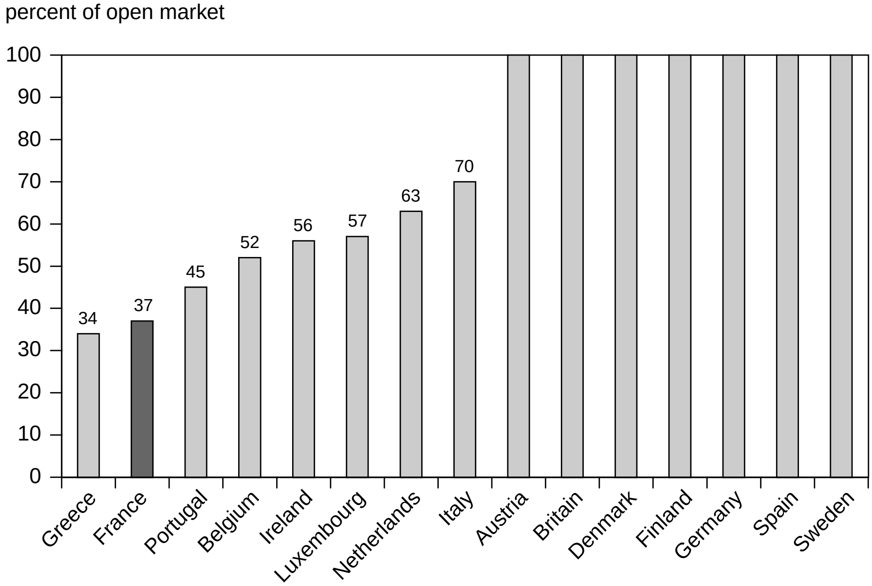
refour has also been more adept at dealing with the complex, and sometimes corrupt, local bureaucracies in these countries. Wal-Mart made mistakes when it entered Brazil, setting up store layouts that were unfamiliar to Brazilians and stocking shelves with items that were not in demand. Wal-Mart has, in contrast, done very well in Mexico.

21. Measures to reduce red tape include, but are not limited to, proposals to: limit the 956 forms that companies may have to complete; introduce a single-counter interface between companies and social security agencies; reduce the costs of hiring part-time and temporary workers (*Cheque emploi associatif*); delay required social security contributions for new firms; and reduce taxes and administrative procedures associated with ownership transfers (OECD 2003b, 58–62).

22. Some encouraging signs that competition is gradually entering the French power sector exist: EdF has lost up to 17 percent of its eligible customer business to new suppliers in areas already liberalized (consumers using more than 7GWh/year). See Prospex Research French Power Market Report 2003, www.prospex.co.uk (accessed January 13, 2004).

Figure 7.1 Degree of competition in the EU's electricity markets, February 2003



Source: European Commission (2003e).

retains an 80–90 percent market share in the fixed-line business. However, competition is increasing, with 28 operators sharing the total markets in local, long distance, and international calls in 2000. Competition has caused large price declines for businesses (22 percent from 1996–99), while consumers have enjoyed only a 6 percent decrease in the same period. Obviously, the high price of fixed-line telephony maintained by France Telecom is one reason for the low French use of the Internet.

We noted above that productivity is outstanding in mobile telecommunications in France, suggesting that if other network sectors were liberalized, substantial gains in productivity would occur and significant price declines could occur. However, workers and managers of the entrenched monopolies are resisting further privatization because of fears of job loss. Thus, further privatization and liberalization will be a considerable challenge.

- Land use restrictions are very rigid in France and limit employment creation. The French retailing sector illustrates how land use restrictions have affected the evolution of a sector and limited employment opportunities. High minimum wages have also limited employment in the retail sector, despite reductions in payroll taxes (see chapter 3).

- The case study evidence for France suggests that barriers to productivity still exist in several industries. France, like Britain, needs a domestic competition agency with the mandate to identify regulations and other barriers to competition—including the barriers that keep manufacturing prices high.

Germany

As in France, raising employment is Germany's biggest priority, followed by improving productivity growth. By mid-December 2003 the German government signed its Agenda 2010 into law, and it is being implemented in 2004. The agenda is not a panacea and will not produce strong job growth (or higher productivity) in Germany without additional reforms. Nonetheless, it contains a number of sensible reforms similar to those in the Netherlands, Sweden, and Denmark. The agenda is focused on labor-market and social policy reform.

