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WHAT IS WRONG WITH THE EUROPEAN ECONOMIES?

Professor Assar Lindbeck*

Policy Paper No. 15

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A.L.
December 7, 1984

WHAT IS WRONG WITH THE EUROPEAN ECONOMIES?*
by Assar Lindbeck

I. The Past

The drastic deterioration in the performance of the world economy
that has taken place from the mid-seventies has been more pronounced in
Europe than in the US. For instance, while the drop in the GNP growth
rate in the Common Market Countries has been from 4.6 percent in 1960-73
to 1.7 percent in the period 1973-84, the corresponding drop in the US
has been from 4.0 to 2.2. (Albert and Ball 1983; Balassa 1984.) Also
the drop in productivity growth has been larger in Europe than in the
US. It is interesting to note also that unemployment today (1984) is
higher in Europe than in the US (in spite of large programs of early
retirement and occasionally also public works in Europe) which is
contrary to previous experience.

When trying to judge the long-term outlook of the European econo-
mies, it is important to understand the causes of this deterioration in
the economic performance. For that purpose it is useful to make a
distinction between three types of causes - i.e. three different, though
complementary, explanations of what is wrong with the European
economies.

*This paper is a revised version of the Finlay Lecture at University
College Dublin, Ireland, November 8, 1984. The author is Professor of
International Economics and Director of the Institute for Interna-
tional Economic Studies, University of Stockholm, Sweden.
I. The most obvious cause is perhaps the well-known specific economic shocks in the early seventies -- not only the dramatic increases in oil prices but also the abrupt large real wage increases in Europe around 1970, and again in 1975. The latter real wage increase occurred, as we know, in a situation when rather reduced real wage rates were required to protect the profitability of production, because of the direct and indirect effects of the oil price increases. To these disturbances were then added various stabilization policy shocks, in particular when governments finally refused to accommodate fully the cost shocks, in the sense that governments started to fight the inflationary consequences of the cost shocks by way of restrictive, i.e. demand-reducing economic policy, with a fall in capacity utilization and hence a rise in unemployment as an unavoidable consequence. This meant that so-called "Keynesian" unemployment, due to deficient aggregate demand, was added to the "classical" unemployment that had been created in the seventies as a result of the drastic increases in real energy prices and real wage rates, or rather "product-wage" rates. The ensuing and prolonged fall in capacity utilization and profitability had long-lasting effects on output growth, productivity growth and employment, due to the negative consequence for capital formation. For instance, the investment share of GNP in Europe has fallen from 24 percent of GNP in the period 1965-74 to 21 percent in the period 1975-80 and to just above 16 percent in 1981-82.

II. If these quite specific shocks had been the only reasons for the deterioration in the economic performance of the western economies, we could perhaps be confident that the performance would improve again when the shocks have worked themselves out through the economic system, even
though the failures of the last decade have left a legacy for the future in terms of high unemployment and a smaller capital stock than otherwise.

However, there are other, and more profound, reasons too for the deterioration in the economic performance. One such reason is the gradual and inevitable subsidence of a number of historically uniquely favorable circumstances for economic growth in the fifties and sixties: (1) the large reallocation gains in the connection to the rapid outflow of labor from agriculture, where a large reservoir of labor was available after the Second World War; (2) the once-and-for-all gains by way of the liberalization of international trade in the fifties and sixties; and (3) the terms-of-trade improvements due to low, and trendwise fall in the real prices of imported energy, up until 1973. Obviously these historically uniquely favorable factors were particularly important for Europe, where the reserves of labor in agriculture were particularly large; where the potential gains from increased trade were substantial, because of the smallness of the domestic markets; and where usually large amounts of energy were imported. Europe, like Japan, could also exploit the possibility of technological "catch-up" to US technological levels, which was facilitated by heavy investment in physical and human capital. Indeed, while the investment share in Europe was about 24 percent (1965-1974) it was only about 19 percent in the US.

