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The Microeconomic Dimensions of the Eurozone Crisis and Why European Politics Cannot Solve Them†

Christian Thimann

The academic and policy debate about the crisis in Europe's single currency area is usually dominated by macroeconomic and public sector considerations. It mostly focuses on such matters as the degree of fiscal retrenchment or "austerity" in the eurozone, the monetary policy decisions of the European Central Bank (ECB), the appropriate treatment of public debt, or the merits of public investment schemes. The microeconomic dimensions of the crisis and the private-sector issues typically get much less attention. However, the crisis will only be over when unemployment falls to socially sustainable levels in the most highly stressed economies (including Cyprus, Greece, Ireland, Portugal, and Spain) and in the larger and virtually stagnant economies of France and Italy. Programs of fiscal and monetary loosening or an array of bilateral support loans will not in and of themselves create jobs in the stressed countries on a sustainable basis or avoid Europe's possible "secular stagnation." It is the private sector hiring choices of domestic and foreign firms that will ultimately be decisive.

So what is currently discouraging domestic firms in the stressed countries from investing more and creating jobs? What is preventing firms abroad from increasing foreign direct investment in these markets?

This paper argues there are two main problems holding back private sector employment creation in the stressed eurozone countries. First, there is a persistent

■ *Christian Thimann is a Member of the Executive Committee of the AXA Group, and affiliated professor at the Paris School of Economics, both in Paris, France. He is an external member of the Council of Economic Advisers to the French Prime Minister. He was Director General and Adviser to the President at the European Central Bank (ECB) from 2008 to 2013. His email address is christian.thimann@psemail.eu.*

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competitiveness problem due to high labor costs relative to underlying productivity. Over the first ten years of the euro, wage developments relative to productivity diverged strongly across the eurozone.[1] Between 1999 and 2008, Austria, Belgium, Finland, Germany, Luxembourg, and the Netherlands lifted their real productivity on average by 12 percent and nominal wages by 22 percent. France, Greece, Ireland, Italy, Portugal, and Spain collectively lifted their real productivity by only 7 percent, but boosted nominal wages by 40 percent. Hence, the latter group of countries had become both less productive *and* more expensive compared with the former group. This cost-productivity disadvantage of 20–25 percent has been corrected only partially, and a substantial competitiveness problem remains. This problem is aggravated by high tax and social insurance burdens for companies, especially in France and Italy. These developments have led to a considerable erosion of firms' margins, which discourages investment.

Second, widespread structural barriers make job creation in these countries far more arduous than in many other advanced economies, and even more arduous than in some key emerging economies and formerly planned economies. Structural barriers to private sector development are particularly widespread in the areas of labor market functioning, goods market functioning, and government regulation. Evidence from the World Economic Forum's Global Competitiveness Index and the World Bank's "Doing Business" dataset confirms the immense size and persistence of these barriers, despite improvements in some countries in recent years.

Many prominent economists have worked on these topics,[2] but has this research fed into the eurozone policy debates? The answer may seem to be "yes," but substantively it is "no." Yes, because references to structural reforms abound: the European Commission has devoted countless workstreams, committees, and reports to the topic; the monthly monetary policy decisions of the European Central Bank have for more than a decade been accompanied by a call for structural reform; and there is hardly a speech by a leading European policymaker that does not include a reference to structural reforms. But despite abundant declarations, actual reforms fall far short of what is needed.

[1] The 19 eurozone countries, ranked by economic weight in descending order, are: Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Finland, Ireland, Greece, Portugal, Slovakia, Luxembourg, Slovenia, Lithuania, Latvia, Estonia, Cyprus, and Malta. The European Union includes 28 countries: those of the eurozone plus United Kingdom, Sweden, Poland, Denmark, Czech Republic, Romania, Hungary, Croatia, and Bulgaria.

[2] For example, Acemoglu, Johnson, Robinson, and Thaicharoen (2002) and Rodrik, Subramanian, and Trebbi (2004) investigate the fundamental role of institutional quality for economic outcomes; Benassy-Quéré, Coupet, and Mayer (2007) show how structural impediments hinder foreign direct investment; Botero, Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2004) and Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2008) focus on driving forces and implications of labor regulation; Djankov, McLiesh, and Shleifer (2007) focus on credit availability; Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2002) focus on the regulation of market entry; and Djankov, Ganser, McLiesh, Ramalho, and Shleifer (2010) focus on the effect of taxation on investment.

There are standard economic arguments as to why structural economic reforms affecting labor and product markets can be difficult: in particular, organized special interests often seek to block such changes. However, in Europe, where structural reforms are even more crucial given the absence of an exchange rate adjustment, they are actually *more difficult*. This is because countries joining the European monetary union were promised that their membership would not affect their social models and because the well-intended movement of economic policy discussions to the highest political level in Europe (observed increasingly in recent years) creates a "European political overlay" that actually distracts from national reform.

More specifically, the main focus of European economic integration has been the single currency and a mixture of rules about the "four freedoms" of movement across European borders: of people, goods, services, and capital. The European project is explicitly based on respect for national diversity, and in particular the notion that each country retains authority over its own labor and social policies. Any suggestions about European processes to reform these policies would be seen as a challenge to the national identities of economic models that have always been excluded from the goal of European harmonization.

Equally important, and related to the financial crisis as well as institutional changes, the level of economic policy discussions in Europe has increasingly moved from technocrats to elected politicians, up to the level of heads of state. Regular meetings of heads of state have been established some years ago, and the EU/IMF-sponsored adjustment programs are discussed at the level of finance ministers in the eurozone, compared to a more technocratic level at the IMF. In a context where the main economic and social policy issues are in the national domain, the increasing shift of policy discussions to the European political level is actually counterproductive. International policy discussions at the European political level are appropriate for dealing with common macroeconomic policy issues, but they are not appropriate for dealing with the microeconomic, structural issues of individual countries. Topics such as labor market regulations, judicial reform, or administrative modernization involve highly complex legal and institutional issues about which politicians from other countries will have insufficient information; and foreign politicians, even in the European context, do not have legitimacy to deliberate on reforms that deeply interfere with the economic and social fabric of another country. Whenever they do so, they expose themselves and the European project to political backlash.

This paper presents a range of evidence on these problems, including wage and productivity developments across countries and over time, examples of tax and social insurance wedges, and a wide array of structural indicators to establish the hypothesis that cost disadvantages, public charges, and structural barriers hold back investment, job creation, and growth. The paper also presents a novel explanation for the difficulty of structural reforms in the eurozone by tracing the challenge to the current trend to "Europeanize" and "politicize" economic reform discussions in national policy fields where "Europe" is not a legitimate actor and the European political level is not effective.

