

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

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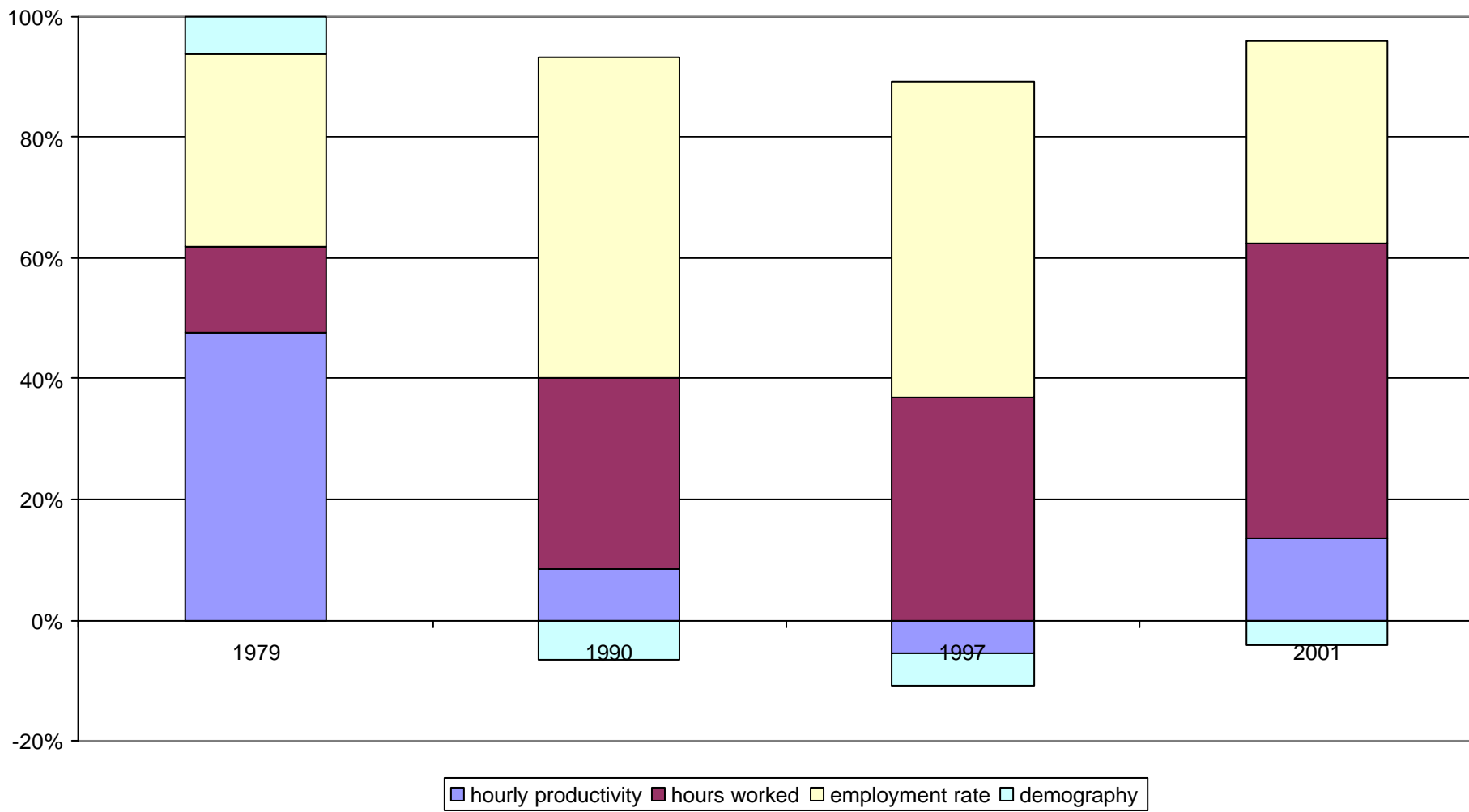
At the roots of Europe's problem

United States			
	81-90	91-96	97-02
L'	1.8	1.1	1.0
(Y/L)'	1.1	1.4	2.2

Euro area			
	81-90	91-96	97-02
L'	0.5	-0.2	1.3
(Y/L)'	1.9	1.7	1.0

- Europe's slowdown largely reflects lower productivity growth
- Europe has not managed to reconcile the twin objectives of high employment and fast productivity growth

Decomposing the income gap between the Euro area and the US



The motivations...

- Is there a link between product market reforms and productivity through:
 - greater efficiency?
 - innovation?
 - input output relationships?
 - incentives to implement labour market reforms?
- Theory is ambiguous and empirical evidence not always fully conclusive

An overview...

- What we have learnt from theory and empirical evidence
- Focus on reforms in the service sector (where most of the unfinished agenda lies)
- Three case studies: Germany, Italy, UK
- Look at:
 - the trees (individual sectors)
 - the forest (input output analysis)
- Assess the impact of service regulation on manufacturing productivity and FDI

Ambiguous lessons from theory...

