Contrasting Europe's decline: do product market reforms help?

by

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Executive summary

In 2001, faced with the US economic slowdown, European policy makers were quite confident that Europe could become the leading engine of growth for the international economy. Strong macroeconomic fundamentals, including low inflation, the lack of current account imbalances, and an increasingly healthy public finance situation, all boded well for the future prospects of the continent's economy. Most of these expectations were much too optimistic. The economic slowdown since 2001 has been substantially more pronounced in Europe than in the US. By and large, Europe has yet to find the recipe for endogenous self sustained growth.

The mediocre growth performance has prompted new concerns about Europe's long term economic prospects. Particularly worrying is the fact that, contrary to the US, productivity growth has been stagnant. In the absence of sustained growth in total productivity, many of the objectives of the Lisbon agenda will be difficult if not impossible to attain. Inadequate productivity growth may also be at the heart of Europe's competitiveness problem, as epitomized in particular by the steady erosion of world exports market shares and the increasingly limited ability to attract foreign direct investment.

Questions and their motives

Do product market reforms have some bearing on Europe's poor growth and productivity record? This is the central question addressed by this report. There is considerable agreement that widespread rigidities in European markets are among the main culprits of Europe's growth record. So far, much of policy makers and public opinion attention has been devoted to the reform of labour markets and the pension system. Yet, pervasive inefficiencies and distortions are not limited to labour markets but are significant features of product markets as well. The tertiary sector accounts for most of the unfinished reform agenda.

The call for further liberalisation in services is however not always unanimous. There are often concerns that this process might entice job losses, lower investments in infrastructure and that the benefits of increased competition do not trickle down to final users through price reductions. Indeed, liberalisation is a difficult process, that many European countries have been able to implement only as a consequence of Directives of the European Commission. Sectoral specificities matter in determining the effects of liberalisation policies. These policies, besides their difficult path and implementation, do not have automatically positive effects on variables such as employment, investment and prices.

These concerns are often raised by interests groups, but may also find support in the theoretical literature that shows that increased competition may sometimes have perverse effects. For example, Aghion et al. (2003) argue that the relationship between market structure and innovation is hump shaped with either highly competitive or a highly concentrated environment fostering innovation. Also, if barriers to entry are not too high, a monopolistic firm may have a strong incentive to keep innovating simply to keep its potential competitors at bay and preserve its hefty monopolistic rents (Etro, 2004).

Notwithstanding these concerns, the overall consensus in the academic community and among policy makers is that the benefits of competition outweigh any eventual costs. Namely, the consensus rests on two key arguments. The first one is that well designed product markets reforms can play a key role in boosting productivity, as shown by recent OECD research (Nicoletti and Scarpetta, 2003). The second one is that many labour market rigidities are intrinsically linked to product market distortions (Blanchard and Giavazzi, 2003; Jean and Nicoletti, 2003; Bertola and Boeri, 2002). In particular, inefficient regulations typically generate economic rents that in turn foster additional labour market rigidities. Hence, reforming product markets may facilitate structural changes in labour markets as well.

Of comfort to these positions, the empirical evidence, while not fully unanimous, generally suggests that more competition raises productivity (see for example Nicoletti and Scarpetta, 2003). This evidence, however, often fails to take into account the comprehensive sets of factors that may affect the relationship between deregulation and productivity.

What does the report do?

In this report we therefore provide a further assessment on this issue. We proceed in two main directions. The first one is to take stock of reform efforts in key services in a number of European countries, by focussing on three case studies: Germany, Italy, and the UK. The choice of the sample is dictated by the need to consider a set of representative countries in the European arena as well as by the desire to focus on a sufficiently wide range of country experiences. The features and the effects of reforms will be examined for individual sectors, as regulatory issues and their effects are industry specific: the problems faced by network industries like energy or communications are completely different from those concerning business services, like accountants or lawyers. So far, most of the attention at the European level has focussed on the reform of the regulatory framework in the network industries. Other sectors, including the wholesale and the retail sectors as well as professional services, while quite crucial in terms of competitiveness and efficiency, have been somewhat less emphasized.

The second feature of this report is that it examines also the indirect effects of the tertiary sector as a supplier of key inputs for manufacturing. Generally, the debate on services is focussed on their effects on final consumption and input output linkages are seldom considered (see however Grillo, 2004, and Nicoletti and Scarpetta, 2003, for two noticeable exceptions). However, services account for an important share of total output value of other economic activities like manufacturing or agriculture. In this respect, the efficiency of the tertiary sector has important implication on the efficiency of overall economic activities.

