McKinsey Global Institute

A Road Map for European Economic Reform

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A Road Map for European Economic Reform

The fears of change and discontent about Europe's economic performance that led French and Dutch voters to reject the European Union's proposed constitution have contributed to the divided election outcome in Germany. The irony of these votes is that for Europe to preserve its way of life, it must embrace change and reform.

The pace of growth in the European Union's core economies has been dismal, and the budgets of some countries are in deficit and threaten to get worse as the population ages.[1] In a recent speech, Vladimir Spidia, a member of the European Commission, summed up the problem: "We cannot accept 17 million unemployed, average economic growth of 0.6 percent in the old member states, and youth unemployment of 18.6 percent in the 25-member European Union. Change begins in our own minds."[2]

To address the political crisis, Europe's leaders must improve the region's economic performance—but no one can agree on how. Many European officials believe that competition and market forces are hindering economic growth and that reform will mean the elimination of their social safety net. Their solution is to protect the region against competition, to maintain regulations that prevent companies from restructuring and making layoffs, and, perhaps, to invest more in research and development.

Such solutions won't work, as history has proved. There is no full-employment economy in the world that is innovative, dynamic, and growing and that also maintains rigid regulations and restrictions on competition. The McKinsey Global Institute (MGI) studied six major European economies and found that a lack of technology is not the reason for slow growth.[3] Instead, boosting competition, often through regulatory reform, is the impetus that Europe needs to improve its productivity.

Europe won't have to abandon its social programs, however. Many European countries may have to modify their social-benefits programs in order to restore the incentive to work, but, as Denmark has shown, governments can provide

1 *The Graying of Europe: How Aging Populations will Threaten Living Standards and Prosperity*, The McKinsey Global Institute, April 2005.

2 Vladimir Spidia, Commissioner for Employment, Social Affairs and Equal Opportunities at the European Commission. The 2005 Jean Jacques Rousseau lecture at the Lisbon Council, Brussels, June 20, 2005.

3 These studies are available free of charge at www.mckinsey.com/mgi.

income support to the unemployed while encouraging them to find new jobs. Paradoxically, Europe must restore full employment and generate economic growth if it is to maintain adequate pensions and social insurance, especially as the population ages.

Ideally, Europe's low-performing nations would embrace economic reform. Not all of them are willing to go down that road yet, unfortunately. While no country has fully liberalized its economy, Denmark, Ireland, Spain, Sweden, and the United Kingdom have undertaken reforms that led to more employment and growth. These countries set an example by combining better economic performance while preserving the essentials of the European way of life.

COMPETITION IS THE KEY TO GROWTH

MGI's research on a range of European economies shows that deregulation or regulatory reform improves productivity. In every one of the countries we studied, a gap exists between the productivity of the majority of companies in a given industry and those that boasted best practice. France and Germany provide a good example.[4] For most industries, labor productivity is lower in France and Germany than in the United States (Exhibit 1). Food retail in France and mobile telecoms in both France and Germany are the only exceptions (Exhibit 2). While a number of European industries closed the productivity gap with the United States during the 1990s, about as many also fell further behind—a worrisome trend.

