Making Europe work
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Some economists believe that this summer could mark the moment when some of the eurozone's peripheral members may begin to be forced out; others think that such a scenario is inconceivable. All agree that, at least in the short term, a eurozone breakup would be disastrous for jobs and growth.

Illustration by John Overmyer

But, because the outcome is unknowable, and depends on politics as much as on economics, let us leave that frightening prospect to one side and look instead at what we know about the underlying performance of the European Union economy. In short, how competitive is Europe in the summer of 2012?

If we compare the EU-15 (the membership before the enlargements of 2004 and 2007) with the US, the most obvious point is that GDP *per capita* in Europe is almost 25% lower, a difference of around $11,000 a year. Furthermore, *per capita* EU productivity, which had been converging on the US level for 20 years up to 1995, when Europe was only about 5% below the US, lost ten percentage points in relative terms in the decade preceding the eurozone crisis. Europe was unable to match America's significant productivity boost from the information-technology revolution.

But Europe managed to hold its share of global exports during that period more effectively than did the US. European companies have been more successful, on average, at maintaining their share of emerging-market demand than have US companies.

Moreover, European job creation has not been as bad as many think. An analysis by McKinsey & Company of new jobs in the US and the EU from 1995 to 2008 suggests that, while the US created 20 million new jobs, 19 million of them were attributable to population growth. The EU-15 created about 24 million new jobs during the same period, with only nine million due to rising population.

This job creation was not evenly spread across Europe, but it happened. That means that the EU now has successful employment models that can be emulated.

There is also solid evidence that Europe's big companies have been competing relatively well globally. The number of Fortune 500 companies headquartered in the EU has grown over the last decade, while the number of those based in the US has fallen. Moreover, big European companies' profits have grown 50% more rapidly than those of their American counterparts.

Few deny the need for fiscal consolidation in many EU countries, especially in the south (and including France). But fiscal adjustment must be accompanied by structural reform. It is clear that the labor-market reforms undertaken by Germany a decade ago, painful as they were, have put the German economy in a far stronger position to compete globally. Similar reforms are urgently needed in countries like Italy and Spain.

Service-sector reform is vital as well. Manufacturing productivity per hour in Europe compares quite well with the US, but Europeans work significantly fewer hours per year, which explains the annual *per capita* difference. But European countries lag badly in services, where restrictive practices, protectionism, and inefficiency hold them back.

Spanish Prime Minister Mariano Rajoy and Italian Prime Minister Mario Monti seem to understand these points, but the reform programs that they have unveiled are not adequate to the challenge. Although Italian employers have dismissed the proposed employment-law reform as far too modest, Monti's government has retreated in the face of trade-union opposition and protests from assorted interest groups (like taxi drivers) eager to defend their privileges.

Governments are inhibited by the knowledge that labor-market reform may well result in a short-term increase in unemployment (and thus further fiscal deterioration), because employers will find it cheaper to fire personnel. The hope is that greater flexibility would also translate into a greater willingness to hire in an economic upturn.

For EU politicians, however, the long term will be reached only after a series of short-term electoral challenges, so pro-reform governments may well not survive to reap the benefits. As Luxembourg's Prime Minister Jean-Claude Juncker remarked, all EU governments know what must be done; what they don't know is how to get re-elected once they have done it.

Is there a way out of this dilemma?

Countries like Germany are adamantly opposed to a fiscal union, with a central EU budget for responding to asymmetric shocks, because they would be the chief contributors. But a variant that might elicit greater support would link fiscal support to labor-market reform. If Italy or Spain introduced changes that led to a short-term increase in joblessness, the fiscal costs would be met from a central EU budget to ease the pain. This "investment" by wealthier countries should pay off if it leads to more flexible labor markets and higher productivity in the recipient countries.

Another proposal is a central-budget subsidy to reduce employment taxes in the EU's most economically challenged countries. The logic is that a country like Greece needs devaluation to enhance its competitiveness, but that leaving the euro would pose major problems. The alternative would be to cut nominal wages ("internal" devaluation), which is hard to do (though it has been achieved in Latvia and Ireland).

Reducing taxes on labor, perhaps for a defined period, would have a similar effect. That would be costly for governments in the short term, though an increase in output and employment might well justify the "tax expenditure" involved; here, too, an EU subsidy might be a worthwhile investment.

If Europe wants to revive sustainable growth and high employment, it must replicate what has worked in those countries that have performed successfully. Doing so will cost money. Governments must be prepared to persuade their electorates that it would be money well spent.

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