It was inevitable that these various, historically uniquely favorable factors for economic growth would subside after a few decades. Together with the earlier mentioned shocks, the subsidence of these factors therefore take us a long way in explaining the fall in output growth and productivity growth since the mid-seventies. (For an
attempt to quantify the importance of these various factors behind the productivity growth slowdown, see (Lindbeck 1983).)

III. However, I will also argue that there is an additional important set of factors behind the recent unsatisfactory performance of the OECD economies, namely a long-term, gradual deterioration in the functioning of some basic mechanisms of the western market economies, at least in Europe. The two most obvious factors are perhaps (i) increased distortions and inflexibilities in markets due to regulations and high and, highly distorting, taxes; and (ii) increased inability of real and relative wage rates to equilibrate various parts of the labor market and to adjust to new circumstances, which has also contributed to severely squeezed profit margins in several sectors, in particular in Europe.

Behind the high, and often highly distorting taxes, lies of course a rapid increase in social spending relative to GNP, i.e. policies which voters and members of labor unions have given strong endorsements. For instance, the share of public expenditures in GNP increased from 40 percent in 1973 to 51 percent in 1982 in the Common Market countries; the corresponding increase in the US was from 31 percent to 35 percent. In the most "advanced" Welfare States in Europe, like Sweden, Norway, Denmark and Holland, the figure is above 60 percent.

However, I would also argue that the previous success of the full employment policy to some extent carried the seeds of its own destruction. What I mean is that wage and price formation gradually became more inflationary, as unions and firms started to believe that they could not, at least not collectively, price themselves out of the market on the assumption that it was the government rather than the parties in wage negotiations that had the responsibility for full employment. Previously perceived limits to wage and price increases were then more
and more exceeded. As a result, governments were later forced to "clamp down" on an ever faster rate of inflation. The consequence was that the government, in order to squeeze out inflation, destroyed the full employment guarantee that it had itself earlier given the electorate. This is an important explanation for increased unemployment, in addition to the earlier mentioned specific shocks and the inability of real and relative wage rates to equilibrate various parts of the labor market.

In other words: To begin with, the full employment guarantee contributed to investment and output growth by creating confidence of high capacity utilization. However, when people later on adjusted not only spending behavior but also price and wage behavior to these expectations, governments finally felt forced to crack down on high and rising inflation, and hence to break the confidence that it had itself initially created by the full employment "guarantees".

Thus, not only the increased distortions and inflexibilities in markets, and the increased inability of wage rates to clear the labor markets, but also the breakdown of the full employment policies can be seen as unintended side-effects of policies which had strong popular support and which, to begin with, certainly had favorable welfare effects in various respects, in particular by enhancing economic security and confidence of individuals and firms.

A problem with the hypothesis that there has been a gradual deterioration in the basic mechanisms of the European economies, largely by way of the accumulation of government regulations and ever higher and ever more distorting taxes, is that the increase in unemployment and the slowdown of productivity growth occurred quite abruptly during the seventies, rather than gradually, as we would have expected if a gradual deterioration in the performance of the economy had been the reason.
However, the point is that as long as the requirements for rapid adjustments of the allocation of resources were not large (beside the contraction of agriculture) ever increasing rigidities did not pose severe problems. When abrupt changes in relative prices and international competition required large and rapid reallocation of resources, the rigidities started to become a severe disadvantage for the European economies. By contrast, the great flexibility in the US economy, including the labor market, has contributed to give that country a relatively better economic performance when the need for reallocation became large. This is reflected not only in the ability to reallocate resources, labor as well as capital, but also to absorb a rapidly increasing labor force.

II. Future economic possibilities of Europe

What are then the future possibilities and problems for the West European economies? And how do they compare with the US economy? Only two main aspects of these questions will be discussed: (I) unemployment and (II) productivity growth. As we shall see, the asserted explanations for both problems largely coincide.

