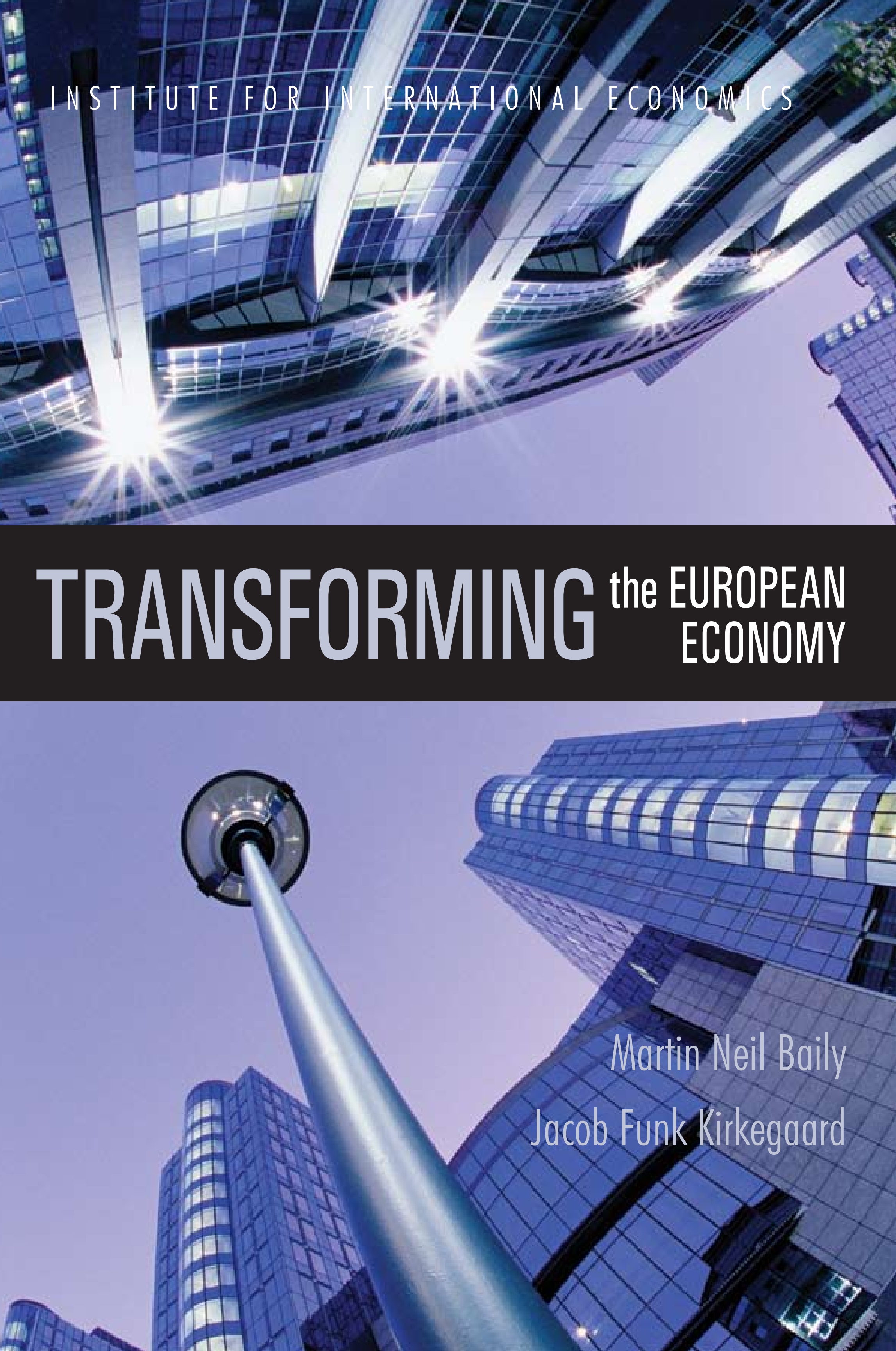

INSTITUTE FOR INTERNATIONAL ECONOMICS

TRANSFORMING the EUROPEAN ECONOMY

Martin Neil Baily
Jacob Funk Kirkegaard

TRANSFORMING the EUROPEAN ECONOMY

INSTITUTE FOR INTERNATIONAL ECONOMICS

TRANSFORMING the EUROPEAN ECONOMY

Martin Neil Baily

Jacob Funk Kirkegaard

Washington, DC
September 2004

Martin Neil Baily, senior fellow at the Institute for International Economics, was chairman of the Council of Economic Advisers of President Clinton (1999–2001) and a member of President Clinton's cabinet. He is a senior adviser to the McKinsey Global Institute. He was a senior fellow at the Brookings Institution (1979–89) and a professor of economics at the University of Maryland (1989–96). He was an academic adviser to the Federal Reserve Board and the Congressional Budget Office. His research focuses on wage setting, macroeconomic policy, innovation, productivity, and economic growth.

