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The Challenge of Economic Growth: What Are the Issues?

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".....the rate of growth, a concept which has been little used in economic theory, and in which I put much faith as an extremely useful instrument of economic analysis."

Evsey Domar (1946)

When we first started to think about organizing a workshop on growth issues the world was under the impression of the "New Economy" miracle, in particular in the U.S., and the discussion in Europe was developing around the question if and how Europe could or could not participate in this new phenomenon. This was also the time when the Lisbon agenda was set up to define a strategy and a set of measures how Europe possibly could cope with the U.S. growth and productivity challenge.

Soon afterwards the situation changed completely. The year 2000 stock market correction as well as a number of additional shocks brought the long-lasting period of growth in the U.S. to a sudden end and the whole world went into a severe cyclical downturn. But, once again, this made growth issues – now from a somewhat different perspective – one of the core economic policy questions. Therefore, growth problems continue to stay at the forefront of European issues, in particular, because the cyclical downturn in Europe turned out to be not only much longer than expected but also significantly worse compared to almost all other parts of the world. At the same time, the mid-term review of the Lisbon agenda under way will raise the fundamental growth issues again in a European economic policy context.

In general, and as the recent situation in Europe illustrates, it is not only very complicated to distinguish between short-term cyclical episodes of low growth and deficiencies in long-term (potential) growth performance, the fundamental

questions of growth and their discussion are by no means new in economic history. Two quotations from the economic literature may illustrate the historical dimension of the problem:

As early as in 1977, Joan Robinson wrote in her famous paper "What are the Questions", published in the Journal of Economic Literature: "In this situation, the cry is to get growth started again. The European countries in a weak competitive position plead with West Germany to spend money on something or other to improve the market for the rest so that they can permit employment to increase. Any up turn in the indicators in the United States is greeted as a sign that we shall once more be pulled up out of the slough."

And Gregory Mankiw in the 25th anniversary issue of the Brooking Papers on Economic Activity in 1995 wrote on "The Growth of Nations": "After many years of neglect, these questions are again at the centre of macroeconomic research and teaching." "There is an increasing consensus that the role of capital in economic growth should be interpreted more broadly." ……..and……. "Yet some recent work on economic growth suggests that a more activist government could be beneficial."

Why Concentrate on Growth?

Why is growth important? Why have some countries grown rich while others remain poor? It is hard to think of a more fundamental question for economists to answer. (Temple, 1999). It is well known – but neglected most of the time - that even moderate growth differentials can lead to substantial differences in the level of per capita GDP – and hence also in welfare - across countries. This is in sharp contrast to business cycle fluctuations which are often found to have minor welfare implications overall. Thus, growth theory appears to be the branch of macroeconomics that really matters in the long-run, although good cyclical policies may be seen as an important prerequisite to become successful.

To appreciate the consequences of apparently small growth differentials the following example borrowed from Barro and Sala-i-Martin (1995) is quite useful: The U.S.A. has grown on average by 1.75 % over the period 1870 to 1990. If the average growth rate had been lower by just one percentage point, than U.S. real per capita GDP in 1990 would have been quite close to that in Mexico or Hungary and also around USD 1.000 below that in Portugal or Greece. But growth obviously matters not only for income levels. Okun's law, or rather, the negative association between unemployment and GDP growth, can still be observed. At the same time and obviously of crucial importance today, sufficient growth also takes away pressure from public finances and makes long-term oriented policies possible and much more likely.

Europe vs the U.S.A.: The Ongoing Growth Match

Many times, relative growth performance between countries and rankings of countries in growth performance are in the centre of public interest. History tells us that the relative growth performance of countries as well as their rank according to GDP- or wealth levels changes considerably over time, due to a large number of different factors. Even looking at the historical period since industrialization only, countries like Argentina or the Czech Republic once ranked among the most developed countries of the industrialized world, which today clearly have lost position compared to the group of high income countries. In the same vain, history since World War II can be interpreted as a sequence of growth comparison stories – and, much more, of growth gap stories - between Europe and the U.S.A., with the U.S.A. in the lead during some periods and Europe in the lead during others.

Nowadays, it is usually claimed that economic growth in Europe has been lagging behind the U.S.A. since the 1980s. Even more worrying - for the first time in decades the EU is now on a lower trend productivity growth path than the U.S.A.. Or, how the OECD postulates the question in its recently published growth project: "What makes some countries seemingly able to thrive on new technological opportunities while others are held back?" (OECD, 2003a and 2003b).