A. Unemployment

(1) To achieve low levels of unemployment certainly requires a mitigation of the inflation bias in our economies, in particular of wage formation. Otherwise restrictive unemployment-creating policies will be regarded to be necessary from time to time. A basic question for the future possibilities of bringing down unemployment is then what could possibly be done to mitigate the inflation bias in the labor market. At least four types of reforms related to the system of wage formation may be worth considering:
(a) One possibility is to introduce new types of wage contracts, with bonus systems. The purpose would, of course, be to stop the present practice of trying "to share the pie before it is baked" -- a practice which often has the effects of making the pie shrink due to low profitability. More concretely, low wage contracts at the beginning of the year could be combined with variable bonus payments at the end of the year. In other words, the size of the wage increases would be contingent on the actual increase in value added during the preceding year rather than the expected increase during the forthcoming year.

(b) A further step in the direction of ex post profit sharing would be to launch systems of individual employee ownership, which may increase the tolerance of profits.

(c) But, in particular, unions and firms have to understand that a strong inflationary bias in wage formation in the long run is a threat to high capacity utilization and full employment. Thus, the idea is to make the agents of wage bargaining take a greater responsibility for the level of employment. Maybe a method to help bring about such understanding and responsibility would be declarations by the government that it is not willing to accommodate high wage increases by way of an expansion of nominal aggregate demand and the money stock, and by way of exchange rate depreciations. The purpose of such a declaration would not be to create more unemployment but to prevent so high rates of inflation that, in the end, governments will be forced to pursue a policy that indeed generates heavy unemployment.

Clearly there are severe "credibility problems" connected with such announcements, as it is tempting for a government, in spite of earlier announcements about a nonaccommodating strategy, nevertheless to accommodate after heavy wage increases have actually occurred, not only to mitigate social problems but also to avoid being blamed itself for
the increase in unemployment. This credibility problem is, of course, accentuated by the tendencies of opposition parties to promise just such accommodations. The credibility of non-accommodating policies could probably be enhanced for small countries if they would make some formal agreements backed by all leading political parties to tie the exchange rate per month to some large "non-inflationary" country or a basket of currencies.

Another obvious problem with "announced non-accommodation policies" is that while aggressive policies by unions may be pursued by employees with relatively safe jobs, due to seniority, the consequences of a non-accommodating policy could in particular hit employees without much seniority as well as new entrants in the labor force. This consequence is indeed difficult to avoid, though greater flexibility in relative wage rates would mitigate the problem. Moreover, to the extent that firms close down entire plants, rather than reduce the labor force in existing plants, the seniority status often does not make much difference.

(d) An additional method of creating incentives among unions to show wage constraint may be to let union members finance the unemployment insurance system to a larger extent than today. In principle, that should make unions more afraid of trying to raise wage rates excessively relative to labor productivity growth. There are, of course, many difficulties connected with a reform like this -- the most severe one being perhaps that attempts to change the system of unemployment insurance along these lines are likely to meet strong opposition among unions. There would also be income distribution consequences, to the disadvantage of employees in sectors with large cyclical instability as well as in trendwise declining sectors.
(2) A second prerequisite for a return to low levels of unemployment is more flexibility of real and relative wages. Otherwise the labor market cannot fulfill its reallocative function at low levels of unemployment and at sufficiently high rates of return on capital. In this respect, the US labor market functions much better than do the European labor markets. It is striking to note that 20 million new jobs have been created in the US during the last decade, as compared to a reduction of 2 million jobs in Europe. It is natural to assume that an important reason for the dismal performance in Europe is the rapidly rising real wages during the seventies and the highly distorted relative wage rates. This point is of particular importance for young people and other inexperienced entrants into the labor market.

Among the various sectors of the economy, this point is of particular relevance for the service sector, where the relative wage rates often are much higher in Europe than in the US. It is interesting to notice that about 70 percent of the increase in employment in the US during the last decade has taken place just in the sector of private services, as compared to about 15 percent each in industry and government.