Competitiveness and Productivity

Competitiveness is often seen as a vague concept. For example, Krugman (1994) offered a powerful reminder that competitiveness can be "a dangerous obsession" when misused as a basis for national mercantilism, and that it is firms and not nations that compete internationally. But competitiveness is well-defined when understood as the ability of firms to sell goods and services profitably in an open economy and to sustain market shares, domestically or abroad. Krugman emphasized that one was "fully justified to speak about competitiveness" when asking "whether a country's exports and import-competing industries have low enough costs to sell products and services in competition with rivals in other countries."

Competitiveness is often used interchangeably in policy debates with productivity, although the two concepts are distinct. For example, the exposition of a European Commission (2014) report on competitiveness jumps straight to productivity: "Promoting productivity growth is crucial to improving competitiveness. However, in recent years EU productivity growth has been low compared to the US. To enhance competitiveness, the EU must use more resources and in better ways." This exposition is at best incomplete and at worst misleading, because it overlooks the price and cost dimension that is at the heart of competitiveness. High-productivity economies can be uncompetitive when wages and other costs are too high, as in Germany in 2000. And low-productivity economies can be highly competitive when wages and/or the exchange rate are sufficiently low and therefore boost exports, as is the case for some developing countries.

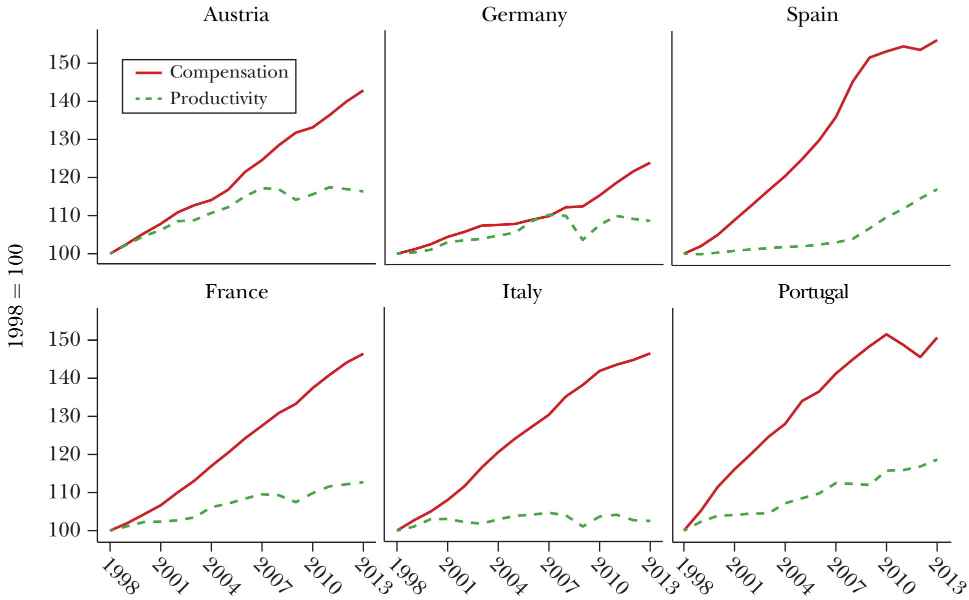
The essence of competitiveness is a comparison of relative costs and relative productivity. Improving competitiveness means improving the price or cost structure of a firm or an economy relative to trading partners; improving productivity means to augment the level of output for a given level of inputs.

The two concepts are related in that competitiveness improves if, for a given level of productivity, costs (and hence prices) can be lowered, or if productivity rises while costs remain unchanged. However, the latter phenomenon is rare because rising (labor) productivity generally triggers demands for higher wages. Competitiveness comparisons usually focus on developments in wages and labor productivity, as cross-country differences in the cost of capital are relatively muted across developed countries.

Competitiveness Problems within the Eurozone

How have eurozone countries fared in terms of competitiveness? Wage and productivity developments in the main eurozone countries are shown in Figure 1. Differences in growth of labor productivity are relevant, but the more striking differences are in wage developments. Austria and Germany are examples of "surplus countries," meaning they have consistently run current account surpluses during this time period. Spain, France, Italy, and Portugal are prominent examples of "deficit countries"—they have consistently run current account trade deficits.

Figure 1
Wage and Productivity Developments, 1998–2013: Selected Countries



Source: European Commission AMECO database.
Notes: 1998 = 100. Productivity is defined as real GDP per employee. Wage growth is in nominal terms, which together with productivity gives nominal unit labor costs, the most widely used competitiveness indicator (see also Draghi 2013). Greece is not shown in the chart because, while the productivity increase is broadly comparable to that of Portugal, the wage growth was even steeper, rising by 2008 to 180 percent of the 1998 value, hence exceeding the scale of the countries shown; wages have declined by about 20 percent since the crisis to 160 percent.

Why did wages surge in the deficit countries? Three reasons seem important: First, wage growth was fueled by a certain growth illusion, stemming from rapid employment growth that had different causes across countries: for example, real estate bubbles as in Ireland or Spain; a rise in hidden government expenditures such as in Greece; or in Spain a surge in immigration between 2000 and 2010, which boosted employment by 10 percent.

Second, public sector wages rushed forward at an astounding pace in a number of these countries. Over the first ten years of the euro, public wages grew by 40 percent in the eurozone as a whole and by 30 percent in Germany. But public sector wages rose by 50 percent in France, 60 percent in Italy, 80 percent in Spain, 110 percent in Greece, and 120 percent in Ireland. Holm-Hadulla, Kamath, Lamo, Pérez, and Schuknecht (2010) provide an overview of public sector compensation trends in the first ten years of the euro, while Lamo Pérez, and Schuknecht (2008) offer a theoretical and empirical analysis of spillovers between public and private sector wages in Europe. This boost in public sector compensation went largely unnoticed at the time, because sharply falling interest rates upon entry into monetary union lowered the debt-carrying burden and made room in national budgets, but it put pressure on private sector wages to rise as well.

Third, higher domestic inflation rates in some countries made nominal wage increases of 6–7 percent, as seen in many deficit countries, seem justified, because the resulting real wage growth was thought to be in line with productivity growth. However, using domestic prices as the deflator was a grave error, because within a monetary union, real wages deflated with domestic prices are not the relevant benchmark. International trade denominated in euros takes place at a single price level that is largely independent of price developments in individual countries. What matters for competitiveness are nominal wages relative to that internationally determined price level. At the same time, business associations and unions in Germany established a period of wage restraint to correct the overvaluation of its exchange rate from the post-unification boom, when it entered the euro. Not even ten years into the euro, wage growth in some European countries was so strong that even *absolute* wage levels exceeded those in Germany: for example, labor costs per hour in 2008 were higher in Belgium, France, the Netherlands, and Ireland than in Germany, according to Eurostat data.

