Comments on “Contrasting Europe’s decline; Do product market reforms help?”*, by Riccardo Faini et al *

Olivier Blanchard

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This paper fits right in the tradition of these annual conferences. It builds on the collective knowledge of the many authors, it contains an enormous amount of factual information about many sectors and many countries, and it is likely to serve as a standard reference in the future.

I learned a lot from it. My comparative advantage is surely not to argue with the specific findings. It may instead be to put the results of the study in the larger context of the effects of deregulation on productivity and employment, and the now traditional comparison between the United States and Europe. I shall expand briefly on six points.

1 Are things really so bad (on the productivity front) ?

Quoting from the introduction of the paper: “There is considerable agreement that widespread rigidities in European markets are among the main culprits of Europe’s growth record”.

Sure, there are many rigidities in Europe. Sure, output growth could be higher. But is the reality so bad? I believe that some of the European self–flagellation is excessive, and the diagnosis should be nuanced.

Table 1, using data from the OECD, gives numbers for labor productivity levels for France, Italy, and the United States. I choose France because I know it well, Italy because of where we are, and the United States as the standard benchmark. Labor productivity is constructed as the ratio of GDP, measured in 1995 PPP prices, to total hours worked. The conclusions are clear: France and Italy were far behind the United States in 1970. They are roughly at the same level as the United States today. (France is actually ahead, but let me remain modest...)

Table 1. Labor productivity levels in France, Italy, and the United States.

<table>
<thead>
<tr>
<th>Year</th>
<th>France</th>
<th>Italy</th>
<th>U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>16.0</td>
<td>16.5</td>
<td>23.2</td>
</tr>
<tr>
<td>1990</td>
<td>30.4</td>
<td>30.7</td>
<td>30.1</td>
</tr>
<tr>
<td>2002</td>
<td>38.2</td>
<td>37.4</td>
<td>37.2</td>
</tr>
</tbody>
</table>

Can these numbers be taken at face value? Don’t these numbers reflect the fact that European countries boost labor productivity by replacing workers by machines and by setting a high minimum wage, therefore eliminating low productivity workers from the employment pool? I have looked at these two issues in a recent paper [2002]. My conclusion is that, while both factors are relevant, they do not radically change the conclusions. Looking at total factor rather than labor productivity, it looks like a close race, and while the United States is probably ahead, it is not ahead by very much.

Table 2. Labor productivity growth rates in France, Italy, and the United States.

<table>
<thead>
<tr>
<th>Period</th>
<th>France</th>
<th>Italy</th>
<th>U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970-1980</td>
<td>3.5</td>
<td>3.8</td>
<td>1.3</td>
</tr>
<tr>
<td>1980-1990</td>
<td>2.8</td>
<td>2.3</td>
<td>1.3</td>
</tr>
<tr>
<td>1990-2000</td>
<td>1.6</td>
<td>1.2</td>
<td>1.4</td>
</tr>
<tr>
<td>(1995-2000)</td>
<td>1.6</td>
<td>1.0</td>
<td>2.2</td>
</tr>
</tbody>
</table>
Table 2 gives labor productivity growth (with labor productivity defined the same way as in Table 1) by decade since 1970, again for France, Italy, and the United States.

Two facts are striking. First, labor productivity growth has been substantially higher in France and Italy than in the United States since 1970. This is the good news (although it is old news, as it was already implicit in Table 1). Second, the gap between French or Italian productivity growth on the one hand, and U.S. productivity growth on the other, has steadily decreased. Indeed, for the most recent period (1995-2000), it has reversed, and, while the table stops in 2000, the reversal appears to have continued so far in the 2000s. This is the bad news.

There are however two ways of interpreting this bad news: One is as a steady deterioration of the European performance, starting in 1970s. The other is as the natural end of catch up as productivity levels have converged, plus additional danger signs since the mid–1990s.

