Comments on “Institutions, Economic Structure, and Performance: Is Italy Doomed?”, by Giuseppe Nicoletti

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This paper is part of a large OECD project on the relation between institutions and economic performance in rich countries. The project is very much needed: This is a topic on which ideology runs rampant. Statements about how labor market rigidities and product market regulations have led to Eurosclerosis and killed growth in Europe are taken by many to be self evident. But they are not:

• First, and to state the obvious, Europe is not doing so badly: GDP per capita is actually quite similar across both sides of the ocean. GDP per hour worked is even more so. For example, a recent McKinsey study concludes that Germany’s PPP GDP per hour worked stands at 87% to 97% of the U.S. level, France’s PPP GDP per hour worked at 90% to 100% of the U.S. level. And, while average European unemployment remains high, a number of countries, from the Netherlands to Sweden and to Portugal, have now achieved surprisingly low unemployment levels. And they have done it without adopting US–type labor market institutions. Do not read me wrong: The point is not that things are great in Europe, just that the gloom and doom statements should be put in perspective.

• Second, and again to state the obvious, as transition in Eastern Europe, the Russian crisis, the Asian crisis, and the Enron scandal, have reminded us,
markets do not function well without proper institutions. Financial markets need serious guidelines. And the labor market looks nothing like the competitive textbook competitive market: Imperfections, from incomplete insurance to the scope for ex-post bargaining and hold-ups, are many, and difficult to deal with. They require carefully designed institutions, not an institutional void.

In short: European institutions may not be best, but to dismiss them en masse is intellectual stupidity. So serious economists have a substantial task on their hands: Establish the facts; think about the role of each institution; and, then, and only then, suggest carefully thought-out reforms.

The OECD is in a unique position to collect facts. And, as this paper shows, fact collection has proven not only fascinating, but also precious. Think of the questions this project in general, and this paper in particular, help us answer:

- What are the actual differences in regulations across countries? In the context of this conference: How is Italy different from other European countries?
- What are the relations between different regulations? Which labor market regulations appear to be complementary? Which ones appear to be substitutes? How do labor and product market regulations interact?
- What are the relations between regulations and outcomes? Does the panel data evidence reveal strong links? If so, which ones?

Before listing some of the lessons I draw from this paper, let me make two remarks:

- The paper focuses on product and labor market regulation. These are only two legs of what is clearly a three-legged beast. The third leg is financial market regulation—and its effect on the financing structure and the nature of governance within firms. I have a sense that many of the outcomes the paper focuses on can in fact be traced to financial market regulation. I hope the OECD team extends its investigation to examine all three legs together.
- There is an alternative—and complementary—approach to the panel data econometric approach followed in the OECD project. It is the McKinsey Global Institute approach of looking carefully at individual sectors (often at individual firms in specific sectors), assessing their factor productivity,
and then trying to relate it to specific features of the institutional environment. Having been involved in a number of these studies, I have found them extremely useful in pinpointing the role of specific regulations in helping or hindering productivity. Often, case studies make the point more convincingly than econometrics.

1 Lessons about Italy, for an outsider

Let me pick and choose here. There are too many important issues raised by the paper to do justice to all.

On product market regulation

One gets the clear impression that product market deregulation has been largely imposed on Italy from outside, i.e. from Brussels. This raises an interesting issue:

One can think of two types of (bad) product market regulation:

- Call the first “inward oriented”. It aims at protecting incumbent firms from potential domestic competitors, through entry restrictions and other means. The result is the creation of rents, and their distribution to incumbents, to the state, and to politicians. The inefficiencies generated by regulation may be substantial, but incumbent firms are better off, and the state and politicians are happy enough to go along.

- Call the second “outward oriented”. It aims at protecting domestic firms from foreign competitors, through barriers to trade and other means.

One can think of the process of European integration as forcing the removal of much of the second type of regulation. But in this case, maintaining the first type of regulation may become quite costly for incumbent firms. The inefficiencies generated by inward oriented regulation may make it difficult to compete with foreign firms. So, from the point of view of incumbents, the best reaction to a decrease in outward oriented regulation may be to decrease inward oriented regulation. In other words, if they have to compete, incumbents may want to be
able to compete as well as they can. One type of deregulation may well trigger the other.