It is also important to note that the average period of unemployment is much longer -- six times as long (six months as opposed to one month) -- in Europe as in the US. It may be argued that "rotating unemployment" (which seems to dominate in the US) is connected with smaller social problems than "permanent unemployment" (which seems to be more important in Europe). It is also tempting to hypothesize that "rotating unemployment" implies that more people are likely to be aware of the unemployment risks than in a system with "permanent unemployment" for largely the same group of people. We may therefore hypothesize that "rotating unemployment" keeps down the rate of nominal wage increase
more than does "permanent unemployment". It is, of course, also conceivable that the low and falling frequency of unionization in the US than in Europe is a partial explanation for the differences in wage formation between the two continents.

To illustrate the difference in wage performance between Europe and the US, it is interesting to note that while the real wage rates in the seventies rose by 10 percent more than labor productivity in Europe, in the US they rose some 5-10 percent less than labor productivity. While labor costs per hour increased at an annual rate of about 3.5 percent in real terms during the seventies in Europe, the corresponding figure for the US was 1.5 percent (statistics from EEC Commission). As a consequence, profit rates fell much more in Europe than in the US in that period.

The disadvantages for Europe of not adjusting real and relative wage rates to demand and supply for labor have recently been strongly accentuated by the more rapid growth rate of the potential labor force during the eighties than in the seventies. The desired labor force participation of married women is also likely to have increased recently in a number of European countries. While the flexibility in the labor market in the US made it possible to absorb the rapidly increasing labor force during the seventies and early eighties, it is doubtful if the same success story can be repeated in Europe during the coming decade.

However, even if real wage rates were to adjust better in the future than in the past in Europe, it might be difficult to return to the profitability levels that were usual in the fifties and sixties. One reason is that the capital-intensive economies of today would be expected to generate lower rates of return on capital than did the less capital-intensive economies of the fifties and sixties. Another reason is that the internationalization of the economic system has resulted in
stiffer competition and hence flatter demand curves for firms, which
would be expected to result in lower profit margins as a consequence.

(3) A third prerequisite for a return to full employment in Europe
is less regulation of the hiring and firing of labor. Hiring is today a
heavy investment in several European countries due to the expense and
difficulties of laying off redundant or inappropriate labor. It is
obvious that this keeps down the willingness of firms to employ workers,
though the quantitative importance of this factor is difficult to pin-
point. The firing of labor, like the closing down of plants, is impor-
tant for the creation of new, highly paid jobs. The reason is that the
old production structures often stand in the way of the new ones. We
may add that reallocations of the factors of production are particularly
important today in order to adjust our economies to the build-up of
production and export capacity in certain sectors of manufacturing in a
number of LDCs, the so-called NICs.

(4) A solution of the unemployment problem would also be enhanced
if it is possible to keep up investment in real capital that is a
complement to labor -- in order to avoid capital shortage. It is a
severe problem that real investment during the seventies and eighties
was not only small but also highly capital intensive (though the invest-
ment volume was kept up for a while by the fall in real capital costs
during the seventies). The background is that the previous combination
of low profits and high real wage rates resulted in both low and (on
micro level) capital-intensive investment.

In the popular discussion, an additional reason for unemployment is
often singled out: technological unemployment. However, the phantom of
technological unemployment is not convincing. There are really no
technological limits to increased employment. Historically, productivi-
ity growth via technological advance has expanded output rather than
reduced employment. However, to experience such a favorable outcome in
the future as well certainly requires a number of conditions concerning the functions of both economic policies and the market system. In particular, demand expansion in line with productivity growth has to be "allowed" by the economic policy authorities; and equilibrating real and relative wage rates has to be accepted by employers, unions and governments. It would seem that several European countries have a long way to go to achieve real wage rates that are consistent with "reasonable" profit levels and relative wage rates that reflect the distribution of demand and supply for labor in various submarkets, though considerable movements in the direction of real wage moderation have recently occurred in some countries. It is, however, also clear that fiscal policy during the first half of the eighties has been very restrictive in several countries in Europe. There are no asserted "supply-siders" that pursue expansionary Keynesian demand management policies in Europe, by contrast to the US! Speaking somewhat more seriously: the rather restrictive fiscal policies in Europe presumably reflect a fear of inflation and a belief that the budget deficits should be kept down. Indeed, the more flexible supply side in the US than in Europe make Keynesian demand management policies more useful in the US than in Europe. Probably many governments also believe that the individual countries in Europe are too small to reflate alone.

