Heritage Lectures

Published by The Heritage Foundation

No. 1012
Delivered March 10, 2007

April 20, 2007

The European Economy Since 1945: Coordinated Capitalism and Beyond

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The 50th anniversary of the Treaty of Rome, which established the European Economic Community, will take place the week after next. There is no other case where a group of sovereign states has delegated such significant prerogatives to a transnational entity. That an undertaking of this sort has survived for 50 years is remarkable enough. But, in addition, what started as a club of six members now has 27, which is again an external indicator of success. So deeply embedded is it in Europe's collective consciousness that it is hard to imagine that the European Union (EU) will not still be here when the time comes for its centennial.

To understand the origins of this initiative, it is important to appreciate how far behind the United States Europe remained in the 1950s. GDP per person was barely half American levels. The modern mass-production methods that the U.S. had pioneered in the first half of the 20th century had only begun to arrive in Europe. Automobiles and modern household appliances, items that typical American families already took for granted, were still exceptional in Europe.

Fifty years later, the countries of Western Europe are within hailing distance of the United States in terms of per capita GDP. If one instead compares income per hour worked, France, Germany, Ireland, the Netherlands, Norway, Belgium, and Luxembourg have surpassed the U.S. (The difference between the two measures, of course, reflects the fact that Europeans work shorter weeks and take longer holidays.) The

Talking Points

- When the European Union began, 50 years ago, it had six members. Europe's economic performance then lagged far behind America's. Today the EU has 27 members, and the countries of Western Europe are within hailing distance of the United States in terms of per capita GDP.
- The structures and institutions inherited from earlier periods emphasized incremental rather than radical innovation and were ideally suited for the process of catching up to the United States. Now, in a world that emphasizes innovation, these same institutions are part of the problem.
- The EU needs to be updated for the 21st century. It needs further deregulation of labor and product markets. It needs stronger incentives for innovation and entrepreneurship. It needs more immigration-friendly policies. It needs lower tax rates and more efficient delivery of public services. And it needs to do these things in ways that are sensitive to national circumstances.

This paper, in its entirety, can be found at:
www.heritage.org/research/Europe/hl1012.cfm

Produced by the Center for International Trade and Economics (CITE)

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

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dramatic transatlantic difference in the quality of life that existed 50 years ago is effectively gone.

Ideal Institutions

The institutions of European integration played a key role in this transformation. They locked a peaceful Germany into Europe, allowing that country's considerable industrial might to be unleashed, something that France and other countries would not have permitted otherwise. They led to the creation of the Common Market, prompting an enormous expansion of trade and increases in efficiency. With the Single Market Program in 1986, Europe created a continental economy capable of supporting global champions—firms with the scale and scope needed to compete internationally. And with the advent of the euro, Europe banished the inflation problem that plagued it for much of the 20th century.

These arrangements were part of a larger constellation of institutions ideally suited for the process of catching up to the United States, what scholars sometimes call the institutions of neocorporatism or the social market economy. Workers assured of employment security and an extensive social safety net moderated their wage demands while firms plowed their profits into investment. Banks with long-term relationships to their industrial clients provided patient finance. Cohesive employers associations encouraged firms to invest in training without fear that their skilled workers would be poached by competitors. These institutions were ideally tailored to a period when growth depended on high levels of investment and on exploiting the backlog of technology that had developed in the first half of the 20th century.

Critically, the different arrangements I have just described were complementary. The effectiveness of one enhanced the effectiveness of the others. Without patient banks and cohesive employers associations, firms would not have been able to make extensive investments in vocational and apprenticeship training, whose payoff was delayed and would have otherwise been difficult to appropriate. And without a system of extensive vocation and apprenticeship training, the advantages of bank-based finance and cohesive employers associations would have been less. Thus, the parts of Europe's economic and social model fit together in mutually supportive ways. For half a century and more, they enhanced the economy's capacity to deliver high-quality manufactured products, stable employment, incremental innovation, and an equitable distribution of income.

"Coordinated Capitalism"

To be sure, the security of private property rights and reliance on the price mechanism were critical to Europe's success. But the rapid growth of the postwar golden age depended on more than just the free play of market forces; in addition it required a set of norms and conventions, some informal, others embodied in law, to coordinate the actions of the social partners and solve a set of problems that decentralized markets could not. Hence the "coordinated capitalism" of my subtitle.

This codified set of norms and understandings—what economists mean when they refer to institutions—did not materialize overnight. To a large extent it was inherited from the past. In fact, the reason that inherited institutions could be so effectively adapted to the needs of post-World War II growth was precisely that the challenges of this period were not dissimilar from those that had confronted Europe in earlier years. Modern industry had developed later on the continent than in Britain and the United States, at a time when the capital intensity of industrial technology was greater. These more demanding capital needs were dealt with by developing great banks capable of mobilizing resources on a large scale. Late-industrializing economies whose initial growth spurt depended as much on assimilating and adapting existing technologies as on pioneering new ones naturally developed systems of human capital formation emphasizing apprenticeship training and vocational skills as much as university education. As industrial production grew more complex and industrial sectors grew increasingly interdependent over the course of the 19th century, it had become more pressing to get a range of industries up and running simultaneously; hence the more prominent role of the state, something that had been further expanded, for better or worse, by fascist governments in the second half of the 1930s and by all European governments, necessarily, during World War II.

Now, as the result of three decades of financial instability, depression and war, Continental Europe had again fallen far behind the technological leader, by this time the United States. There was scope for fast growth and convergence simply by importing new technologies and mass-production methods from America. And, under these circumstances, it was fortunate that Europe had developed, as a result of its earlier history, a set of institutions suitable for doing just that—institutions better for emulation than innovation. My point is that this was no coincidence. This particular inheritance reflected Europe's particular history. This is how I understand the golden age of economic growth, lasting from the late 1940s through the early 1970s.