- The duration of unemployment benefits will be reduced to 12 months (up to 18 months if the unemployed is older than 55), depending on the age of the recipient, which is a significant reduction from the current range of 14–32 months.[23]
- The contribution-financed UI benefits will be renamed "unemployment benefit I" (*Arbeitslosengeld* I), while the former government-financed unemployment assistance (previously available after a means test was administered to those ineligible for unemployment benefits) will be merged with the government social assistance plan into a fixed-rate "unemployment benefit II" in 2005. All recipients of unemployment benefit II will be required to accept legal job offers, regardless of pay—even if the wage on the job is not based on collectively agreed rates.[24] Recipients who refuse a job offer will have their benefits cut by 30 percent, or stopped completely for three months if they are below the age of 25. People considered not fit to work will receive social benefits (*Sozialgeld*) at a rate similar to unemployment benefit II.

  In addition a modest wage insurance program was instituted to help older workers become reemployed. Thus far very few people have taken advantage of the program, but it represents a hopeful beginning to what could become an important program.

23. See German government (2004) and European Commission MISSOC Database, www.europa.eu/int/comm/employment_social/missoc/2003/missoc_238_en.htm (accessed May 29, 2004).

24. This decision to ignore collective-bargain agreements in the hiring decision—if locally demanded—sets a welcome precedent and should be introduced for much wider implementation across the German labor market. See description of "opening clauses" later in this section.

- German wage taxes will also be cut in 2004, which should increase labor supply. Low-income groups (earning less than €20,000 per year) will see a noteworthy decline of 10–40 percent in wage taxes, which will generate significantly larger incentives to create and accept employment.[25]

- Small employers are exempt from some of the rules that make German labor markets so rigid. The size of companies whose new hires are exempt from these rigid rules was increased from 5 employees to 10 employees.

- In October 2003 the German government announced that pension benefits for 2004 would be frozen in euros, eliminating the upward indexing that would otherwise have occurred.[26] Simultaneously, pensioners had to pay the full amount of contributions into an old-age care plan, part of which had hitherto been paid by the government. As such, German pensions were de facto cut.

- The government introduced the idea of a "sustainability factor" (*Nachhaltighkeitsfaktor*) in the pension system. If implemented, this would ensure that the total pension payout would be held equal to or below a contribution level of 20 percent of wages in 2020 (the current figure is 19.5 percent). It could rise to 22 percent of wages by 2030. Implementation would require either cuts in pensions, relative to the historical trend rate of growth, or an increase in the retirement age. It would, however, ensure the sustainability of the German pension system—albeit at very high rates of contribution. At present, however, this is only a rather vague proposal, and it is doubtful if appealing to an abstract idea like the "sustainability factor" will be sufficient to carry through such a politically difficult measure.

Reforms of the German health system have been very gradual, despite the fact that the high contribution rates (2003 average rates of 14.30 percent of wages, split evenly between employers and employees) add much to excessive German labor costs, and contributed to a combined €3 billion cash shortfall for sickness insurance funds (*Krankenversicherung*) in 2002. As part of Agenda 2010, beginning in January 2004, a quarterly €10 fee for visits to general practitioners and dentists will be charged. Of potentially more far-reaching cost containment consequences is the new Act on

25. Data for the *Entlastung der Lohnteuer/Solidaritatszuschlag* in 2004 from the German government, www.bundesregierung.de/Anlage578309/Steuertabelle.pdf (accessed December 19, 2003). According to the tax tables only low-income single parents with one child (*Alleinerziehende mit 1 Kind*) will not see major tax rebates in 2004.

26. This move was not part of Agenda 2010. It was caused by an acute cash shortage faced by the German government PAYGO pension system, since the government was not willing to let pension contributions increase to more than 19.5 percent of wages.

Diagnosis-Related Flat Rates (*Fallpauschalengesetz*) that stipulates that from January 2004, sickness insurance funds will pay hospitals according to a diagnosis-related flat rate, rather than simply the hospital charges so far in use. As patients retain their free choice of hospitals, this may lower costs substantially. However, it does not necessarily eliminate the potential financial incentive for German hospitals to keep patients hospitalized longer than strictly medically required. While these reforms are welcome, it is too early to properly gauge their effect on reining in German healthcare costs.

Even though these reforms are modest, sensible, and helpful, they have proven very unpopular. The political position of Chancellor Schröder has weakened significantly as has the position of his party, the SDP. Therefore, it is very unlikely that he will propose further reforms any time soon. The prospects for additional reform over the longer run are not quite so bleak, however, because both major political parties recognize that further changes will be needed.

