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How the EU can move to a higher growth path : some considerations

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How the EU Can Move to a Higher Growth Path — Some Considerations*

1. In the current slowdown in Europe, the United States and Japan, policy makers are vexed by the question when a recovery will come. This is the wrong question. The issue should be how a higher growth path can be reached in the long run, i.e., how the potential growth rate of our economies can be increased from the supply side.

The answer to this question seems to be different for the three most important regions of the world economy, the United States, Japan, and Europe. All three regions had quite diverging growth performance in the nineties. The United States reached an annual growth rate of 3.7 percent in the nineties (Table 1); with its "new economy" and some exuberance, its growth rate of 4 ½ percent was unusually high for a mature economy in the second half of the nineties. Japan more or less stagnated during the nineties while digesting the fallout of its burst financial bubble of 1989. It was a lost decade for Japan. Europe exhibited a low growth rate of around 2.1 percent in the nineties (and 2.9 percent in the second part of the nineties). Capital formation there was low relative to the United States; the rate of capital formation was at one-third the U.S. rate in the nineties. The increase in employment was also low.

Table 1: Economic Activity in Industrial Countries, 1992–2000[a]

	United States	EU
GDP	3.7	2.1
Gross fixed capital formation	7.3	2.4
Employment	1.6	0.5

[a]Average percentage rates of growth.

Source: OECD, *Main Economic Indicators*, and U.S. Department of Labor according to Thomson Financial Datastream.

It can be expected that the United States will return to a higher growth rate after the current slowdown but with the rate being somewhat lower than in the second part of the nineties. Japan will get out of stagnation. The EU can be expected to continue on a low growth path of around 2 percent or a little higher. Thus, the decisive question is how the EU can get on a significantly higher growth path with rates of, say, 3 percent plus x.

The Strategic Variables for Growth

2. How can continental Europe get on a higher growth path? What are the most important ingredients of a growth process? What factors stimulate economic dynamics?

- It is technical progress, that is, new products, new production processes, and organizational change.
- It is human capital formation, which may very well be the most important growth determinant in the information society.
- It is capital accumulation, physical capital, new machines, and new hardware.
- It is doing away with existing growth impediments, inefficiencies, and institutional arrangements that reduce the production potential. Most crucial is the inflexibility of the labor markets in the major continental countries. Likewise crucial is openness to competition (both internal and external) as an efficiency whip.

If we want to develop a growth strategy, we have to answer the question: How can we stimulate these growth factors? How can we create an environment that is conducive for them? And how can we remove growth impediments?

Note that to investigate growth factors is not to investigate the question of convergence, i.e., the catching-up-process. Convergence means to approach the level of economic prosperity in the economically leading countries; this is not the relevant question for the core of Europe. The

* President of the Kiel Institute of World Economics and member of the German Council of Economic Advisers. Paper prepared for the first meeting of the Group of Economic Analysis of the European Commission (GEA) on December 6, 2001. I appreciate critical comments from Henning Klodt, Rolf Langhammer, Oliver Lorz, Joachim Scheide, Jens Weidmann, and the participants at the GEA meeting.

question for Europe must be how to become a growth engine in its own right.

Create an Environment Conducive for the Growth Factors

3. We have to create an economic environment in which inventions, innovation, and investment flourish. We have to enhance technological change as a process endogenous to an economy.

An important element is the entrepreneur, the Schumpeterian entrepreneur, who takes on risk and who daringly implements new combinations of factors of production. For growth you need the entrepreneur. And we need more of them in Europe.

There must also be a preparedness in the European societies to take risks including technological risks, in areas such as atomic energy and biotechnology. Moreover, higher economic risks should be accepted. This, however, implies that the reward for taking these risks should not be called into question. This means accepting differences in income.