Jacob Funk Kirkegaard is a research associate at the Institute for International Economics. His research focuses on European economies and reforms, offshoring, and the impact of information technologies. Before joining the Institute, he worked with the Danish Ministry of Defense and the United Nations in Iraq. In 1996 he graduated from the Danish Army's Special School of Intelligence and Linguistics with the rank of first lieutenant.

INSTITUTE FOR INTERNATIONAL ECONOMICS
1750 Massachusetts Avenue, NW
Washington, DC 20036-1903
(202) 328-9000 FAX: (202) 659-3225
www.iie.com

C. Fred Bergsten, *Director*
Valerie Norville, *Director of Publications and Web Development*
Edward Tureen, *Director of Marketing*

Typesetting by BMWW
Printing by Kirby Lithographic Company, Inc.
Cover Photo: Getty Images/Guy Vanderelst

Printed in the United States of America
06 05 04 5 4 3 2 1

Library of Congress Cataloging-in-Publication Data

Baily, Martin Neil.
A transformation of the European economy / Martin Neil Baily, Jacob Funk Kirkegaard.
p. cm.
Includes bibliographical references and index.
ISBN 0-88132-343-8
1. Europe—Economic conditions—21st century. 2. Europe—Economic policy. I. Kirkegaard, Jacob F. II. Title.

HC240.B24 2004
330.94—dc22 2004051598

Contents

Preface ix

Acknowledgments xv

1 New Policies and New Goals for Changing Times 1
The Need for Sustained Economic Reform in Europe 4
Reform Progress to Date 6
A Framework for Transforming the European Economy 7
Summarizing the Nature of the Reform Proposals 21
Feasibility of Reform Proposals 25
Chapter Summaries 26
Concluding Remarks 31

2 Europe's Postwar Success and Subsequent Problems 33
What Drove Rapid Growth in Postwar Europe? 35
The European System's Advantages for Postwar Catch-Up 40
The 1973–95 Global Growth Slowdown 43
The Impact of Slower Productivity Growth: The US Lesson 47
The Impact of the Productivity Growth Slowdown on the European Economy 49
Cyclical and Structural Sources of Low Employment 60
Skill Differences and the Distribution of Wages 62
Taxes, Transfers, and the Willingness to Work 66
Demographic Changes: Extended Life Expectancy and Changes in Cohort Size 69
The Possibility of an Unstable Labor Market: A Warning Parable 75

Economic Performance since 1995 83
The Diagnosis 86
Appendix 2.1 A Model of Employment and Productivity 88

3 What Drives Productivity and How to Improve It in Europe 93
Policy Implications of the OECD Growth Analysis 95
Understanding What Drives Productivity Improvements Based on US Experience 102
Can Growth Accounting Track US Productivity Trends and Reveal the Role of IT? 104
Industry Data and Case Studies: How Much More Do They Explain? 110
A Summary Explanation for the Post-1995 Improvement in US Productivity Growth 116
Case Study Evidence on the Importance of Regulation and Competition in Europe 118
Lessons for Europe about Procompetitive, Productivity-Enhancing Regulation 129
The Role of IT in Productivity in Europe: Is an IT Policy Needed? 131
The Role of IT in European Economic Growth 133

4 The Productivity Puzzle in Britain 139
Economic Performance in the Postwar Period 141
Resolving the Productivity Puzzle: Capital, Skills, and Other Factors 144
Productivity Differences Associated with Nationality of Ownership and with Being Part of a Multinational Company 159
Case Study Evidence of Barriers to Productivity in Britain 162
Why Does the OECD Conclude that Product Markets in Britain Are Deregulated? 175
Conclusions on the Productivity Gap in Britain 177

