



# Breaking Down **Barriers** to Growth

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**H**OW BEST to rekindle growth is a subject of intense debate in most of Europe's developed economies and in Japan. Over the past decade, these countries have experienced a slowdown of economic growth at the same time as lengthening life spans have caused their pension and health care costs to mount. Some economists have recommended lifting restrictions on competition in the many sectors where they remain and reforming labor market regulations. But such moves are resisted by those who fear they will lead to mass unemployment and destroy social safety nets. Others recommend more invest-

ment in research and development (R&D) and education to equip workers with the skills to perform higher value-added tasks as more low-value jobs are automated or migrate to lower-cost economies.

Who is right? In exploring the debate, this article focuses on supply-side barriers to growth (demand-side macroeconomic policies have been examined extensively elsewhere). After a decade of research comparing productivity in private sector industries in the world's major economies, our conclusion is that the key to boosting productivity and thus growth is a policy framework promoting competition in all sectors.

**Encouraging competition is key to reviving stalled industrial economies**

Getting the pace right. Shopping for sports shoes in Germany.



## Productivity is paramount

Rates of economic growth among developed economies have varied over the past 15 years, creating quite significant changes in relative GDP per capita (see Chart 1). As the chart shows, GDP per capita can be broken into GDP per hour worked (a rough measure of productivity growth) and hours worked per capita (labor utilization). Productivity growth is clearly the main source of GDP per capita growth, so policy-makers should make promoting it a top priority. However, overall growth has been curtailed in a number of economies because of substantial declines in hours worked per capita. Accordingly, creating jobs is vital, too.

Our research on six major European economies, the United States, and Japan shows that regulatory reforms resulting in greater competitive intensity within an industry will improve overall productivity within that industry. The more sectors that improve their average productivity, the greater GDP growth in that economy will be.

Look at Europe. In each of the six countries we studied, there is a significant gap between the labor productivity levels of most companies in any industry and those of world-class companies. In France and Germany, for instance, labor productivity is lower in most industries than in the same industries in the United States (see Chart 2), with food retail in France and mobile telecoms in both France and Germany as the only exceptions.

While several European industries closed the productivity gap with the United States during the 1990s, just as many fell further behind. What prevents Europe's labor productivity

from reaching its potential? The gap in some industries has structural causes. In European retailing, for example, small, proprietor-owned stores—less productive than either large discount retailers or chains of small specialty stores—are much more common than in the United States. Similarly, in Japan, mom-and-pop stores have a large share of the market. In other industries, productivity gaps arise because national industries introduce more productive innovations at different times. French automakers, for instance, adopted lean manufacturing in the 1990s, igniting a jump in the sector's labor productivity, from just 42 percent of the U.S. level in 1992 to 72 percent in 1999. German auto companies, in contrast, began the decade in a dominant position and felt little pressure to change. As a result, their productivity levels fell behind those of French companies, from 59 percent in 1992 to 69 percent of the U.S. level in 1999.

We found that where European industries had retained structures and processes that impeded productivity growth, the underlying cause was a lack of competitive pressure. Competition raises productivity because it allows the most productive companies to gain market share and create more jobs, obliging the less productive to either improve or go out of business. But in several European economies, the most productive businesses are neither growing nor increasing their workforce, while the less productive ones are still hiring (see Chart 3). The reason is that many regulations on product markets and policies governing labor and the use of land overly restrict competition.

The same is true of Japan. Its economy grew rapidly, fueled by high capital investment and the mass movement of workers from low-productivity agricultural jobs into manufacturing and services. But in the 1990s, that path of growth stalled. Japan's economy today contains some productive, profitable, world-class companies like Toyota but also many overregulated industries that are protected from competition. After a decade of stagnation, Japan now shows a new commitment to economic reform and liberalization. But while it will take time to dislodge vested interests, the need for productivity-led growth is becoming acute. Japan's aging population means its workforce and its savings rate will both decline: it does not have the option of input-led growth.