In essence, innovation is achieved by recombining existing ideas in a new manner. As the potential for new recombinations is higher in diverse societies, rising diversity could promote innovative dynamics. We should therefore be prepared to accept higher diversity. Across countries, Europe exhibits quite a high degree of diversity—not only in income levels, but also in social and cultural attitudes. Within countries, however, diversity is much lower than, say, in the United States. With a deeper integration of European capital and labor markets, diversity could probably be much better harnessed to gain new momentum in the innovation process.[1]

The innovative dynamics of an economy are no longer solely determined by its efforts in industrial R&D. Europe is not industry-based any more, but service-based and knowledge-based. Innovation policy has not yet followed these fundamental shifts and still sticks too much to traditional innovation concepts and support schemes. Successful innovation in new technology fields—such as e-business or biotechnology—depends much more on open markets and favorable conditions for technology-intensive start-ups than on conventional R&D subsidies. Innovation policy at the EU level and at the national level as well certainly needs a fundamental redesign. It should be less concerned with distributing public funds and more concerned with removing market barriers to innovative activities.

Ease of market entry is a key prerequisite for economic dynamics both in newly emerging and in traditional industries. Most relevant is market entry regulation in the new technological areas of biotechnology, pharmaceuticals, communications, and information. Regulations to obtain a business permit, to build a factory or construct a new building, and to license a new product define market entry. Market exit regulations affect market entry as well. The Internet and the new economy should not be confronted with too narrow regulations. Another prerequisite is access to capital in the venture capital market, bypassing the traditional ties to banks as the only financial intermediaries.

We should open up our product markets to competition where this has not yet been done and deregulate them where regulation is no longer justified. Quite a bit has been achieved in Europe in this respect. In some areas, however, competition is still lacking, especially in some network industries (energy, gas, water, and parts of communications) and previously public enterprises like the postal service. Protected areas are equivalent to a tax on downstream industries and activities.

We should not introduce new forms of internal protection against competition, neither through new regulation nor through subsidies.

A continuous flow of inventions and innovations cannot be generated by the national governments or the European Commission. Starting from a Hayekian view of technological progress, the flow of new technologies must come from a decentralized process. The role of governments

[1] In this view, the envisaged Eastern enlargement could well turn out to be a stimulus to innovation also in the incumbent countries, as it will foster the flow of capital, people, and ideas in both directions.

is to co-finance basic research and to ease the diffusion of new technical knowledge. National governments and the EU should refrain from attempting to "make" or "steer" the strategic sectors.

For a strong endogenous process of technological change, a tax system is required that induces firms to innovate and to build capital and that does not slow down and restrict effort. A central aspect is entrepreneurial effort. A precondition for reducing taxes and contributions to social security is to redefine the role of the state and bring down the share of government activities from 50 percent of GDP in the continental countries to a lower value.

Locational and institutional competition is an important vehicle with which to bring forth strong economies, to force firms to use their imagination to cut costs and to find new products. Competition will prove to be a discovery process that points out more efficient solutions. It will make an economy strong and robust in the long run. Competition policy and antitrust policy are necessary ingredients to prevent distortions in the competitive process.

4. With human capital being a major determinant of economic growth, we should improve the national systems for human capital formation. The tax system should not disfavor human capital accumulation relative to the accumulation of physical capital. It is not sufficient to reduce taxes for firms; the high marginal and average tax and mandatory contribution rates to the social security systems (of 60 percent and more in quite a few countries) that workers have to pay must also come down.

In quite a few European countries, contributions to finance the social security systems imply high (average and marginal) tax and contribution rates on labor income. Contributions to social security systems in the Continental countries are already running up to 15–20 percent of GDP, whereas they account for 7 percent in the United States and 6 percent in the United Kingdom. This poses a high tax wedge and a disincentive for human capital formation (as well as effort). Necessary steps to change this are: to insure people only against the large risks that they cannot cover themselves by a mandatory insurance and to let them decide whether they want additional private insurance for the smaller risks; to partly replace the pay-as-you go system by a capital funded system for old age in order to increase the return for the working generation; and to bring mandatory insurance premia and benefits more in line with each other by uncoupling the financing of social security from the work contract, thereby reducing or eliminating distributional elements.