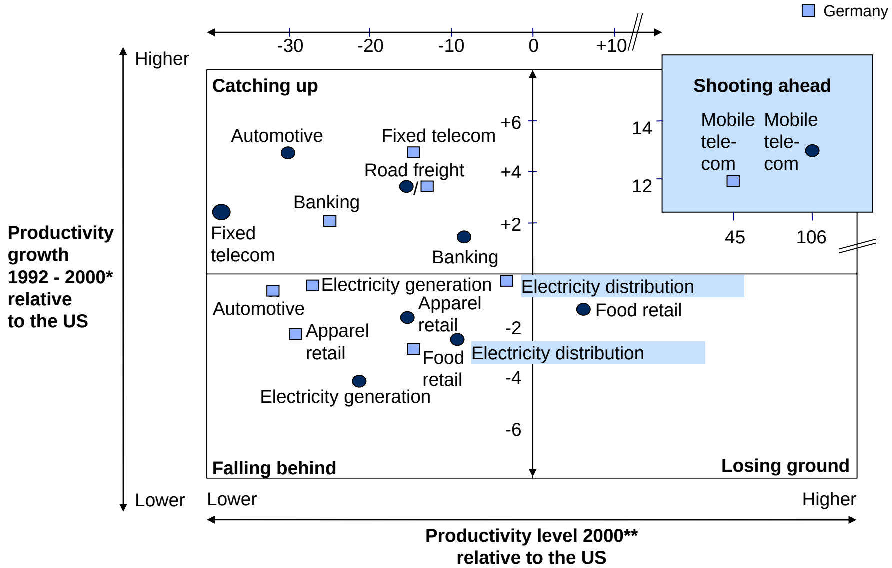
Regulations stifle competition

What causes Europe's productivity to lag behind its potential? The gap in some industries is caused by structural differences. In retailing, for example, small proprietor-owned stores are much more common in Europe than in the United States; they are also less productive than either large discount retailers or chains of small specialty stores. In other industries, differences in productivity stem from how production processes came about. On the one hand, French automakers adopted lean manufacturing in the 1990s, sparking

4 Diana Farrell, Heino Fassbender, Thomas Kneip, Stephan Kriesel, and Eric Labaye, "Reviving French and German productivity," *The McKinsey Quarterly*, 2003 Number 1, pp. 40-55, (www.mckinseyquarterly.com). See also Martin Neil Baily and Jacob Funk Kirkegaard, *Transforming the European Economy*, Institute for International Economics, Washington DC, 2004.

Exhibit 1

PRODUCTIVITY PERFORMANCE RELATIVE TO THE US

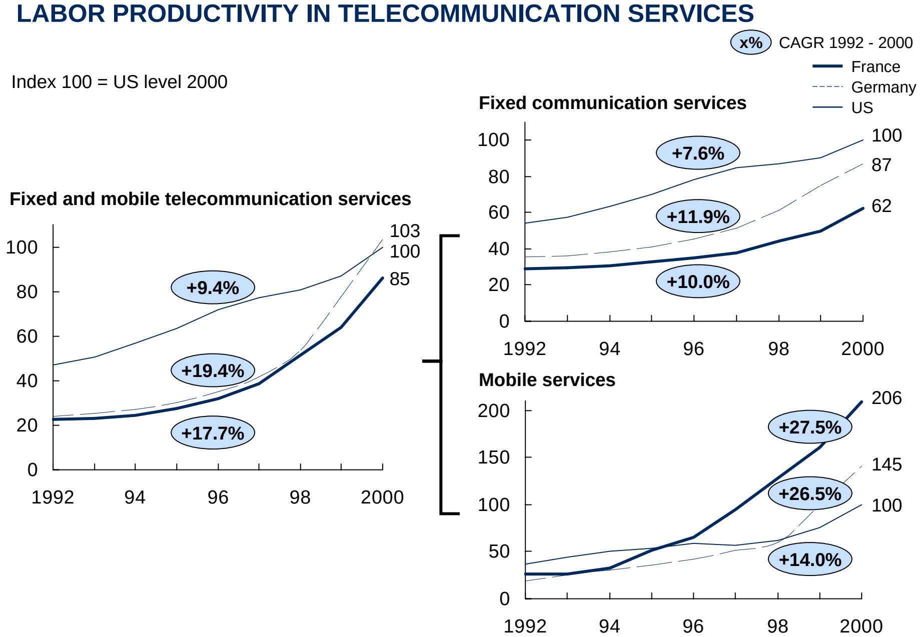


* Automotive and utilities 1992 - 1999; banking 1994 - 2000, retail 1993 - 2000
** 1999 for automotive and utilities

Source: MGI analysis

Exhibit 2

LABOR PRODUCTIVITY IN TELECOMMUNICATION SERVICES



Source: FCC, NECA, CTIA, Reg TP, ART, ITU, OECD, Gartner/Dataquest, annual reports, operators' Websites, MGI analysis rapid productivity growth. German auto companies, on the other hand, started the decade in a dominant position and felt little pressure to change. As a result, their productivity stagnated. The MGI studies found clear evidence that the differences in both structure and processes were symptoms of a deeper problem: a lack of competitive pressure.