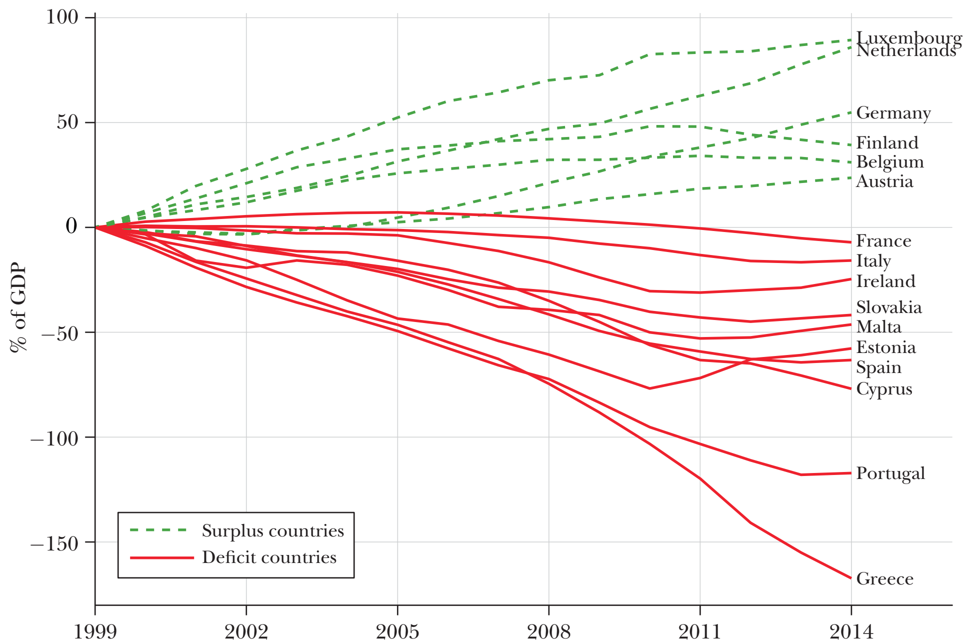
The divergence between relative wages and relative productivity was noted by some observers at the time, but European leaders later admitted that they had not fully realized the importance of the competitive divergences. For example, German chancellor Angela Merkel (2012) noted: "The differences in the competitiveness of the member states of the eurozone have increased, not decreased. We need only look at the development of unit labor costs. Jean-Claude Trichet as ECB president has often pointed this out to us. But all too often, it fell on deaf ears" (see also Trichet 2004).

This shift in competitiveness has had various consequences. For example, some countries began to run systematic current account surpluses, while others began to run systematic current account deficits, as shown in Figure 2. In the financial crisis, a large part of the deficits ended up being financed through central bank money (by the ECB and the national central banks) such that the deficits became a public-sector issue (Cour-Thimann 2013).

These macroeconomic divergences were also reflected at the microeconomic level in an erosion of firms' profitability in deficit countries. Back in 2000, the ratio of gross operating surplus (revenues net of labor costs) to value-added was about 38 percent across the eurozone, and the average was the same for the group of countries that would become deficit countries as for the group that would become surplus countries. But as Figure 3 shows, the gross operating ratio then diverged sharply between these two groups of countries, boosting the incentive for firms to create jobs in one set of countries and reducing it in the other.

Since the economic crisis began in late 2007, nominal wage growth flattened in Spain, while productivity per employee rose, mainly through labor shedding in which less-productive jobs are typically cut first. Hence, Spain apparently regained competitiveness, with the improvement in the current account balance being based almost exclusively in export growth. Yet if one looks at the competitiveness gains

Figure 2
Cumulated Current Account Balances in the Eurozone since the Start of the Euro
(in percent of GDP)



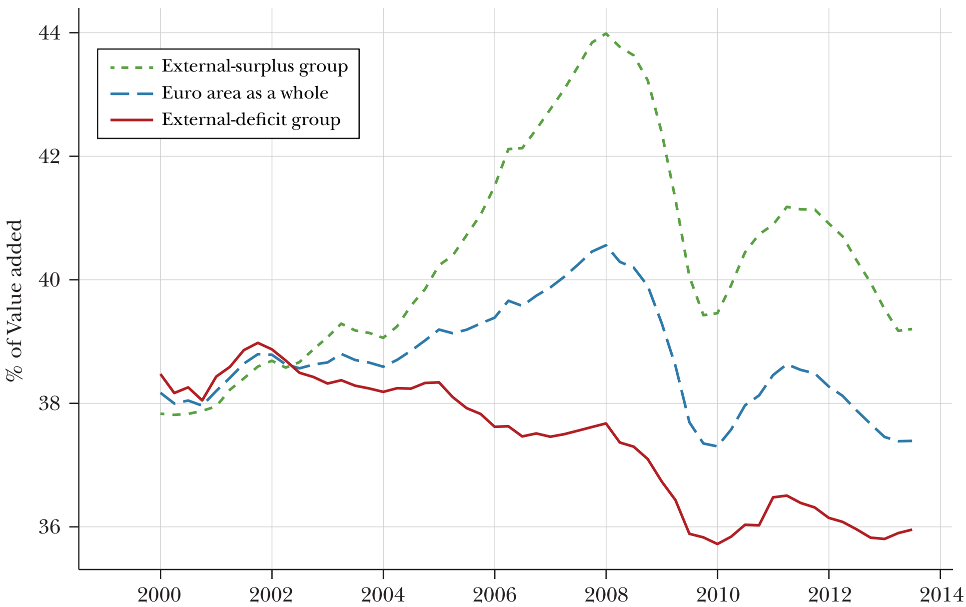
Source: European Commission AMECO database.
Note: Annual data.

based on the total labor force rather than on remaining employment, the improvement in Spain's competitiveness is no longer material. Indeed, measured in terms of real GDP per potential worker (that is, employment plus unemployed), productivity would show a decline in the stressed countries (Sinn 2014). Portugal witnessed a similar development but with more volatility due to earlier nominal wage cuts that were later reversed. Greece has also seen some reduction and ultimate elimination of its current account deficit since 2008, but about three-quarters of the change has been due to import contraction. Perhaps most importantly, in the two largest stagnant countries, France and Italy, the path of nominal wage growth has remained virtually unchanged and the competitiveness problem remains. In France's wage development, neither the global financial crisis nor the eurozone crisis appear to have had an impact, and the current account deficit persists.

The Cost of Creating Jobs and Attracting Talent

It is not just the wage/productivity disadvantages embodied in competitive concerns that hold back economic growth and private sector job creation in the stressed countries. The costs imposed on employers and workers by social insurance contributions and taxation regimes add to the disadvantage of several countries.

Figure 3
Gross Operating Surplus after Labor Costs in the Corporate Sector of Different Country Groups
(in percent of value added)



Source: European Commission AMECO database.
Note: Gross operating surplus is defined as revenues net of labor costs, in percent of value-added.