Restructuring the social security systems is also necessary because the contributions affect employment and unemployment. For workers, the wedge between the gross wage and the net wage makes it harder to accept lower wage increases in wage negotiations. However, they have a choice between a net wage and the social wage, i.e., benefits paid by the social security system. If the sum of the net wage and the contributions to the social security system ("social wage") exceeds productivity, jobs will be reduced. In that sense, rising contributions imply a tendency to reduce employment and have an incidence similar to a tax on labor.[2] Firms react to these costs with lower employment, so that labor bears the burden of the system in terms of higher unemployment. Last but not least, the aging population will require the social systems to be adjusted and be made sustainable.

5. The organizational conditions for human capital formation are an important key in a strategy for growth. We should make sure that each country has an efficient primary and secondary school system. Vocational training systems combining formal schooling and on-the-job training for the young, such as in Germany, represent a promising approach, but they must be more innovative with respect to new job opportunities, for instance, in the information and communications industry.

[2] In a more formal analysis, an implicit tax on labor is given if contributions exceed benefits (no marginal equivalence). In such an approach, the rise in the marginal and average contribution rates in the last decades indicates there has been an increase in the implicit tax on labor.

6. The future academic elite of the world is overwhelmingly being educated in the United States. The university system in some major European countries, for instance, in Germany, is inflexible and rigid, being steered by administrative procedures, nearly like in central planning. Open this system to competition. Let universities compete for the best researchers and students and let students compete for the best universities. Make sure you use all the talents available in a society and keep the educational system open to all talents.

Keep Monetary Conditions Stable

7. Monetary policy can best serve a growth strategy by providing a stable money in the long run. At the same time, it has to provide sufficient liquidity such that the demand side is not restricted and can go along with the increase in the production potential. Monetary policy must be aware of the time lag involved between the current money supply and the price level more than a year down the road. A more traditional failure of monetary policy is that short-run stimulation and excessive liquidity require a stabilization recession at some time in the future because otherwise price level stability cannot be obtained.[3] A more recent and a new form of monetary failure is that excessive liquidity can create a bubble without affecting price level stability. The example of the burst Japanese bubble and its aftermath in the nineties show this new risk of failure for monetary policy and the severe negative implications for growth that can follow from excessive liquidity. Greenspan's story and the Fed's impact on financial exuberance may still have to be rewritten.

Do Away with the Impediments to Growth

8. Besides setting free these factors of growth, impediments of growth have to be abolished. The most important impediment is the rigidity of the labor markets in the major Continental countries. We should undo this rigidity. The institutions that we have developed for the labor market in most European countries malfunction. Unemployment ratchets upwards in each recession, and jobs are not coming back to the same extent when the economy is doing better; hysteresis follows. External shocks hit European workers harder and more permanently than workers in other regions of the world. This requires redoing the institutional set-up of the labor market in the European countries. Since the institutional arrangements are national (and should remain so), redoing the labor market is a national task; the EU may help in stimulating a process of international competition to find the best solution.[4]

The rigidity mentioned above does not refer to working time (where some flexibility has been obtained), but rather to wages. The major continental countries exhibit a relatively low degree of wage differentiation. Differentiated wages, however, are needed because of varying job qualifications, varying regional situations, and varying conditions in the firms. Efficient labor contracts comprise three variables: wages, working time, and employment guarantees. Such contracts are Pareto-efficient, and both the firm and the worker can benefit from them. Since employment guarantees cannot be given by centralized employers' associations, these contracts have to be made in a decentralized way, that is, in the firms. We therefore have to look for institutional forms which allow these decentralized contracts.

Since the market does not seem to be a politically acceptable form of wage formation in the Continental countries, we have to look for institutional mechanisms that allow efficient labor contracts including some aspect of job security. A first approach is to adjust individual working time when there is a slowdown of economic activity (and to adjust labor income along with adjustments in working time, though not proportionally). This would secure jobs and allow working time to "breathe" with the level of activ-

[3] Compare the United States in 1981.