- It is disappointing to note that increases in collective bargaining flexibility at the local level were postponed.[27] However, it is encouraging to note the increased use of company-level collective agreements,[28] as well as the wider use and more inclusive nature of so-called "opening clauses" in industry-level agreements.[29] Both instruments are facilitat-

27. It is our understanding that the possibility of government-regulated liberalization of collective bargaining remains possible, should Germany's traditional self-regulating social partners fail to agree upon increased flexibility within the next 12 months.

28. In September 2003 the German Institute for Labor Market and Employment Research (*Institut für Arbeitsmarkt- und Berufsforschung*, or IAB) published new figures that showed that only 61 percent of West German workers (and 35 percent of East German workers) were now covered by industrywide collective agreements. However, as many companies without an industry-level agreement "orient" themselves to the industry-level agreement, the true importance of these agreements is somewhat higher than indicated by these percentages. Seven percent of West German employees and 15 percent of East German workers were covered by company-level collective-bargain agreements. See EIRO (2004), Coverage of Collective Agreements and Works Councils Assessed, www.eiro.eurofound.eu.int/2004/01/feature/de0401106f.html (accessed December 18, 2003).

29. The use of "opening clauses" (*Öffnungsklauseln*) in industry-level collective bargaining inserts an instrument of differentiation and flexibility into the otherwise rigid German collective-bargaining system. The opening clauses come in numerous varieties, but at least three main categories should be mentioned for illustrative purposes: 1) Opening clauses on pay are defined as agreements between social partners that generally allow divergence from the collectively agreed payments, in case of dire economic circumstance. The most well-known example is the "general clause" in the German metalworking industry, which explicitly allows local bargaining parties to agree on other standards in order to avoid bankruptcy. 2) Opening clauses on working time are possibly the most widespread type and generally increase companies' flexibility with respect to flexible working hours. 3) Opening clauses for particular groups of employees or companies are a residual category that en-

ing much-needed flexibility in the German labor market (for example, the agreement obtained by Siemens in June 2004 to raise working hours). A legislative initiative making such company-level agreements and opening clauses the standard, rather than the exception to the norm, would be beneficial to German employment.

- Rather than being abolished—or at least moved up to a much higher company employee threshold—Germany's strict job protection rules were preserved for companies with more than 10 employees.[30]
- Foreseen with the introduction of the so-called Hartz Laws[31] the reductions in both employers' and employees' social security contributions are a move in the right direction, but seem too small to have much impact on German unemployment (Ich AG and "mini-" and "midi-jobs" will not lead to substantial drops in German unemployment[32]).

As in France, despite changes in unemployment benefit provisions, there are not *effective* (Danish-style) programs to encourage workers to retrain, relocate, or create a plan of action to obtain new employment. The so-called Job-AQTIV Act of 2002 was intended to mobilize the unemployed by offering improved job counseling in return for a more active job search by the unemployed. This will not have much effect, however, unless sanctions are imposed on those unwilling to truly participate in the program.

The new wage insurance program and other financial incentives for the unemployed to take a new job at a lower wage are limited to those over 55 years of age and are not being publicized or promoted. Workers who accept wage insurance have to give up the opportunity to collect alternative and more attractive benefits. The apprenticeship model historically

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compasses opening clauses valid for specific groups of companies or employees, below the industry level of opening clauses. Examples include only small companies (15 employees or fewer) or specific employees—say, newly hired employees in the West German chemicals industry. See EIRO (1997).

30. Increasing the threshold to 10 employees is simply a reversal of earlier actions by the Schröder government in 1998, when—as one of its first measures—it overturned an earlier attempt to raise the threshold (also to 10 employees) by the previous center-right CDU/FDP government. See EIRO (2003e).

31. The Hartz Laws were named after Peter Hartz, the chairman of the Hartz Commission. The Hartz Commission published a government-sanctioned report on German labor-market reforms in late 2002.

32. "Ich AG" refers to the unemployed, but hoping to become self-employed, who through the Federal Employment Agency can receive up to a €1,200 subsidy. Mini-jobs refer to small-scale employment paying less than €4,800 a year, which is exempt from income taxation and has only fixed-rate social security contributions attached. Midi-jobs refer to employment paying between €4,800 and €9,600 a year, on which employer social security contributions increase incrementally up to the full rate (German government 2004).

has provided Germany with a highly skilled workforce and has served as a substitute for other active labor-market policies. But it does not function as well in today's rapidly changing global economy. In fact, many of the unemployed have been through apprenticeship programs.