- Standard argument:
 - In imperfectly competitive markets, marginal costs equal marginal revenues rather than prices,
 - but static costs amount to just a few decimals of a percentage point of GDP.
- Dynamic effects are ambiguous
 - Contracting environment and asymmetric information (Hart, 1983, Vickers 1995 etc.)
 - Incentive to innovate (Aghion et al. 2003, Etro 2004)

What does the empirical evidence show?

- Firm and industry level studies of effects of competition on efficiency:
 - => not always positive (.....)
- Studies of relationship between indicators of regulation and performance (Nicoletti and Scarpetta 2003.....):
 - => deregulation improves efficiency

Limits of available evidence

- Reduced form estimations do not capture full set of determinants
 - => industry/country studies
- Focus on within sector effects and do not capture spillovers:
 - => input/output analysis

Why the service sector?

1. A key provider of inputs to the other sectors of the economy
2. This is where most of the unfinished reform agenda lies
3. Largely non tradeable

1 + 2 + 3 ⇒ business services are a key determinant of competitiveness (however defined)

Three case studies

- Italy, Germany, UK
- Large European countries
- Wide range of liberalization experiences
- Need to take a close look at the reforms in individual countries/sectors

Looking at the trees..

- Energy (electricity, gas)
- Telecoms
- Transports (railways)
- Professional services
- Trade

A preview...

- **Productivity** increased in the aftermath of liberalization
- However, in most cases, this was due to a fall in **employment**
- Despite the rise in productivity, **prices** did not generally fall:
 - Half hearted liberalization?
 - Prices initially below costs?
 - Need to fund large infrastructural programs?
- The **quality** of services typically improved