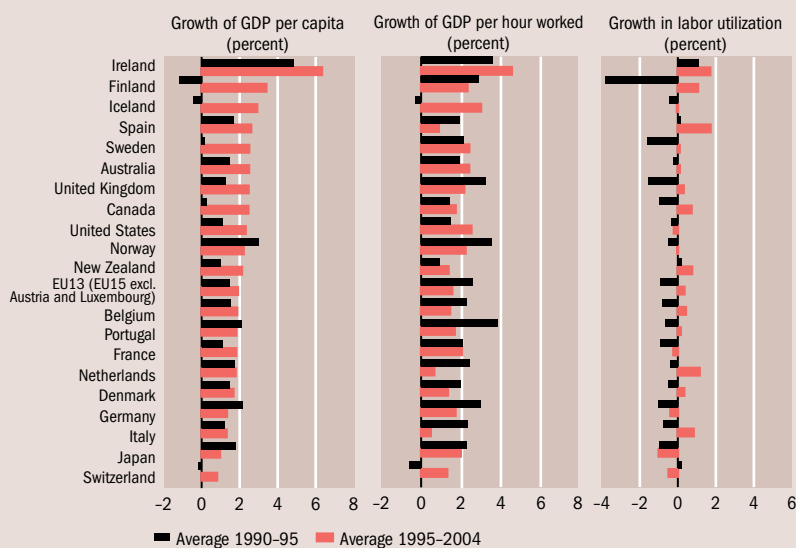
## Importance of the service sector

Industrial countries also face a shift from manufacturing to services. Since 1997, employment has declined in the goods-producing sectors of most developed economies, leaving service industries responsible for all net job creation. In OECD economies today, services generate 70 percent of all employment, on average,

Chart 1

### Working smarter

Rates of growth have varied substantially among developed countries over the past 15 years, largely because of variations in productivity growth, which is the main source of GDP per capita growth.<sup>1</sup>



Sources: OECD Productivity Database and annual national accounts.

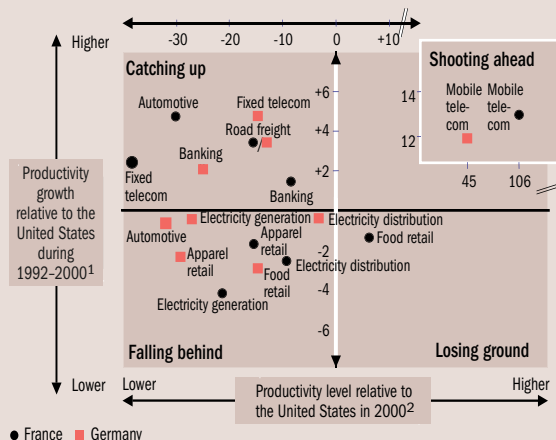
<sup>1</sup>GDP per capita can be broken down into GDP per hour worked (a rough measure of productivity growth) and hours worked per capita (labor utilization).



Chart 2

### Losing ground

Europe's productivity—as exemplified by France and Germany—has been trailing that of the United States in most industries.

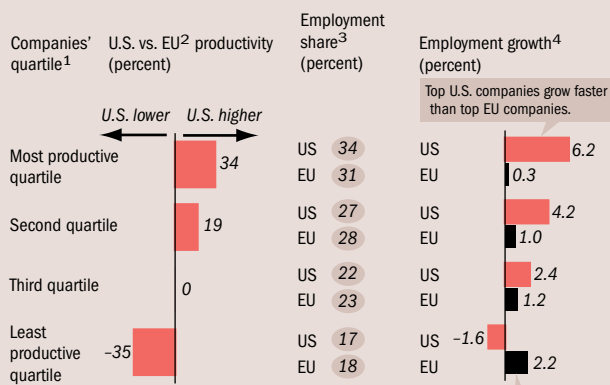


Source: McKinsey Global Institute.  
<sup>1</sup>Data for automotive and utilities cover 1992-99, data for banking cover 1994-2000, and data for retail cover 1993-2000.  
<sup>2</sup>Data for automotive and utilities are from 1999.

Chart 3

### Adjusting faster

The United States is better at ensuring that resources are allocated to the most productive companies.



Source: Economic and Social Institute, Vrije University, the Netherlands. Unless otherwise stated, all data are for 2000.  
<sup>1</sup>Aggregated data for manufacturing sector.  
<sup>2</sup>Weighted average of EU countries for which data were available, including Finland, France, the Netherlands, Sweden, and the United Kingdom.  
<sup>3</sup>Average share, 1995-2000.  
<sup>4</sup>Average annual growth in resources, 1995-2000.

and the higher a country's GDP per capita, the higher the share of service employment.

Manufacturing employment is shrinking—roughly 22 million manufacturing jobs disappeared worldwide between 1995 and 2002. Even China, the world's "factory floor," lost 15 million manufacturing jobs, equivalent to 15 percent of total Chinese manufacturing, and a higher proportion than the global average loss of 11 percent. Not enough new jobs were created by the boom in foreign manufacturing investment to offset these losses, caused largely by restructuring in China's state-owned factories.

Local service sectors like retail and construction are important drivers of overall GDP growth because of their sheer size, while access to good local services affects growth rates in all other sectors because every enterprise uses them. Japan's experience is a case in point. By 2000, its world-class export manufacturers were legendary. But output from these companies comprised only 10 percent of GDP. Productivity in the rest of the economy—about 68 percent of it in local services—was only 63 percent of U.S. levels. That partly explains why Japan's growth tailed off in the 1990s, just as eventual reform of local service sectors helps explain its recently improved performance.

