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Economic Values and Dynamism in the EU Economy

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This paper addresses economic values and dynamism in the context of general European values. More precisely, it discusses how the lack of dynamism in parts of the European economy is not explained, in the main, by a lack of technology or capital or natural endowment; it is not even explained by big government, high taxation and strong social protection per se. Rather, the main explanation is to be found in the way certain economic institutions influence or reflect our culture and our attitudes vis-à-vis change and risk-taking.

This paper essentially follows the ideas of a prominent American economist, Edmund Phelps of Columbia University, who has provided new perspectives for understanding low growth in the European economy.

The notion of prosperity

A prosperous economy is more than simply high income per capita – it is an economy with high wages in a wide range of jobs that are also engaging and challenging.

Job satisfaction in turn has positive effects such as promoting high participation rates in the labour force, feeding morale, loyalty and commitment to one's employer or activity, as well as to society as a whole.

The key condition for prosperity thus defined is dynamism, not high productivity. Dynamism depends on an environment that generates strong stimulus to change and is open to new players and new experiments in production, distribution and financing. Dynamic economies, of course, will tend to display high productivity – but high productivity economies can show low dynamisms, the obvious examples being Germany and Italy.

A high productivity economy can display low dynamism when the technology is not generated from within, but comes from outside, as was the case in much of Western Europe in the second half of the last century; when company control cannot be challenged in open capital markets; when foreign investment is discouraged and domestic producers and banks are protected.

Dynamism is the ability to generate a lot of innovation plus an effective selection mechanism to drive and select them. Dynamism is supported by strong competition and free entry, financial institutions that encourage risk-taking, and entrepreneurs willing to risk their capital in the hope of large rewards. These entrepreneurs need a supportive cultural and social environment, notably including widespread social acceptance and indeed approval of risk-taking and the fact that winners will make large profits. Making money must be accepted as a good thing, and not appear as some kind of sin requiring penitence and engendering social resentment.

Corporatism

Corporatism, as pioneered in Continental Europe in the 1920s, basically was a system for mediating conflicts between labour and capital in the large corporations produced by the second industrial revolution. It soon evolved into a tripartite system of big corporations, big unions and big banks, whose leaders negotiate and decide – under strong government oversight – the 'strategic' economic choices, and control economic change through barriers to entry, licensing systems, standards, labour unions and the like.

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Thinking ahead for Europe

The core of the system is that the elites who run the corporations, the unions and the banks block change unless there is consensus, and they work together to keep the system closed and impede entry by new firms and new financial intermediaries. Wage systems are also coordinated centrally, and entry into the labour market is regulated by union agreements that effectively protect incumbents against competition from newcomers.

The state intervenes in the economy to support corporatist strategic choices and to provide subsidies and privileged access to credit for favoured investment projects. With corporatism, there is also a lot of rent-seeking behaviour, cronyism and corruption, because contracts and markets may be won on the basis of connections and bribes. Merit and performance are only one among many factors that determine the choice of managers, partners in business or financial arrangements.

Corporatism is rigid in that outsiders are kept from entering and insiders are protected, exit is retarded, failure is slowly recognised and change requires a high degree of consensus.

But corporatism has also shown a lot of flexibility in adapting to changing circumstances and helping solve coordination problems in modern societies. This was the case with Italian *concertazione* helping the reduction of inflation in the 1980s, German co-determination *(mit Spreche*) supporting long-term investment strategies, and workers councils fostering the reduction of industrial conflict. In the Netherlands in the 1980s, the governments and social partners were able to agree on a dramatic reduction of real wages and public spending (the Wasenaar Pact), thus revamping growth without renouncing corporatist practices.

There is even a decentralised version of corporatism, which views the corporation as surrounded by a set of stakeholders for which it has to care. According to this view, the corporation must deal effectively not only with customers, competitors and suppliers, but also worry about the well-being of other 'stakeholders'. It cannot simply try to make as much money as it can, but must also take care of other goals such as a clean environment, ethical investment or maintaining employment in disadvantaged regions even at a loss. It must do so, however, by spontaneously going beyond what is required by the existing laws, regulations and common social practices; because of course there can be no special merit, or social appreciation, in respecting the law and established practices.