Part of the Problem

But the structures and institutions inherited from earlier periods and elaborated after World War II were better suited to incremental than radical innovation and to periods when the challenge for growth was to fine-tune and apply existing technologies rather than to fashion new ones out of whole cloth. They were tailored to a world of limited international competition and foreign investment, not to one of seamless integration and intense cross-border competition. The institutions of European integration were designed for a handful of countries, not for a European Union of more than two dozen members with diverse political cultures and very different visions of the future. They were devised to achieve limited economic goals—the expansion of heavy industry, the liberalization of trade, the deregulation of product markets—not to push through wide-ranging and socially invasive structural reforms. For better or worse, these are the institutions that have been handed down to the present day.

Once the backlog of technology was gone, growth became increasingly dependent on innovation. And now the same institutions that had been part of the solution became part of the problem. Norms limiting wage differentials made it hard to offer generous rewards to risk-taking entrepreneurs. Banks accustomed to lending to familiar customers hesitated to take bets on unproven technologies. Laws providing for employment security discouraged start-ups, since investors in new firms that did not pan out might end up with substantial liabilities to their former workers. The high taxes needed to support an elaborate welfare state made it hard to compete in a globalized world. European societies appreciate the need for more flexible labor markets, the development of securities markets, lower taxes, and more efficient delivery of welfare-state services. But it is not easy to restructure a system of interlocking parts.

One worries that the European Union is similarly a solution to yesterday's problems. High inflation has been vanquished, but now a diverse set of European countries suffer with the one-size-fits-all monetary policy of the European Central Bank. The efforts of the European Commission to advance the so-called Lisbon Agenda of reforms intended to make Europe the world's most competitive region by 2010 has been heavy on rhetoric and short on accomplishment. Indeed, I would argue that the idea that the Commission is supposed to point the way toward productivity-enhancing reforms has had the effect of relieving national governments of responsibility for doing so. And the members' inability to agree on a constitution that would enhance the powers of the European Parliament means that there is no one capable of holding Commissioners accountable for their actions and therefore no willingness to give the Commission meaningful executive powers.

Update the EU for the 21st Century

The solution, in my view, is not to abolish the EU but to update it for the 21st century. There needs to be a clear division of responsibilities between the Union and the member states. Here what economists call the theory of fiscal federalism points the way. Policies toward issues where preferences are relatively homogenous and there are efficiency advantages from centralized provision should be provided by the EU. This argument about the efficiency advantages of centralized provision suggests that the EU should be responsible for Europe's border security and competition policy. Virtually by definition, a single market can have only a single competition policy. (After all, this is why, in the U.S., we have an Interstate Commerce Commission.) And individual European states have inadequate incentive to secure their borders against illegal immigration or terrorist threats from outside insofar as the Schengen Agree-

ment permits free mobility among the participating member states. Illegals can enter through Italy but end up living in Germany. Insofar as Italy pays the cost of patrolling its own shores, this creates a classic free-rider problem and underprovision of internal security. These are areas where, on efficiency grounds, the EU deserves a role.

In contrast, where efficiency is not enhanced by centralization and preferences or problems differ, authority should reside with the member states. I would argue that the member states should assume responsibility for their own economic reforms. Each country has its own distinctive economic structure and institutional inheritance. Each needs different reforms. Making economic reform a competence of the Union encourages one-size-fits-all advice and allows governments to abrogate responsibility. Making clear what the EU cannot do as well as what it can will put that responsibility squarely where it belongs. Maybe it is time for a new Treaty of Rome to make that assignment of responsibilities clear.

At the national level, there are plenty of problems to address. Unemployment is too high. Fiscal discipline is too weak. It is unclear whether France and Germany are truly willing to embrace market deregulation, not just in goods but also factor services, and to accept the further intensification of product market competition remains.

Looking further forward, a major challenge will be to cope with an ageing population. The share of the elderly in the population of the EU will double by 2050, reflecting a combination of continuing increases in longevity and low birth rates. These may be global trends, people living longer everywhere, but they are especially pronounced in Europe. In 2050 the ratio of population aged over 65 relative to those aged 15–64 will be nearly half again as high as in the United States. Inevitably, a larger share of European savings will have to go to support health care and retirement benefits, implying much higher tax rates insofar as these programs are mostly financed on a pay-as-you-go basis.

The U.S. deals with these problems partly by embracing immigrants, who are disproportionately of working age. It has higher labor force participation rates. In principle, Europe could do likewise. It could change its tax and pension laws to discourage early retirement. It could provide tax incentives and child care to stimulate fertility, as France has successfully done. It could admit Turkey to the EU and extend full freedom of labor mobility to its residents. But Europe is less tolerant of immigrant cultures. Its lower participation rates plausibly reflect culture and norms as well as tax laws. Thus, it is not clear that Europe will display the cultural and economic flexibility needed to cope easily with its demographic future.

A Full Menu of Reform

So, in a month when we mark the EU's 50th anniversary, it is worth remembering that Europe has a lot on its plate. It needs further deregulation of labor and product markets. It needs stronger incentives for innovation and entrepreneurship. It needs more immigration-friendly policies. It needs lower tax rates and more efficient delivery of public services. And it needs to implement reforms in ways that are sensitive to the institutional inheritance—that avoid excessive disruption to an inherited system of interlocking parts—since such disruption would provoke a backlash against reform. It needs to do these things in ways that are sensitive to national circumstances, including variations in that institutional inheritance, which is why I believe that reform needs to bubble up from below rather than to be directed from above—from Brussels. This is nothing if not a full menu.

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