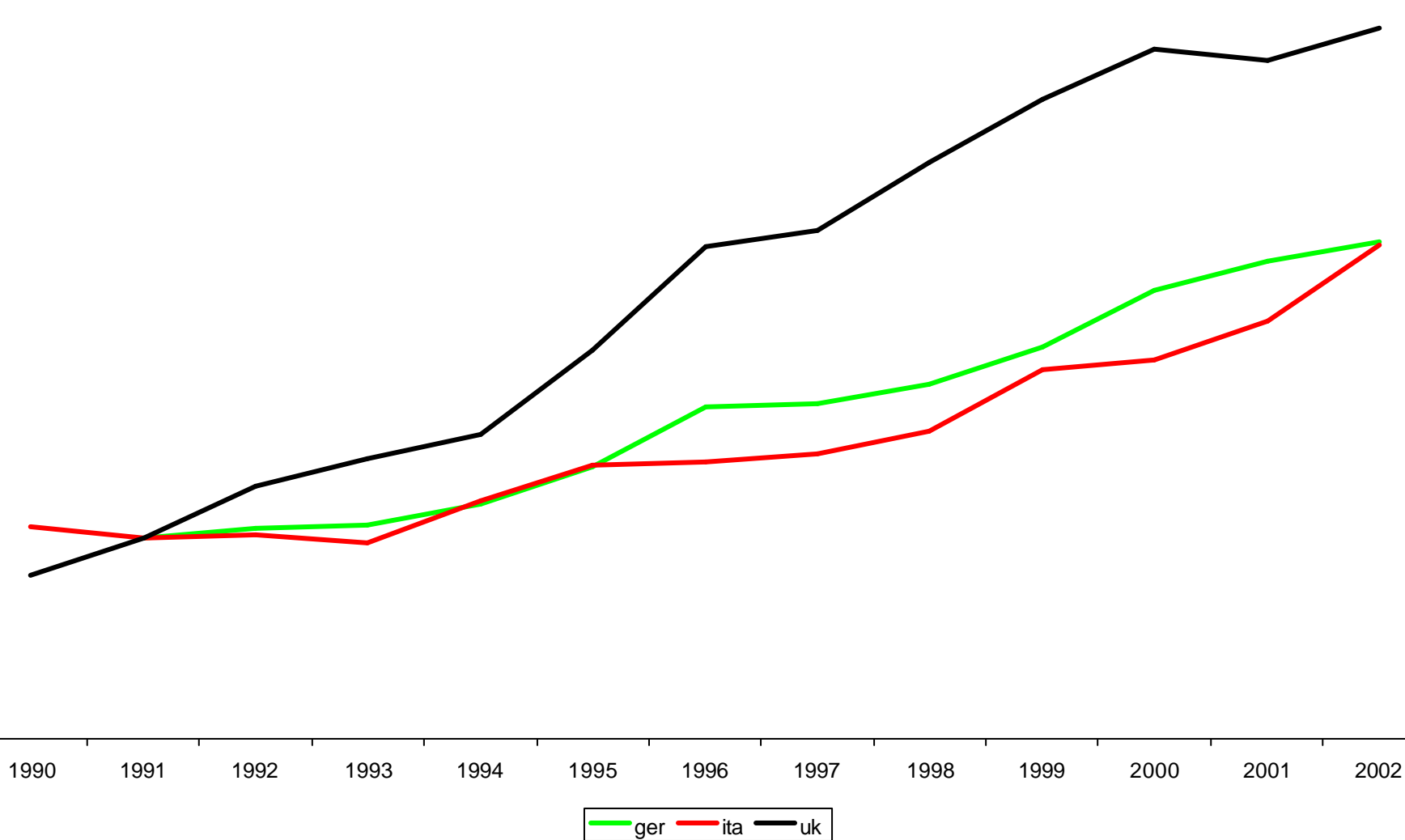
Energy: the reform agenda

- Competition in upstream activities (generation, production and import of gas)
- Vertical separation
- (Regulated) third party access to the network
- Liberalization on the demand side
- Optional: anti trust ceilings

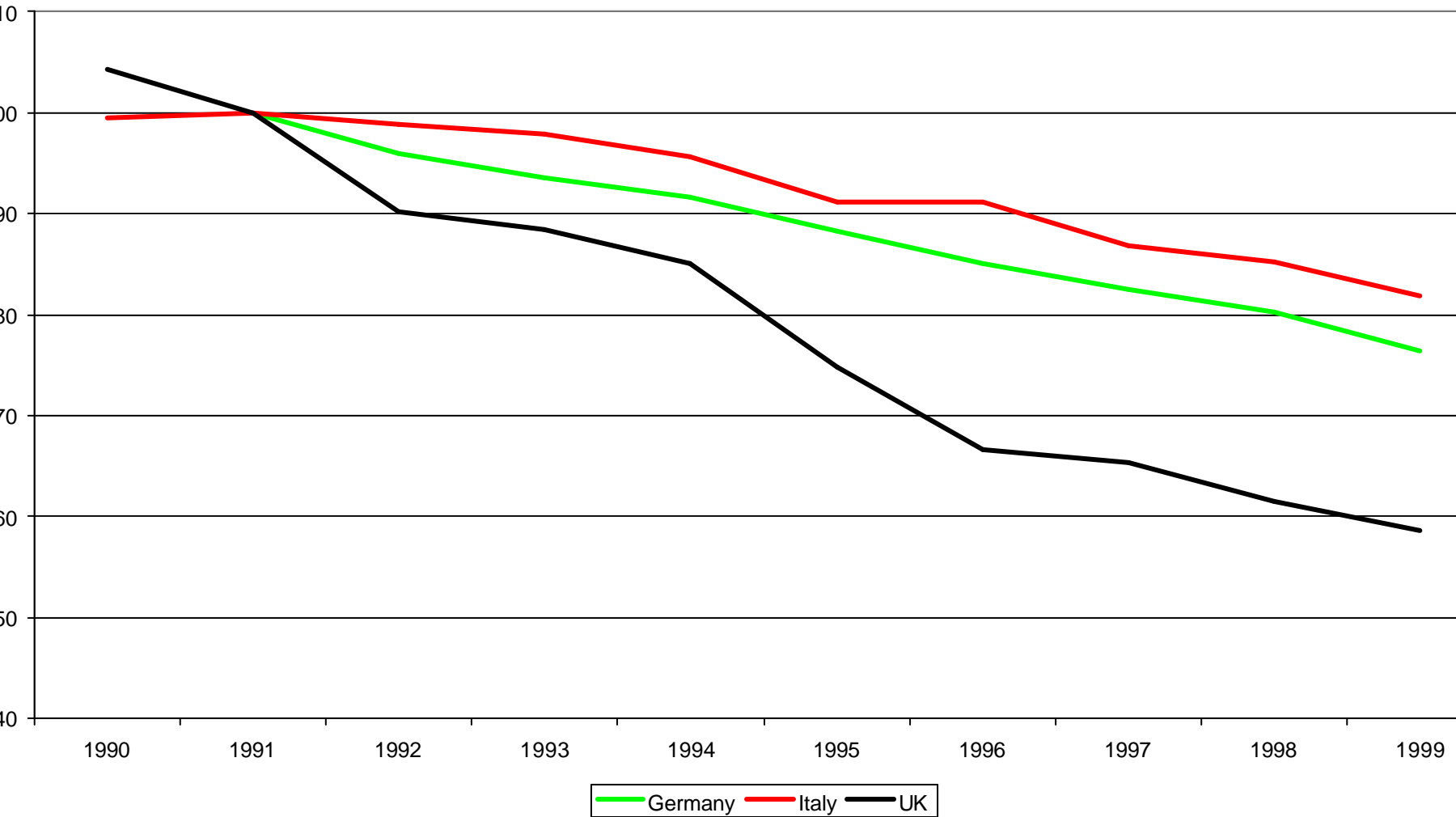
Implementation

- ***United Kingdom.*** Well ahead of the pack; even there, however, vertical integration was difficult to dismantle.
- ***Italy.*** A latecomer. Anti trust ceilings for both electricity and gas. Proprietary separation only in electricity.
- ***Germany.*** Negotiated TPA. Strong vertically integrated regional monopolies