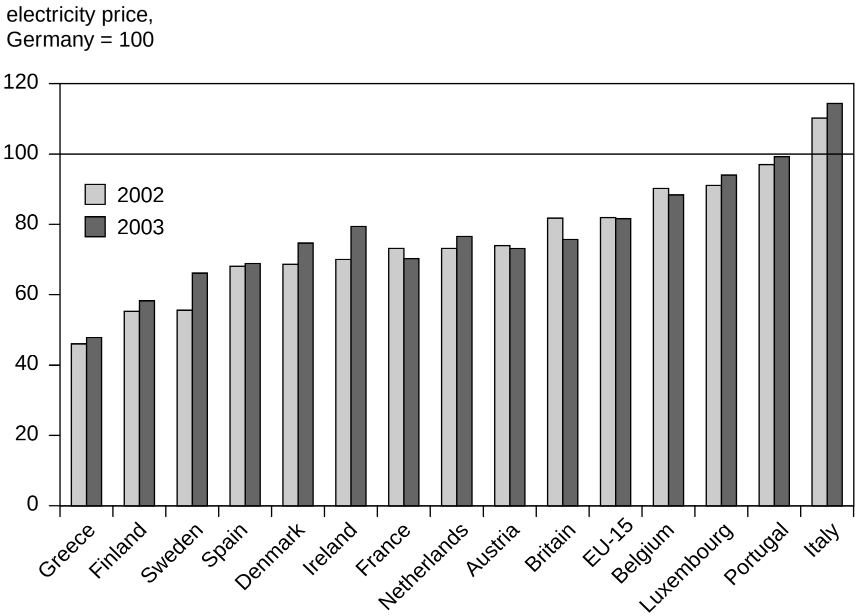
- Public-sector spending in Germany is as high as in France, exacerbated by continuing transfers to East Germany, which means that the overall tax burden is very high. The comments above regarding French public spending—including the need for fundamental pension reform—apply equally to Germany. The continuing east-west split in Germany is a separate issue. West Germany has generously provided sustained support to the east. However, the price of that generosity was applying union-set wages in both the west and the east. Combined with generous social-support payments, this has resulted in chronically high unemployment in the east and created an excessive tax burden on the west. It is impossible to replay history, but the situation in the economic east gives increased urgency to reforms of unemployment insurance, pensions, and the wage-setting process.

Turning to product markets, we look first at the privatization of the utility sector. Since the early 1990s, Germany has privatized a significant number of network industries, and thus competition policy has been brought to the forefront, as authorities have struggled to avoid merely privatizing former government monopolies. In particular, the telecommunications, electric power, and gas sectors have experienced dramatic changes.

- In telecommunications, the former government monopoly Deutsche Telekom (DT) was partly privatized in the mid-1990s, and the sector liberalized in accordance with EU directives. As a result, prices for various telecommunications services have declined drastically. However, local phone calls are an important exception since local service is not subject to competition and thus prices have been flat since 1997. Moreover, even though prices have fallen for many services, average German telecommunication prices are still among the highest in the European Union.[33] As we noted earlier, there is less competition and lower productivity in mobile phone service in Germany than in France. Therefore, significant competitive improvements can still be achieved in the German telecommunication sector.

33. The Eurostat Structural Indicators lists Germany as the EU country (together with Italy) with the highest price level for a 10-minute national call in 2003 and the fifth highest rate for local calls in the European Union. In contrast, Germany has the third lowest rate for international calls. Data from Eurostat Structural Indicators (Eurostat 2004b).

Figure 7.2 Household electricity prices in the European Union (euro per kilowatt hours)



Source: Eurostat (2004b).

- In principle, the electricity sector in Germany should be completely liberalized and subject to competition, as a result of German law passed in 1998. In practice, this sector is dominated by vertically integrated, regional conglomerates that control the majority of both generation and distribution assets. The detailed regulation of the sector has been laid down in two "Associations' Agreements," approved after the Federal Cartel Office enacted demanded changes. The privatization has been helpful. We saw earlier that productivity had improved even in anticipation of privatization, and the sector has seen price declines since 1998 of approximately 15 percent for industrial producers (although none for consumers).[34] As with telecommunications, however, Germany has persistently high relative power prices (figure 7.2), which indicates that significant competition advances can also be made in this sector. Furthermore, there are still significant problems with third-party access to the distribution networks, and Germany has

34. Data from Eurostat Structural Indicators (Eurostat 2004b).

by far the highest network access charges in the European Union.[35] The fact that Germany will create an energy sector regulator (covering both power and gas) in 2004—after six years of sector self-regulation—indicates that the German government may be forced to confront the competitive problems in the sector.

