THE 2005 LUDWIG ERHARD LECTURE

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Brussels 08 December, 2005

Getting Europe Moving Again:

Concrete Ideas for Reform, Prosperity and Renewal

"Revitalizing Reforms in Europe" The Ludwig Erhard Lecture by the IMF Economic Counselor, Raghuram G. Rajan on Dec 8th 2005 in Brussels.[1]

Good morning. It is an honor to be invited here to give the Ludwig Erhard lecture. It is only when I realized that the topic the organizers wanted me to speak on was reforms that my excitement turned to trepidation. Never in the history of economics has so much been written about so important a topic with so few generalizable implications. I am not speaking about what needs to be done. There we have some consensus, certainly among economists, but also among politicians. What is much less clear is how to get it done. There we move from the Elysian elegance of economics to the disorderly reality of leadership and luck. Nevertheless, there are lessons to be drawn from the past, including those that Ludwig Erhard taught us in creating that uniquely European structure, the social market economy.

Before continuing, a clarification and a caveat. The clarification is that when I speak of Europe in this talk, I refer primarily to Continental Western Europe. The caveat is that I speak for myself, not for the Fund or its management.

In what follows, I will argue that if Europe is to retain its elegant way of life, to retain social solidarity, it will have to create more opportunity and growth. Or to quote the Italian author, di Lampedusa "The more things have to remain the same, the more things will have to change." I will then describe the needed reforms and end with some lessons we have learnt about implimentation.

Let me admit that I am not an expert on European reforms, and the learned audience in this room has a far better sense of current European dilemmas than I have. But I have been a student of reforms in developing countries, including my own, and I see many similarities. In particular, the greatest need for a reform process is leadership – not necessarily heroic leadership that stirs people up and makes them willing to move mountains: modern societies are perhaps too cynical for

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[1] I thank Laura Kodres for extremely useful comments and Sergei Antoshin for superb assistance.

that – but sensible leadership that lays down true choices and time-frames, sets a reform pace that is ambitious but not quixotic, and is realistic enough to make the compromises that build the necessary support for the program. All too often, however, it is in the nature of politics to downplay the extent of pain and overemphasize the rapidity of the gain. As the public becomes increasingly disillusioned – the pain always has to be banked now and the gain is always a post-dated check that is never cashed – reforms become a dirty word that politicians become increasingly loathe to utter.

As detrimental as leadership that overpromises is leadership that offers false choices. Growth and opportunity in Europe today are often counterposed against equity and social solidarity. [Chart 0: Equity and Incomes] But these are false choices, attempting to preserve the status quo. As the graph shows there is no inherent tradeoff between growth and equity or solidarity. In fact, growth and opportunity are critical to social solidarity for the status quo is often highly inequitable – the disaffected youth rioting on the streets in France, complex though their motives were, were there partly because they did not perceive they had the same opportunities others had. But let me be more concrete on why the status quo is not a viable option in Europe today.

Start first with familiar themes. [Chart 1: Europe per capita GDP relative to US]Since the early 1980s, Europe's per capita GDP has been falling relative to the United States. As is well known, some of this reflects a voluntary reduction in average hours worked: as is sometimes simplistically put, Europeans earn to live while Americans live to earn. But some of it also reflects lower labor participation rates as well as greater unemployment. Again, not all of this is involuntary, or even inefficient. For example, in Europe, a greater share of production is undertaken in the household, and this is not reflected in GDP numbers.

[Chart 2: Labor productivity and TFP growth] What is hard to dispute, however, is that since 1995, total factor productivity growth, as well as labor productivity growth, in the United States have outpaced that in the Euro area. [Chart 3: Changes in labor productivity and TFP 1986-95 to 1996-2004] Moreover, the US has considerably improved its performance over the last decade, while Europe's performance has declined. While a percent point or so of difference in TFP growth may seem small, pretty soon the power of compounding leads to substantial differences in wealth and competitiveness.