### IT only part of the solution

Europe's leaders generally agree that spurring investment in information technology (IT), R&D, and basic education should generate productivity improvements and, therefore, GDP growth. Exceptionally high productivity growth in the United States from 1995 to 2000—a period when U.S. investment in high tech also grew at 20 percent a year, nearly dou-

ble its growth rate over the previous decade—would suggest they are right. But sector-level data from the United States show that such investments on their own would be insufficient to raise GDP growth.

First, industry studies found that IT was only one factor behind the acceleration of U.S. productivity growth after 1995. Although increased investment in IT was widespread among companies across all 59 of the economy's sectors between 1995 and the end of 1999, managerial and technological innovations in just six sectors—wholesale trade, retail trade, securities, semiconductors, computer manufacturing, and telecommunications—accounted for virtually all net productivity growth (see Chart 4). Innovative use of high tech was an important element of growth in some of these sectors (notably securities trading) but was not the whole story. Equally critical were standard, low-tech capital investments—the development by retailers of big box outlets, for instance—and changes in businesses' processes, such as wholesalers' new approaches to warehouse management. These innovations were prompted by increases in competitive intensity in each of the six sectors, often spurred by industry-level regulatory changes. This conclusion is reinforced by the fact that U.S. productivity since the end of the high-tech boom has grown faster than in the 1990s and in more industries, even though company investments in IT have declined sharply.

Second, comparing European and U.S. industries' use of IT shows that neither access to IT nor the ability to use it explains much of the difference in their productivity. Many industries in Europe have adopted the same productivity-enhancing technologies as their global competitors. However,

they cannot all make full use of the labor-saving potential because of regulations restricting the scale of enterprises that also limit potential returns from large investments in IT, or because of labor laws restricting the layoffs that could result from deploying such technology.

In short, policies that simply target higher IT spending are neither necessary nor effective as growth boosters. Economic growth in developed economies will naturally involve substantial IT investments, but these should flow from businesses' innovations and expansions—the real growth drivers.

We also caution against relying too much on education policy as a source of faster growth. Numerous companies and industries have achieved world-class levels of productivity with a workforce not especially skilled or well educated by introducing best-practice business processes in a competitive environment. The general merchandise and food retailing sectors in the United States and the United Kingdom are notable examples.

### A recipe for growth

To enjoy strong GDP growth, developed economies need, as a priority, policy frameworks that encourage competitive intensity. This means lifting product market regulations, enabling firms to achieve economies of scale, easing land-use restrictions, promoting competition in their often neglected domestic service sectors, and encouraging labor market flexibility.

**Ease product market restrictions.** Governments rightly create safety standards to ensure that electrical appliances are not a fire hazard, and food standards to protect public health. But some product market regulations hinder companies from innovating and becoming more productive, hurting consumers in the long run. Japan's regulations governing materials and techniques used in home construction, for example, aim to preserve the national character of the nation's housing stock. But they also prevent the construction industry from raising productivity through standardization, which would make houses cheaper for consumers to purchase. In Germany, limits on the hours of operation of stores prevent retailers from realizing the better service and employment gains that would result from remaining open longer.

**Encourage economies of scale.** Enabling companies to achieve economies of scale is a critical way for countries to boost their productivity growth; indeed, Europe created a common market partly to this end. Policymakers can encourage scale efficiencies by facilitating mergers and acquisitions and by standardizing regulations. Antitrust regulations rightly seek to prevent mergers that would create monopolies. But regulations that unnecessarily restrict mergers—such as those governing Germany's small regional banks—in effect allow inefficient operators to stay in business when newcomers could provide the same services more efficiently. Standardizing regulations, too, can enable the kind of cross-border expansion that delivers rapid productivity growth. Applying common rules to Europe's road-freight industry in the 1990s, for example, triggered a wave of consolidation, and the continent's long-haul routes are now more efficient. The bigger companies can deploy expensive tools, such as route optimization systems, that have dramatically increased capacity utilization and productivity.

**End the bias in land-use policies.** Zoning decisions should aim to encourage economic growth while protecting the environment. But many restrictions on land use in Europe and Japan discourage productivity and employment far beyond what is necessary to preserve national heritage. The high price and shortage of available land add to the difficulties of companies such as Carrefour and Ikea, for instance, in finding locations for new large stores, thus holding back productivity and employment in the retail sector. Even though many European policymakers want more manufacturing jobs, it can take months or years for companies to obtain approval to build a new factory. (Indeed, local authorities may deny building permits in response to pressure from local companies keen to keep new competitors out.) Similar restrictions apply to new housing developments, making new houses scarce and expensive and making workers wary about relocating.