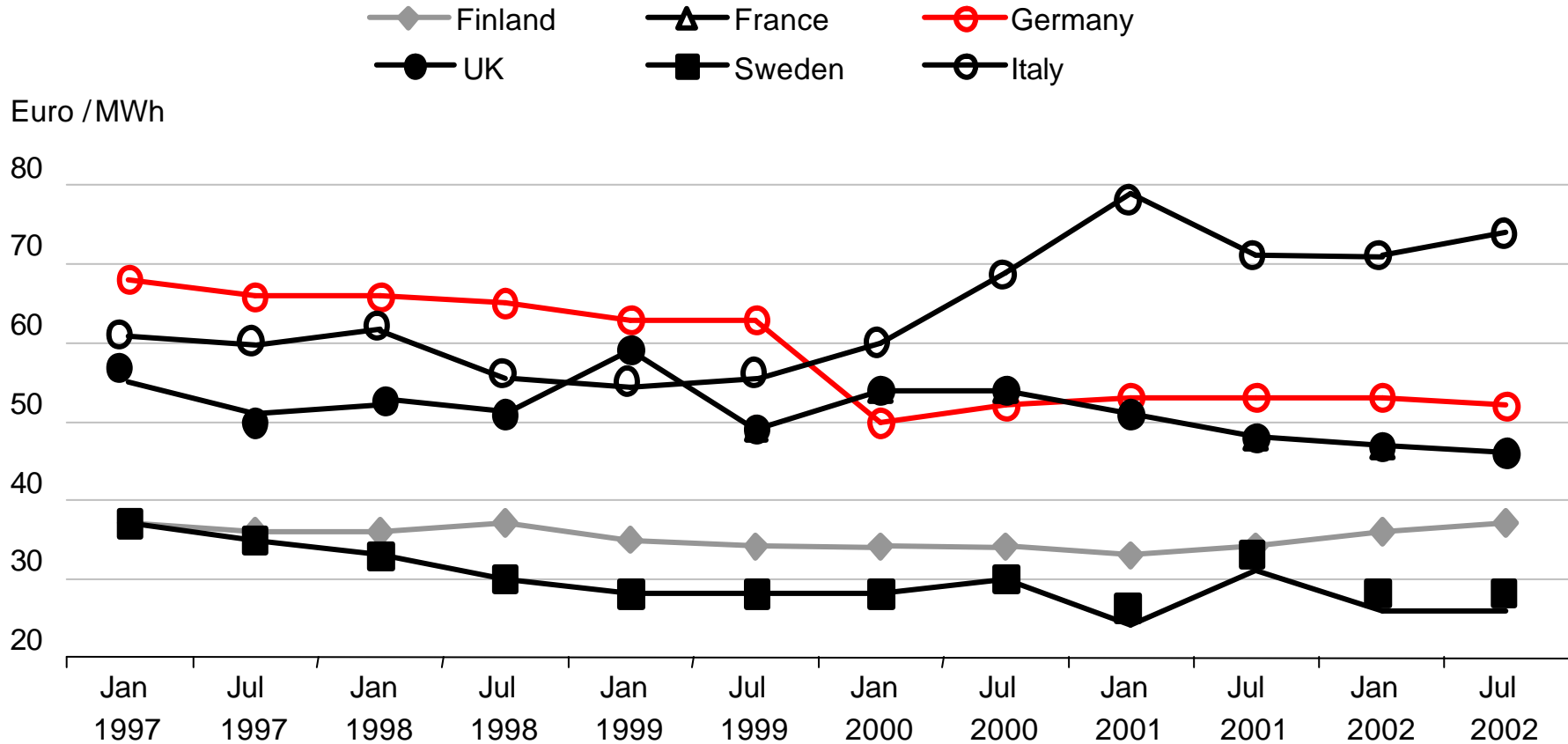
Productivity in the energy sector



Employment in the energy sector



Final electricity prices(*) for large industrial customers (24 GWh/year)



(*) Net of taxes.

Source: Ref on Eurostat data

Quality of service (as measured by service interruption) has also improved...

