European Economies in Transition

Also by Oliver Fabel

THE ECONOMICS OF PENSIONS AND VARIABLE RETIREMENT SCHEMES

INSURANCE AND INCENTIVES IN LABOUR CONTRACTS: A Study in the Theory of Implicit Contracts

Also by Francesco Farina

ETHICS, RATIONALITY AND ECONOMIC BEHAVIOUR (*co-editor*)

Also by Lionello F. Punzo

THE DYNAMICS OF A CAPITALIST ECONOMY: A Multi-Sectoral Approach (*co-editor*)

ECONOMIC PERFORMANCE: A LOOK AT AUSTRIA AND ITALY (*co-editor*)

CYCLE, GROWTH AND STRUCTURAL CHANGE (*co-editor*)

European Economies in Transition

In Search of a New Growth Path

Edited by

Oliver Fabel
Professor of Management Studies
University of Konstanz
Germany

Francesco Farina
Professor of Economics
University of Siena
Italy

and

Lionello F. Punzo
Professor of Economics
University of Siena
Italy

First published in Great Britain 2000 by
MACMILLAN PRESS LTD
Houndmills, Basingstoke, Hampshire RG21 6XS and London
Companies and representatives throughout the world

A catalogue record for this book is available from the British Library.

ISBN 978-1-349-42022-3 ISBN 978-0-230-28910-9 (eBook)

DOI 10.1057/9780230289109

First published in the United States of America 2000 by
ST. MARTIN'S PRESS, INC.,
Scholarly and Reference Division,
175 Fifth Avenue, New York, N.Y. 10010

Library of Congress Cataloging-in-Publication Data
European economies in transition : in search of a new growth path / edited by
Oliver Fabel, Francesco Farina and Lionello F. Punzo.
p. cm.
Includes bibliographical references and index.

1. European Union countries—Economic conditions—Regional disparities. 2. Europe—Economic integration—Social aspects. 3. Monetary unions—European Union countries. 4. Fiscal policy—European Union countries. 5. Labor policy––European Union countries. 6. Public welfare—European Union countries. I. Fabel, Oliver. II. Farina, Francesco. III. Punzo, Lionello F.

HC240 .E83613 2000
338.94—dc21

00–021163

Softcover reprint of the hardcover 1st edition 2000 978-0-333-79461-6

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources.

10 9 8 7 6 5 4 3 2 1
09 08 07 06 05 04 03 02 01 00

To the memory of our friend Bruno Miconi

This page intentionally left blank

Contents

List of Tables

List of Figures

Acknowledgements

Research leading to the writing of the papers published in this volume was largely financed by the European Commission, through contracts no. ERB CHR XCT 930231 and ERB CIP DCT 940015, establishing a Human Capital and Mobility network called EUCompEcs and its extension to Central Eastern European Countries. Laboratories involved were: Department of Political Economy (Siena, co-ordinator), LATAPSES (Nice), PREST (Manchester), Department of Economics (University of Madgeburg), CNR-IDSE (Milan), Instituto de Analis Economica (Valencia), and in the extension, Charles University (Pargue), IBSPAN(Warsaw), and Budapest University of Economics.

Introduction

The emergence of the European Monetary Union (EMU) certainly represents the most significant recent development in the transition towards European economic and political integration. Thus, the monetary and financial aspects of the ongoing process have come to dominate public debate for a time, its focus being distracted away from the issues of convergence in real terms and social cohesion. After a substantial chapter devoted to the monetary issues, this book concentrates on some of the real aspects of the process of continental integration. These, as the title implicitly suggests, share the complexities of other parallel processes, technically denominated 'transition'.

While after December 31 1998, the EMU being 'done', the debate has returned to convergence and cohesion, it is nevertheless appropriate to begin with some comments on monetary issues. This major change, the launching in earnest of the EMU, presently involves the establishment of irrevocably fixed parities among the currencies of the Euro-11 and the introduction of Euro-denominated financial assets. The main boost to European integration is expected to come on January 1 2002. Following this date, all transactions of the EMU countries – which, including the four countries that have not joined yet the common currency, form the widest productive area of the world – will be settled in Euro. Since the European Central Bank (ECB) has definitively established a reputation for giving priority to monetary stability, incentives for government authorities within the Euro area have radically changed. Upon experiencing an asymmetric shock, a country can no longer rely upon beggar-thy-neighbour policies. It cannot provoke an inflationary process ending in the devaluation of the currency in order to maintain competitiveness at an unchanged level of economic activity. In fact, the ECB will conduct a European monetary policy, which will intentionally oversee any differences between the business cycles of the member countries.