5 Reforming the Labor Market and Social Programs 179
Reform and European Labor-Market Values 180
Social Policy Reforms 182
The Wage-Setting Process: Making Jobs Available 197
Labor-Market Reforms: European Solutions that Have Raised Employment 204
Appendix 5.1 The Nonobserved Economy, Undeclared Work, and European Economic Reforms 235

6 What Should Europe Do: Getting the Macroeconomics Right 245
The Stability and Growth Pact 245

Fiscal Policy Leading Up to and after the SGP 254
Problems with the SGP 257
Reform Proposals from Economists 259
The European Commission's Reform Proposal for the SGP 264
Modifying the European Commission Proposals 266
Getting the Macroeconomics Right: The ECB Mandate and Its Stated Goals 269
External Assessments of What the ECB Has Actually Done 272
Is the ECB Following the Right Monetary Policy? 276
Macroeconomic Policy to Support Reform 280

7 Are Current Reform Efforts on the Right Track? 281
Where Does EU Competition Policy Stand Now and What More Is Needed? 282
Reform: Driven by Individual European Governments, Reinforced at the EU Level 290
A Summary of Reforms to Date in the Four Largest Economies 291
A Big Push or a Slow and Incremental Approach to Reform? 308
Conclusion: Progress Has Been Made, but Much More Is Needed 309

References 311

Index 329

Tables

Table 2.1 Annual hours worked per person employed, relative to the United States, 1950 and 1973 36
Table 2.2 Sources of growth in real national income per person employed, 1950–62 37
Table 2.3 US unemployment and inflation, 1950–95 48
Table 2.4 Employer wage cost for alternative hourly after-tax wage rates 68
Table 2.5 Average retirement age, select countries, 1965–99 71
Table 3.1 Productivity growth accounting pre- and post-1973 in nonfarm business 105
Table 3.2 Accounting for the post-1995 productivity speed-up 106
Table 3.3 Labor productivity growth by industry, 1989–2001 111
Table 3.4 Labor productivity growth, 1990–2000 134
Table 4.1 Growth in capital investment, 1979–99 149
Table 4.2 Average research and development expenditures as shares of output, 1973–98 150
Table 5A.1 Undeclared work in the European Union and select labor-market statistics 240

Table 6.1 Actual monetary policy and the Taylor Rule, 1985–2003 279
Table 7.1 International mergers and acquisitions by target country 288

Figures

Figure 1.1 EU-15 employment growth, 1992–2003, and 2010 Lisbon goals, annual change 31
Figure 2.1 Productivity growth pre- and post-1973 44
Figure 2.2 Comparative effect of post-1973 slowdown on productivity growth and labor utilization 45
Figure 2.3 US wage growth pre- and post-1973, 1959–95 47
Figure 2.4 End of economic convergence in GDP per capita, select countries, 1950–2003 50
Figure 2.5 Total hours worked per capita, select countries, 1973–2003 52
Figure 2.6 Public- and private-sector average employment growth, select countries, 1992–2001 53
Figure 2.7 Real-wage compensation pre- and post-1973, select countries 55
Figure 2.8 Wage distribution, select countries, 1973–2000 63
Figure 2.9 Tax wedge and direct wage cost, select countries, 2003 67
Figure 2.10 Rising life expectancy after age 65, 1970 and 1999 70
Figure 2.11 Rising life expectancy at effective retirement age, select countries, 1970 and 1999 72
Figure 2.12 Number of employees for each retiree, select countries, 2000 and 2030 73
Figure 2.13 Age profiles for public per capita health expenditure, select countries 75
Figure 2.14 A stable labor market: As employment falls, the work-incentive ratio rises until it reaches its critical level 79
Figure 2.15 An unstable labor market: As employment falls, the work-incentive ratio falls 80
Figure 2.16 Comparative effect of productivity growth and labor utilization pre- and post-1995, select countries 83
Figure 3.1 Net employment gains among surviving firms at different lifetimes 101
Figure 3.2 US labor productivity, March 1973–December 2003 103
Figure 3.3 French and German productivity performance relative to the United States, 1992–2000 119
Figure 4.1 Britain's real GDP growth, 1992–2002 140
Figure 4.2 Labor productivity gap: Contribution of capital intensity, skills, and MFP to the market economy, select countries, 1999 146

