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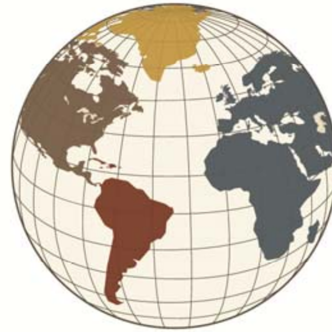

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Structural Reform and the Future of Europe

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In recent years I have had the honor of joining a small delegation from the National Association for Business Economics (NABE) on several trips to meet European economists, policymakers, bankers and business people. This year a larger group of us traveled to Munich, Germany to participate in a symposium hosted by the Deutsche Bundesbank called “Economic Growth, Monetary Policy and Structural Reform: Challenges Ahead for the U.S. and Europe”. In addition to distinguished speakers such as Ignazio Visco – Governor of the Bank of Italy - and Charles Evans - President of the Chicago Federal Reserve Bank - we shared ideas with approximately 80 other American and European economic and financial professionals.

While the financial press is focused on the Greek melodrama (sometimes called the “Melodrachma” after the old Greek currency prior to the Euro) and European Central Bank (ECB) monetary policy, our group also delved into the relationship between structural reform and long-term economic growth. The term “structural reform” came into vogue during the Eurozone economic crisis, but few people seem to know what it means. As we sought to better understand structural reform with our European colleagues, it became clear that Europe is finally starting to reduce long-standing legal and regulatory barriers that restrict financial markets, inhibit business competition and hinder efficient labor markets.

Why is “Structural Reform” a European Issue?

The legal system in Continental Europe is very different than ours. The U.S. legal system is a variant of British Common Law. In Europe only Britain, Ireland and Malta are Common Law countries. All other European countries operate “Civil Law” systems. Developed originally in the ancient Roman Empire, Civil Law has very different historical and philosophical origins than British Common Law. In many ways Civil Law is more orderly, logical and less litigious but can also be inflexible and hard to change. Common Law on the other hand is more flexible, even though it can seem chaotic to people accustomed to a Civil Law system.

To greatly simplify, a fundamental assumption of the Common Law is “all business transactions and relationships are permitted unless explicitly prohibited by law.” By contrast, Civil Law essentially holds the opposite assumption that “all business transactions and relationships are prohibited unless explicitly permitted in law.” In a Civil Law system, business activities that do not clearly fit into a defined legal structure are generally considered illegal. Before companies can engage in these activities the legislature must pass laws to authorize them (i.e., the legislature must reform the structure of the law). This difference is perhaps most pronounced in the financial system.

Structural Reform in Finance

Civil Law countries rarely produce financial innovations. Moreover, they typically adopt some of the innovative financial products, institutions or practices originated in Common Law countries slowly and cautiously over time. As an example, there are now $10 trillion in asset-backed securities outstanding in the United States comprised of mortgages, credit card receivables, auto loans, student loans or commercial debt. Due to legal restrictions European (ex U.K.) asset-backed securities amount to just $1 trillion. Only now – in response to the Eurozone banking crisis – are European parliaments debating whether to allow much larger issuance of asset-backed securities.

Another example is peer-to-peer lending. This new industry, where individuals can lend their savings directly to borrowers over the internet, cuts out the banking middlemen altogether. Renaud Laplanche – a French national and one of the leading peer-to-peer lending entrepreneurs - founded Lending Club in the United States in 2007, but his business model was illegal in his home country until 2011. Because new financial practices often require legislation in Europe, incumbent financial institutions or other potential competitors often pressure politicians to smother newly born financial innovations before they can gain momentum.

European law favors traditional banks over alternative financial institutions or capital markets. Without these alternatives banks could not sell assets to shore up their balance sheets during the Eurozone financial crisis. While large companies tapped stock or bond markets to a certain extent, small and medium sized companies lacked back-up financial systems. As credit dried up, companies in the hardest hit countries slashed payrolls to survive, pushing unemployment to 25% in Spain and Greece.

Structural Reform to Promote Business Competition

European countries have numerous laws that impede business competition. Some of these rules are visible to tourists such as limitations on store hours, locations and square footage. In many countries supermarkets cannot compete with pharmacies, for example. Other less visible barriers are inherent to the way a Civil Law system operates such as the role of notaries in business contracts.

In the United States notaries merely verify the identity of signatories. Notaries in a Civil Law system, however, are very powerful figures. A contract typically cannot be considered legal until a notary has inspected it and affirmed it complies with appropriate legal codes. Notaries jealously protect their privileged and lucrative monopoly, often pressuring politicians to maintain high entry barriers into their profession. They lobby governments to squelch viable competitors such as lawyers and accountants or to prevent limitations to their purview (for example, exempting automobile or residential property transactions). Notaries are such a significant economic bottleneck in Italy that Matteo Renzi – the Prime Minister – included notary reform as one of his important structural reforms. To American ears this sounds paltry, but in a Civil Law context it is quite significant.

Labor Reform

The most discussed structural difference between America and Europe is employment law. Europe does not have “at-will” employment. Rather employment contracts have certain provisions spelled out in law. Typically employees cannot be terminated without due process, often in costly judicial proceedings. Employers face many other labor restrictions and costs such as hefty social insurance payments, generous leave policies, employee involvement with firm governance, and employee tenure among others. In most European countries these legal mandates apply to business firms once they employ a certain number of people. In Italy, for example, most labor laws apply once a company has 15 employees. As a result, half of all business firms in Italy employ 14 or fewer people. Other countries have similar quirks at certain important legal thresholds such as 50 employees.

Europe is Overcoming Inertia

European countries with a Civil Law background have a more rigid economic structure that reflects their more inflexible legal structure. Changes in technology or new business models - such as online shopping - certainly drive competition in Europe as they do in America, but many economic activities require legislation. The idea of “structural reform” is not an alien concept in America. For example, we still need to restructure our mortgage market and the role of government sponsored enterprises such as Fannie Mae and Freddie Mac. But entrepreneurial initiative is by far the primary source of economic change in the United States. Entrepreneurs are also in plentiful supply in Europe wherever the law allows them to operate.

Legislation is a political process that lets established interest groups lobby against reforms that would harm their interests, even if society ultimately benefits. The Eurozone’s financial crisis weakened many of these groups. Politicians recognize that economic bottlenecks must be reduced to alleviate unemployment. Europe is now a crucible of structural reform. The one recalcitrant country – Greece – is the exception that proves the rule. The anti-reformist government in Greece hoped to bring like-minded countries into its camp. Instead, even reluctant reformers such as Italy accelerated their push toward improved financial markets, more competitive businesses and more liberal labor markets. As the reform momentum gains traction, Europe could become a very attractive destination for long-term investors like us.