[4] It is important to note that the answer to solving the unemployment problem may very well differ from country to country.

ity (for instance, through annual or even lifelong budgets of working hours). A second approach is a bonus system with salaries that are part fixed and part flexible. A third approach is to introduce a two-tier wage bargaining system where job security, an important aspect of the wage contract, is dealt with on the firm level ("efficient labor contracts" including wages, working time, and job security as important variables).

Although the institutional set-ups differ between countries, the institutional arrangement is generally in favor of insiders; it discriminates against the outsiders, the jobless. Make sure that all legal rules that disfavor the jobless are changed. Abolish all market entry barriers for the jobless. Do not protect wages negotiated centrally or at the sector level when they imply that jobs will be lost and that new jobs will not be created. Allow deviations from negotiated wages when this creates jobs or saves jobs. Puncture the walls of the wage cartel. Shift wage formation to the firms and to the markets. Allow decentralized solutions at the firm level in sector-level wage bargaining. Give up central wage bargaining.

Give up the concept of the minimum wage because if minimum ages are binding (for instance, in low-income regions or in age groups like younger workers) they destroy jobs and cause unemployment. Minimum wages are at the root of youth unemployment. Do not declare negotiated wages mandatory.

Redefine the reservation wage in Continental countries that is determined by the social security systems. Unemployment benefits[5] and social welfare payments define a reservation wage that determines search behavior in the labor market and preparedness to accept a job. Empirical analysis of the unemployed (in Germany) shows that the reservation wage is at 1.2 of the previous wage when employed. The reservation wage prevents wage differentiation in the lower labor market segment.

The alternative to the approach of adjusting the reservation wage downward is to pay a wage subsidy, i.e., to bridge the gap between the (low) productivity of the worker and the (higher) wanted wage (the reservation wage) by a governmental subsidy. I am extremely skeptical about this approach. First, the approach hinges on the level of the reservation wage provided by the governmental systems. If the reservation wage is high, high subsidies would be required. Second, empirical results of pilot projects (in Germany) show a rather limited employment effect. Limited overall employment effects are also observed in the case of the Earned Income Tax Credit in the United States and for the Working Families Tax Credit in the United Kingdom (both, however, with positive employment results for single parents and for parents with children). Third, a wage subsidy presupposes that the trade unions not be induced to make higher wage demands, since the wage subsidy would take care of those in the lower segment in the labor market. Fourth, the costs for this program would be sizable if it were applied widely; if, however, the program were not applied widely, stigmatization effects might arise. Fifth, a new form of a subsidy would be introduced. The reservation wage and the level of the subsidy are political variables that would be likely to rise in the mechanics of the political process over time. It is likely that, in the political process, subsidies and the reservation would move up. Sixth, the assignment of responsibilities would change. The government takes over the responsibility from the trade unions for employment in the lower segment of the labor market.

9. Subsidies require sizable financial resources (in Germany, 8 percent of GDP if a broad concept of subsidies is applied) and imply distortions and efficiency losses. They tend to protect and favor old sectors and they impede structural change. Subsidies should be done away with.

Take a Long-Run View of the Conflict between Equity and Efficiency

10. Equity and social cohesion cannot be defined as job protection for those employed at the cost of discriminating the unemployed. Unemployment is social exclusion. Equity cannot be equity

[5] In Germany, in two schemes, *Arbeitslosenhilfe* being paid with no time limit after *Arbeitslosengeld* is terminated.

in a static context for mainly those of today. We should interpret distribution and social equity in an intertemporal sense and not put too much weight on short-term social equity. Instead, we should look at the question whether income per capita will improve in the medium run, and we should look at vertical mobility in the income distribution over five or more years. According to empirical studies, vertical income mobility is a relevant fact.[6] We should take a longer-run view of distribution and social equity. Growth can improve the situation for most of the people. The political task is to develop a win-win situation in which benefits are spread out widely.[7]

There is a conflict between dynamics and social cohesion. Partly, this conflict may be overcome by approaches such as raising labor productivity and using productivity increases from more flexibility in working time. But, in essence, there is a choice between more dynamics and more cohesion. The EU has to be realistic enough to acknowledge this conflict.