The variation in employer costs and net compensation can be substantial for a sample of eurozone countries consisting of Belgium, France, Germany, Italy, and Spain, as well as some relevant outside references, such as Switzerland and the United Kingdom. For simplicity and purpose of comparison, Table 1 provides information on five benchmark types of positions, with annual gross salaries from €35,000 to €1,000,000, which for illustrative purposes shall be labeled "clerk," "professional," "manager," "executive," and "chief executive officer (CEO)." Such a comparison is directly relevant for the many multinational corporations that operate across many European countries. It is equally relevant for domestic firms in these countries because it affects the price and cost competitiveness for their goods and services in Europe's highly integrated single market.

For example, for a job with a local annual gross salary of €50,000, corresponding broadly to the median compensation in Western Europe and many professional functions, the costs for the employer range from €59,000 in Switzerland and €65,000 in Germany to €74,000 in Italy and Belgium and €77,000–82,000 in France. The costs are €77,000 in France if the position is in the nonfinancial sector and €82,000 if it is in the financial sector because France maintains a special levy on firms in this sector that is a function of the wage level. As a result, for a single position with the

Table 1

Labor Costs across Eurozone Countries for a Given Level of Salary Category (with Switzerland and the United Kingdom for Comparison)

(annual costs for the firm in bold; net wages for the employee in brackets below; in €)

	"Clerk"	*"Professional"*	*"Manager"*	*"Executive"*	*"CEO"*
Gross salary:	**35,000**	**50,000**	**100,000**	**300,000**	**1,000,000**
Belgium	**53,000**	**74,000**	**143,000**	**321,000**	**1,059,000**
	(25,000)	(32,000)	(52,000)	(141,000)	(458,000)
France					
Financial sector	**57,000**	**82,000**	**166,000**	**502,000**	**1,559,000**
Other sectors	**53,000**	**77,000**	**154,000**	**450,000**	**1,375,000**
	(26,000)	(36,000)	(66,000)	(169,000)	(497,000)
Germany	**46,000**	**65,000**	**120,000**	**330,000**	**1,065,000**
	(25,000)	(32,000)	(62,000)	(172,000)	(548,000)
Italy	**53,000**	**74,000**	**143,000**	**419,000**	**1,385,000**
	(24,000)	(32,000)	(57,000)	(155,000)	(501,000)
Spain	**53,000**	**68,000**	**120,000**	**322,000**	**1,022,000**
	(25,000)	(34,000)	(59,500)	(163,500)	(534,500)
Switzerland	**41,000**	**59,000**	**118,000**	**352,000**	**1,137,000**
	(25,000)	(36,000)	(68,000)	(183,000)	(552,000)
United Kingdom	**48,000**	**67,000**	**127,000**	**366,000**	**1,176,000**
	(26,000)	(36,000)	(63,000)	(162,000)	(526,000)

Sources: HR department, AXA Group, and author's compilation.
Notes: The labor costs for the employer (in bold) are calculated by adding to the given gross salary the local social security contributions that the employer has to pay (including in France a specific tax ("taxe sur les salaires") for the financial sector). The net salary for the employee (in brackets) is calculated by subtracting from the given gross salary the local social security that the employee has to pay and the income tax, which is calculated for a married employee without dependents.

median salary in the country, a firm in France has to pay €12,000 more per year, or almost €1,000 each month, than a company in neighboring Germany. If this firm belongs to the financial sector, the difference rises to more than €1,400 per month. Overall, Switzerland and the United Kingdom stand out as attractive; within the eurozone, Germany and Spain are relatively attractive, whereas Belgium, but even more so Italy and especially France, must be seen as relatively unattractive as far as cost of labor is concerned.

Importantly, the differences in net wage income are far less relevant, ranging between €32,000 and €36,000 for all countries (see the column for the "professionals," who receive the median compensation for the region). Hence, when speaking about lowering labor costs to foster job creation, the focus should be on taxation and social insurance charges at the firm level, rather than on lowering compensation net of employer costs.

For higher levels of remuneration, the differences in labor costs across European countries are even more striking. The labor costs are increasing most for

France, as important social insurance contributions such as health insurance do not level off, but remain a fixed proportion of the notional salary. For a gross compensation of €1 million, the employer faces a total cost of pay of about €1.1 million in most countries but almost €1.6 million in France. The difference amounts to the gross salary of almost ten regular employees and might help explain the exodus of many executives and firms that is observed in France.

Some warnings are in order. Part of the pay differences may be explained through differences in national price levels, even though in a European context the difference is likely to be significant only for Switzerland; the price level in Germany is about the same as in Italy and actually somewhat lower than in France. Other parts of the differences in social insurance contributions may stem from differences in deferred compensations or pensions and different qualities of social insurance services. But the possible differences in the quality of social support systems are likely to be small compared to these cost differences and may not necessarily favor France and Italy compared to other European countries that also have highly developed social systems.

Structural Impediments to Growth

Business operations can be arduous and expensive in some of the eurozone economies. Indeed, there is a remarkable correspondence between the eurozone countries that have significant structural impediments to business growth and the countries that find themselves under economic stress—and hence a correspondence between microeconomic conditions and macroeconomic performance. The strongest impediments to growth appear again in the labor market, exactly where the cost competitiveness problems lie.