Looking a little bit behind the available figures, European economic performance is not that bad in a long-term perspective. Over 10 years there is an almost equal performance of the U.S.A. and the EU in growth per capita and productivity growth (Daly, 2004). From 1993 to 2003, GDP per head grew at an equal rate of 2.1% in the U.S.A and in the Euro area without Germany, which still suffers from the consequences of the reunificiation as the latest OECD country survey (2004) concedes. With Germany, the Euro area achieved a growth rate of 1.8% which is only slightly lower than 2.1%. In addition, since 1997 European employment has grown by 8%, whereas employment in the U.S.A. has only grown by 6%. As Lisbon relates to a long-term programme (10 years), this time span should be adopted for the economic analysis as well.

Europe seems now to be somewhat similar than the situation was in the U.S.A. in the 1980s – raising employment prevents productivity gains in the short term. We should also mention that the recent American recovery which has widened the gap relative to Europe has been supported by a unprecedented large fiscal and monetary stimulus and is certainly not only – if at all - the result of America's superior supply-side performance. In a recent article, The Economist (2004) writes that optimistic American policymakers stress success, while playing down macro-economic imbalances (and acting rather pragmatically on economic policy), while European policymakers only complain.

Last but not least, there is another important empirical aspect to be mentioned here, although it is clearly beyond the European topic to be discussed here: Africa. "We have learned a lot about growth in the last few years. However, we still do not seem to understand why Africa turned to have such dismal growth performance…..Understanding the underlying reasons for this gargantuan failure is the most important question the economics profession faces as we enter the new century." (Sala-i-Martin, 2002).

What Can Growth Theory Tell Us?

The number of insights – both theoretically and empirically – has increased tremendously since the renewed interest in economic growth that started in the mid 1980s because of the lack of convergence to U.S. income levels. Although factor accumulation is important, it seems to be mainly growth in total factor productivity (TFP) which determines long-run growth. This means that those countries which are best able to introduce new work practices – i.e. raising the efficiency of the input factors - will grow fastest. For example: The recent productivity pick-up in the U.S.A has been linked to the role of ICT in the economy – a general-purpose technology that is changing work practices and may be one of the drivers of TFP-growth.

In this particular context, Easterly and Levine (2002) – when documenting what they call five stylized facts of economic growth – stress very much the importance of "something else" besides factor accumulation to play a prominent role in explaining differences in economic performance. The TFP-residual accounts for most of the cross-country and cross-time variation in growth. And they also conclude, that overall growth is highly unstable over time, while factor accumulation is much more stable. In a very stimulating way Jones (2003) addresses the whole issue from the perspective of "ideas", how they are produced and how they contribute to understand TFP-growth.

Some of the main drivers of or barriers to TFP-growth are the core of the European agenda today – R&D, R&D diffusion, human capital as well as ageing. The important contributions of R&D and human capital to TFP growth has been known for some time, but new theoretical and empirical work sheds new light on those issues. That ageing may not only have consequences for public finances, but also for productivity growth is a very recent and urgent issue developed in the much broader context of the ageing agenda.

There are important effects of each of these elements, but there is no single cause. It seems that each country pursues a rather different growth mix determined by its productivity growth regime. Several studies show that TFP growth has more country-specific components than it has cross-country components. This suggests a

large role for national policies and to take a much broader picture of a country's overall structural features to be relevant in this context. In face of the population ageing and the declining productivity trend in Europe, the need for an explicit growth strategy is obvious but very hard to agree upon below the level of (too) general policy messages.

Many empirical findings remind us to be very careful in our (pre-)judgement of economic performance and in our pinpointing the "culprits" come out of a paper by Pritchett (2000) and a recent paper by Hausmann, Pritchett and Rodrik (2004). The first tells us that the more typical pattern of economic growth is that countries experience phases of growth, stagnation or decline of varying length. The second finds that what they define as growth accelerations (an increase of per-capita growth of 2% sustained for eight years) is highly unpredictable and that most instances of economic reform do not produce successful growth accelerations. It finds as well that growth accelerations seem to require more investment, more exports and a more competitive real exchange rate. They do not seem to happen by pure accelerations in total factor productivity alone. Of course, this does not mean that reforms are not necessary and that we can be complacent, but one should keep in mind that we should be careful blaming slow growth only on very narrow reasons.

At the same time, one very important development also seems to be, that the new economic growth literature has quantified the importance of having the right institutions to let growth develop (Sala-i-Martin, 2002). Empirically, it has become increasingly clear that institutions are an important determinant of growth, but we are still in the early stages when it comes to incorporating institutions to our theories. For example: What are better institutions and policies for encouraging the efficient amount of research? The extent to which individual firms might underinvest in research as well as estimates of the "true" social rates of return to research are well documented in the literature. To the extent the marginal benefit of research to the overall economy and to society are underestimated, better institutions might improve allocations and thereby foster welfare and growth (Jones, 2003).