**On labor market regulation**

Perhaps one of the most interesting findings reported in the paper is Figure 6. I have a hard time understanding the notion of “corporatist protection”, so I read that graph as stating that, at least in continental Europe, there is a clear inverse relation across countries between the degree of employment protection and the degree of unemployment insurance. Italy and Greece have the most employment protection, the least unemployment insurance.

That we would observe such a negative relation is perhaps no big surprise. If unemployment is painful, workers will lobby hard to avoid it, and ask for high employment protection. Governments may go along, thinking that it is much cheaper to have the firms provide employment protection, than having the government to pay for unemployment insurance.

But, from a normative point of view, this is likely to be a very poor outcome. Unemployment insurance and employment protection should go hand in hand. Generous unemployment insurance leads to excessive job destruction. Employment protection (in the form of severance pay for example) leads to insufficient job destruction. To avoid distortions at the destruction margin, it is clearly best to use both. The more one is used, the more the other should be, ceteris paribus.

This suggests a potential direction for labor market reform. Starting from the Italian starting point, more generous unemployment insurance, in exchange for a reduction in employment protection, appears to hold the scope for an improvement in efficiency at little or no cost in social protection. This direction seems very much worth exploring, conceptually and empirically.

**On the mapping from regulations to facts**

The paper documents the relatively low levels of R&D and FDI, and the relatively large number of small firms in Italy. It then tries to relate those to product
and labor market regulations. This is not fully convincing: This is a case where financial market regulation, and its effect on governance, on the nature of external finance, on transparency, strikes me as much more important than either product or labor market regulation.

The same is true of the attempt to explain the low employment rate. There again, one is led to think of other factors than product and labor market regulation. Culture, and the organization of the family, strike me as relevant. So is for example the limited public availability of child care, a topic explored in another paper at the conference.

2 The likely effects of further deregulation
If Italian policy makers were given a magic wand and removed all “bad” product market regulations, what would happen to the Italian economy?

Productivity growth

Would there be a burst of productivity growth? This is what is suggested by the fascinating Figure 12, which plots the change in total factor productivity growth against the change in procompetitive regulatory reform, and finds a reasonably strong relation between the two. I was initially skeptical that the relation was there. Having played with the numbers (gracefully given to me by Nicoletti), I believe the relation is truly there. It may still be an accident, but not an intentional one...

And the McKinsey studies I refered to earlier provide some support for the idea of a potential productivity boom. A study of a number of sectors in France and Germany showed that the productivity gap relative to best practice—a gap of 20% on average—could often be traced to specific regulations. It is not crazy to think that removing these regulations could therefore lead to an increase in productivity in these sectors of up to 20%. If these sectors account for, say, half of the economy and the adjustment takes, say, ten years, this implies an increase
in tfp growth of 1% a year, an implication consistent with the size of the effects implied by Figure 12.

**Real wages**

Higher product market competition would likely lead to lower markups, and thus to higher real wages—given productivity. (At the economy-wide level, a lower markup means a lower price level given the nominal wage, thus a higher real wage). This effect is conceptually separate from the productivity increase; it could take place even if there is no productivity boom.

**Unemployment**

What would happen to unemployment? Two main effects are likely to be at work. On the one hand, higher productivity growth and lower markups both tend to lead to lower equilibrium unemployment, at least for some time: Such an effect of higher productivity growth has been clearly visible in the United States in the second half of the 1990s. But stronger competition in the goods market may also lead firms to work hard on eliminating chronic labor hoarding, increasing productivity but also increasing unemployment for some time. Such a coincidence of higher productivity growth and higher unemployment has dominated much of the transition experience of Eastern European countries in the 1990s. Which effect would dominate in the case of Italy is difficult/impossible to predict.

**Product and labor market interactions**

The discussion of the effects of higher competition in the goods market on labor hoarding leads to my last point. One of the effects—the main effect?—of product market deregulation is likely to be its effect on labor market relations and labor market regulations. Many of the regulations in the labor market are predicated on the existence of rents in the product market, and designed to help workers appropriate some of these rents. With smaller rents to appropriate, some of these regulations may become counterproductive. Also, with smaller rents to
appropriate, unions may have less to offer to workers, and, as a result, become weaker. In a recent paper, Francesco Giavazzi and I have explored some of these potential interactions between product market regulation and the labor market. We concluded that product market deregulation may well trigger labor market deregulation. But we feel we only scratched the surface, and that much remains to be done here.