There is much debate over how these differences arise, including whether they stem from differences in usage of Information Technology. But at least a portion, in my view, has to do with changes in the nature of innovation. Innovation in Continental Europe typically takes place in large corporations rather than in small start-ups. In part, this is because the number of innovative start-ups is limited. Our research suggests the lack of entrepreneurship seems to be related to institutional and regulatory impediments to entry, tax wedges against incorporation, inadequate finance for small businesses, and overprotective labor laws. However, large corporations are perfectly capable of good R&D when technical change is incremental or catch-up. But when change moves from the incremental to the disruptive, arguably a characteristic of the last two decades, start-ups become far more necessary because they can think outside the box. [Blank Slide]

In fact, the absence of start-ups also makes incumbents slow and inefficient. Consider an example. Italy is often praised for having many small firms. But this is not because it has a lot of entrepreneurship – the number of new firms incorporating is only a fraction in Italy of what it is in the UK. In part this is because the average direct cost of registering a new corporation in Italy is 20 percent of per capita GNP compared to an average 10 percent for other G-7 European countries. So why are there so many small Italian firms then?

Perhaps because the limited entry makes incumbents less dynamic. A picture is worth a thousand words. [Chart 4: Italy vs UK firm age] Across all industries, firms start out larger when young in Italy, but grow more slowly so that firms in the United Kingdom are about twice as large by age ten. This suggests Italy has small firms not because there is too much entry but perhaps because there is too little!

More generally, continental Europe is too protective of insiders. This was not as much of a problem when the current outsiders were future insiders. As two Harvard economists, Alesina and Glaeser, argue, one reason European countries have been more tolerant of redistribution than, say, the United States, is that they have been relatively homogenous societies. [Chart 5: Immigrant unempl. vs nationals] But as populations age and more immigrants enter, matters change. The unemployment rate of foreigners in European countries is higher than that of nationals. [Chart 6: Jobs needed] But even in countries where foreigners are particularly likely to be unemployed, such as in Belgium, Finland, Sweden and France, the number of additional jobs needed to bring the foreign unemployment rate into line with that of nationals is quite small.

The consequences of not doing this could, however, be large—if young immigrants do not get jobs and fall back on welfare, not only does it jeopardise the current political consensus for all redistribution (despite the evidence that immigrants do contribute on net to revenues, they are convenient scapegoats), it also creates an underclass that will be permanently scarred by its formative experiences, and less willing to assimilate into society. Europe needs to create opportunity through new firms and jobs if it is to retain its sense of social solidarity.

Of course, the world will not stand still while Europe makes up its mind on whether it wants to reform. Clearly, Brazil, China, India, and Eastern Europe are becoming more competitive. [Chart 7: Graduates from India and China] India alone has over a million students enrolled in engineering colleges. But before loose talk starts about hypercompetitive Asian economies, let me point out that only 3000 students graduate every year from the Indian Institutes of Technology and only about 20,000 more from other reputable technical institutes. The remaining come from schools of varying quality – some not even equivalent to a good high school education here. I would guess something similar is true of China.

[Blank Slide] However, the potential of these countries is truly awesome, especially if they can expand high quality education. And the potential to insulate oneself from their competition diminishes as more and more of the work rich countries do travels over the airwaves. One possible attitude rich countries can take is to engage with fast-growing emerging markets, with a view to both aiding, and benefiting from, their growth. Singapore took a decision some time back to attract smart mainland Chinese students into its schools. As Singapore's education minister, Tharman Shanmugharatnam recounts, these students started at the bottom of the class in the first year because they did not speak English, but within three years were topping their class. When Singapore parents complained to him about all the top places going to these imports, Shanmugharatnam replied, "Ten years from now, would you rather have these students competing on your side or against you?"

Of course, rich countries can engage in other ways than recruiting the best and brightest from emerging markets, and that implies emphasizing their own comparative advantage. For instance, as middle classes in China and India grow richer, they want European designer goods – Louis Vuitton bags or Mercedes cars -- as well as holidays in Europe. [Chart 8: Tata Avia Car] Their corporations also want the best from Europe – for example, the Tata Aria's engineering is from the Indian firm Tata, and the body is designed by an Italian firm, IDEA. The growth of emerging markets can be mutually beneficial.

More generally, Europe's economy needs to become more flexible to adapt to coming competition, even while providing a robust safety net. As physical and financial capital becomes more widely available, Europe's citizens will need to upgrade their human capital if they are to improve their standard of living.The needed reforms do not require Europe to sacrifice what is essential about its way of life, the Scandinavian successes show that. But if Europe does not reform, its way of life will have to change, almost certainly for the worse.

[Chart 9: Train is leaving] Unfortunately, time is running out. Many of the reforms require older workers to give up some protections and pension rights. But as populations age, the median voter is becoming older. In many European countries, demographics are likely to make reforms more difficult in the future. Europe needs to summon the will very soon.