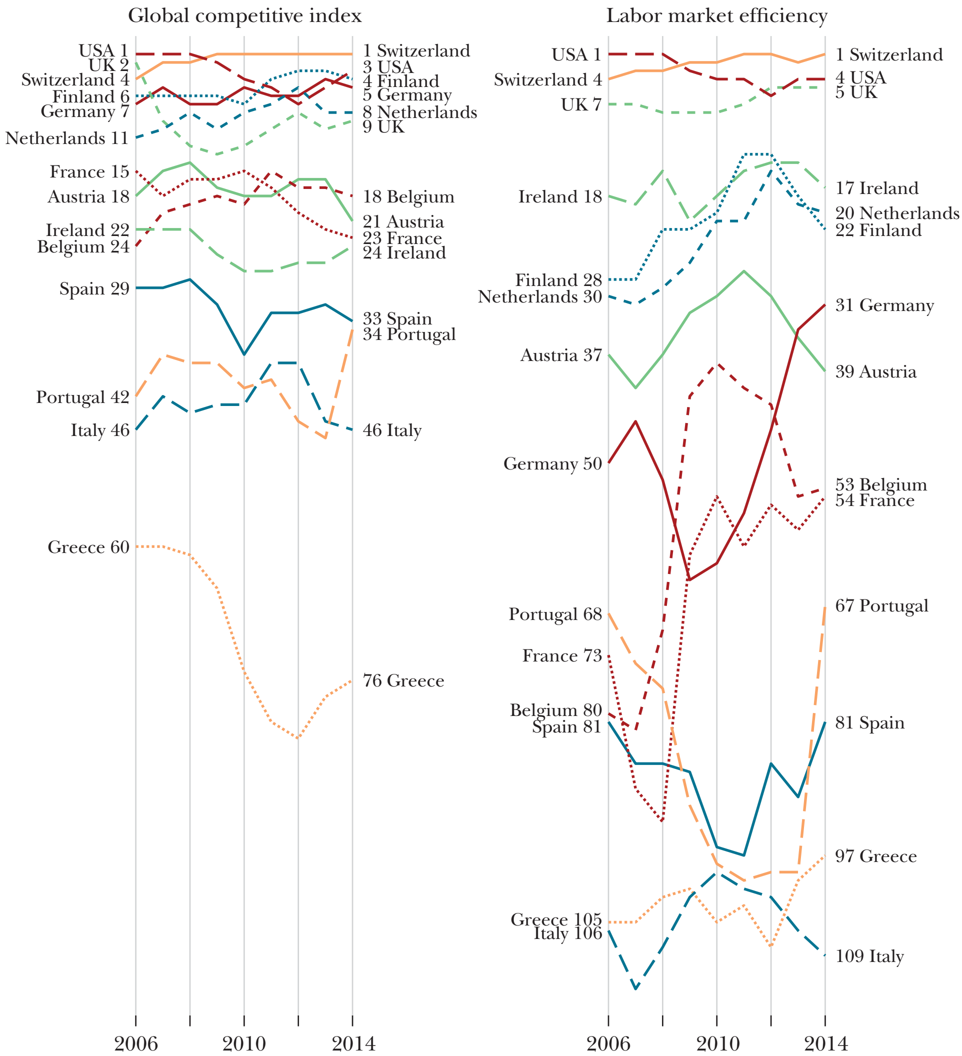
Consider the largest available set of structural competitiveness measures, the Global Competitiveness Indicators that the World Economic Forum has been compiling for over 30 years.[3] The average of eurozone countries (not weighted by GDP) would be ranked 33 in the world, which is not impressive for a single currency area composed of advanced economies founded on trade and free mobility of goods, labor, capital, and services. The European countries in the global top ten for competitiveness indicators—Switzerland, Finland, Germany, Sweden, the Netherlands, and the United Kingdom, in that order—do include some eurozone countries, as shown in the left-hand panel of Figure 4. Some other eurozone countries—Austria, Belgium, France, Ireland, and Luxembourg—are found among the top 30. But Spain ranks significantly lower, Italy and Portugal are placed around rank 40, and Greece ranks 76 out of 148 countries in this worldwide series, with virtually no advanced economy ranked lower. The overall pattern is that eurozone countries usually perform rather well by world standards on the more

[3] These indicators started with a limited number of countries and have been continuously adjusted to take account of newly available data and the latest understanding of factors driving economic performance.

Figure 4

The World Rankings of Eurozone Countries in Structural Competitiveness

(Switzerland, the United Kingdom, and the United States are included for comparison)



Sources: World Economic Forum, Global Competitiveness Indicators, and author's compilation.
Note: This graph shows the ranking over time of eurozone countries within the global sample in terms of overall competitiveness (left panel) and labor market functioning (right panel).

macroeconomic indicators—stability of the macroeconomic environment, and so on—but are weaker than one would expect based on their per capita GDP in the microeconomic dimensions.

"Simple level accounting," also called "development accounting," has been used as a tool to explore the sources of income and productivity differences across countries. The literature has distinguished between differences in factor endowments and differences in the efficiency with which these factors are used. The overwhelming evidence points to differences in efficiency as the chief explanatory source (Caselli 2005). Structural barriers can be seen mostly as standing in the way of efficient use of factor endowments. These structural barriers include the complexity, cost burden, and uncertainty generated by the regulatory, institutional, and bureaucratic framework in each county, which are important variables not usually captured by economic models.

Among efficiency indicators, eurozone countries rank unfavorably in goods market efficiency and very poorly in labor market efficiency as shown in the right-hand panel of Figure 4. The reasons for the low labor market ranking are *difficult labor-employer relations* (France, Greece, and Italy rank about 130 in this category, compared with Ireland, which ranks 13, Austria 10, and the Netherlands 5), *adverse effects of taxation on incentives to work* (Italy ranks 148, the world's lowest among the countries covered; Belgium and Greece rank about 140), *hiring and dismissal practices* (Belgium, France, and Italy again around rank 140), the country's capacity to *retain talent* (Italy, Portugal, and Spain are particularly weak within the eurozone and rank about 110), and *female participation* in the labor force, where Italy and Greece rank about 100.

In the areas of goods market efficiency, the results are particularly striking for the effect of *taxation on incentives to invest*: here, France, Greece, Italy, and Portugal—which together account for more than one-third of eurozone GDP—rank about 140 in the world, and they rank almost as poorly as far as the *overall tax burden* and the business impact of *rules on foreign direct investment* is concerned.

Many formerly planned economies in central and eastern Europe rank higher than several western European eurozone countries; the Czech Republic ranks 37 and Poland 43, which is well above some longstanding European Union member states. It is remarkable that formerly planned economies have overtaken many western European countries in terms of important aspects of economic environment, and especially in goods and labor market functioning.

These rankings can change relatively quickly if effective structural reforms are undertaken. For example, France's labor market reform of 2008 allowed the country to jump 30 ranks higher in the market efficiency index over the next two years, while Portugal jumped 30 ranks in one year (between 2013 and 2014) due to its important labor market reforms. Greece has improved its ranking throughout, although it remains by these measures the weakest-rated eurozone country.

For another perspective on corporate decision-making on investment and operations, one can consider the data on the "Ease of Doing Business" index established by the World Bank. These data are divided into ten main areas: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts, and resolving insolvency. Each of these main headings is then evaluated in a number of subcategories. There is also a separate section on labor market regulation, with subcategories including difficulty of hiring, rigidity of

Table 2
Ease of Doing Business: The Global Ranking of Selected Eurozone Countries

Rank	Eurozone country	Weaknesses (In italics: selected competitor countries)
		(1–8 ranks include: Singapore, New Zealand, Denmark, Korea, Norway, United States, United Kingdom)
9	Finland	Protecting minority interests
13	Ireland	Dealing with construction permits
14	Germany	Starting a business, Registering property
		(15–20 ranks include: Canada, Malaysia, Taiwan, Switzerland)
21	Austria	Starting a business, Dealing with construction permits
25	Portugal	Getting credit
27	Netherlands	Dealing with construction permits, Getting electricity, Protecting minority interests
		(29 rank: Japan)
31	France	Dealing with construction permits, Registering property, Paying taxes
33	Spain	Dealing with construction permits, Getting electricity, Paying taxes
42	Belgium	Dealing with construction permits, Getting electricity, Registering property, Getting credit, Paying taxes
56	Italy	Dealing with construction permits, Getting electricity, Getting credit, Paying taxes, Enforcing contracts
61	Greece	Dealing with construction permits, Getting electricity, Getting credit, Enforcing contracts
65	Cyprus	Dealing with construction permits, Getting electricity, Registering property, Getting credit, Enforcing contracts