B. **Productivity Growth**

If the reasons, mentioned at the beginning of the paper, for the slowdown of productivity growth make sense it is not likely that the productivity growth rate in Europe will be as fast in the future as it was during the fifties and sixties. However, it could certainly be faster than in the seventies, as new "specific shocks" of the same size as in the seventies are not likely. The US has even a chance of
experiencing a speeding up of its productivity growth relative to that in the fifties and sixties. The reason is not only that the US economy is characterized by more flexibility and less distortions than the European economies. It may also be argued that (total) productivity growth in the US during the fifties and sixties was closely related to the expansion of the technological frontier, while Europe could rely more on "technological catch-up". Now, when the technological gap is smaller, and when the technological frontier is pushed out by research and development work in many countries, the frontier will probably move faster than before. As a consequence, the US has a chance to experience a more rapid rate of (total) productivity growth than earlier during the past World War II period, provided investments will be large enough to introduce new embedded technology into the production structure.

The main obstacles for productivity growth in Europe have already been specified: (a) low factor mobility and rigidity of real and relative factor prices, in particular for labor; (b) government regulation of production, employment and exchange; and (c) distortions of markets and disincentives for productive effort -- including low profitability, high and distorting marginal tax rates and highly selective subsidies (the latter euphemistically called "industrial policy"). These distortions and disincentives refer to work effort, saving and investment decisions. Another, probably important handicap for Europe is that there is no large and integrated capital market in Europe as in the US. Europe also suffers from highly unstable rules concerning the tax systems and regulations, which makes the "pay-off functions" for individuals and firms highly uncertain. If individuals "every morning" wake up to find that what they did yesterday was wrong because the rules of the game were changed "during the night" individual agents are certainly
not encouraged to commit themselves in long-term commitment in the official production system.

It is clearly important that these various obstacles are removed if the Europeans want to return to a more successful economic performance than during the last decade.

However, to avoid painting too idyllic a picture of the US economy it should be mentioned that the US economy too is plagued by severe problems, such as low investments -- and, in particular, low savings because of the large budget deficit. Moreover, also the US has a number of "sick" industries, with highly distorted relative wages; the automobile and steel industries are perhaps the most well-known examples. It would also seem that there are problems with the product quality in these sectors in the US, as well as in some other industries like textiles.

A difference between the US and Europe, though, is that in the former country there are more expanding sectors around the sick industries - not just high-tech manufacturing but, also, low-tech services, where firms in the US, as already mentioned, are confronted with much lower relative wage rates than are firms in Europe. This is most likely an important explanation for the success of the US service sector in absorbing labor during the last decades.

III. The US influence on Europe

It has been argued above that the European economic problems are firmly imbedded in the economic and political structure in Europe. This point is, of course, in some conflict with prevalent European complaints to the effect that Europe's economic problems to a considerable extent are caused by the economic policy of the US -- in particular by the high real interest rates in the US, which are often asserted to be a conse-
quence mainly of the US government budget deficit. However, it is important to realize that the high real interest rates in the world in the first part of the eighties are largely the result of the fall in world real saving, which to a considerable extent is due to the large government budget deficits, of some 4 percent of GNP in the OECD area -- in the same way as the low real interest rates in the world economy in the seventies were a consequence of high world real saving after the international redistributions of income to the high-saving OPEC countries in the seventies.