It should not escape our attention that the company will be able to meet these complex demands from society only to the extent that it enjoys some kind of rent, either because its customers are willing to pay a premium price for its products, in view of its nice attitude with respect to societal goals, or because it enjoys market power, and therefore is able to extract a rent from its customers. Either way, the company will in fact be giving back to society a part, typically a small part, of what it receives in the form of protection from competition.

The basic problem with corporatism is that it tries to retain the private income and private ownership of wealth, which is central to capitalism, but in a way to 'remove the brains' of capitalism; to curtail the inner motor of experimentation and discovery undertaken by decentralised and uncoordinated entrepreneurs and financiers, on which capitalism relies to select opportunities and innovate, and replace it with decisions on investment and innovation based on social consensus.

This explains why corporatism is good at managing imitation and incremental improvement, but not invention and endogenous, radical innovation. And this is why it could not cope well with the IT revolution, since this technology is in many ways inconsistent with, and very upsetting for, established economic and social equilibrium.

It is interesting to recall, in this connection, that when the ICT revolution was taking off around the mid-1970s, there was a government programme in the US to accelerate the creation of *information highways*, i.e. the infrastructure necessary for the exploitation of ICT. In Europe, we launched a programme for the *information society*, basically aiming at reducing social resistance to ICT by showing with restricted experiments that no one was threatened.

The set of values associated with corporatism

Cultural values and attitudes, as may be expected, tend to be consistent with the economic environment. I will not try to decide whether it is culture supporting economic institutions or vice versa. Open and dynamic economic environments tend to be associated with an ethos of ambition, competition, self-help and initiative. People take risks because they have confidence, and they have confidence because they are supported in their risk-taking by the social environment, financiers and even the legal and judicial system. Failure in business does not lead to any economic, social or legal stigma for the failed entrepreneur.

On the other hand, you have high-productivity economies, such as Italy and Germany, where innovation is not encouraged, and often is actively discouraged by entry barriers, conservative bankers who only give money to those who have money, aggressive unions who fear that innovation will weaken their grip over the workforce.

The prevailing attitude is that one's economic position in life is determined by luck, connections, or inheritance, and certainly not by capacity and initiative. For this very reason, there is a lack of confidence and ubiquitously low morale. There is also the widespread belief that if somebody makes a lot of money, he probably did so because he managed to get special protection from the law or the political system – which by the way is often true.

As a result, big profits became the target of invidious resentment, which on occasion may lead to confiscation or sharp restrictions on the business, notably when the business is in a heavily regulated sector and there is a change in the governing majority.

These attitudes have deep roots. Compare the role of family values and education in promoting a culture of self-reliance in the US and one of dependence and status-consciousness in much of the EU.

Some tentative conclusions

From Adam Smith onwards, economists always knew that legal and social institutions determine economic performance. They are not sure on the directions of causation: whether institutions are the endogenous product of culture and values, or whether on the contrary the right institutions will generate the right set of values.

Be that as it may, in practice there is little choice but to try and improve institutions, and hope that attitudes and culture will also evolve in the process.

The analysis above calls attention to the fact that institutions are not all alike in promoting a high-performance and dynamic economy. High taxation may not be so good for business, but will do less damage if resources are well used and there is a clear benefit for the economy and society of public spending. Strong welfare is expensive and may hamper incentives to work, but also has positive effects of societal cohesion and acceptance of the market economy.

The fact is that some high-taxation, high-welfare economies seem to prosper while others languish. What makes the difference is the way public money is spent and social assistance is provided.

For instance, protecting the employed from the risk of becoming unemployed is useful to the extent that it facilitates labour mobility; it may become an unbearable burden if it makes it impossible to move resources away from unprofitable businesses. Thus, the consequences are very different depending on whether protection takes the form of a restriction on the possibility to fire workers who are no longer productive in a particular occupation; or whether instead it takes the form of social insurance providing income, training and assistance in finding a new job for those displaced by technological change and globalisation.

Similarly, institutions that favour capital mobility, including well-functioning markets for corporate control, are good for economic dynamisms; systems of entrenched control where managers and owners are shielded from market discipline are bad.

In general, institutions that foster competition and merit are good; those that protect incumbents are bad, in the production of goods and services as much as in the production of education, research or culture. Retarding adjustment, impeding entry, resisting change is not the right way to promote dynamism, together with its benefits of high-quality and high-reward jobs.

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