What reforms are needed? [Chart 10: Radar Chart] First and foremost, Europe needs to increase employment. As the more successful countries on the right suggest, lower unemployment is associated with lower tax wedges between what the employer pays and the employee takes home, and more important, lower employment protection, perhaps cushioned by higher levels of unemployment benefits for limited time. But greater employment also means active labor market policies, such as offering laid-off workers job placement facilities, as well as targeted benefits like child care and generous policies for parental care so as to encourage more women to participate—areas where some European countries compare favorably with the United States. It means wage support programs such as earned income tax credits and in-work benefits, programs provided already by a number of European countries like Belgium, Finland, France, and the Netherlands. Denmark—through insisting on participation in active labor market policies and shortening the benefits period—has attained higher participation rates and lower structural unemployment.

[Blank Slide] The best form of insurance for a worker, though, is to continuously renew her human capital. While the mixed success of job retraining programs suggests they need to be rethought, we also need to rethink the process of tertiary education. It might have made sense for an individual to finish university at 25 when he or she were likely to be active in the labor market for only another 25 years; it no longer makes sense when his or her workspan has doubled. Not only do universities need to expand their continuing education programs, they also need to seriously consider whether their programs should become more modular, with lifelong learning being the objective. Admission should be for a lifetime, not for a degree. Individuals should be able to take a short basic undergraduate course in their 20s, return repeatedly for specific skills as they specialize or shift careers in their 30s, pick up management courses in their 40s and 50s, and renew interests in art appreciation and philosophy in their 60s.

[Chart 12: Pension viability in Europe] In addition to education reforms, the viability of public pension and healthcare schemes have to be restored so that workers have the explicit assurance their old age is provided for. At the moment, either the pension systems of Europe will eat up increasing amounts of GDP or benefits will have be cut to 60 percent of their 2004 level for their sustainability to be maintained. Here again, the principles to restore viability are well known—for example, extending the age before pension rights kick in while reducing incentives to retire early, reducing automatic indexation to wages, etc.

But if older people are to be encouraged to work, the workplace should also accommodate their needs. For instance, there is no reason career progression should only be upwards. After a certain age, if workers find it more difficult to do their job, there should be ways for them to descend a hierarchy without stigma being attached to their descent. This will require a cultural change in the way organizations work, and governments may need to play a role in building awareness, or even initially provide tax incentives to create such jobs.

[Chart 12: Employment vs regulation] More generally, if reforms are successful in expanding the supply of labor, the supply of jobs also needs to expand. This implies enhancing competition. For when firms compete, and barriers to entry are lowered, the supply of jobs increases, matching the increased demand for jobs created by the labor market policies described above. Incumbents are also forced to be innovative, ensuring that the jobs are likely to survive the emergence of new international competitors. In this regard, the setback to the Services Directive was disappointing, as are the continuing constraints on cross-border mergers and the emphasis on protecting "national champions."

[Blank slide] Of course, one of the greatest barriers to entry is access to finance. The "relationship" finance that still persists in some European countries limits access. It is also particularly ineffective when economies are faced with rapid technological and competitive change, as appears to be the situation now. A reduction in implicit and explicit barriers to cross-border bank mergers would enhance efficiency-enhancing merger opportunities. As firms have to raise money at arm's length in a pan-European market, they will be forced to improve disclosure, governance, and payouts, allowing retail investors a more level playing field. As the dividend culture takes hold and incumbent firms can no longer reinvest their cash flows, they have to raise money for investment from the market, subjecting these investment decisions to scrutiny. As more money is returned to investors, they can reallocate it to start-ups, allowing institutions like venture capital to take firmer hold.

Necessary changes are happening, albeit slowly, in Europe. For example, the recent takeover of Banca Antonveneta by ABN Amro was important not just because of the outcome but because the investigations triggered by the bidding process subjected the whole system to the disinfectant of public scrutiny. Also, private equity and venture capital are growing in Europe, by one estimate adding jobs equivalent to 3 percent of the labor force. But it has some way to go to match the United States.

The changes I have discussed above are important but not dramatic. Europe has much that can be built upon, including strong economic and legal institutions, generally high levels of primary and secondary educational attainment, universal healthcare, a robust safety net, a strong culture of solidarity, and the wealth to make any needed investments. Why then has Europe not reformed as yet? In part, the fact that the needed reforms are not dramatic, that the system still works reasonably well, may be the problem. When things get really bad, even a small push can gather momentum because there is nothing to lose – think of Britain before Thatcher. Too many in Europe still fear more what will be lost through reforms rather than yearn for what will be gained.