Certainly, this is not the only reason for high real interests now. Recorded real interest rates (as measured by current rather than expected inflation) always tend to be high immediately after periods of rapid inflation, due partly to long-term contracts, partly to great uncertainty about the expected rate of inflation and partly to expectations that lag the actual rate of inflation. Thus, in a short-term perspective real interests would be expected to come down somewhat, when the memory of the high and wildly fluctuating rates of inflation in the late seventies and early eighties recede. However, in a more long-run perspective, the remedy for high real interest rates could only be lower budget deficits or higher household and business saving in the world economy relative to real investment. The theory behind these assertions is, of course, that real interest rates are determined by real saving and real investment propensities in the world economy, and not by monetary policy of central banks, which then (in a medium- and long-term perspective) mainly influences the rate of inflation and the nominal interest rates.

As we know, it is popular today among economists to adjust the statistics of the budget deficits by "inflation accounting" and cyclical
adjustments, which often means that the measured deficits tend to disappear. It is certainly useful to make such adjustments when we are interested in the development of the wealth position of the government. But then it is important to point out that the deficits that are "removed" from the public sector then instead "pop up" in the statistics for the private sector. The aggregate saving ratio is, of course, not influenced by such recalculations (to the extent that the debt is domestically held).

However, the main point to stress in this context is that the European governments, and European economic commentators, strongly exaggerate the negative effects on their economies of the US budget deficits. First of all, high real interest rates did not stop the cyclical business upswing in the US in the 1983-84 period, even though the US too is hurt by high interest rates. Though one reason may be that the deductibility of interest rates is more liberal in the US than in most European countries, I would hypothesize that the main reason is that in a situation of low capacity utilization it is not the capital cost but rather the existence of large excess capacity that is the most important constraint on investment. More importantly, it is not reasonable to analyze the effects of high interests in the US, or in the world, on business conditions without also analyzing other effects of the policies that have resulted in the high interest rates. And that policy, more specifically the expansionary fiscal policy in the US, has certainly increased demand for products not only in the US but also, via higher US imports, in the rest of the world -- an effect that has been accentuated by the high dollar exchange rate, which is another obvious effect of (among other factors) the increased and large US budget deficit.
Thus, to summarize we may say that the expansionary fiscal policy in the US has created two expansionary effects and one contractive effect on Europe (and other non-US countries). The high level of demand in the US and the high dollar rate have, by themselves, stimulated economic recovery in Europe, while the high interest rates by themselves have had the opposite effects. It is, of course, an empirical question whether it is the positive or the negative effects that dominate. What has in fact been argued above is that in deep recessions, where most likely capacity utilization rather than capital costs is the main obstacle to investment, the two positive effects mentioned above are likely to dominate. We may add that the budget deficits in Europe have been quite as large as in the US during the first half of the eighties.

Thus, it would seem that the attempts of politicians and economic commentators in Europe to blame the US for its problems are not well founded. A cynic would perhaps say that Europe's only remaining superiority today is its ability to blame the outside world for its problems!

IV. Which countries can reform themselves?

It is difficult to predict which countries in Europe have the best chances of removing the obstacles discussed above to cyclical recovery, of achieving a drastic reduction in unemployment and of restoring a rapid rate of productivity growth. Indeed, views on this important issue have to be mere speculations, which nevertheless might be worth trying.

A. For instance, which countries are likely to succeed the best in reducing marginal tax rates, in removing distortions of the tax structure and in deregulating? The truth is, of course, that we do not know. This is not only an issue of bourgeoisie versus social democratic
governments, as many bourgeoise governments have been highly interven-
tionist and also contributed to a rapid expansion of public spending
(such as in Italy, Ireland and Belgium) at the same time as some social
democratic governments, in particular in the fifties and sixties,
pursued very liberal economic policies, and in some cases have also been
careful with public spending (for instance in Austria and Finland).