Italy

1998

2002

Minutes

188

98

United Kingdom

1991

2001

Minutes

200

70

Open issues:

- Vertical integration: a limit to double marginalization or a major barrier to entry?
- Entry and investment in generation: are high prices enough of an incentive (Italy versus the UK)?
- Anti-trust ceilings: a necessary step?
- Take or pay contracts and international pipelines

Telecoms

- Reform agenda broadly similar to energy (entry liberalization, TPA, demand liberalization)
- However: fast technological progress and buoyant demand

Telecommunications: rising employment and productivity

EMPLOYMENT IN TELECOMMUNICATIONS 1991 - 2001

	1991	1993	1995	1997	1999	2000	2001	Annual Growth 1991 - 2001 %
Germany	225,628	234,000	217,900	215,624	221,400	240,700	241,800	0.07
Italy	104,714	93,172	91,802	93,782	100,026	95,809	90,880	1.04
United Kingdom	224,197	185,505	153,166	168,740	206,500	230,300	231,500	0.03

TELECOMMUNICATIONS REAL REVENUE PER EMPLOYEES, 1991 - 2001 (USD)

	1991	1993	1995	1997	1999	2001	Annual Growth 1991 - 2001 %
Germany	126,005	155,659	212,133	202,659	229,027	236,044	6.05
Italy	173,375	182,763	201,359	254,629	266,888	296,325	5.05
United Kingdom	116,107	129,824	186,411	212,054	246,036	241,156	7.06

Railways

- Again, a network industry
- The initial step: unbundling the track and the train operations
- Moving a step further: conferring carriages and locomotives to leasing companies (UK)
- Italy: limited unbundling
- Germany: no separation

Employment and productivity trends

United Kingdom		
	1996	2002
L	100	68
Y/L	100	182

Italy		
	1996	2002
L	100	81.6
Y/L	100	125.8

- Employment fell and productivity rose
- Most of productivity gains (esp. in Italy) were due to labour shedding

Professional services

- A highly (self) regulated sector
- Educational and training requirements
- Restrictions on entry, prices, and advertising
- Required business structure and constraints on ownerships
- Compulsory membership of professional associations

Employment in professional services

PROFESSIONAL SERVICES EMPLOYMENT			
Sources	Germany	Italy	United Kingdom
Legal	105,724	139,500	111,772
Accountancy	14,078	88,421	51,675
Technical	130,148	131,448	199,039
Pharmacy	46,078	64,000	31,000
Total	296,028	423,369	393,486
<i>% of total employment</i>	<i>0.8</i>	<i>1.8</i>	<i>1.3</i>

Note: Data for Professional Services Employment from IHS Questionnaire 2002 in Paterson, I, Fink M. and Ogus A. (2003), "Economic impact of regulation in the field of liberal professions in different Member States", Study for the European Commission, DG Competition, Final Report, Institute for Advanced Studies, Vienna

Measuring regulation in professional services

INDICES OF REGULATION OF PROFESSIONAL SERVICES

<i>Professional Service</i>	<i>Germany</i>	<i>Italy</i>	<i>UK</i>
Lawyers	6,5	6,4	3,5
Notaries	11,0	10,7-	
Accountants	6,1	5,1	3,0
Architects	4,5	6,2	0,0
Engineers	7,4	6,4	0,0
Pharmacists	5,7	8,4	4,1
Mean	6,9	7,2	2,1

Source: IHS Questionnaire 2002 and other sources in Paterson, I, Fink M. and Ogus A. (2003), "Economic impact of regulation in the field of liberal professions in different Member States", Study for the European Commission, DG Competition, Final Report, Institute for Advanced Studies, Vienna

Open issues:

- Does self regulation
 - alleviate informational constraints?
 - preserve quality?
- Should professional services be subject to competition laws?

(Retail) trade

- Widespread restrictions on:
 - Opening hours
 - Promotional sales
 - Entry especially of large firms
- with a view to:
 - addressing environmental and traffic concerns
 - protecting small shops