One such common monetary policy can then be expected to accelerate the move towards more specialization at the regional level and more uniformity in specialization at the national level. This should sensibly reduce the risk of asymmetric shocks. Therefore, the single currency is envisaged as the new institution which should accompany the emergence of economies of scale within the most dynamic industries of the EU area – thus fostering both homogenization of business cycles among the

European nations and real convergence among European regions. However, such exclusive commitment to monetary stability raises doubts concerning the capability of the ECB to cope with the need to push the continental productive system towards a higher activity level. The whole burden of sustaining employment expansion and growth in the Euro area will in fact fall upon fiscal policy. Yet, the Stability Pact and the commitment to zero public deficits within the transition period to the Euro are bound to lead to the loss of all classic 'automatic stabilizers' aimed at cushioning declines in demand. Moreover, resorting to an increase in public expenditure – as is allowed in particular cases to counteract a recession – will prove almost impossible for governments compelled to run large primary surpluses to service their public debts.

One might then ask for the rationale of a Stability Pact, which could only further depress growth rates in Europe. The official tenet stresses the moral hazard problem of a 'free-rider' country that may be tempted into excessive public borrowing which will eventually be paid for by higher interest rates in all other countries. This implication is at least questionable. In the liberalised and fully integrated international financial market a 'risk premium' would be imposed upon the assets of such 'divergent' government. Hence, the true reason behind this general ban against public deficits more likely aims at preventing national authorities from servicing their public debt by continually increasing tax revenues instead of proceeding to its rapid reduction through radical cuts in public expenditure. Drastic downsizing of public sectors is conceived as the main route to achieve considerably lower levels of taxation in Europe. This, in turn, is thought to provide the prime supply-side measure urgently needed to boost private investment and to definitely unleash the demand for labour in Eurolandia. In fact, the shrinking of the Welfare State in the EU countries – necessarily reducing the present high level of social protection – is considered as one of the reform instruments that can improve the incentive structure in the labour market.

However, the likely shortcomings of full capital mobility and, in particular, of the increasing mobility of highly educated and generally skilled workers, should not be underestimated. Fiscal competition among European countries – competing with each other through tax cuts in order to attract more corporate investment and highly productive human capital – runs the risk of producing a chronic underprovision of social insurance. Moreover, less regulation and lower levels of social expenditure may aggravate the significant inequalities in income distribution already existing as well as the abnormally high unemployment rates – thus endangering the EU long term growth rate. In the light of these considerations, the main problem faced by European governments is to find ways to reconcile the rapid strengthening of market forces triggered by globalization and privatization processes on the one side, and the efficient functioning of the public institutions aimed at guaranteeing social cohesion on the other. In order to prevent a stiffening competition from further increasing income disparities at the personal as well as at the regional levels, co-ordination among the fiscal policies of the European countries – and possibly their thorough harmonization – will have to figure high among the priorities in the agenda of the institutional arrangements to come.

It is worth noting that, at least up to now, the process of monetary integration has hardly closed the gap between the countries in the so-called Core and Peripheral Europe. In his contribution in Chapter 1, Francesco Farina questions the conventional wisdom according to which, during the EMS, the low credibility of the central banks of the Peripheral Europe countries would be explained by their time-inconsistent monetary policies. Evidence for a high real wage rigidity in Europe suggests that monetary authorities could not have relied upon a 'surprise inflation' to temporarily improve income and employment levels. Farina's alternative interpretation instead highlights the low degree of credibility of the peripheral countries' fixed exchange rates as the consequence of the Bundesbank dictating tight money creation to the whole system. Excessively high real interest rates thus determined very low growth rates. Inflation was eventually defeated at the cost of high unemployment. If the monetary stance of the ECB will pursue a 'zero inflation' target, the condition of a lower real wage rate – which in the peripheral countries is the pre-condition to improve activity levels – will not be obtainable by means of a monetary expansion. As a result, aggregate demand will continue to be depressed. Hence, convergence to the target levels of the Core Europe will obviously not be realized.