B. Another important issue in this context is if it will be an advan-
tage or disadvantage in the long run to have private and public sectors
that are well organized like in for instance West Germany, Sweden,
Norway and Austria. For instance, a provocative speculation might be
that a good organization in the long run might be a cause of "arterio-
sclerosis", e.g. rigidities. We know that innovations usually come from
outsiders. Efficient routine administration may therefore in a long-
term perspective be an obstacle for innovation and renewal. Could it
even be the case that the most successful countries in a long-run
perspective will be those that are characterized by what may be called a
"functioning chaos", like in Italy, with poor administration in the
public sector and perhaps also rather chaotic conditions in some of the
large firms in the private sector. The reason for the possibility of a
long-term success of countries like these could then be that rigid
structures and policies, which could stop new initiatives, would not
exist. Of course, certain parts of the public sector have to function
reasonably well -- e.g. the infrastructure in transportation and energy
and the education system. And here Italy certainly has problems.

A brave speculation might be that the best type of public adminis-
tration is a small and efficient one, the second best a large and
inefficient one that is unable to thwart individual initiatives, while
the worst public administration, from the point of view of economic
vitality, is a large and efficient one, which succeeds in its attempt to regulate private activities and initiatives. From that point of view countries like France and Sweden, with rather efficiently functioning and large public administrations, might have long-term problems concerning vitality and flexibility.

C. We may also ask if it is advantageous for a country to have weak unions, which do not cooperate much with firms and the government, as in the US, or strong unions that are willing to cooperate with the government, as in Austria and occasionally also in West Germany and some of the Scandinavian countries? Again, we do not really know. However, loyal firm-specific labor unions, as in Japan, seem to be particularly favorable for productivity growth. Most likely, the worst alternative is strong and non-cooperative unions as in the UK.

D. Another speculative question is whether a "deteriorating economic system" in terms of efficiency, like the UK, Benelux and Sweden, can be revitalized? It is then important to realize that the decline of productivity growth in the UK cannot be regarded as a consequence only of government interventions and the build-up of a Welfare State. The decline in the UK started earlier, at the turn of last century. It was really the private sector itself that lost its vitality at that time in England. One conceivable explanation might be that the rate of return on domestic investment in England fell relative to the rest of the world -- partly due to the previous capital deepening in the UK (along the lines of neoclassical production function analysis), partly due to the possibility to exploit specific knowledge of running firms in other countries, which generally has been regarded as a factor behind real investment abroad (including foreign subsidiaries). Technological "catch up" by other countries to UK technology levels could also be an
important factor behind the decline of productivity growth in England relative to other countries at the turn of the century -- in the same way as productivity growth was slow in the US relative to Europe in the fifties and sixties. Cultural factors could hardly be excluded, however. Metaphorically speaking, we may speculate that the decline of vitality in the British economy started when the new business class acquired the habits of the old class of rich landowners -- and indeed married into their families.

However, again we have to say that we do not really know much about the mechanisms by which a civilization loses its previous vitality, for instance via changes in values, habits and institutions. The most pessimistic outlook is perhaps provided by Mancur Olson’s theory (Olson, 1982) according to which rigidities necessarily accumulate over time if there are no drastic overhauls of the institutional structures, such as by way of wars, revolutions and similar drastic events. The idea is that it takes time and stability to build up interest groups which are more interested in the zero-sum games of redistributing income to themselves than in increasing productivity -- in other words groups that believe that more is to be gained from obtaining large slices of a fixed, or even shrinking, cake than by contributing to making the cake larger.

However, even if for these various reasons it probably would be wrong to put all the blame for "Eurosclerosis" on government policies including the Welfare State, it is certainly true that government regulations, and disincentives connected with public sector growth and the tax structure, are important reasons for the rigidities and distortions in Europe. Indeed, the private interest groups have been able to play their zero-sum games just by using an expanding public sector and the tax system as their basic instrument.
It is also true that we do not know for sure at what levels of public spending and taxes (relative to GNP) serious economic problems start to emerge. In practice, there are really no non-distorting taxes, which means that the expansion of "the tax bite" necessarily means increased distortions. My casual observation is that the problems were probably not severe as long as the Welfare State spending was less than 40-50 percent of GNP, and inflation was low (2-4 percent). We know that the public sector is today some 45-65 percent of GNP in most European countries, at the same time as high inflation in the late seventies and early eighties accentuated the distortions of the tax system, which is mainly nominalistic, i.e. constructed for a non-inflationary world.