Reduce the Role of the Status Quo – Rely on Competition

11. Economic policy must shift its orientation away from the short run and take a longer-run view. Adhocery, a quick fix of political problems, and a populist short-run reaction to sudden issues imply that side-effects in a general equilibrium and long-run effects over time are neglected. Very often, short-run fixes are at the cost of long-run negative implications. Unfortunately, the media require extremely simple and naïve ideas that can be understood in thirty seconds. Nevertheless, the long-run impact has to be taken into account. Sustainability of public finances is an example. This is first of all an issue of economic policy orientation, in the words of Churchill: "A politician always thinks of the next election, a statesman considers the next generation." We need institutional rules that have to be followed and institutional safeguards so that intertemporal restraints are not violated. These may be constitutional constraints in each country, for instance, on the permissible level of new public debt or rules such as the Stability and Growth Pact.

12. Growth means change; it transforms society. But mature economies are characterized by structural rigidities. Japan is a case in point. Rigidities are also a problem for Europe. The status quo plays an important role in economic policy making. Traditional sectors like agriculture are protected. Income distribution is influenced by the status quo. Wage negotiations favor the employed, not the unemployed. Trade unions maximize the income of their members. Vested interests are politically organized. University systems cannot be opened to competition. The consensus approach favors the existing power structure. Member states of the EU define their political interest from their status quo. All this causes inertia, which is an impediment for change, a barrier to innovation, a hurdle for economic dynamics and growth. Institutional innovation is lacking in Europe. It is the task of political leadership to open the way to overcome the status quo and to set in motion a process that will eventually modernize societies.

13. An important mechanism to overcome the status quo is an open economy. Protectionism is not a viable alternative, as it implies lower gains from trade. It would mean lower welfare for the countries of the world. Harmonizing labor norms worldwide is a protectionist instrument for the industrialized countries, but it would restrict the economic opportunities for the developing countries. Therefore, one should not give in to the illusionary requests of the NGOs. The failure of the Seattle Meeting was deplorable in the context of a growth strategy for the world economy. After the terror attacks of September 11, it is especially important to develop the WTO further in order to reduce uncertainties. The role of the EU in the Doha Round should not be defensive, the intention being to continue agricultural protection and protect the status quo. The EU should take a much more active role in enhancing the world trade order.

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[6] In West Germany, 54.1 percent of those below 50 percent of the median income in 1995 were in a higher relative income position after four years. See Sachverständigenrat (2000: Table 69).

[7] Profit sharing is a relevant strategy.

14. A very serious risk for the EU is that after enlargement the institutional arrangement of decision-making will no longer be appropriate. The voting scheme established by the Nice Treaty will make it difficult to reach decisions in important areas. There is a risk that the EU will block itself in its decision making and that the status quo will play an even larger role (Siebert 2002). Thus, a new voting scheme is a prerequisite to prevent stagnation in the EU.

15. Europe is at a crossroads. It needs a new policy orientation in favor of dynamics, growth and employment. It needs a sea change in its policy orientation, similar to France's change to stability orientation in 1983. This is an issue of political leadership. Ideas already expressed in the Broad Economic Policy Guidelines (European Commission 1999) and the Presidency Conclusions at Lisbon (European Commission 2000) should be implemented.

Some Adverse Conditions

16. The question of how to reach a higher growth path is especially relevant for the EU, since the major Continental countries will be characterized by a sizable aging of their population. This will mean less economic dynamics (Siebert 2001). Moreover, the global environmental constraint may prove to be an impediment to growth that has to be tackled. Finally, it cannot be ruled out that there will be a third energy crisis in the long run.

Eight Points for the Next Five Years

17. Within the next five years, the larger Continental member states of the EU should shift their policy orientation in favor of economic dynamics and growth by

- relying on competition to enhance dynamic performance,
- establishing an innovation-friendly environment,
- strengthening human capital formation,
- reducing the size of government,
- cutting subsidies in half,
- reducing marginal tax and contribution rates,
- relying on wage moderation in countries where unemployment is high, and
- deregulating the labor market to allow a more decentralized wage formation in firms.

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