Source: World Bank, Ease of Doing Business, 2015.
Notes: "Weaknesses" lists those sub-categories in which the country concerned is below world average. Those ranked below 65 are mostly developing countries.

hours, difficulty of redundancy, redundancy costs, and social protection and labor disputes. The components of the index have been subject to in-depth academic research (for example, Botero, Djankov, La Porta, Lopez-de-Silanes, and Shleifer 2004; Djankov, La Porta, Lopez-de-Silanes, and Shleifer 2002, 2008; Djankov, McLiesh, and Shleifer 2007; Djankov, Ganser, McLiesh, Ramalho, and Shleifer 2010). This research has investigated implications of these "doing business" factors on labor regulation, credit availability, market entry regulation, and the effect of taxation on investment. It has found significant impact from such indicators on investment and job creation.

On Table 2, we see that eurozone countries are above the world average as regards trading across borders, starting businesses, and obtaining permits, which is not really a surprise for high-income countries within the European Union. But eurozone countries are below average—sometimes significantly so—as regards other corporate activity, in particular, dealing with administrations (construction permits, paying taxes), utilities (getting electricity), or courts (enforcing contracts). While all eurozone countries have weak areas in which they rank below world average, the number of weaknesses rises significantly for stressed eurozone countries, making corporate activity also structurally more difficult and providing another reason for lower investment and job creation.

The Political Economy of Structural Reforms in Europe's Monetary Union

Calls for structural reforms are ubiquitous in European policy documents and declarations at both the country and European Union level, but there is a distinct and longstanding lack of achievement. One might think that an EU-style arrangement should be a fertile setting for a program of structural reforms, even if the process is a slow and evolving one. Yet progress toward structural reform in the most deeply afflicted countries, with a few notable exceptions including Ireland and Spain, has been so limited relative to what is at stake that there may well be higher barriers to action deeply rooted in the political economy of implementing Europe's construction.

Why the Eurozone Should Facilitate Structural Reforms

In principle, eurozone participation should facilitate structural reforms because countries have strong economic incentives to engage in them, and because there are multiple formal and informal schemes for devising and coordinating such reforms. The main incentive for structural reforms, especially to increase the flexibility of product and labor markets, comes from the absence of the exchange rate as an adjustment mechanism (Duval and Elmeskov 2005; Bean 1998). Moreover, enhanced competition should make the costs of rigidity higher; the costs of protection for insider firms and workers should become more visible to consumers and voters; firms facing greater cost pressures from competition should exert greater political pressure for deregulation of the market for services, energy, and transport; and countries should have incentives to improve labor market functioning to foster wage adjustments and labor mobility (for an overview of these arguments, see Alesina, Ardagna, and Galasso 2011).

The European project has built vast and far-ranging formal and informal arrangements to "coordinate" economic policies and foster reforms. Formal coordination mechanisms involve precommitments through multi-annual policy plans and public declarations, thus seeking to overcome time inconsistency problems. A range of informal coordination mechanisms seeks to foster an early and politically acceptable process for launching structural reforms (Begg, Hodson, and Maher 2003). The instruments available are plentiful, consisting of guidelines, recommendations, and warnings, based on peer reviews, benchmarking, and a large number of studies and reports provided by all European institutions (Cini 2001).

The question is therefore why, despite these built-in incentives and institutional arrangements, structural reforms have not been up to the challenge.

Why Structural Reform is Slow to Work: Conventional Explanations

The blatant shortcomings of structural reforms have given rise to a large literature explaining why such reforms are slow in general, and within the European

Union and the eurozone in particular (for an overview, see Leiner-Killinger, López Pérez, Stiegert, and Vitale 2007). Several arguments are commonly presented.

One argument is that the case for major structural reforms in Europe is overblown. Bentolila and Saint-Paul (2000) argue that the optimal size of reform may be smaller in Europe's monetary union if, as suggested by Elmeskov, Martin, and Scarpetta (1998) and Orszag and Snower (1998), there are political or economic complementarities across individual reforms. Others argue to the contrary that the case for structural reforms was underestimated for a long time such that now a large amount of catch-up is required with regard to reforms. In this journal, Fernández, Garicano, and Santos (2013) explained how the boom in the run-up to the financial and economic crisis beginning in 2007 relaxed the budget constraint for countries and made reform incentives vanish during that period.

A standard argument, applicable to any country context, is that reform is slow because the long-term benefits of reform are often less visible and more diffuse than the possible short-term costs. Special interest groups focus intensely on these short-term costs, and the schemes often proposed by economists to compensate special interests can be difficult to implement (Rajan 2004; Duval and Elmeskov 2005). For the eurozone, in particular, the upfront costs of reforms may be larger with a single currency because there is no softening certain costs of reform through an exchange rate adjustment (Bean 1998).

Given the recession and persistent joblessness in some European countries over the last seven years, the short-term costs of structural reforms have often become entangled with arguments about contractionary macroeconomic policy. In general, eurozone countries can find it more difficult to conduct expansionary macroeconomic policies given that monetary policy for the currency area is determined with an area-wide focus, and rules across the eurozone limit fiscal policy (Eggertsson, Ferrero, and Raffo 2014; Calmfors 2001; Duval and Elmeskov 2005). However, the lack of reforms means that labor-cost competitiveness problems go unaddressed, making it harder for eurozone countries to participate in the growing global economy.

Finally, the sequencing of reforms is believed by some to pose particular challenges in Europe. Alesina, Ardagna, and Galasso (2011), Blanchard and Giavazzi (2003), and Fiori, Nicoletti, Scarpetta, and Schiantarelli (2007) have pointed to an ideal sequencing in which goods market reforms precede labor market reforms. But within the European Union, some product market regulation is linked to the single market, which can make it harder for individual countries to take actions that would sequence reforms in this way.

Deeper Reasons Why Structural Reform Has Not Occurred

There are deeper reasons for the lack of sufficient structural modernization and reform, which can be understood from the eurozone's specific political economy context. Three issues in particular have to be considered: 1) there are different economic models across eurozone countries, reflecting different social preferences and institutional frameworks, which monetary union was not supposed to change;

2) recognizing this, the European institutional set-up is such that European institutions and fora have little leverage over national economic and social policies; and 3) the European "political overlay" created by taking economic policy discussions up to a higher and cross-country political level can actually interfere with efficient national reform.

