

# **Economic Policy Issues for the Next Decade**

Edited by

**Karl Aiginger**

*Austrian Institute of Economic Research, Vienna and  
University of Linz, Austria*

and

**Gernot Hutschenreiter**

*Austrian Institute of Economic Research, Vienna and  
European Forum, Stanford University, California, U.S.A.*



**KLUWER ACADEMIC PUBLISHERS**

BOSTON / DORDRECHT / LONDON

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## THE CASE FOR A NEW POLICY FRAMEWORK – INTRODUCTION

There are several reasons why it has become important to rethink economic policy. From a European perspective there is a need to define which the policies should be made at national level and which at European level. Europe was tremendously successful in the introduction of a new currency, but is now struggling to find the optimal macro economic policy for a set of economies which are diverse both in their economic performance and their social and political systems. Europe was moderately successful in reducing public debt, yet the institutional arrangement (Maastricht criteria, Stability Pact) chosen is quite definitely suboptimal and currently under revision. The fiscal goal of approximately zero deficits proved sustainable for some countries during a period of slow growth, but failed in three of the four large economies. Europe is quite successful in pushing exports over imports partly by moderate wage increases, but has been consistently lagging behind the USA in growth during the 1990s and the first years of the new decade. The productivity gap between the USA and Europe, which had narrowed from decade to decade, started to widen again in the late 1990s (*Aiginger, 2002; Gordon, 2002*). Europe has successfully increased employment by adding 14 million jobs over the past five years. This, however, reduced multifactor productivity and the contribution of capital deepening, instead of accelerating growth. And the progress made in cutting down on unemployment has not been impressive, considering that unemployment is still higher and employment lower in Europe than it is in the USA.

Looking into the future, Europe expects that enlargement of the European Union will enhance growth and competitiveness, which will in turn boost vertical cooperation and accelerate restructuring. Enlargement, however, also imposes a burden of change on specific regions and on less qualified employees. It strains the institutional organisation of the EU by encompassing between 25 and 50 members over the coming decades. On the negative side of the balance sheet there is the burden of ageing. Ageing is not only a fiscal burden which mandates changes in the retirement system, but it may also slow down innovation. Europe is already lagging behind in its innovative drive and did not invest enough in research and education in the 1990s. Both OECD and EU are setting goals for higher growth, but they tend to downplay the proactive role of government in innovation policy. Making product markets more competitive and labour markets more flexible are assessed to be sufficient to encourage innovation growth.

A broader look on policies on both sides of the Atlantic indicates that after decades of convergence in their economic policies, we may be in for a period of increasing divergence and conflicts. One area of divergence is monetary policy. The US Fed, after experimenting with fixed rules and making inflation its primary target, started to assume more comprehensive responsibility for growth and cyclical stability. Fiscal policy allowed the US budget to switch from a considerable surplus to a deficit of about 4 percent of GDP in 2003. A conflict may develop if the US currency continues to depreciate and Europe perceives this as being welcomed and enforced by the USA as a strategy for adjusting the balance of current account. For Europe, the devaluation of the dollar, although welcomed for the associated strong position of the euro, constitutes a further obstacle to getting back on a growth course. A second conflict arises from the USA needing to attract an ever increasing share of capital investment as the only way to finance a deficit of the US balance of current account in the long run. In view of the need to re-establish confidence after diverse auditing scandals, a clash of opinions arises on whether the US system or the European system is the optimal accounting method, and on whether one country can force multinational firms working in both regions to follow its preferred rules. A third set of conflicts may arise in trade policy, on standards for genetically modified food, and on agricultural subsidies.