It is with the emergence of the new growth theory that the issue of convergence within and among national economies has received increased attention. Being predominantly preoccupied with the dynamics of economic aggregates, however, the fundamental structural and institutional changes which do take place over the transitional phase and are integral parts of its realization are not at the heart of such analyses. Yet, persisting institutional and economic structures obviously govern the adjustment processes and mark their unfolding and exits – affecting their speed, nature, and possibly even the very success in achieving their implicit goals, among them 'macroeconomic convergence'. This applies to processes ignited by policy reforms that are designed to achieve such a goal – as is the case with the institutional changes enacted in the course of

European political and economic integration. However, it is also equally true for the current developments in the former socialist countries, which have been initiated by exogenous, fundamental changes in their general political system. In this respect, two basic issues are at stake then. First, any policy for institutional reform is bound to alter the incentive structure in an economy. Hence, the decisions induced on the part of the economic agents may well counteract the intentions pursued when implementing a regime change. They may generate other – sometime undesirable – consequences as well. Second, it is necessary to keep track of the actual time paths of institutional and structural economic adjustments in order to understand the nature of the overall transition process.

Reflecting their applied nature, the studies collected in this volume are certainly diverse in their choices of analytical subjects. Nevertheless, on the whole they provide exemplifying approaches towards addressing these two issues associated with investigating the characteristic features of economic transition. Furthermore, all contributions are to be noted for their consistently selecting a comparative outlook. This in fact constitutes a truly unifying element beyond the fact that the particular methodologies employed – ranging from simulation and empirical work, theoretical incentive models, purely conceptual discussions to, finally, policy assessments – appear to even add more diversity. It also contrasts sharply with more conventional analyses that are based on what can be called a set of continuity-assumptions between the old and the new paths emerging through the transition process. Given the fundamental changes of policy regimes involved, only a comparative conceptual framework promises to reach (tentative) conclusions about the ultimate economic state(s) that will be attained and the manifold processes leading towards them: the 'attracting path', if there is one, of the transitional phase(s). These comparative perspective manifests in analysing theoretical steady states associated with different institutional regimes, investigating historical economic developments as reference models, or contrasting policy-contingent time-paths of adjustments.

In order to serve an exemplifying purpose, applied work must further be restricted in scope and concentrate upon a selected number of general topics. Hence, contributors to this volume were asked to supply studies that would fit under three themes: general structural adjustments following the process of European economic integration, consequences of specific legal/institutional changes, and characterization of national systems of industry and technological innovation. This thematic distinction combined with an attempt to also provide the necessary links between topics, explains the organization of contributions. Hence, following the opening discussions on monetary and financial issues, the focus shifts towards the real aspects of the European integration.

The production systems of the Euro area are under pressure to put themselves in pace with the transformations that developed in the last two decades. In fact, after the recent structural changes, such as the lean production overtaking the Fordist model and the huge technological revolution brought about by the new sectors of informatics and telecommunications, process and product innovations have emerged as key factors propelling productivity growth. How they combine with the processes of capital accumulation, and to what extent the related figures really capture the ongoing dynamics in production (and in the services sector) still constitutes an open, challenging question. Hence, Bernhard Böhm and Lionello F. Punzo provide an investigation of the dynamic changes in the industrial structure as national economies are merged to form an integrated European economy. The focus is on how reciprocal integration interacts with technological change and capital accumulation to determine the observed cross-country dynamics. A set of data on the development in the last two decades of four European countries, and in addition of Japan and the US, is analysed with a novel framework proposing a critical reconstruction that highlights fundamental changes at the levels of the dynamics of the industrial structures. The time evolution of the economies under scrutiny exhibits certain 'dynamic discontinuities' that need to be taken into account on the eve the continental unification to understand the pace and the peculiarities of the latter (for example, *vis-à-vis* other integration processes). The analytical method to tackle the issues involved, departs from neo-classical and modern growth theories as it focuses on irreversible changes that on one side affect long run sectoral performances, while on the other substantially determine the forms and possibilities of mutual economic integration.

The parallel experience in Japan and the US is used as a benchmark in the study of European industrial adjustment. The case of the US also provides an interesting benchmark to evaluate perspectives of the service industry. Compared to the recent US experience, the development of the latter has doubtlessly not yet attained similar significance in Europe. Hence, Jacques De Bandt addresses the issue of the emergence and the development of the service industry, a nearly new event in European history. In order to assess its economic potential, against opposing views from an 'industrialists' side, the author reviews a wealth of empirical material, coming to highlight the central position already occupied by and becoming increasingly central of the banking and business service activities in the European panorama.