1) Diversity of economic, social, and institutional arrangements across European nations. It is well-known that structural reforms can tear at a nation's social fabric. Almost by definition, labor market and social policies relate to deep-rooted preferences for protection, redistribution, flexibility, mobility, and short-term/long-term tradeoffs that often differ from country to country. As a result, there is no "one-size-fits-all" model for social welfare policy, labor market functioning, or the national pension system. Proposals for structural reforms would change institutional arrangements that Shepsle (1986) describes as representing the "frozen preferences" of those who created them. Using the example of Bismarckian welfare systems and their reform over the twentieth century, Palier and Martin (2007) illustrate how difficult and drawn-out such reforms are and what time span, crises, and other disruptions are necessary to alter such systems.

In the context of monetary union, national identities and national models are seen as excluded from the European integration agenda. The social protection of the employee in France, the constitutionally guaranteed tax exemption of ship owners in Greece, the highly federal structure of legal frameworks in Spain or Germany—each reflect not only economic choices, but democratic choices and often historic outcomes. When countries joined monetary union, this was seen as a decision about their national monetary and exchange rate policies in the first place, and about the imposition of constraints on fiscal policy in the second place. Possible implications for economic or even social policies were not discussed rigorously and would have been vociferously refused (Marsh 2011, p. 99f). The public was told that national economic and social identities would be maintained, and diversity was stressed as an essential European characteristic. Fear of social and economic harmonization was one of the reasons for the rejection of a European constitution in 2005 by voters in France and the Netherlands (Jérôme and Vaillant 2005).

The presence and strength of this social fabric also means that possible changes can only come from within the system—that is, they need to come from national governments and other national economic policy actors. Changes can be accelerated in periods of economic disarray or loss of financial market access, but they cannot be imposed by other countries, nor by European institutions.

2) The European institutional set-up. The institutional design of European monetary integration can be viewed as a pyramid with four layers. At the top sits the single currency, with a single institution and a single monetary policy. Just below are fiscal policies that remain national but are closely scrutinized at the European level with formal enforcement mechanisms and the possibility of financial sanctions. Further below are general economic policies, which also remain national but are coordinated much more loosely. Finally, at the bottom of the pyramid are the social policies that are fully national and have hardly any European framework at all, with

European activity being restricted to information, consultation, and "encouragement." The two layers where the microeconomic dimensions of the eurozone crisis lie are therefore overwhelmingly national, with little European leverage.[4]

Because this issue is so fundamental for understanding the difficulties of structural reform in the eurozone, it is worthwhile recalling the exact EU Treaty formulations for economic and social policies. The EU Treaty chapter on "economic policy coordination" starts with a solemn declaration: "The Member States shall regard their economic policies as a matter of common concern and coordinate them."[5] But how is coordination enforced? It turns out that the ultimate "threat" that the European level can exercise is that the EU Council of Ministers adopts a "recommendation" for the country and "may decide to make the recommendation public."

What does a Council recommendation—the ultimate position on economic policies and structural reforms in Europe—look like? It is a short document of usually six to ten pages, the bulk of which is taken up by recitals recalling the legal basis and policy context. The actual recommendations are extremely short and general in nature.

For example, the June 2014 recommendations for Spain from the EU Council take two pages. The recommendations include "promote real wage developments consistent with the objective of creating jobs"; "strengthen the job search requirement in unemployment benefits"; "enhance the effectiveness of active labor market policies"; and "reinforce the coordination between labor market policies and education and training policies." The June 2014 EU Council recommendations for Italy are one-and-a-half pages long.[6] They include generalities such as "work towards a comprehensive social protection for the unemployed, while limiting the use of wage supplementation schemes"; "strengthen the link between active and passive labor market policies"; "improve school outcomes and reduce rates of early school leaving"; and "increase the use of work-based learning and upper secondary vocational education." These recommendations represent at best general policy orientations; they are by no means actionable reform proposals.

By comparison, Germany's own Hartz reforms, which triggered what is widely seen as the most comprehensive labor market reform in Europe in recent decades, are based on a report of 350 pages (Bundesministerium für Arbeit 2002). The Hartz commission was launched in February 2002 by the German government and presented its report in August 2002; the legal transposition was conceptually prepared so that the first laws could be submitted to the German Parliament shortly

[4] There are two policy fields of a more microeconomic nature that are fully coordinated at the European level of the EU (not the eurozone): trade policies and competition policies. These two fields are explicitly identified as EU mandates in the Treaty.

[5] The quotation is from Article 121, available at http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:12012E/TXT.

[6] The recommendations for Spain are at http://ec.europa.eu/europe2020/pdf/csr2014/csr2014_council_spain_en.pdf. The recommendations for Italy are at http://ec.europa.eu/europe2020/pdf/csr2014/csr2014_council_italy_en.pdf.

thereafter and adopted in December 2002, entering into force from January 2003. Such a format is not unusual for national reform commissions and points to the gap between European and national reform discussions. European program countries are faced with much more detailed structural reform agendas, but their implementation is often blurred due to the "political overlay" discussed in more detail below.

On social policies, the European Union legal framework is even looser and essentially focused on information sharing, facilitation, and encouragement: "The Commission shall *encourage* cooperation between the Member States and *facilitate* the coordination of their action in all social policy fields. To this end, the Commission shall *make studies, deliver opinions* and *arrange consultations.*"[7] In an environment that involves difficult political decision-making, the weight of these "encouragements" is virtually nil.

3) The unintended consequences of a political overlay in European economic and monetary union. It has become customary in recent years to elevate negotiations about economic policies and adjustment programs, such as the one for Greece, to the level of elected politicians operating on a European level. Uncountable bilateral visits by politicians across the eurozone have taken place in recent years for this purpose. In many cases, representatives from countries that are receiving adjustment loans have visited "creditor" countries, often giving public speeches and interviews in the home countries of creditors, and even had public meetings with politicians of the opposition.

Escalation from technocratic and national levels to political and European levels was further supported when the Lisbon Treaty in 2009 recognized the European Council of heads of state or government as an official institution of the EU. During the financial crisis, the European Council, sometimes in Eurozone composition, met as frequently as every two months and dealt directly with the adjustment in stressed countries, fiscal targets, and the conditions of financial support including the amount of support loans, interest rates charged, and repayment periods.

While escalation to political and European levels may seem appealing given the broader ambitions of the European project (Habermas 2012), it entails unintended consequences for the efficiency of reform for several reasons. With an escalation to the political level, information asymmetries grow. Finance ministers and heads of state are not familiar with intricate structural, regulatory, administrative, or social insurance issues in other countries. Also, the risk of "negative politization" grows. Well-intended policy proposals can easily be perceived as interference in the domestic issues of other countries. Finally, as the discussion rises to higher political levels, there is a tendency to move from microeconomic issues to macroeconomic issues and from allocation to distribution, as notions of fairness play a particularly important role in politics. Hence, rather than discussing the nitty-gritty of structural reforms, there is a temptation to focus on the "bigger

[7] The quotation is from EU Treaty Article 156, available at http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:12012E/TXT, with italics by the author.

picture" and the "European dimension" of the crisis. For all these reasons, a movement of the debate to higher political levels up to heads of state has gone hand in hand with a move away from national, structural microeconomic issues towards European-level macroeconomic issues.