The two interpretations point to potentially different factors. Under the first, one naturally thinks of rigidities as progressively asphyxiating Europe, steadily reducing its growth since 1970. Under the second, which has my preference, the problem is more recent, dating perhaps to the mid–1990s. The slowdown in productivity growth is due to catch up and does not reflect badly on Europe. What is worrisome is that the U.S. appears to have recently found a second youth, while Europe is still looking. The questions are then why, and what in particular is the role of differences in product market regulation. This brings me to the second point.


Much work has gone into trying to understand the divergence of productivity growth rates across the two sides of the ocean since the mid–1990s. I am a consumer, not a producer of this research. I have a lot of admiration for what has been done already, in particular that of Van Ark and co-authors [2002a, 2002b]. I am not sure however we, as a profession, have the story tied down. The time series are short, the measurement problems gigantic. (There are also complex macro factors
at work. Take the example of Spain which has had roughly zero measured total factor productivity growth since 1990. There is little question that low measured total factor productivity growth and the large unemployment decline during the same period must be related. The question is how. Is it due to the reemployment of low productivity workers—so, to measurement problems, which would disappear if we weighted workers properly? Or is it for real, with firms facing a trade-off between TFP and employment? The questions are obviously central to thinking about the future of Spain. But they are relevant for other European countries as well.)

What do we know with reasonable confidence?

We know that the GDP share of the IT producing sector, the sector with very high productivity growth, is smaller on average in Europe than in the United States (the European average hiding however substantial heterogeneity across countries). Does this smaller share point to problems with goods market regulation? I am not sure. To me, it points more to problems with the education system, with credit and financial markets, with the financing of R&D.

We are less sure about the role of differences in the use of IT by firms. U.S. firms spent more on IT than their European counterparts in the 1990s, but, in retrospect, one is not sure all that money was well spent. Case study evidence, for example from the McKinsey studies on the use of IT in specific sectors in France, Germany, and the United States [1997, 2001, 2002], does not point to major differences. In most cases, European firms appear to be just as eager, and just as able, to introduce IT as are their U.S. counterparts.

One sector stands out as accounting for much of the difference between the U.S. and European productivity growth since 1995: the trade sector, especially retail trade. (The other sector singled out by Van Ark et al is “securities”. The problems of measurement of productivity in the financial sector seem so large in that case that I am not sure how much weight we can put on the finding.) This indeed points to a potential role of goods market rigidities: Retail trade is organized very differently across the two sides of the Atlantic. Retail trade does not fall under Bruxelles’ mandate to make goods markets more competitive, and thus has largely escaped deregulation. Many European countries still have tight national and local
regulations, from restrictions on opening hours, to zoning restrictions on what can be built where. This brings me to my third point.

3 A closer look at the retail trade sector.

What do the data say about differences in productivity in retail trade across countries, and do they indeed point to regulation as the culprit?

Here again, except for my participation in the McKinsey studies, I am a consumer rather than a producer, of research. And I must admit to being a fairly confused consumer.

First, this is a case where visiting the kitchen makes you less enthusiastic about the meal. Measuring productivity in the retail trade sector is an accounting nightmare. For example: Value added data is rarely available. What is typically available is gross margins, so that the cost of intermediate inputs other than the goods purchased for resale is not taken into account. The price deflator typically measures the price of goods sold (the PCE deflator), rather than the price of services provided. (As Martin Baily has reminded us, in the United States, the retail sector with the highest measured productivity growth, is electronics...) When one attempts to measure total factor productivity rather than labor productivity, measuring capital is nearly impossible. Values of capital including land at market value make capital much larger in European countries, where stores tend to be in the center of town, and land prices are much higher. Approximating, as is often done, capital by square footage leads instead to a smaller value of capital in Europe relative to the United States (stores are smaller in Europe, largely because they are on more expensive real estate). And using square footage does not seem promising if one of the goals of a study is to find the effects of IT capital on productivity in the sector.

With these caveats duly registered, Table 3 gives the numbers I have been able to collect for labor productivity levels and growth rates in the retail trade sector for a number of European countries (in this case, I could not get numbers for Italy), and for the United States.
Table 3. Productivity levels and growth rates in retail in Europe and the United States.