Labour productivity in retail rose more slowly in Italy

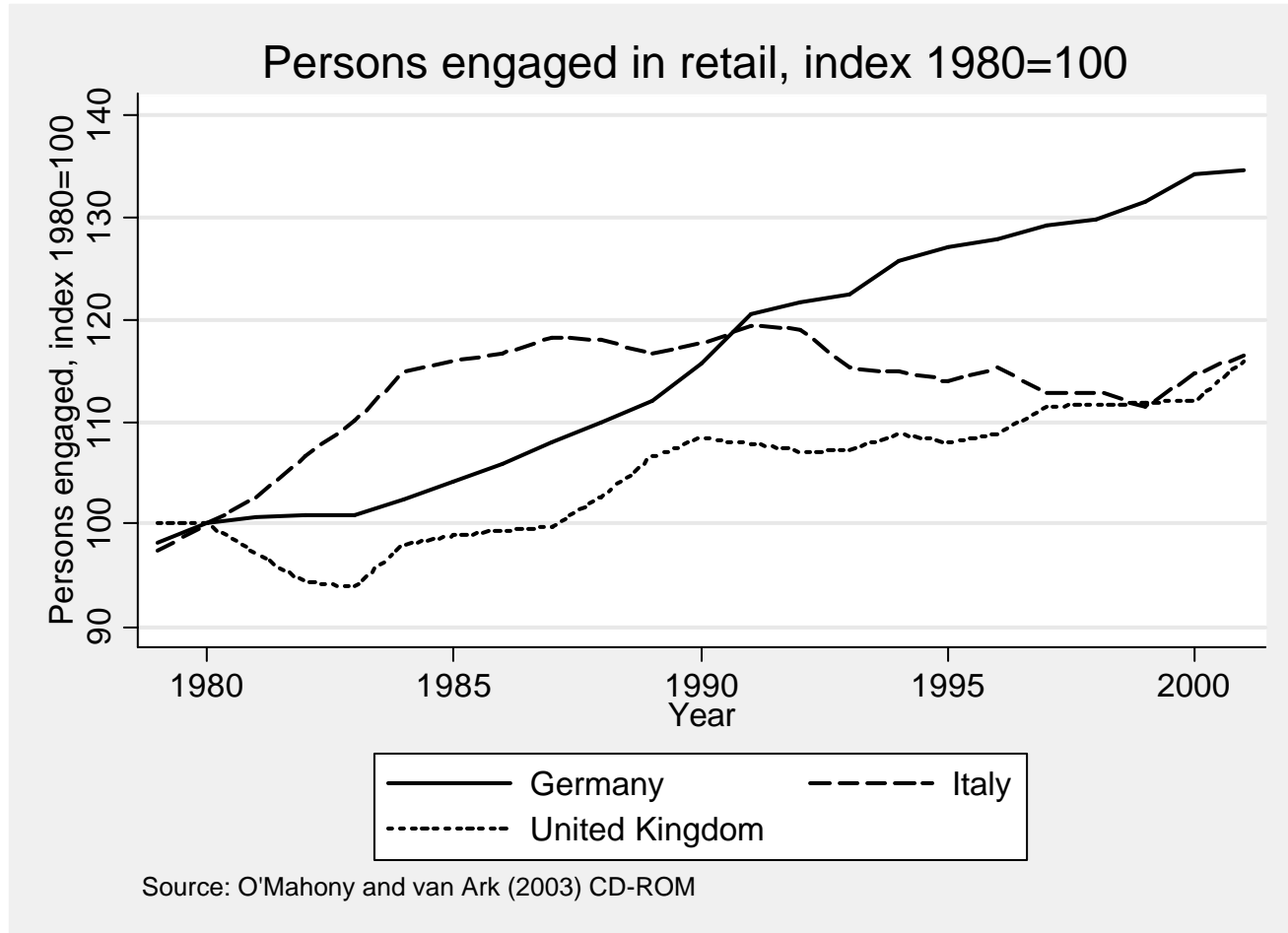


Italy is where...

- Shops are smallest
- The retail share of employment is small
- Productivity is lowest

	Firm's size	Empl. Share	Productivity
Germany	9.0	8.2	113
Italy	2.2	7.6	72
UK	14.2	10	99

and where employment rose very slowly



Service's quest for special treatment

The motivations:

- Universal service obligations (USO)
- Protection of quality
- Pervasiveness of informational asymmetries

However:

1. Services increasingly cater to business
2. USO have not been undermined by liberalization
3. Quality is not enhanced by restricting competition

1 + 2 + 3 ? services should be subject to competition laws

Turning to the forest:

**The weight of services in gross ‘manufacturing’
output**

	<i>Germany</i>			<i>United Kingdom</i>			<i>Italy</i>	
	1986	1990	1995	1984	1990	1998	1985	1992
Unweighted average	0.30	0.31	0.34	0.24	0.39	0.45	0.29	0.36
Weighted average	0.35	0.36	0.41	0.26	0.41	0.45	0.31	0.38

Four key facts:

- The weight of services in total manufacturing gross output is quite substantial
- Services are largely non tradeables
- They carry a larger weight in the less regulated country (the UK)
- Total I-O coefficients are significantly larger than direct coefficients

Openness in manufacturing and services

	<i>Germany</i>		<i>Italy</i>		<i>United Kingdom</i>	
	Import Penetration	Trade Openess	Import Penetration	Trade Openess	Import Penetration	Trade Openess
Manufacturing	0.31	0.63	0.23	0.42	0.4332	0.7715
Services	0.02	0.05	0.02	0.06	0.0383	0.1090