For example, the documents outlining the Greek adjustment program, as prepared by a team of staff experts from the European Commission, the ECB, and the IMF, are actually highly detailed on structural reforms. They cover measures related to privatization, revenue administration, tackling tax evasion, tax reform, and expenditure control; moreover, the program includes far-reaching measures regarding labor market functioning, regulated professions, energy and transport, product and services markets, and judicial reform (European Commission 2012). However, whenever these documents were brought to the European political level for discussion and approval, the debates surrounding them have almost exclusively focused on the macro issues, in particular the fiscal policy stance and the sustainability of Greek government debt. As these political discussions have become very thorny and drawn out over time, they have frequently led to delays in implementation of the urgent microeconomic reforms. Therefore, the "political overlay" has created a distraction, both at the European level and at the national level, from important microeconomic reforms that are essential to getting the economies of the crisis countries on their feet again.

More generally, in comparison with the IMF, Europe has taken a different approach to the governance of adjustment programs. At the IMF, country programs are discussed and approved by an Executive Board of technocrats sent by national administrations; this is a de-politicized process. In Europe, the country programs for Greece and other stressed countries are approved and discussed by the Eurogroup, which is the body of finance ministers that in virtually all cases are elected politicians, who are of course sensitive to political issues, including their reputation and chances of reelection; this is a political process. This difference has far-reaching implications for the contents of the debate, which in the case of Europe has shifted to macroeconomic issues and become heavily politicized; and this has not been conducive to a smooth implementation and has actually led to political backlash.

The rising politicization has been accompanied by a new version of the European "blame game": no longer "against Brussels," but instead among countries. Monetary union, which was created to avoid "beggar-thy-neighbor" policies, has recently witnessed a lot of "blame-thy-neighbor" politics. The rising national accusations in the press of individual countries that invoke national stereotypes and historical images are ample testimony of this issue.

For example, there is a widespread public perception in countries such as France, Italy, and Spain, nurtured by many political declarations, that Germany's fiscal policy plays an important role in explaining those countries' economic malaise. The fact that this argument rests on weak economic grounds has not obviated its political attractiveness. A French think-tank considered a substantial fiscal impulse in Germany amounting to one percentage point of GDP for three consecutive years, and estimated that a German fiscal expansion of this size would “unambiguously stimulate German growth, but the spillovers to Spain would be negligible” (Blot, Cochard, Ducoudré, Schweisguth, Timbeau, and Creel 2014, p. 25).

Finally, the “political overlay” has led to a blurring of responsibilities. As it is very difficult for politicians to tell other countries what they should do, the debate has shifted from “country-specific” recommendations to recommendations focused on Europe as a whole. Politically, it is much easier to say what an abstract “Europe” should do than to say what a concrete other country should do.

Conclusion

At the core of the economic crisis in the eurozone is the problem of unemployment in several countries. Roughly 18.2 million people are unemployed in early 2015. In about half the eurozone countries, the unemployment rate is below 10 percent, and in Germany it is actually below 5 percent (Eurostat data, February 2015), but in France, 10.7 percent of the labor force are unemployed; in Italy, 12.7 percent; in Portugal, 14.1 percent; in Spain, 23.2 percent; and in Greece, 26.0 percent. In the latter group of countries, the overall unemployment problem is compounded by large-scale youth unemployment.

It is legitimate to speak about this as a problem *for* the eurozone in the sense that economic policies in a single currency area are truly a matter of common concern, and also because high unemployment interferes with the smooth functioning of the eurozone, challenging its economic and political cohesion. But it is not accurate to attribute responsibility for the problem, or the solution, to the eurozone as a whole, to European institutions, or to other countries.

Jobs fail to be created in a number of these countries not because of a “lack of demand” as often claimed, but mainly because wage costs are high relative to productivity, social insurance and tax burdens are heavy, and the business environment is excessively burdensome. All of this should be viewed not in absolute terms, but in relative terms, compared with other economies in Europe and countries around the world where labor costs and productivity are more advantageous, and the business environment is friendlier.

“Europe” is not an all-powerful actor in the field of national economic policies, but only a potentially useful facilitator. Only the country concerned is the legitimate and able party to improve its own economic functioning in line with its social preferences and economic setup. This is why European politics cannot solve the microeconomic dimensions of the eurozone crisis. Within individual countries, it is the governments, administrative authorities, social partners, and all other economic stakeholders that are the legitimate actors in the field of economic and social policies.

The founders of the European Union always had in mind the overarching goal of lasting peace in Europe. For this reason, Europe’s political construction allows for a broad range of different economic models and social preferences, and leaves responsibility for the consequences of different models with the countries concerned. It is unlikely that a "deepening of integration" to include social or economic policy harmonization is the answer desired by the democracies in Europe. Such a proposal fails to take account of the historic diversity on the European continent. Moreover, voters showed a lack of support for "deepening integration," when they rejected a European constitution in 2005.

For the eurozone countries, their economic and unemployment problems are not primarily a question about some countries versus other countries within the monetary union, but about finding their place in an open global economy—that is, about competing and cooperating successfully with advanced, emerging, and developing economies across the globe. An inward-looking European debate on the distribution of the relative adjustment burden for structural reforms would dramatically overlook the much broader challenges of integration into the global economy.

If Europe wants to focus on microeconomic adjustment and reform, a de-escalation from the political level seems essential. Rather than discussing structural reform among elected politicians, Europe could provide technical advice by subsuming the extensive expertise on structural reform issues existing across European institutions into a "fiscal institute" or "competitiveness institute," perhaps under the umbrella of the European Commission but at arm's length from the political level. In such a context, experts could analyze experiences across countries and provide insights on best practices. It would benefit country governments to take account of any such analysis, which would be provided on a technical rather than a political level.

In addition, academic research could usefully turn more to the microeconomic dimensions of the eurozone crisis: wage determination and labor market reforms; labor costs and productivity developments; regulatory and tax burdens and business operations; and the efficiency of judiciary and administrative systems. Policy advice could focus on promising options for lowering costs for employing labor while not reducing disposable incomes to workers; raising labor force participation rates and part-time work arrangements; and, ultimately, raising long-term productivity growth. It may be more glamorous to focus on European monetary policy, the "European architecture," or the "bigger macro picture." But the real issue of—and solution to—the crisis in the eurozone lies in the mostly *micro*economic trenches of national economic, social, and structural policies.

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