The present volume touches most, but not all of these topics. It starts with an overview by Joseph Stiglitz on policy issues specifically deemed to be important for the new century. The next chapter discusses macroeconomic policy in Europe and specifically the setting of the Maastricht Treaty and the Stability Pact. The next chapter concerns what may be the most challenging burden for Europe, the consequences of an ageing population. This is followed by possibly the most beneficial challenge, enlargement of the European Union. There are major differences in taxation and in the role of public finance between the USA and Europe, but also within Europe. Lower and harmonised taxation is as much wanted as it is difficult to achieve. The relative competitiveness of individual countries and Europe in general will be decided by investments into new technologies and the progress made towards a science-based economy. Apart from a general discussion of progress in the new technologies, contributions also focus on the specific success of small European countries (such as Ireland) in catching up, and on the competition for leadership in the upcoming new general purpose technologies – information, communication and life sciences. In the final section we discuss the role of economists in shaping the economic agenda and giving policy advice.

The papers were presented originally at the 75<sup>th</sup> anniversary of WIFO, the Austrian Institute of Economic Research, which is a major European research hub in Austria, founded by August von Hayek and Oskar von Morgenstern and now a participating or leading member in many European research projects. The initiative for and structure of the conference was shaped by Helmut Kramer, the present director of WIFO. We wish to acknowledge the intellectual contributions of many economists and politicians to this endeavour, specifically of Christoph Badelt, Martin Bartenstein, Brigitte Ederer, Alfred Finz, Thomas Klestil, Michael Landesmann, Christoph Leitzl, Klaus Liebscher, Walter Rothensteiner, André Sapir, Wolfgang Schüssel, Joseph E. Stiglitz, Erich Streissler, Thomas Wieser, Georg Winckler and Heinz Zourek. We are grateful for the financial contribution of Austria Tabak, Porr, Boeringer Ingelheim, Kika, SKWB Schoellerbank,

RZB Niederösterreich Wien, Österreichische Lotterien, RLB Steiermark, Oesterreichische Nationalbank, Bundesarbeitskammer, and Wirtschaftskammer Österreich. We thank Ilse Schulz and Marianne Uitz for editing this volume.

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## WHAT DO WE KNOW ABOUT THE NEW ECONOMY?

### TWO GENERAL PURPOSE TECHNOLOGIES DEFINE THE NEW ECONOMY

Quite a few attempts have been made to define the "New Economy". One indirect approach is to stress the two input factors which increasingly shape developed economies: knowledge-based services and information and communication technology (ICT). Another line is to stress the interrelated changes in technology, organisation and consumption that came up in the last decade of the twentieth century. Paul Geroski offers a third definition which is very nice and easy: he defines the New Economy by the existence of two sectors; for him, "New Economy" is information and communication technology (ICT) plus life sciences. Countries with large shares of these two industries in production and consumption are frontrunners in the New Economy.

### A GROWTH PENALTY OF HALF A PERCENTAGE POINT FOR EUROPE IN ICT ALONE

Assessing the relative progress of Europe versus the USA in the New Economy, we have to acknowledge that the USA is leading in both New Economy industries. This is well documented for ICT: the share of ICT is higher in the USA relative to the EU in production investment and in consumption. The extent of the US lead versus Europe differs depending on the indicator used, but ranges between a third and a half. The well-known "growth accounting method" calculates the impact of labour and capital on economic growth (labelling the unexplained part as multifactor technological progress). This approach can be used to compute the impact of ICT on growth. It is calculated to have added about 1 percent to US growth in the 1990s, but only half a percentage point to European growth. Thus Europe suffers a "growth penalty" of half a percentage point for its late entry and/or the slow diffusion of this technology in production and consumption. The relative share of life sciences is more difficult to measure. The consensus is that the USA is leading there too, but maybe to a lesser extent than in ICT. Taking the calculations for ICT at their face value and the impact of life sciences conservatively at half of that of ICT, we find that US growth has been accelerated by 1½ percent by these new generic technologies, or half of the trend growth rate of about 3 percent in the USA. In Europe, the impact could be ¾ of a percentage point. And the difference in the impact has the same magnitude as the growth gap between the USA and Europe in the 1990s.