In a similar vein, one must also not underestimate the ambivalence of the underprivileged towards reforms. This seems strange because the underprivileged should be all for pro-competitive reforms that even the playing field. Yet, empirical studies using the World Values Survey indicate that the world over, the unskilled and the poor are against more competition. In part, this may be because skills and finance are typically needed to compete, and so reforms open up far more opportunities for the skilled and the rich. At the same time, the unskilled lose whatever little rents they might have enjoyed pre-liberalization—for example, as employees of the overstaffed public sector monopoly. In short, opposition to reforms may also come from the underprivileged who have the certainty of losing their small rents, and little hope of obtaining new opportunities in compensation. This is another reason why education reforms and financial sector reforms should come high on the agenda.

One should also not underestimate the power of sophisticated organized interests in opposing reforms. Europe's subsidized farmers, for example, not only have the power that comes naturally to a well-organized small group, but also can appeal to the public's nostalgia for the traditions small farmers represent (even if many farmers are actually corporations). This then leads to the paradoxical situation of Europe sending billions of aid to poor countries even though reducing barriers to agricultural imports from those countries might be far more useful a contribution to poverty alleviation, even while also benefiting domestic consumers.

Finally, one must not overestimate the courage of politicians. [Chart 14: Response of Real GDP to Reforms] As a study by the Fund of reforms in OECD countries suggests, the cumulative gains from structural reforms in trade, product market, and labor market areas are positive but they predominantly materialize in the long run. In particular, labor market reforms come with short- to medium-term growth risks. [Chart xx: Cumulative Reform Efforts across Sectors]If the pain is front loaded while the gain comes after the election, is it any wonder that labor reforms have proved so elusive everywhere?

So when do reforms come about? Let me highlight some lessons from our work at the Fund, laced with some speculation, on what might work going forward. Here are ten.

Lesson 1. Bad times are good times for reform.

[Chart 15: More Reforms in Bad Times?] Specifically, recoveries after a prolonged period of weak or negative growth are conducive to an acceleration of structural reforms. With the exception of the financial sector, in all other areas, episodes of low or negative GDP growth were followed by more ambitious reforms than in normal or good times. Perhaps contrary to what some would conjecture, however, reforms also take place during “bad years” when GDP growth is less than 1 percent. The lone exception is labor markets, where apparently, governments are understandably reluctant to impose adjustment costs on workers when they already suffer from adverse economic conditions. But more generally, bad times convince the public of the need for reform while the recovery allows the payoffs from reforms to be realized. In this sense, there is no better time than the present for Europe.

Lesson 2. Government money helps.

[Chart 16: First 5 lessons] Since compensation for those who stand to lose from structural reforms is mostly provided by government transfers, reforms are more likely when fiscal positions are strong, especially when labor and tax reforms are attempted. Large transfers may indeed be required to gain the necessary political support for labor reforms – for example, the minimum wage and unemployment benefits were cut in the Netherlands in the 1990s but employee taxes and social security contributions were also cut to make the reforms palatable.

Lesson 3. Build commitment through external fora.

Liberalization commitments under the umbrella of the WTO or the European Union have clearly helped trade liberalization. Similarly, the reduction of barriers to cross-border competition under the Single European Act and the banking directives in the European Union has shaped product market and financial market reforms in member countries. One must acknowledge, however, as the European constitutional vote indicates, that outside forces cannot substitute indefinitely for domestic consensus building.

Lesson 4. Preannounce.

In addition to committing externally, preannouncing a future reform well in advance seems to secure greater commitment for it. The Big Bang financial reforms in London and Tokyo are good examples. On the one hand, pre-announcement offers domestic interests time to adjust, on the other, they do not oppose the reform fiercely when it is announced, because they discount the adjustment costs. By the time the date draws near, the preannounced reform has a life of its own and it is too late to fight it even if adjustment costs are larger than anticipated. China, for example, has used WTO accession, not so much to gain access to international markets, but to force the pace of domestic reforms – for instance, banking sector reforms are being accelerated anticipating that foreign banks will have free access to the Chinese domestic market in 2007.

Lesson 5: The easiest path between two points is not a straight line.