Competition raises productivity because the companies that do best are the ones that respond by making the smartest innovations. The winners expand their market share and create more jobs, so the less productive companies have to either improve or go out of business. But this dynamic is not working in Europe. In several European economies, the most productive businesses are not growing or increasing their workforce, while the less productive ones are still hiring (Exhibit 3).

The reason is that regulations on product markets, and policies governing labor and the use of land, have the effect of protecting incumbents, limiting new entrants, preventing companies from achieving economies of scale, and restricting the way businesses operate.

Promoting R&D and IT is not the answer

Much of the discussion in Europe focuses on policies to spur investment in IT and R&D rather than on increasing competition through regulatory reform.[5] Our research into European industries shows that this approach doesn't address the source of the problem.[6] European leaders stress the need for R&D, because they see how the US high-tech sector, which boasted double-digit productivity increases each year over the course of the 1990s, has benefited the United States. But the impact of this sector on the overall economy is often overstated: it accounted for only about a third of the growth differential between Europe and the United States in the late 1990s; most of the gap in productivity growth was the result of other industries, not IT.

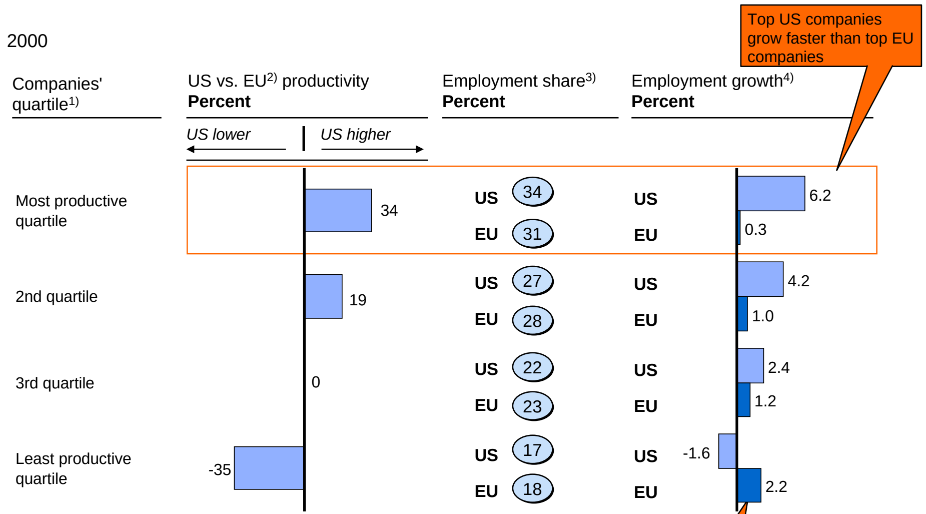
When MGI compared European and US industries that use IT, we found that access to IT or the ability to use IT were not major reasons for the difference in their performance. For one thing, many industries in Europe have already widely adopted the productivity-enhancing technologies used by their global

5 To that end, the European Commission recently proposed the creation of a publicly funded research institute to mimic the Massachusetts Institute of Technology, and the EC's Competitiveness Council is seeking increases in government funding for R&D.[/f]