Introducing to the analysis of specific institutional changes, Oliver Fabel and Bruno Miconi study the incentive stability of policies designed to limit the scope of government itself as the national states are replaced, respectively amended, by supra-national authorities. Going beyond popular criticism, an extensive survey of the literature aims at identifying the political and economic essence of current reform proposals in the provision of public services. This review by itself yields a clear warning against implementing only partial reforms. To strengthen the argument, a simple analytical model comparing a two-layer and a three-layer bureaucratic organization confirms that an isolated 'flattening' of the decision hierarchy – as is on the agenda of all approaches to lean government – may in fact increase the overall size of bureaucracy. The decisive incentives to downsizing in fact hinge on the degree of integration, which is achieved within the decision process. In consequence, the threat of developing 'Eurocracy' in the course of European political integration must be associated with the subsidiary principle contained in the Maastricht Treaty which precludes the full assignment of residual decision rights to the respective European authorities.

National systems of social transfer clearly also face growing competitive and harmonization pressure. Despite the ongoing controversy over implementing the Social Charta, the German government stepped foreword in 1995 and, by introducing public long term care insurance, even added an entirely new scheme to its already highly developed social security system. In doing so, it responded to demand from the growing number of elderly relying on Social Aid paying the high cost of care which – as in all other developed countries – appears to reflect inadequate private insurance coverage. Employing a comparative theoretical analysis based on the strategic bequest hypothesis, Oliver Fabel and Daniela Georgus investigate the induced behavioural changes in the parent-child relationship. As it undermines the strategic importance of bequests, public insurance is predicted to eventually crowd out private savings. At the same time, the reduced risk of exhausting private wealth is bound to increase the provision of care by children for parents with health deficits. Yet, averaging over all families including those with healthy parents the amount of attention devoted to parents will decrease. These results highlight the conceptual deficit involved when emphazising solely fiscal problems in addressing social security policy issues.

The above theme already touches upon the issue of existence, character, and adjustment capabilities of the national and local systems of innovation. In this respect, Michel Quéré provides a critical conceptual discussion of the two approaches to the role of institutions in the process of innovation enhancement and promotion of growth. Such a role is essentially seen in the establishment of incentive schemes that are able to confine co-ordination failures, if and when they occur, within an acceptable viability corridor that is still able to support long run growth.

On the other hand, Mario Maggioni investigates the impact of European economic integration on national systems designed to propel and diffuse technological progress. By means of a network approach, Germany and Italy as well as the two industrially most advanced regions of Italy – Lombardy and Piedmont – are compared. Under the assumption that technological leadership requires a high degree of systemic connection, Germany appears to be better prepared to cope with the increased competitive forces exerted by European economic integration. The German network of innovative links can be shown to be significantly more tightly knit. Furthermore, innovations primarily diffuse through the production process itself, while technological progress in Italy predominantly aims at reducing the resource cost in production. Similar reasoning leads Maggioni to conclude that Lombardy acts as the 'engine' for the Italian technological innovation, whereas Piedmont's industries are rather isolated from external innovative links.

Distinguishing efficiency gains in resource use from the effects of technological innovation constitutes the main point of interest in Jan Gadomski and Irena Woroniecka's paper on a technically defined transition path, the one associated with Poland. Their simulation analysis of the country's transition towards a market economy demonstrates the efficiency-enhancing virtue of privatisation – generating the most significant increase in labour productivity in the agricultural sector. Nevertheless, due to simultaneous technological change the Polish economy is expected to also experience a fairly dramatic structural shift towards the manufacturing sector. In consequence, employment in agriculture will further decrease, well beyond the point in time when aggregate employment begins to increase again.

The final contribution, by Ugo Pagano, fundamentally questions whether institutional rules can be actually imported via the pursuit of privatization policies. Disputing the neo-classical view that property rights govern the productive environment, the author argues that insider knowledge potentially induces high agency costs. Thus, already existing hierarchical structures in the production entities may also allocate property rights. The emergence of the postwar Japanese firms is thoroughly analysed as a support to this assertion. Emphasizing the similarities between Japan's initial situation and the current state of the former socialist countries, the convergence of institutional rules is therefore not likely to occur in the latter cases neither. However, as many Western firms today attempt to imitate the contractual environment associated with a Japanese firm, economic performance may also well be improved by developing even more national institutional diversity.