Rather than tackling the most difficult reform head on, it may make sense to ease the path by undertaking other, easier, complementary reforms.

[Chart 17: Product and Labor Market Reforms] For instance, there is a positive correlation between product and labor market reforms. Deeper analysis shows that earlier reforms in product markets have led to more labor market reforms, while the reverse does not happen. This may be because greater competition in product markets reduces the rents to be shared by producers and workers, and therefore lessens the resistance to reforms. Sequencing, therefore, is important. Since product market reforms are marginally easier to undertake, it might make sense to focus on them first.

Similarly, openness to trade and capital flows seems to be correlated with financial development. Again, the notion is that a competitive environment makes it harder for vested interests to hold back financial sector reform, while it also creates a constituency that will push for it, namely firms that face competition from foreigners. A classic example is India, where trade reforms created a competitive environment that woke Indian firms up to the high cost of domestic finance. This in turn made them press for financial sector reforms.

Lesson 6. Protect the worst affected.

[Chart 18: Last 5 lessons] There is no need to take on the entire opposition at one go. For example, if the oldest workers, who are also most resistant to change, are protected in a pension reform, you eliminate a huge source of opposition. Instead, it may make sense to change the rules for only younger workers, who anyway do not believe they will get a pension under the current system. Eventually, as these workers get older, all workers will be covered by the change. Of course, one also has to avoid the other danger of making the reform so marginal or gradual that the entire population will not be covered for centuries.

Lesson 7. Get the camel's nose under the tent.

A number of financial sector reforms have been undertaken in India by first undertaking innocuous changes that established the principle. For instance, public sector unions were against the introduction of computers into public sector banks. The government negotiated their introduction but with strict work rules that limited their usefulness – for example, bank transactions could not be automated but still had to be laboriously entered in ledgers. However, the principle that computers would enter branches was established. When competition from foreign banks – whose expansion was encouraged to spur domestic bank reform – accelerated, the public sector banks had developed the technical expertise, as well as the computer networks, to compete, so persuading the unions to relax rules became easier.

My last three principles are based on common sense.

Lesson 8. Involve the middle class.

Some of the suggested reforms include active labor market programs such as help with job placements. There is always a temptation to target such assistance at the very poor, and thus save money – this is the American way. Unfortunately, the poor often do not have adequate voice, so the quality of such programs degenerates quickly. Extending a program to the middle class, while costing more, ensures that the beneficiaries have enough voice to demand changes if the program is ineffective. This is a practice Europe has followed more, and I believe it works better. What Europe does less of is to involve the private sector, for example, creating competition between service providers through mechanisms like coupons. This deserves to be contemplated.

Lesson 9. If it is to be done, do it early.

While I have argued there is merit in picking one's battles, it was that great European thinker, Niccolo Machiavelli, who said it is politically wise to do enough early on in one's tenure so that the benefits start showing up towards the end of one's term. Of course, this is easier said than done, and reforms may require politicians to commit political hara-kiri for their country until one is lucky enough to reap the benefits. But given that benefits will typically show up only after some time, it is wise to take advantage of the initial political momentum after election. It is also wise to do enough that there will be tangible benefit, for otherwise one inflicts the pain without purpose.

Lesson 10. Don't let short term policy be the enemy of long term structural change.

Both monetary and fiscal policy should take cognizance of the reform agenda, and be supportive whenever possible. If, in fact, structural reforms will enhance growth potential, fiscal rules should take these into account, and allow greater current room to finance support for reforms – in this light the greater flexibility introduced into the SGP, if carefully used, is welcome. Monetary policymakers should also be able to incorporate the greater resulting output gap into their assessments of monetary conditions. Implicit assurances that the reform agenda will be supported can also bolster the courage of politicians. Of course, given the common currency, only if policymakers undertake a concerted reform effort across the major countries will monetary accommodation be possible.

I have offered 10 lessons from past reforms; some of which you will find contradictory, others of dubious value. Europe needs good political leadership to mix and match them in a way that will produce results. Unfortunately, economics is even more clueless about how to generate good leadership. I will not venture there, but instead conclude.

Europe has much to be proud of. But to preserve its rich heritage, its delightful way of life, and to retain its rightful place in the world, Europe needs to increase its growth potential. The needed reforms are not dramatic, at least set against what countries like mine need. That in itself might be why the difficulty of undertaking them looms so large. I am confident, however, that Europe will find both the will and its own unique way. Thank you.