Figure 3.1
The weight of services in total output
Italy versus the UK

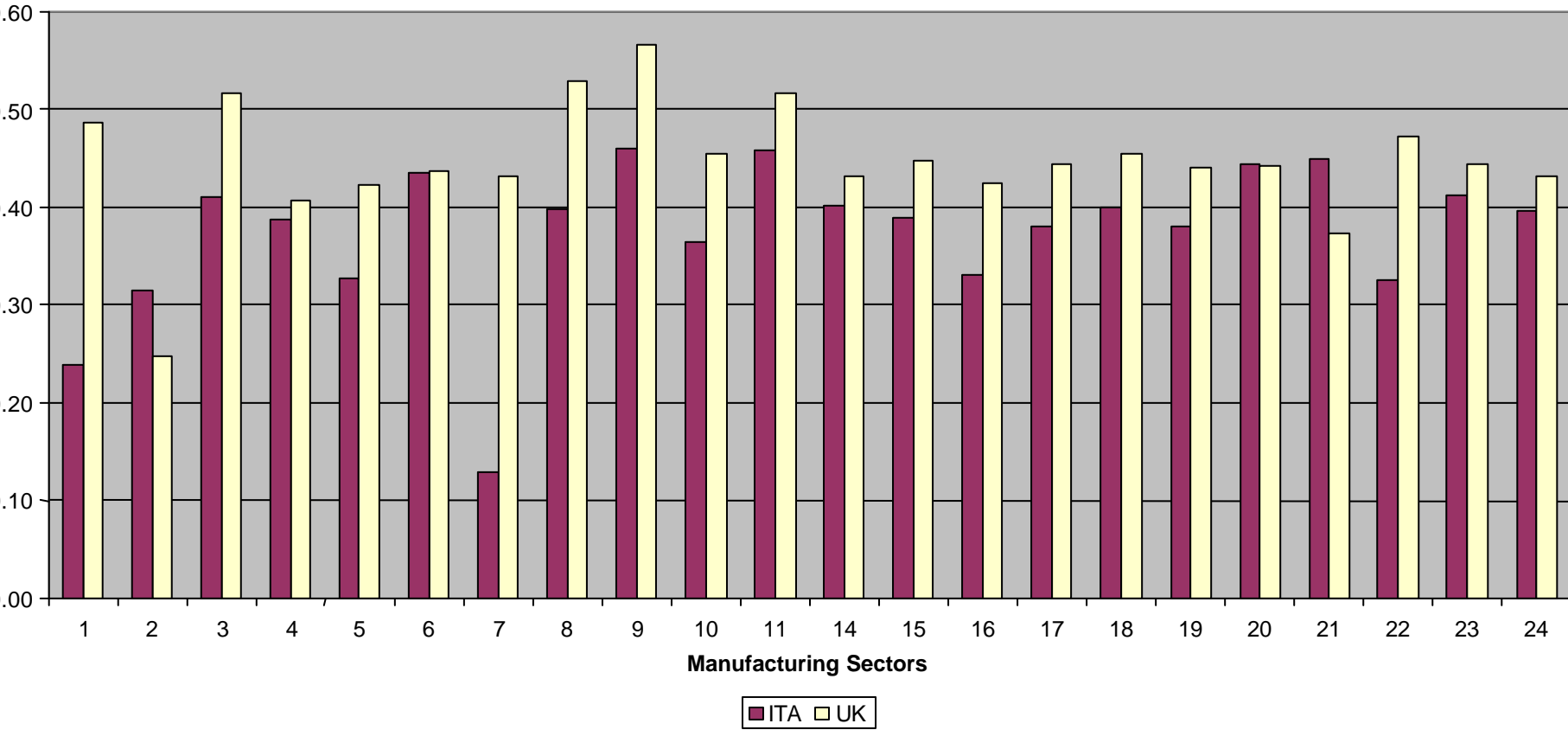
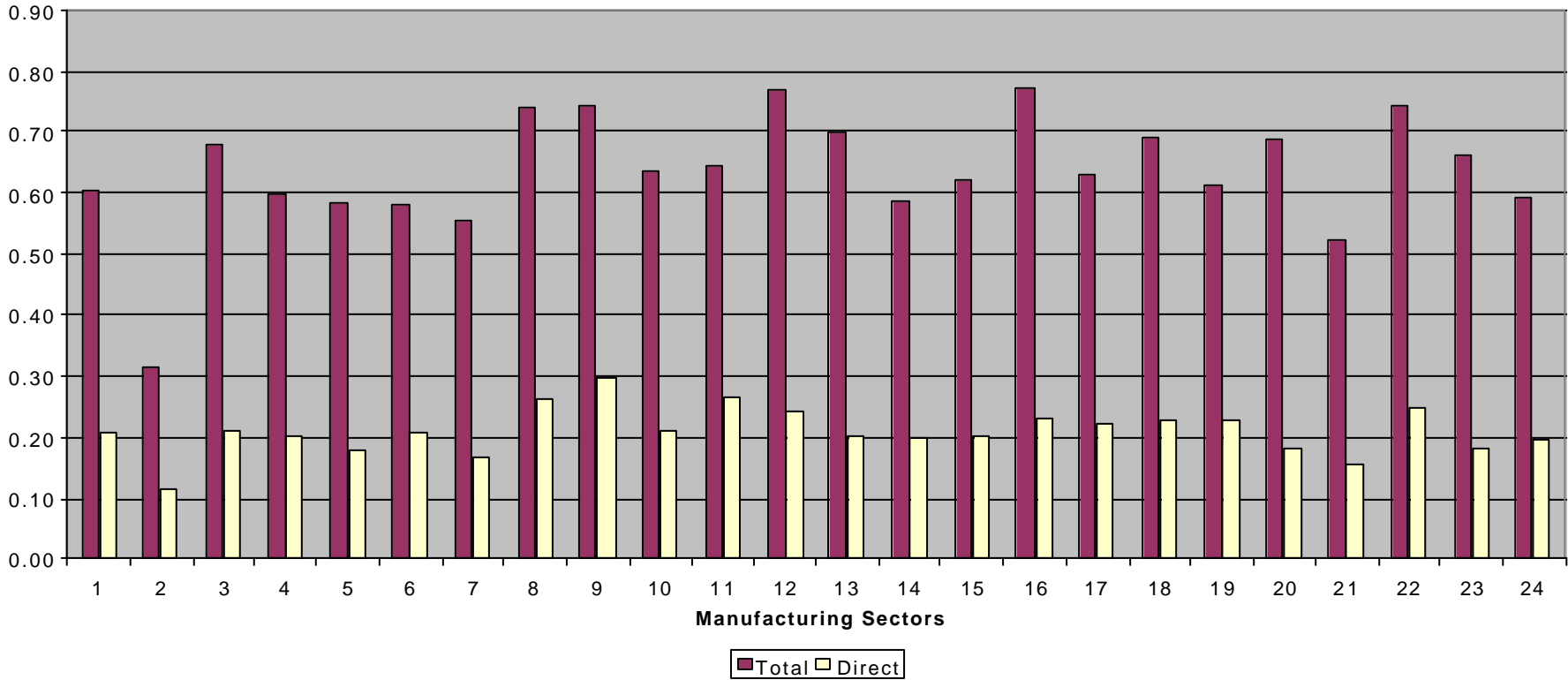