## SMALL EUROPEAN COUNTRIES KEEP UP WITH THE USA

As Paul Geroski demonstrates, New Economy industries are characterised by pervasive economies of scale, economies of scope and network economies. Therefore it comes as a surprise that it is the small countries in Europe which most closely emulate the USA in the New Economy with respect to the importance of ICT in production and use. For information technology, the leading European countries are Sweden, Finland, Denmark and the Netherlands, and these countries are also surprisingly good in biotechnology. Some economists stress the role of large firms for the position of these countries within information technology, as that of Nokia for Finland, Ericsson for Sweden and Philips for the Netherlands, but this is too simple a view. Nokia had already been a conglomerate with a broad range of production lines less than 15 years before, and electronics was certainly not its largest and most profitable sector. In Sweden, the success of a widespread electronics sector kept the economy growing in years when Ericsson was in considerable turmoil (2002-03). Denmark is a leader in ICT diffusion and biotech clusters without any mega-sized firms.

## GOVERNMENT PLAYED A DECISIVE ROLE

The progress of the New Economy is heavily intertwined with economic policy. Both technologies started out as public-sector research, both industries are heavily regulated, and in both industries a large share of demand comes from government or semi-private institutions. For information technology as well as biotechnology, national research grants are very important, and deregulation and liberalisation determine the speed of diffusion of new technologies. In biotech and the life sciences, health and safety as well as precautionary regulation and supervision play a decisive role. In all countries, studies and plans were made in the 1980s on what to expect from and how to shape the future information technology societies. In Northern Europe, emphasis was put on identifying targets for kindergarten, schools, and government agencies of when and to which extent to use the new electronic devices, and of ensuring the supply, organisation and use of the infrastructure (broadband lines, etc.).

## LIBERALISATION IS NECESSARY, RESEARCH AND EDUCATION IS SUFFICIENT

In the European countries currently leading in information technology, the network industries were medium- to above-average regulated in the 1980s, but their regulatory regime today is far more liberalised than that of other European countries (with the exception of the UK, which, together with the USA, plays "in another league" in this respect; data on product market regulation are published by the OECD). But liberalisation of the product market is not the only success factor by far. Three other conditions have been singled out as decisive for the success of these countries in ICT as well as in their economic performance in general (*Aiginger, 2002*): each of the four countries suffered a severe crisis in competitiveness in the 1980s (the Netherlands and Denmark) or 1990s (Sweden and Finland). All are welfare states which were determined to regain competitiveness by increasing productivity by way of a proactive

innovation policy. To put a long story into a single indicator: today the average share of R&D in their GDP is 3.2 percent, well above the European average of 2 percent and well in line with or above the US share. Fifteen years ago, R&D in these countries was lower than the average European rate.

### HIGHER GROWTH BUT NO ABOLITION OF BUSINESS CYCLES

Some of the predictions as to the consequences of the New Economy were exaggerated. Thus it is accepted and well documented today that the New Economy will not lead to a world free of business cycles. Investment in ICT is cumulative and firms, knowing that other firms will invest too, may push up investment above the optimal rate. In periods of lower profits, investment in ICT can be deferred. Yet we also know that the New Economy has contributed to growth and will continue to do so over the next decade. Production, organisation and qualification have changed irreversibly. We have seen that strategies and policies towards these new technologies differed across countries. This led to a competitive advantage for some smaller European countries specifically in relation to larger European countries, which did not embrace the new technologies to the same extent (notably Germany in ICT and Italy in both new technologies; France and the UK similarly are not among ICT leaders).

### WELFARE STATES NEED TO BOOST PRODUCTIVITY

The decisive proactive role played by the government in those European countries that are leaders in ICT is in sharp contrast to the view that the only role for government in boosting economic growth is to liberalise product and labour markets. Functioning markets are necessary conditions for innovation and diffusion of technologies, but research and education – heavily influenced and partly financed by government – are a sufficient condition for economic growth. The success of the Northern European welfare states in the new general-purpose technologies demonstrates that innovative forces need not suffer from high costs and reduced risk-taking. New technologies were given their boost by the pressure to stay competitive and by the determination to preserve the main elements of the welfare systems.

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