Figure 4.3	Labor productivity gap: Contribution of capital intensity, skills, and MFP to the total economy, select countries, 1999	147
Figure 4.4	Adjusted total IT investment in Britain and the United States, 1974–98	152
Figure 4.5	Skill levels of workforce, selected countries, 1999	154
Figure 4.6	Level of labor productivity among main OEMs in Britain, 1996	163
Figure 5.1	Out-of-pocket patient financing as a percent of total healthcare expenditure, select countries, 2000	185
Figure 5.2	Total assets of private pension funds, select countries, various years	192
Figure 5.3	Probability of layoff following wage increase with restricted competititon	199
Figure 5.4	Probability of layoff following wage increase with competition	201
Figure 5.5	Employment/population ratio and unemployment in the Netherlands, 1980–2002	205
Figure 5.6	Part-time employment of total population and women, Netherlands and EU average, 1983–2002	211
Figure 5.7	Average annual hours worked, select countries, 1979–2003	212
Figure 5.8	Unemployment benefit recipients in the Netherlands, 1970–2000	213
Figure 5.9	Sweden's open unemployment and participation rate in ALMPs, 1986–2002	216
Figure 5.10	General government revenues and expenditure in Sweden and the eurozone, 1985–2002	217
Figure 5.11	Select social expenditures in Sweden, 1980–98	221
Figure 5.12	Sweden's sick leave, men and women, 1955–2003	222
Figure 5.13	Unemployment and employment to population rates in Denmark and the European Union, 1983–2002	225
Figure 5.14	Overall employment protection legislation indicator, 1998	227
Figure 5.15	Passive measures and labor-market training expenditures, select countries, 1990–2000	229
Figure 5.16	Active labor force enrolled in labor-market training, select countries, 1990–2000	230
Figure 5.17	Youth unemployment in Denmark, 1996–2003	231
Figure 5.18	Disability benefit recipiency rates in the 20- to 64-year-old population, select countries, 1980–99	232
Figure 5A.1	Underground activities in OECD countries, 2002–02	238

Figure 6.1	General government lending or borrowing, select EU members, 1991–2005	255
Figure 6.2	General government consolidated gross debt, select EU members, 1980–2005	256
Figure 6.3	Cyclically adjusted budget position of the EU member states, large EU economies, 1999–2004	257
Figure 6.4	EU member states' actual and cyclical budget position, 2003	258
Figure 6.5	Eurozone inflation and ECB main refinancing rate, January 1999–May 2004	273
Figure 6.6	Eurozone M3 annual growth rate and ECB main refinancing rate, January 1999–May 2003	274
Figure 6.7	ECB main financing rate and selected economic indicators, January 1999–December 2003	275
Figure 7.1	Degree of competition in the EU's electricity markets, February 2003	299
Figure 7.2	Household electricity prices in the European Union	305

Boxes

Box 2.1	The timing of European welfare states	57
Box 2.2	Measurement issues	84
Box 3.1	Prices of manufactured goods: Evidence that Europe still has trade barriers	94
Box 3.2	National regulatory barriers limit competititon within the European Union—but the European Commision is fighting back	127
Box 4.1	Problems in the construction industry exacerbate problems from planning restrictions: Conclusions from a UK Treasury report	174
Box 4.2	Constructing the product-market regulation index	176
Box 5.1	Offshore assets in Europe	194

Preface

The European Union has been plagued by high unemployment for many years. More recently, it has been unable to achieve the high productivity growth experienced in the United States since the mid-1990s. As intensified global competition and aging populations in the 21st century threaten to further increase the pressure on European labor markets and government budgets, EU leaders in 2000 in Lisbon set out a bold vision for Europe in 2010: "*. . . to become the most competitive and dynamic knowledge-based economy in the world. . . .*" Such a Europe was to be achieved through growth-promoting policies and a modernization of the European social model.

Nearly halfway to 2010, the European Union continues to be mired in low economic growth, persistently high unemployment, and large government deficits despite a strong global economy. Why is this so? What is the right diagnosis of the problem? Is the correct cure being administered?

In this study, Senior Fellow Martin Neil Baily and Research Associate Jacob F. Kirkegaard explore why major European economies have not been able to maintain the rapid pace of economic growth and productivity increases that they experienced in the initial decades after World War II. The authors make a strong case for comprehensive reforms of Europe's social systems and product markets to generate the essential flexibility needed to fulfill the goals of the Lisbon agenda.