<table>
<thead>
<tr>
<th></th>
<th>FRA</th>
<th>DEU</th>
<th>U.K.</th>
<th>U.S.</th>
<th>E.U.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Labor pty growth</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Van Ark 1990-95 (%)</td>
<td>1.3</td>
<td>0.2</td>
<td>2.6</td>
<td>2.3</td>
<td>1.1</td>
</tr>
<tr>
<td>Van Ark 1995-00</td>
<td>-0.2</td>
<td>3.5</td>
<td>6.9</td>
<td>1.4</td>
<td></td>
</tr>
<tr>
<td><strong>Labor productivity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mahony 1999</td>
<td>98</td>
<td>78</td>
<td>61</td>
<td>100*</td>
<td></td>
</tr>
<tr>
<td>McKinsey 2000</td>
<td>98</td>
<td>90</td>
<td>100*</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Food retail (McKinsey)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Modern segment</td>
<td>107</td>
<td>86</td>
<td>100*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Traditional segment</td>
<td>77</td>
<td>70</td>
<td>48</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Share of modern</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>80-95</td>
<td>-23%</td>
<td>-17%</td>
<td>-9%</td>
<td></td>
<td></td>
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<tr>
<td>∆ share trad 80-95</td>
<td></td>
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</table>

I draw three conclusions from the table.

The first two lines, coming from the work of Van Ark et al, give the numbers for labor productivity growth since 1990. They show much higher labor productivity growth in retail trade in the United States than in Europe since the mid–1900s—6.9% versus 1.4%. The American “Wal Mart” miracle, documented by McKinsey [2001], does not appear to have had a European counterpart.

It is this pair of numbers which has led many to blame goods market rigidities in Europe: What Wal Mart could do, European retailers would not or could not do.

The next two lines do not quite fit this simple theme however. They give labor productivity levels, from studies by Mahony et de Boer [2002] and McKinsey [2002]. Both studies suggest roughly similar levels of productivity for France and the United States—surely not what the simple rigidities story would suggest.

The laggard appears to be the United Kingdom, a country relatively unregulated relative to its continental European counterparts! This again is not good news for the rigidities thesis. (A side, but relevant, remark. I have a hard time getting a sense of the U.K. productivity level or growth rate in retail trade. The numbers on U.K. productivity growth in the retail trade sector from Van Ark in line 2 of Table 3—which are the numbers cited in the paper by Faini et al—are high. But
the numbers constructed by Basu et al [2003] are extremely low, indeed negative for the second half of the 1990s. I could not trace the difference in findings.

The last two lines of the table try to get at what lies behind the surprisingly similar levels of productivity in France and the United States. They are taken from the McKinsey study of food retail in France, Germany, and the United States [2002]. The study measures productivity levels separately for the modern and the traditional segment, and this leads to an interesting conclusion. For both the modern and the traditional segment, productivity is higher in France than in the United States! The last two lines of the table show why this does not translate into a higher average productivity level in France: The share of the modern sector is much smaller in France than in the United States.

Let me again insist on the fact that all these numbers must be taken with more than a grain of salt. But, such as it is, the picture which emerges is interesting: Format by format, retailers are as efficient or even more efficient in France than in the United States. But the various policies put in place in France to protect small businesses in the center of towns lead to a larger share of small retailers, and thus a productivity level which is lower than it could be. Are these policies justified? Their design is often mediocre, and sometimes counterproductive. But their goal, keeping the center of cities alive, can surely not be rejected a priori.

4 Deregulation and productivity growth.

Whether Europe is or is not behind the United States, it is still the case that deregulation—or, for most of the sectors this study is looking at, better regulation—would allow for substantial improvements in productivity.

This is indeed the credo of most economists. It is also the conclusion of the sectoral studies summarized in the paper by Faini et al. One may wonder whether the correlations prove causality. My impression from the McKinsey studies—which go into the entrails of particular sectors, and often allow to trace the specific effects of deregulation more convincingly—is that they do. I shall add three examples to the discussion given in the paper, all from services, and all taken from McKinsey [2002]:
The first is mobile telephony. Labor productivity today is about twice as high in France as it is in the United States. The main reason appears to be simple, but perhaps surprising: Good regulation, which has limited the numbers of mobile operators in France relative to the United States, and allowed for economies of scale while maintaining a high degree of competition.