Findings

The key finding of the report is that, although reforms are difficult to implement and they do not always deliver the expected gains, particularly in the short term, deregulation of services in all the three countries analysed is found to be associated with faster productivity growth and competitiveness both in the service sector and in the rest of the economy. This latter result is largely due to the fact that services play a much more pervasive role in the overall economy than generally acknowledged, as they are fundamental inputs to most non-service activities like manufacturing and agriculture. Consequently, changes in efficiency, quality and costs of the services delivered trickle down in large competitive gains in the overall economy. The bottom line is that liberalization in services has the potential to bring large welfare gains and governments need to persevere in their effort to reform the service sector. In what follows we discuss these results in some detail.

Liberalisation has positive direct effects on productivity in services, but does not always result in declining prices and employment gains. Liberalisation seems to have positive effects on *productivity,* which – almost invariably because of a reduction in employment relative to excessively high levels – increases in all cases where its measurement is possible and reliable. Productivity may increase even well before privatisation and liberalisation, in anticipation of tightening market conditions.

As for *prices* and *employment*, the jury is not out yet. Prices decline and employment increases when liberalisation is actually successful in fostering competition. This happens either in naturally competitive industries, where regulation is simply a way to protect producers, or when technological progress allows entrants to offer new products or force the incumbent to be more innovative himself. Telecommunications are the key example of this virtuous pattern.

Effects are less on the positive side in other industries characterised by limited product and process innovations, where natural monopoly elements do not allow competitors to easily by-pass a strong incumbent. In general terms, prices did not decrease as much partly because of the limited competition that countries were able/willing to introduce. Also, liberalisation has taken place in sectors where prices were initially well below cost. Notwithstanding the continuation of subsidies, in sectors such as railways or water, market oriented reforms are bound to raise prices so as to fund investments. Finally, in energy sectors expectations on the effectiveness of reforms were probably excessive. Users' prices are still largely determined by fuel costs and taxation and massive investments are required to raise efficiency.

The tertiary sector plays a large and increasing role as provider of inputs in manufacturing and agriculture. The benefits of product market reforms therefore go well beyond their direct sectoral impact. In particular, the tertiary sector provides a substantial share of intermediate inputs to manufacturing and plays therefore a key role in affecting industrial and more broadly economic competitiveness. Services are indeed increasingly business oriented and their efficiency can greatly affect the competitiveness of other sectors in the economy.

In this report we document the role of the tertiary sector as a supplier of key inputs for manufacturing. Input-output analysis is used to show that the increasing weight of services in employment and GDP reflects not only the shift in consumers demand toward services but also the greater weight of services as providers of inputs to other sectors of the economy. Services indeed increasingly cater to business. This is true for trade, energy, finance, and professional services.
Our analysis allows for both direct and indirect effects of input usage. Direct effects capture the costs that a given manufacturing sector A has to face for the services it uses as inputs. Indirect effects capture the further costs borne by sector A for services which are inputs to other manufacturing products that A uses as factors of production. When direct and indirect effects are taken into account, three key findings emerge. *First,* service inputs account on average for more than 40 percent of the value of production in other sectors. *Second,* this share has been steadily increasing since the mid eighties for the three sample countries. For example in the UK it rose from 25 percent in 1984 to 45 percent by the end of the nineties. This rise was faster and larger than the increase in the overall GDP weight of services. This increased from 62 % in 1970 to around 74% in 2000 in the US and from 52.2% to 70% in the EU-15 during the same period. *Third,* when we decompose the total share of the tertiary sector in the contribution of individual industries - network industries (transport, energy and telecommunications), trade (retail and wholesale), finance and other business activities (e.g. lawyers, accountants etc.) - we find that the contribution of each industry is broadly balanced. Interestingly professional services, which are often considered less important than network industries or finance, account for a substantial share (around 10 percent on average) in all three countries.

We also notice that while business oriented services are increasingly tradeables, they remain substantially less open than manufacturing. We show in the report that whereas import penetration, defined as the ratio of imports to domestic gross output, ranges between 23 percent and 43 percent in manufacturing it varies between 2 and 3 percent in services . This implies both that services are not exposed to international competition and thus national regulations are the only effective channel to raise competition and also that activities using them as inputs cannot resort to cheaper imported alternatives.