The study reveals that the challenges facing EU members are indeed severe but punctures the myths that Europe is doomed to perpetual economic decline or that the destruction of the European welfare states is inevitable in the reform process. Indeed, Baily and Kirkegaard show the great variety of performance among European economies, some of which—particularly smaller ones—have already carried out social reforms that have succeeded in raising employment and lowering unemployment while maintaining high levels of social protection. Similar variety exists in product markets. Baily and Kirkegaard demonstrate convincingly, using detailed industry case study evidence, that European industries have achieved strong productivity growth when faced with the correct competition-enhancing regulation. In the case of mobile telecom, for example, productivity levels in France and Germany are above those in the United States.

Building on these past European experiences, as well as results from the United States, Baily and Kirkegaard propose reforms aimed at improving the incentive structures faced by all European economic actors: workers, the unemployed, companies, and regulators. EU welfare states must provide new employment opportunities rather than protect existing jobs, and do so via realignment rather than dismantlement. EU product markets must similarly facilitate competition, innovation, and choice rather than shelter unproductive incumbents and suboptimal standards.

With macroeconomic variables playing an important supporting role in generating sustained economic growth, corresponding proposals are made for adjusting macroeconomic institutions. EU government budgets need discipline but in a way that does not unnecessarily constrain countercyclical expenditure. On the monetary side, the European Central Bank should not only be a strong and credible inflation fighter but also growth promoting, and it should recognize the costs imposed when inflation falls too low.

Baily and Kirkegaard illustrate that member states, rather than EU-level or entirely new institutions, have to be the main drivers of change. In evaluating the reform process to date in the largest EU economies, they conclude that progress is occurring albeit at an uneven, slow pace. The book offers a positive way forward for Europe—one the authors hope Europe's decision makers will choose to embrace. They conclude that standing still is not an option, given the sweeping forces of change occurring within Europe and deriving from Europe's place in the global economy.

The Institute for International Economics is a private, nonprofit institution for the study and discussion of international economic policy. Its purpose is to analyze important issues in that area and to develop and communicate practical new approaches for dealing with them. The Institute is completely nonpartisan.

The Institute is funded largely by philanthropic foundations. Major institutional grants are now being received from the William M. Keck, Jr. Foundation and the Starr Foundation. A number of other foundations, private corporations and individuals contribute to the highly diversified financial resources of the Institute. About 23 percent of the Institute's resources in our latest fiscal year were provided by contributors outside the United States, including about 8 percent from Japan. Support for this study was provided by JER Partners, reflecting its major interest in the European economy and in transatlantic economic relations.

The Board of Directors bears overall responsibility for the Institute and gives general guidance and approval to its research program, including the identification of topics that are likely to become important over the medium run (one to three years) and which should be addressed by the Institute. The director, working closely with the staff and outside Advisory Committee, is responsible for the development of particular projects and makes the final decision to publish an individual study.

The Institute hopes that its studies and other activities will contribute to building a stronger foundation for international economic policy around the world. We invite readers of these publications to let us know how they think we can best accomplish this objective.

C. Fred Bergsten
Director
August 2004

Acknowledgments

The authors would like to thank their colleagues at the Institute for International Economics for many helpful comments, and C. Fred Bergsten and the Institute for sustained support of this project. Bart van Ark from the University of Groningen and Stefano Scarpetta from the World Bank reviewed the book and made a number of valuable comments and suggestions. We also thank European Commission President Romano Prodi, Robert Solow and Olivier Blanchard from MIT, Robert Gordon of Northwestern University, and Paul Hofheinz and Anne Mettler from the Lisbon Council for their advice and assistance. Tamim Bayoumi of the International Monetary Fund, Hervé Carré and Moreno Bertoldi of the European Commission, William Dickens and Charles Schultze from the Brookings Institution, and Dirk Pilat and John Martin of the Organization for Economic Cooperation and Development commented on a prior draft of the book. We would like to thank Gunilla Pettersson and Pavel Trcala for their excellent research assistance, and Marla Banov, Madona Devasahayam, and Valerie Norville for their excellent and tireless assistance in editing the manuscript and preparing it for publication. The book draws extensively on work at the McKinsey Global Institute, where Martin N. Baily is a senior adviser. The opinions and any factual mistakes are the authors' own, and the views expressed do not necessarily reflect the opinions of the staff or trustees of the Institute for International Economics.

1

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 DeLong[1]

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 policymakers 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 its—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 polices.

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 nontariff 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 interest[9] 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 nonemployed 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 Economies, 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 rates[13] 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