The Lisbon Agenda and Growth Policy

The EU-Lisbon Strategy of March 2000 has the intention to make the European Union the "most competitive and dynamic knowledge-based economy in the world" by 2010. The member states are to meet a number of defined and mostly quantified targets in this respect. Beyond the overall strategy defined at EU level, there is a clear need for national formulation because different situation, institutions and structure of the economy in each country.

The focus of the Lisbon midterm review process should be placed on how to reach the numerical Lisbon targets in employment, R&D spending, schooling etc. rather than on analyzing the recent growth performance and suggesting new fields of economic policy measures. The main question is how to foster timely and successful implementation of measures that move the European economy closer to an improved macroeconomic outcome – ranging from better growth to higher employment and improved long-term competitiveness. Of course, an agreed theoretical blueprint of determinants of growth and TFP is crucial for addressing the right (intermediate-) targets and selecting the right instruments.

There seem to be two (conflicting) views on how a successful implementation of policies can be achieved:

One maintains that only a real economic crisis will produce the necessary acceptance for change, while the other calls for a pronounced upswing to facilitate reforms. Definitely, the first view cannot be a sensible guide for action as no politician will actively try to produce a (national) crisis, which would be very costly in macroeconomic terms. By comparison, an explicit growth strategy will not only generate more resources to spend on knowledge investment, ICT infrastructure etc., at the same time, changes and structural reforms necessary are always easier to implement in a growing economy, in particular at lower political cost. For example, the International Monetary Fund (IMF), (2004) recommends in a recent study to take advantage of recoveries for structural policies and states that (p. 132) "*in practice, it can be difficult to undertake fiscal adjustment and structural reforms simultaneously*". Structural reforms should be of high priority at times of favourable cyclical prospects and, therefore, for public finances. The first priority for the success of the Lisbon strategy must thus be a pronounced and sustained economic upturn and a European macroeconomic policy mix that makes this possible. How can we achieve this while making sure that those favourable economic conditions will be effectively used for implementing measures to reach the core structural Lisbon targets? Sequencing of measures to be implemented should be pragmatic and concentrate on reforms first which will boost private consumption and confidence.

In this respect, one has to bear in mind that many of the structural reforms necessary and policy measures to be implemented are quite costly and may require more fiscal leeway than currently foreseen under the Stability and Growth Pact - if we think for instance of investment in human capital or a higher share of R&D expenditure. It is also extremely important to get reforms to be undertaken accepted in society. A proposal which refers to an idea of the pioneering public-finance economist Richard Musgrave from Harvard for example suggests to exclude growth enhancing public expenditures (such as public investment) from the current budget. The idea behind this proposal is that those public expenditures that generate benefits to future generations do not have to be financed by current budgetary revenues but can be financed by debt – very similar to the arguments

behind private investment decisions. Although a (credible) implementation of this proposal may be quite complicated the basic idea of generating focus on growth enhancing public expenditures and raising the share of such expenditures in public budgets is also part of the EU tool kit for improving the overall quality of public finances.

For each of the five domains of the Lisbon Strategy (employment, research and innovation, economic reform, social cohesion and sustainable development), the EU has set itself targets, sometimes numerical ones. Instead of complaining generally it is essential to talk at the European and national level at the same time about where a country stands numerically in comparison with the Lisbon targets. In the spirit of Kok (2003), there is a need to formulate clear national policies with targets reflecting those agreed at the EU level. Why is the employment ratio in country A only at 62%, what measures could we take to increase it? Why is the R&D ratio in country B only at 1,5%, why does the transposition rate of the Lisbon directives stand at only 60% in country C, why have only 70% of 22-year olds in country D completed upper secondary education, what measures…

Building a constructive atmosphere involving governments, academia, social partners and the civil society and creating a feeling of Europe moving forward in a socially accepted way would speed up the implementation of measures and strengthen consumer confidence urgently needed. Another advantage of addressing more precisely the numerical benchmarks would be to put targets into focus which can really be influenced by national governments, whereas the overall growth rate can only be influenced via those benchmarks very indirectly and, at best, in the medium-term. (Improved) overall economic performance should be looked at once all the numerical targets (benchmarks) set in the Lisbon strategy have been achieved.

As Kok et al. (2003) also stress clearly, the success stories of a number of Member States show that apart from a clear vision about to path to sustainable growth and social cohesion, strong political will and co-ordinated efforts of all actors and relevant social groups are crucial. A national growth strategy (or a strategy for each Lisbon domain) could be both a vehicle for a clear vision and a co-ordinating device for all actors. Such a strategy could work like the goal of EU-Membership worked for the new member states, qualification for EMU or many other similar experiences, as a general accepted anchor of targets to be achieved and of policies to be implemented.

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