- Germany's gas sector is very similar to its electricity sector, dominated by a few large firms that control the distribution network. Since 2000, the industry has also been regulated by an Associations' Agreement, which regulates third-party access and transmission charges to the distribution network. Significant problems still remain in this area and limit the effect of competition.

Looking at other aspects of product markets, relatively little has been done to increase flexibility and competitive intensity or really open up the economy for new job creation. The basic problem, as we noted earlier, is that Germany's economic system is designed to preserve existing companies and jobs, and not adept at allowing establishments to fail or flexible enough to create a more dynamic platform for future growth. The current economic system worked well for many years, but is struggling today as economic conditions change. The German economy is still heavily based in manufacturing—a sector where employment has been declining for years among developed economies.

The interlocking network of manufacturing companies, suppliers, unions, regional and local government, and banks remains largely intact and is protected from full competition by formal and informal barriers. Making use of highly skilled workers and strong technologies,[36] many companies in the manufacturing sector have remained strong exporters—providing unique and high-quality products to global markets. In the face of increased competition within the European Union and globally, and as a result of disruptive new technologies, it will be hard—maybe impossible—to maintain employment and investment in this sector.

- To repeat a familiar theme, Germany's land use restrictions are inhibiting the expansion of the service sector and the creation of new service-sector employment.

35. This problem is aggravated by the fact that most local grids are owned by small municipalities and regional governments, which have a financial interest in maintaining monopolies since they have generated rents to them as the industry has consolidated. See European Commission (2003e, 13, graph 1).

36. Incremental technological innovation in Germany remains strong in traditional areas of manufacturing. Innovation in start-ups and brand new technologies is weaker.

- The banking system suffers from having too many small banks that are protected by regulation or owned by local governments. Germany needs financial-sector reform to provide it with a more modern financial sector to direct the country's savings toward new opportunities and away from state-guaranteed loans automatically provided to traditional borrowers.
- Germany—like Britain and France—needs a strong national competition authority with a mandate to tackle not just the anticompetitive behavior of companies but also anticompetitive regulations—such as the water purity law used to protect local breweries.

Italy

This book has not emphasized policies and economic performance in Italy to the same extent as Britain, France, and Germany, therefore this section will be brief. Another reason for the section's brevity is that Italy has not embarked on any significant reforms. Innumerable reforms have been proposed in Italy in recent years for social institutions as well as labor and product markets, but Prime Minister Silvio Berlusconi—despite his professed market orientation—has not been willing to tackle the unpopular issues of opening the labor market and dealing with social insurance issues. That is particularly unfortunate because with a debt to GDP ratio of over 100 percent, high payroll taxes, and the prospect of one worker per retiree by 2030, Italy faces severe challenges. The country must be applauded, however, for recent reductions in total payroll taxes, which have declined since 1996 from over 50 percent to "only" 45 percent for the average worker.[37]

An important issue for Italy is that it is de facto divided into two parts. Northern Italy is prosperous and has a (mostly) dynamic private sector, with many successful and relatively flexible small- and medium-sized enterprises, and moderate unemployment. Some flagship companies, such as Fiat, face difficult futures, but, overall, the region has great strengths. However, southern Italy is very different. Employment is low, and unemployment is high. Organized crime remains a serious problem as well, that is as much a consequence of poor economic performance as it is a barrier to future progress. A major feature of Italy's reform should be to change the structure of social insurance, income transfers to the south, labor laws and institutions, and pensions in a way that increases employment in the southern half of the country.

37. Defined as single, without dependents, and earning the average industrial wage (OECD 2004b).

A Big Push or a Slow and Incremental Approach to Reform?

Some of the social and competition policy issues highlighted above cry out to be part a reform package, rather than separate policies to be enacted individually. For example, no European government will be able to create a sustainable national pension system if it does not raise its employment level to near the Lisbon goals. This point is made by the recent *Joint Report by the Commission and the Council on Adequate and Sustainable Pensions* (European Commission and ECOFIN 2003), in which the Netherlands, Sweden, and Denmark—countries whose labor-market reforms we have examined in chapter 5—get "passing grades" in terms of the sustainability of their pension reforms.[38]

Restructuring industries to make them more productive must be accompanied by increased incentives for workers to take new jobs and a better environment for job creation. Otherwise, restructuring will lead to higher unemployment rather than lower unemployment. On the economic side, the case for a comprehensive program of reform is, therefore, pretty strong.