6 Diana Farrell, "The real new economy," *Harvard Business Review*, October 2003

Exhibit 3

THE US IS BETTER AT ACHIEVING HIGHER PRODUCTIVITY AND REALLOCATING RESOURCES TO MOST PRODUCTIVE COMPANIES



1) Aggregated data for manufacturing sector, STAN 15t37
2) Weighted average of EU countries for which data were available; Finland, France, United Kingdom, the Netherlands and Sweden
3) Average share 1995-2000
4) Average annual growth in resources, 1995-2000
Source: ESI-VU

competitors. Those that haven't are limited by regulations that prevent them from making large-scale investments in IT or by labor laws that restrict the layoffs that could result from such technology. Regulatory reform is the best way to increase IT use: under competitive pressure, companies will adopt the technologies that can help them to survive and prosper.

The MGI studies strongly support the case for reforming regulations that constrain how European companies operate and compete and that interrupt the virtuous cycle of competition, innovation, and productivity growth. Investments in R&D and IT should be made on the basis of realistic estimates of returns, not as an excuse to avoid the politically difficult task of economic reform.

A EUROPEAN ROAD MAP FOR REFORM

The goal of economic regulation should be to ensure fair competition. At the same time, regulation needs to protect consumers, the environment, and a society's more vulnerable citizens from market failures. Parts of Europe's current regulatory framework focus on protecting society to the detriment of competition, perversely making Europeans more susceptible to the consequences of the region's flagging competitiveness.[7] The good news is that policy makers can often achieve these social objectives at less expense to productivity and growth. Four areas of reform are critical. While these suggestions aren't new, they are worth repeating, given the disagreement in policy circles over what hinders Europe's competitiveness.

Finish liberalizing the service sector

Service industries—everything from hairdressers and retail stores to accountants and engineers—constituted roughly 70 percent of Europe's GDP and all of the net job growth during the past five years. Manufacturing is not going to be a major source of new jobs in Europe or any mature economy, regardless of how much money governments pump into R&D. For Europe, revitalizing its service industries will be the key to boosting economic growth and employment levels.

In service industries, however, national and often local companies remain shielded by a thicket of regulatory barriers. In Germany, for example, limits on operating hours prevent retailers from providing the better service and higher employment that would result from remaining open longer. In Portugal, the government requires hotels to employ a set number of staff in each job category, depending on the hotel's size. Across the Continent, small family-run corner shops with low productivity and relatively high prices are protected by tax and zoning laws.

Regulations such as these aim to preserve the unique culture, traditions, and lifestyle of Europe, but they have the effect of limiting prosperity—on which the region's cultural continuity ultimately depends. Fortunately, adjusting the level of regulation to increase competition in service sectors doesn't mean abandoning

[7] Scott Beardsley and Diana Farrell, "Getting regulation right," *The McKinsey Quarterly*, 2005 Number 2, (www.mckinseyquarterly.com).

all the old traditions. If Germany were to lift restrictions on the hours that stores could remain open, not all consumers would shop around the clock, and small stores offering a unique service would still prosper. If individual hotels in Portugal didn't have to maintain such a large workforce, employment across the industry would increase, since more entrepreneurs would establish hotels. Removing the protections that allow small but inefficient retail stores to survive will not drive these businesses out of Europe, because a sufficient number of consumers like them.

The EU Services Directive, proposed last year, would remove national regulatory barriers and liberalize cross-border competition and trade in services. By creating a common market for services, companies could consolidate and gain scale, thus reducing prices and increasing productivity. A report by *Copenhagen Economics* found that liberalizing the service industries would create up to 600,000 jobs in Europe and stimulate €33 billion worth of new economic activity each year.[8] The directive came under fierce attack, and revisions are inevitable. Yet the essential goal should remain: to create a single competitive market for services in Europe.

Encourage economies of scale

Enabling companies to achieve economies of scale is one of the most important ways countries can boost their productivity growth; indeed, this goal was one major reason why Europe created a common market in the first place. Policy makers can encourage the efficient use of scale in two ways: by facilitating mergers and acquisitions and by standardizing regulations across the European Union so that companies can expand easily into other national markets.