V. Concluding remarks

The main message of this paper is that the problems of heavy unemployment and slow productivity growth cannot be solved just by a more "clever" use of discretionary policies of various types. Improvements in some basic mechanisms of the functioning of the European economies are necessary. It is not too difficult to say what types of reforms that are potentially useful: (i) to restore mobility in factor markets and flexibility of real and relative wage rates; (ii) to remove, or at least reduce, the inflationary bias in wage formation; (iii) to bring about less distortions and non-symmetries in the taxation of work, saving and asset holding, which certainly requires a reduction of marginal tax rates; and, finally, (iv) to bring about more stable rules so that the "pay-off functions" for individuals become more predictable than at present.

As an underlying factor behind many of our problems is the rapid expansion of public spending, and therewith connected increases in the marginal tax rates, it is clearly necessary to do something about this
expansion. A basic question is therefore how this possibly could be brought about. One possibility is (i) to shift to more reliance on actuarially fair social insurance systems, whereby the fees become prices rather than taxes. The tax burden can in principle be kept down also by (ii) fees on public services, which would turn some taxes into prices. (iii) Lesser ambitions to redistribute income within the middle of the distribution of income would also help reduce public spending and taxes. Finally, there is the possibility of (iv) allowing more private services in competition with public services, as this would not only reduce the tax rates but also contribute to more efficiency in the production of services that today are largely monopolized by public agencies.

However, we should by now also have learnt that it is not enough to recommend policy actions to the politicians. It is even more important to suggest reforms of the mechanisms by which political decisions are undertaken. My favorite explanation for the rapid expansion of public spending is that while publicly provided benefits usually are specific, the taxes to finance them are usually general. This creates a strong incentive for individual voters, and groups of voters, to accept offers from politicians of higher benefits on the assumption that the costs in terms of higher taxes are mainly paid by others. This is probably a main reason why the welfare state tends to turn into a "free-for-all"-competition for public benefits with an apparently "limitless" expansion of public spending as a result -- possibly also a shift of the burden of part of this spending to future generations via budget deficits. (Lindbeck, 1984.)

Against this background, let me end with a few examples on how political institutions and mechanisms may be modified if we want to
reduce the political propensities for expansion of public spending. Conceivable examples are constitutional reforms for the purpose of (1) making expenditure and tax decisions simultaneously, so that parliament is not allowed to raise public spending without at the same time raising taxes to finance the higher spending; (2) qualified majority for spending and/or tax decisions; (3) referenda; and (4) permanent broad coalition governments. For instance, it is likely that the requirement of two thirds majority for tax increases in Finland is one important reason why public spending there is a smaller fraction of GNP than in the other Nordic countries. We may also ask why public spending is 68 percent of GNP in Sweden but only 30 percent in Switzerland. Is the reason that preferences differ that much between the voters in the two countries, or is the reason rather that these two democracies have different political constitutions -- Switzerland being characterized by a federal structure, permanent coalition governments, and frequent referenda, while Sweden (in fact) is characterized by a centralized public sector, with partisan governments in hard competition with an equally strong opposition, and practically never any referenda? (Lindbeck, 1984.)

If the answer (as I personally believe) is that differences in the political constitution play an important part here, the possibilities of reducing the rate of expansion of public spending has partly to be found in reforms of the decision-rules and hence the constitution in our societies. Indeed, this position has been held for a long time by at least one outstanding economist, James Buchanan, who has emphasized the importance for political decision-making of "constitutional factors".
References


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