On the political side, there is an obvious risk that the sheer scale of the required economic reforms could cause unrelated national special-interest groups to form a "status quo–preserving coalition" against governments trying to implement simultaneous reforms to such systems as pension, the labor market, and social welfare. Counterbalancing this, perhaps, is the idea that if reform is comprehensive it reinforces in people's minds that the status quo cannot be maintained and a range of interest groups will have to make sacrifices in the short run in order to improve the situation for everyone in the long run. Change is sometimes said to be easier if "everyone's ox is being gored."

Election cycles and particular issues in individual European countries will determine the approach any given national government must take to successfully steer economic reforms through their legislative process. Some political systems with numerous stakeholders, decision-making bodies, and frequent elections—such as the German federal system—will favor big reform packages, where multiple issues can be traded against each other to satisfy all the different political actors involved. Other political systems with "a less constrained majority executive"—like Britain or

38. The report states, "The Dutch pension system performs well in terms of adequacy" (European Commission and ECOFIN 2003, 152) while "the reformed Swedish pension system should be able to deliver adequate pensions in a financially sustainable way" (European Commission and ECOFIN 2003, 169). The Danish pension system is also well structured: "In sum, the pension system seems to be financially sustainable in the long term under present policies with a fairly equitable sharing of the burden between generations" (European Commission and ECOFIN 2003, 116).

France when the president and the majority in parliament are from the same party—will facilitate reform less inhibited by outside actors.

If political considerations make a big-push reform effort impractical, then it may be possible to get a reform snowball rolling with incremental or local reforms. Specific firms or industries may break away from national rules, if their survival is threatened. Regions or localities may become easier on zoning rules if their economic base is eroding. Investors may move money overseas if local companies fail to restructure. Economic necessity can become the mother of invention in the area of reform.

Given the priorities listed above, Europe's main goal is to raise the employment level by finding jobs for the unemployed. This should occur naturally during 2004, since a worldwide cyclical recovery seems to be taking place (although the rising euro may limit the pace of expansion). This makes the present an ideal time for structural reforms to add reductions in structural unemployment to the reductions occurring in cyclical unemployment. It would be a tragedy if a cyclical recovery became an excuse to avoid further structural reforms.

The US economy has suffered a sharp drop in employment since 2000, but employment is now recovering strongly. We have acknowledged the many problems faced by the United States, but its economy is also a prime example of how a flexible labor market and a competitive product market benefit both employment and productivity. It is also important to remember that the Netherlands, Sweden, and Denmark show that "European-style" labor-market reforms also are effective in raising employment. Britain also has created a more flexible labor market, and generated solid employment growth and a relatively low rate of unemployment. In short, there are many examples from Europe (and around the world) to demonstrate that economic reform can succeed.

Conclusion: Progress Has Been Made, but Much More Is Needed

This chapter started with the question: Is the reform process on the right track? The overall answer is a qualified yes. Policymakers have said that work incentives must be increased to make work pay for individuals and make employment profitable for companies. There are now examples of countries within Europe that have instituted social policy reforms and been rewarded with rising employment. There are reform efforts under way in most of the major European economies—with Italy a notable exception.

On the product-market side, opening the single market has increased competitive intensity, and the pressure to privatize and open markets to competition is producing concrete results in higher productivity in some sectors. The fact that the mobile telecommunications industry started at a time when competition was being introduced has produced a very different outcome for that industry than would have occurred had it developed 20 years earlier.

Thus far, however, reforms have not been broad enough or widespread enough to really transform the European economy. The looming demographic crisis makes it imperative that such a transformation occur. Reform is on the right track but is not moving fast enough or far enough. Europe needs to transform into a new economy where change is the norm and is facilitated, not restrained, by policies and institutions. Social policies must move people into new jobs and not trap them in unemployment or early retirement. If Europe is to really embrace its future as a single market, there is no place for policies that prop up national champions or preserve state-linked behemoths that enjoy protection from competition.

If Europe really embraces transformative change, it has the potential to have it all. It can achieve rapid growth and full employment, while maintaining a high standard of living and avoiding severe poverty. To achieve success, Europeans will have to give up some deep-seated beliefs about what is expected of workers and managers. However, this seems a small price to pay if the alternative is to allow productivity to remain stagnant as special interests resist competition, or to see fewer people working to support larger cohorts of retirees.