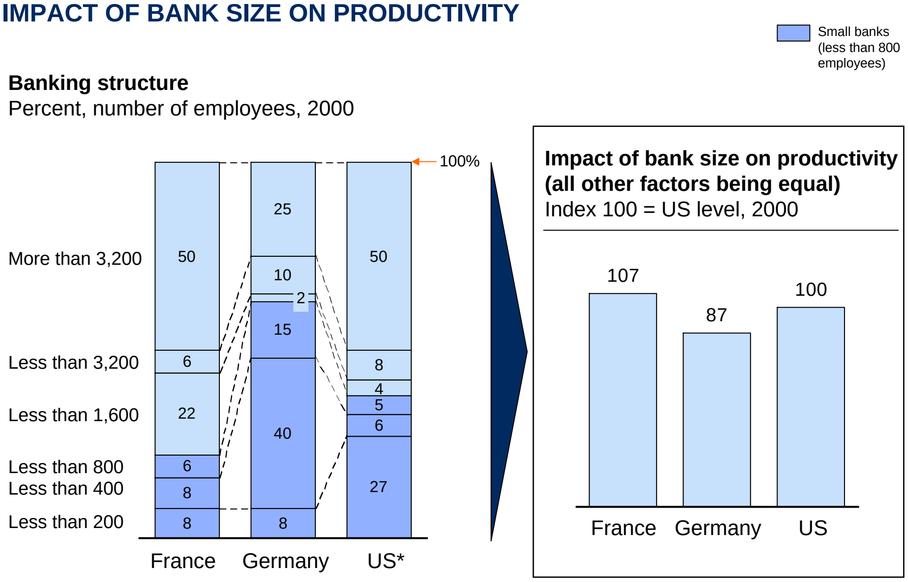
Antitrust regulations rightly seek to prevent mergers that would create monopolies. But regulations that restrict mergers unnecessarily—such as those governing Germany's many small regional banks—have the effect of allowing inefficient operators to stay in business when newcomers could provide the same services more efficiently (Exhibit 4).

In principle, the rules adopted by the European Union in 2004 already allow companies greater freedom in M&A. But a proposed ban on multiple voting rights and unapproved poison pills was made optional, in deference to those

8 "Economic assessment of the barriers to the internal market for services," *Copenhagen Economics*, January 2005.

Exhibit 4

IMPACT OF BANK SIZE ON PRODUCTIVITY



* 1997
Source: National bank associations, BLS, MGI analysis

member states that felt hostile acquisitions would undermine their brand of capitalism (which gives stakeholders other than shareholders a say in corporate governance).[9] And inefficient incumbents—the potential takeover targets—lobbied their governments the hardest to block the ban. Such companies remain protected, at the cost of true competition.

Establishing uniform EU regulations, too, can allow the kind of cross-border expansion that unleashes rapid productivity growth. Europe's road-freight industry is a good example. Its deregulation in the 1990s sparked a wave of consolidation, and long-haul routes are now more efficient across the Continent. Larger-scale companies are better able to deploy expensive tools, such as route optimization systems, and capacity utilization and productivity have increased dramatically.

9 "The EU takeover directive and the competitiveness of European industry," André Nilsen, Oxford Council on Good Governance, analysis number 1.

Increase work incentives and labor-market flexibility

Yet unemployment across the European Union remains stubbornly high, particularly among the young and those near retirement age. This may seem odd, since so many countries have strict labor laws in place to protect jobs. Yet restrictions on laying people off, plus high taxes on employment to finance generous social-security benefits, deter companies from hiring new people. And these benefits, depending on how they are structured, can lower the incentives for people to work. An overhaul of Europe's labor regulations should aim to promote job creation and employment as well as smooth the transition of workers between jobs.