Figure 3.5
United Kingdom
Weight of Services Sectors in Manufacturing Total Output



More than just financial services

The share of selected services in gross 'manufacturing' output

<i>Services</i>	<i>Germany</i>	<i>UK</i>	<i>Italy</i>
Network services	0,08	0,12	0,11
Financial services	0,09	0,09	0,09
Wholesale and retail trade	0,07	0,07	0,07
Other business activities	0,11	0,11	0,07
Total	0,34	0,38	0,34

The impact of service liberalization on 'manufacturing'

Question:

do 'manufacturing' sectors that rely more intensively on highly regulated services perform less well in terms of:

- a. Productivity growth?**
- b. Ability to attract FDI?**

Answer:

- a. Yes**
- b. Yes**

Productivity growth in manufacturing and regulation of services

Dependent variable:

Δglp

OLS estimation

	(1)	(2)	(3)
<i>Sectoral Dummies</i>	YES	YES	YES
R^{BA}	-0.1368* (0.0491)	-	-
glp	-0.3472 (0.2306)	-0.3465 (0.2318)	-0.3455 (0.2350)
R^{NET}	-	-0.0767* (0.0268)	-
R^{NET+BA}	-	-	-0.0510 * (0.0174)
<i>Number of observations</i>	56	56	56
<i>R - squared</i>	0.6548	0.6564	0.6581

Regulation and FDI

<i>Dependent variable</i>	$\Delta Mner$		
	OLS estimation		
	(1)	(2)	(3)
<i>Sectoral Dummies</i>	YES	YES	YES
<i>MNER</i>	-0.1377 *	-0.0858 (0.0525)	-0.1038 * (0.0488)
R^{BA}	(0.0442) -0.1865* (0.0413)		
R^{NET}		-0.0653 * (0.0224)	
R^{NET+BA}			-0.0524 * (0.0146)
<i>Constant</i>	0.0672* (0.0117)	0.0423 * (0.0119)	0.0516* (0.0111)
<i>Number of observations</i>	41	41	41
<i>R - squared</i>	0.5412	0.3794	0.4384

Summing up:

- Services are a key input to economic activity
- Restrictive regulations in services negatively affect productivity growth and FDI in downstream sectors
- Despite its large dividends, opposition to services liberalization is strong, due to:
 - its negative impact on employment
 - its limited if any impact on prices
 - the lack of political pressure by service users
- Looking forward, we need to:
 - Enhance the design of liberalization policies
 - Strengthen the Lisbon process