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An agenda for a growing Europe

Comment by
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The report

- I share much of the diagnosis
- General issues:
 - Covers a lot, sometimes at the expense of focus
 - Some priors are not questioned (e.g. cohesion, stability)
 - Hiatus between problems and policy tools to face them (most evident in the field of structural policies)
 - Macro recommendations sharper than structural ones
- I organise my comments around the holy trinity (growth, stability, cohesion)

The holy trinity

- According to the report, the EU:
 - Preserved cohesion
 - Reached stability
 - But missed the growth train
- And without growth both cohesion and stability are at stake
- I share this view, I will address four items:
 - What are the proximate causes of weak growth?
 - What do we mean by stability?
 - What policies are needed for stability and growth?
 - Could a misguided concept of cohesion slow down reforms and contribute to low growth?

Growth

- EU-US gap in GDP p.c. explained by:
 - Lower labour utilisation (lower hours per worker and participation, higher unemployment)
 - Lower labour productivity (but ‘apparent’ productivity is at par or higher in several EU countries)
- The gap in ‘structural’ productivity is even greater if underutilisation of labour is factored in
- Despite the gap, over 95-02 growth in both labor utilisation and productivity was weaker than in the US

Productivity growth

- Productivity growth was dragged down by:
 - A declining contribution of labour quality as more unskilled workers were employed
 - A low and stagnating contribution of capital quality
- This points to the inability of reaping benefits of ICT investment, and is particularly evident in ICT-using services
- Very problematic because in principle these benefits could more than offset the drag on growth due to declining labour quality (as seen e.g. in the US)

Stability

- The report defines stability in terms of macro policies/monetary outcomes:
 - Sound monetary policy – low inflation
 - Sound budgets – low interest rates
- What about stability of real outcomes (bringing back output to potential quickly over the cycle)?
 - Recently, such real stability (resilience) was stronger in several non-EMU countries notably the US (though the US was the epicentre of shocks)
- Resilience to shocks has implications for the conduct of macro policy
 - Bang-for-the-buck/room-for-manoevre higher in resilient countries (no hysteresis in these examples)

Stability

- Are product, labour and capital market flexibility partly responsible for differences in resilience? E.g.:
 - Policies that make hiring and firing difficult
 - Policies that make consumption smoothing difficult
- If so, stability should also be defined in terms of structural policies/real outcomes
- Resilience also helps adjusting rapidly to potential in the face of permanent supply shocks (e.g. ICT)
- Hence, policies in an enlarged concept of stability are conducive to both less cyclical fluctuations and quicker adjustment to higher potential output

Cohesion:country/regions

- **First best policy should favour mobility of factors, eliminate market segmentation (services) and differences in endowments (human capital)**
- **Other policies are second best and imply deadweight, but could be justified on political economy grounds**
- **With limited resources and growth priority, report suggests to reallocate regional funds to EU-wide (R&D, human capital) and country levels**
 - Convergence at country level, but much less at regional level
 - Effects of regional funds unclear
 - Pol. eco. effects of regional funds perverse, especially with enlargement
- **Jury still out on effects of regional policies/funds, but reverse pol. eco. arguments can be made:**
 - “EU of regions” can counter centrifugal tendencies at country level
 - Strongly-conditional regional spending effective vehicle for furthering EU supply-side growth objectives
- **To prevent that EU funds are used as a palliative to eliminating distortions that originate in wrong national policies (pure deadweight), conditionality could focus on:**
 - Local implementation of EC directives or national reforms
 - Elimination of wage-productivity gaps
 - Elimination of distorting national transfer policies

Cohesion: interpersonal

- **Bargaining systems and transfers have succeeded in keeping inequality lower than in US**
- **But costs in terms of growth and employment have been high**
- **To minimise these costs (Nickell et al.):**
 - Consequences of national bargaining for unemployment of low skilled, regional imbalances and incentives to skill upgrading should be acknowledged
 - The contract/mutual obligation nature of transfers needs to be stressed:
 - Example of Nordic countries/United Kingdom on mix of ALMPs and conditional benefits
 - Italy still backward – lack of clear and transparent benefit system
 - Longevity must be seen as opportunity for increasing employment (no lump-of-labour fallacy)
- **More generally, one needs to go beyond complacency for low Gini coefficients and take a more dynamic view:**
 - Intergenerational equity dimension
 - Non-employed and long-term unemployed are a drag on human capital, growth and social cohesion
 - So is lack of incentives/possibilities for social mobility
 - So are limited opportunities for integration of immigrants
 - Cohesion also means less outsiders and more common sense of belonging to an equal opportunity society

Policies

- **There are solid arguments that weak growth and lack of resilience in the EU are the result of ill-designed structural policies**
 - Weak incentives for participation, job-seeking and working long hours
 - Obstacles to and weak incentives for elimination of slack, adoption and innovation especially in services
 - Obstacles to reallocation of resources across markets and firms
 - Financial markets offer little possibility of consumption smoothing over the cycle
 - Long adjustment lags linked to labour and product market rigidities
 - Lesser effectiveness of macro stabilisation policies
- **The report explores some of these links, but remains a bit vague on desirable labour and product reforms**
- **This is partly because EC has little leverage on structural policies, which remain largely national**
- **Evidence is that structural policy reform is uneven across the EU and exceedingly slow, especially in large continental countries**
- **This may be partly due to misgivings about what cohesion means**