France's minimum wage, for example, is twice that of the United States. As a result, when combined with strict regulations on hiring and firing workers, French retailers employ 50 percent fewer workers, as a percentage of the population, than their US counterparts. The European view that anyone who holds a full-time job should be able to support his or her family appeals to a sense of fairness. If all employers are required to pay high-skill wages for low-skill work, however, then more jobs will disappear. Procedures are a problem too: hotels in France have to maintain a small army of lawyers to deal with complex labor regulations. Not surprisingly, these laws curtail employment and do little to improve customer service. Giving companies the freedom to hire and fire employees and negotiate salaries will actually boost job creation overall in Europe's economy.

Europe also needs to adjust its generous unemployment benefits so that they don't deter people from working. In the Netherlands, for example, a 60-year-old person receiving jobless benefits stands to lose 90 percent of any extra income that taking a job would provide.[10] Countries can encourage people to move into, or return to, the workforce without removing the social safety net. Permitting employers to pay lower salaries for some jobs but asking the government to make up the difference with a wage subsidy would encourage people to move off welfare into work, irrespective of the pay. This form of benefit provides an incentive for people with low incomes to seek, rather than to avoid, work and helps protect their income.

10 *Going for Growth*, Organization for Economic Co-operation and Development, Paris, 2004.

End the bias in land-use policies

Within the relatively small confines of Europe's borders lie important historical sites and immense natural beauty, and Europeans understandably want to preserve this heritage. Few people realize, however, the extent to which restrictions on the use of land are discouraging productivity and employment.

The high price and lack of available land, as well as other regulatory barriers, constrain companies from expanding and creating new opportunities. Carrefour and IKEA have had difficulty finding new locations for their large stores, for example, thus holding back productivity and employment in the retail sector throughout Europe—notably in Germany, where a license is required even to convert an existing building for retail use.

The bureaucracy alone can be a problem. In France, it takes ten administrative procedures and nearly 200 days just to register a sizable business property, even when no zoning changes are required. By contrast, in Sweden this type of registration takes only two days. Even though most European policy makers say they want to increase manufacturing jobs, in practice it can take months or even years for companies to get approval to build a new factory. The costs of construction are often inflated by a variety of regulations. The same applies to new housing developments, and the resulting shortage of new construction raises housing costs and makes workers wary of relocating to find work.

Zoning decisions should aim to encourage economic growth while protecting the environment and to balance the two priorities appropriately when conflicts arise. At present, European land-use policies are biased against development. One reason is that the local officials in charge of granting building permits have no incentive to encourage investment or job creation, since state and central governments receive most of the taxes from new businesses. Sometimes local authorities deny building permits in response to pressure from incumbent companies that want to keep out new competitors.

The residential-housing market in the Netherlands provides one example where Europe's approach to zoning has promoted productivity. A key for developers is to create large plots of land, thus allowing for economies of scale. By frequently using land reclaimed from the North Sea, the Netherlands has been able to boost its productivity in home building—a huge job creator and an engine of output for all economies—to levels comparable with that of the United States.

LOOKING AHEAD

Europe can get its economy moving again without abandoning all the social values it holds dear. But many of Europe's current regulations, while aimed at preserving those values, are hindering the region's ability to compete in global markets. They need a thorough overhaul.

At times the European Commission has been a source of pressure for reform and for greater competition. And it still can push for the liberalization of markets, through its competition policy and perhaps by introducing a new services directive to replace the recently rejected one. But national governments must take the initiative.

Some countries have already made great strides. Ireland and Spain have enjoyed strong growth. The United Kingdom enjoys full employment and has overtaken France and Germany by such measures as per-capita income. Denmark and Sweden undertook labor market reforms in the 1980s that helped them to reduce unemployment. And the new Eastern European entrants to the European Union are transforming themselves by liberalizing their markets.

Even if Europe doesn't move forward in unison, one country's successful reforms can point the way to better economic performance for all while preserving the essentials of a European way of life. If enough governments start to move in the right direction, the rest of Europe will surely follow.

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