Widespread rigidities in the supply of key largely non tradeable inputs from the service sector discourage foreign direct investment - and deprive therefore the host country from a number of beneficial externalities, like further gains in wages and productivity. The effectiveness of business services is a key factor in the location of multinational enterprises. FDI, whatever the reason for carrying them out (to enter new markets or to save on costs) need an efficient network of suppliers and producers' services. While traded inputs can be imported, non tradeable inputs – and we have seen that services are much less tradeable compared to goods - must be purchased locally. Their availability and their costs are therefore instrumental in affecting the investment decision of multinational corporations. Inefficient regulations that hamper the quality and the variety of business services are found to discourages foreign direct investment in all the sample countries.

Services therefore are a key determinant of economic competitiveness. High quality, efficient and competitively priced services carry strong cost savings for other sectors. Even when gains of reforms in the tertiary sector itself are small, they get magnified when indirect effects on the rest of the economy are also taken into account. Pervasive rigidities in much of the tertiary sector are likely to penalize manufacturing production, particularly in those sectors that are more exposed to international competition and to discourage foreign direct investment..

Overall, our results help to understand a number of stylized facts. We know that the UK is by far the least regulated country. However, at the beginning of the period, productivity growth in most manufacturing sectors was lower there than in either Germany or Italy. In the following few years, the UK productivity gap fell markedly, a fact that our estimates attribute to a favourable regulatory environment rather than more trivially to a simple country effect. In the end, therefore, it was most likely a better regulatory framework that allowed UK firms to more fully capture new technological opportunities or, more modestly, to escape the fate of declining productivity growth that has characterized many industries in Germany and in Italy.

Looking ahead

Service liberalization has however met with strong resistance. There have been repeated calls for treating services differently. The need to provide universal service, in energy and telecoms, is often mentioned as a reason for such special and differential treatment. Other sectors – professional services in particular – have claimed that they should be granted an exception given the pervasiveness of informational asymmetries and the need to ensure quality for unprotected users. We are wholly unconvinced by these arguments. *First*, there is no evidence whatsoever that universal service obligation has been undermined by liberalization. *Second*, there is no reason why restrictions to competition will necessarily ensure higher quality. Actually, the opposite is likely to be true as suggested by both theory and empirical analysis. Similarly, informational asymmetries are not a unique feature of professional services. We see therefore no reasons why services, including professional services, should not be fully subject to competition laws.

In light of the many benefits associated with the liberalization of producers services, it is somewhat puzzling why national governments have not pushed the reform agenda in this sector more decisively. This political economy puzzle is addressed in the companion paper of Galasso et al. (2004). We offer nonetheless some simple speculations.

The evidence collected in this paper suggests that the short-run employment impact of liberalization may be unfavourable. For many sectors, the combination of pervasive overmanning, large productivity gains and inelastic demand meant that employment had to fall in the aftermath of liberalization. Moreover, sectoral employment losses are not always easily absorbed. If labour is at least to some extent sector specific, then some aggregate employment losses are virtually unavoidable. It is not too surprising therefore to find that liberalization is typically opposed by labour. Moreover, the support for liberalization may be further undermined by the fact that prices fell only moderately in the post liberalization period.

It is also surprising that support for liberalization has not been boosted by sectors using services as inputs. A standard result in the political economy of trade literature is that sectors that cater mainly to other producers have a harder time in getting protection. This argument may not fully apply to the case of services because users of services are more dispersed, and therefore less keen to mobilize in favour of liberalization, than users of intermediate goods. Also, our evidence shows how the total weight of services in the value of manufacturing production is substantially larger than its direct weight. Hence, a large share of services inputs bought by manufacturers is embedded in other inputs and will not be immediately visible to buyers. To the extent that buyers are not fully aware of these general equilibrium effects they will lobby less hard for liberalization.

Political economy consideration only partly account for the limited success of liberalization policies. The design of such policies needs also to be improved. Half hearted liberalization that fail to deliver lower prices may be self defeating to the extent they will not be able to garner the public support necessary to proceed further. Regulatory authorities need to be truly independent from the executive and be given a clear mandate. Equally crucially, the regulatory framework must be stable and predictable. Otherwise, investment will suffer most creating widespread bottlenecks and further undermining the support for liberalization.

Yet, the fact remains that liberalization in services has the potential to bring large welfare gains in terms of higher productivity and higher FDI throughout the economy. So far, liberalization of services has proceeded mainly at the urging of the European Commission. It is to be hoped that national governments throughout Europe will recognize the large economic dividends that a better regulatory framework for services can elicit. Far reaching reforms in this area should represent a top priority for economic policy. Unfortunately, the waning commitment toward the Lisbon agenda does not leave much room for optimism in this respect.