The second is road freight. One of the characteristics of road freight is that the technology is simple, and inputs and outputs relatively easy to measure. This makes it easy to link productivity growth to specific actions (load rate for trucks, truck size), and in turn specific actions to regulation. There, the story is one of large increases in productivity in road freight in France in the 1990s. And most of the increases can be directly traced back to deregulation—the development of the European internal market, the elimination of restrictions of foreign carriers, and other national reforms.

The third is an example a contrario. France often boasts of the efficiency of its electricity generation and distribution system. Indeed, labor productivity was slightly higher in France than in the United States in the early 1990s. Since then however, productivity growth has been lower in France than in the United States, and France now appears to be slightly behind. Why? One factor—admittedly only one—is the considerable pressure from the French government on EDF to hire approximately 10,000 employees over the period. Stricto sensu, this example points more to the dangers of state ownership than of regulation; but the two are closely linked.

5 Deregulation and employment.

Another big issue studied in the paper is the effect of deregulation on employment. It is useful here to take a short theoretical detour:

At the aggregate level, deregulation is likely to be good for employment. Deregulation increases productivity. The macro evidence is that such increases in productivity decrease unemployment for a while, if not forever. Deregulation decreases monopoly power and thus decreases prices given wages. Put another way, deregu-
lation increases real wages effectively paid by firms. This is also likely to decrease unemployment, at least for some time.

These are however aggregate effects. At the level of the sector being deregulated, the effect of deregulation on employment is definitely ambiguous. Higher productivity leads to a decrease in employment for a given level of output. Lower prices, induced either by higher productivity or/and by reduced monopoly power, lead to an increase in demand and thus an increase in output. Which effect dominates is ambiguous.

The conclusion of the paper by Faini et al is that, in most of the cases they study, sectoral employment decreases. This again fits with the sectoral evidence from the McKinsey studies. One of the main effects of deregulation is a decrease in x-inefficiency. In the short run, this almost always means layoffs. In the longer run, higher productivity could lead to higher output and higher employment; in fact, I have not yet seen a sectoral study in which employment recovers or more than recovers. (Employment has obviously increased in telecommunications in the 1990s. But how much is due to deregulation, how much is due to the introduction of new products, indeed how many of the new products introduced have been introduced because deregulation made it possible, is hard to establish.)

The conclusion that deregulation, even if it increases employment at the aggregate level, is more likely to decrease than increase employment in the sector being deregulated, is an important one, one that politicians are unlikely to ignore. This takes me to my last point.

6 Deregulation and labor market reforms.

Europe needs reforms not only in the goods market, but also, and perhaps more so, in the labor market. This raises the issue of the interactions between the two. This is something I have explored in a paper with Francesco Giavazzi [2003]. Let me just state what I see as the relevant conclusions in the present context:

Deregulation lowers monopoly rents for firms; it also leads to higher entry and exit, to higher reallocation. Both changes put pressure on a number of labor market
institutions. If workers try to extract the same level of rents, or keep the same level of employment protection for example, some firms are likely to go bankrupt.

Deregulation is likely however to weaken unions. To the extent that unions are about transferring some of the monopoly rents to workers, smaller rents means a smaller scope for transfer of rents to the workers, weaker unions. Why join a union if there are no rents to appropriate in the first place? Faced with this problem, unions may either retreat to the sectors protected from deregulation (for example the public sector) and continue to fight for rents there. Or they can modify their strategy, for example by actively participating in and influencing the reform process. Some unions choose the first route, some the second.

The optimistic scenario is then one in which the pressure from deregulation on labor market institutions, together with either weaker or reformed unions, leads to reforms in the labor market. The pessimistic scenario is one in which labor market institutions are adjusted too slowly in response to changes in the goods market, squeezing firms’ profits, and potentially leading to bankruptcies. (The two scenarios are played out in the airline industry.) We are likely to see a mix of both scenarios played out in Europe over the coming decade.
References


