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Why Europe Needs More Balance in Financial Policies

BC economist says austerity measures only go so far in solving woes

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The economic debate roiling post-recession Europe often focuses on reigning in public debt, persistent unemployment and the largesse of the welfare state. But leaders in European Union nations and others should consider relaxing controls on competition for goods and services in order to spark job creation and economic growth, according to Professor of Economics Fabio Schiantarelli and a team of researchers.

Twenty years of data from nations within the Organization for Economic Cooperation and Development show that stimulating competition and improving access to markets for new firms leads to improved employment outcomes, says Schiantarelli, who conducted the research with former doctoral student Giuseppe Fiori PhD '10 and a pair of OECD researchers, Giuseppe Nicoletti and Stefano Scarpetta.

The analysis by Schiantarelli and his colleagues found that in countries with heavily regulated labor markets, product market reforms could reduce barriers to entry and raise the overall employment rate by as much as 5.4 percentage points.

Over the long term, product market reforms lead also to labor market changes that improve employment levels – a so-called "double dividend," according to the researchers, who detailed the findings in the Economic Journal earlier this year.

The findings take on heightened importance as many countries in Europe and elsewhere try to climb out of the recession, battling stubbornly high unemployment, budget deficits and expanding public debt.

Austerity alone won't generate economic growth, Schiantarelli says.

"You cannot exclusively rely on a policy of fiscal rigor to solve the economic problems in Europe. It is necessary to stimulate growth, and for that it is also necessary to implement structural reforms to the product and labor markets that foster competition and allow a more flexible and efficient use of the labor force."

Schiantarelli points to his native Italy, where growth has been stagnant for more than a decade. Excessive protections shield older workers, while younger workers and women face high unemployment rates and are often relegated to a series of temporary jobs. Labor policies have effectively provided an incentive not to hire new workers with long-term contracts. Coupled with regulations that limit competition in service sector industries – such as telecommunications, energy, and transportation – these rigid policies only handcuff economic growth.

In an additional analysis, Schiantarelli estimated reforms that make the labor market more flexible by reducing the costs of layoffs and by creating pathways for hiring new workers into permanent contracts could produce up to a million new jobs in Italy in the long run. This research provides support for the attempt by the technocratic government led by Mario Monti (who served as Schiantarelli's undergraduate thesis advisor at Bocconi University).

Without policies that stimulate long-run growth, Schiantarelli says, there is little hope that the European countries that have accumulated large government debts over the last 20 years will be able to experience successful fiscal consolidation that brings excessive government deficits and debt under control.

As Greece teeters on the edge of insolvency, economists fear its failure could create a domino effect toppling the weakened economies of countries like Spain, Italy, Portugal and Ireland. Schiantarelli says such a chain reaction would have a damaging effect on the US economy.

"We need to avoid the contagion from Greece to other exposed European countries. Otherwise, not only Europe will suffer, but there will be negative consequences for the US economy. We have to hope that the G8 meeting will ultimately help in finding a better balance between fiscal rigor and measures for growth. Whether that will happen is, however, an open question," he said.

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