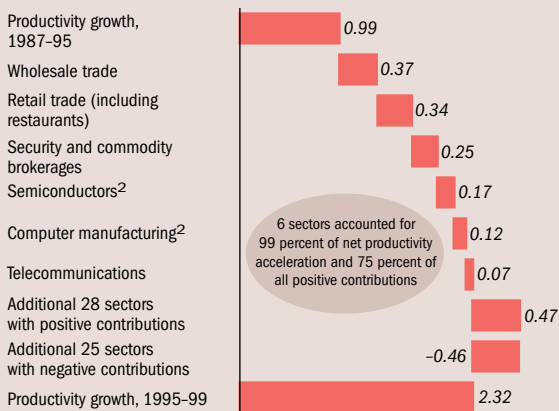
**Boost service sector productivity.** Until recently, policymakers in developed economies considered productivity in domestic service sectors less critical than competitiveness in sectors that trade globally. But because the vast majority of employment is in services, liberalizing service sectors should be their top priority. The proposed EU Services Directive

Chart 4

### IT is only part of the explanation

Six sectors accounted for almost all of the increase in U.S. productivity growth after 1995. Business process innovations, not just high-tech investments, caused this acceleration.<sup>1</sup>

(compound annual growth rate (CAGR), percent)



Sources: U.S. Bureau of Economic Analysis, and McKinsey analysis.

<sup>1</sup>Analysis based on U.S. Bureau of Economic Analysis sector data, which differ slightly from widely publicized U.S. Bureau of Labor Statistics (BLS) aggregate data. BLS labor productivity growth figures show 1.4 percent CAGR for 1987-95 and 2.5 percent CAGR for 1995-2000.

<sup>2</sup>The semiconductor industry, representing 20 percent of overall productivity growth, is a subset of "electronic and electric equipment," which as a group contributed 17 percent; computer manufacturing, representing 10 percent of overall productivity growth, is a subset of industrial "machinery and equipment," which as a group contributed 12 percent.





would have liberalized cross-border trade in services. A report by Copenhagen Economics found the directive could have created up to 600,000 jobs and spurred 33 billion euros in new economic activity each year. Its defeat in 2005 was clearly a step in the wrong direction.

To harness the power of local services, policymakers need to recalibrate regulations across the economy, enforce them fairly and firmly in every sector, and lighten their overall load. Recalibrating regulations means giving equal treatment in fiscal, financial, and development policies to all businesses, regardless of sector. No more cheap loans or tax breaks to pet industrial projects; no more punitive taxes on local services; and an end to product market barriers stifling service competition—for instance, restrictions on foreign direct investment in services.

Lightening the regulatory load means setting taxes at a level that all businesses accept as fair and will pay. It means cutting red tape to simplify business registration, ownership, and bankruptcy procedures, so that innovators can enter markets and grow, and failed firms can exit quickly. And it means revising labor laws so that employers can hire and fire in step with the business cycle, giving workers more jobs to choose from overall.

**Increase work incentives and labor market flexibility.** Labor regulations in developed economies should promote job creation and employment and smooth the transition of workers between jobs. But tight restrictions on laying people off, plus high taxes on employment to finance generous social security benefits, will deter companies from hiring new people. French retailers, for instance, employ 50 percent fewer workers as a percentage of the population than their U.S. counterparts because of strict regulations on hiring and firing workers and a minimum wage twice that of the United States.

Generous unemployment benefits may also deter people from working. In the Netherlands, for example, a 60-year-old person receiving jobless benefits stands to lose 90 percent of any extra income a job would provide. But countries can encourage people on welfare to work without undermining workers' security. Permitting employers to pay lower salaries for some jobs but asking the government to make up the difference with a wage subsidy would encourage people to take a job irrespective of the pay. Procedures are a problem, too. For example, hotels in France need a small army of lawyers to deal with complex labor regulations. Not surprisingly, these laws curtail employment and do little to improve customer service. Giving companies the freedom to hire and fire and negotiate salaries will actually boost job creation in developed economies.

## In sum

To rekindle growth, Europe and Japan must allow for more competition. Promoting competition in service sectors, both traded and domestic, is particularly important because they account for more than 70 percent of all employment and value added in OECD economies. Investment in technology, R&D, and education can be helpful in stimulating productivity growth, but in isolation will not be sufficient to rekindle growth and employment.

Maintaining a highly competitive, dynamic, open, developed economy with flexible labor markets does not mean abandoning a commitment to social programs. Many European countries may need to modify their welfare provisions to restore incentives both for businesses to hire people and for unemployed workers to seek work. But the success of several smaller European economies, notably the Netherlands and Denmark, in combining economic reform with a strong social safety net shows that the two are in no way mutually exclusive. On the contrary, every OECD country with a strong social agenda needs to generate economic growth and high employment if it is to finance adequate pensions and social insurance, especially as their populations age. ■

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