On the whole, the research effort exposited in this collection of studies can be usefully compared to the literature on growth and convergence which has dominated the discussion over the nineties. While the demise of the State-rule, along with privatization, has boosted growth in Central Eastern Europe, the slowdown in growth experienced by most Western European countries has been attributed to the negative influence exerted by income inequality. The median voter is induced to press for a high redistributive tax rate with the result of reducing incentives to private investment. The idea of a link between inequality increases and higher redistribution, which in turn would gravely hamper growth, *de facto* locates the growth enterprise led by market forces and public institutions on two opposite sides of the economic arena. The contributions in this volume depart from the traditional way of accounting for economic institutions which assumes that they are external to the market game, and of looking at the public economic institutions – such as the Welfare State – as fundamentally antithetical to the efficiency-enhancing functioning of the market competition. The unifying feature of the book lies in the attempt look at the complementary roles of public and private sectors in promoting the widening of technology and human capital as the main recipe for growth and convergence. In pointing at the strategic importance of public as well as of private institutions as providers of financial and organizational support to the stability of the market mechanism, the contributions contend that the interactions between the State and the market is far more complex than is hypothesised by mainstream economics.

Therefore, as the central message conveyed by the volume, the process of institutional reforms in Central Eastern Europe should not forget the historic lesson of the importance of social cohesion for incentive stability. On the other hand, Western European countries should sensibly orientate their institutions to balance a stronger incentive structure aimed at fostering growth with the smoothing of income and regional disparities, the fundamental condition for convergence.

List of Contributors

Bernhard Böhm is Professor for Economics and Applied Econometrics at the Institute of Econometrics, Operations Research, and Systems Theory of the University of Technology, Vienna, Austria. He directs a post-graduate programme in applied economics at the Academia Istropolitana Nova in Slovakia. He specializes in econometric model building, structural change, and environmental economics.

Jacques De Bandt is Research Director at the Centre National de la Recherche Scientifique and Professor at the University of Nice-Sophia Antipolis. He is editor of the *Revue d'Economie Industrielle*. He is a specialist in industrial economics. He has been concentrating his research progressively on informational business services, and on the knowledge economy.

Oliver Fabel until 1999 professor of management, in particular labor and industrial organization, at the Otto-von-Guericke University, Magdeburg, and since 1999 professor of management, in particular firm policy formation, at the University of Konstanz. His main research interest focused on the theory of the firm and incentives and risk shifting in organizations.

Francesco Farina has taught at the Universities of Naples, Perugia and Toronto, and is presently professor of economics at the University of Siena. He is the author of books and articles on monetary economics, social choice and economic integration.

Jan Gadomski is senior researcher in the Systems Research Institute of the Polish Academy of Sciences (SRI PAS). With SRI PAS from 1974 till now. Between 1980 and 1991 was also involved in the Center for Vocational and Social Studies of the 'Solidarity' trade union (from 1990 to 1991 its deputy director). From 1997 to 1998 worked in the Department for the Financial Policy in PKO BP bank. From 1997 lectures on introductory economics at the University of Information Technology and Management in Warsaw (linked to the SRI PAS). His main field of research is the dynamics and structural changes in economies in transition.

Daniela Georgus has since 1996 worked at the Ministry for Justice, Federal and European Affairs of the Länd of Schleswig-Holstein in the section for budget planning and control. She is also a lecturer at the 'Verwaltungsfachhochschule' (administration academy).

Mario A. Maggioni is a lecturer in economics at the Catholic University of Milan, and was a research fellow at IDSE-CNR between 1989 and 1997. His main field of research is industrial and spatial economics. His research interests focus on the relationships between technological change and economic development at both local and national level.

The late *Bruno Miconi* was Professor of Economics at the Department of Political Economy, University of Siena, and served a number of years as department chairman and as active member of the university's board for foreign relations. A key member of the EUCompEcs network, and a visiting professor in foreign universities of two continents, he contributed to the debates on value theories, game theory and growth theory, and finally to the discussions on the restructuring of government and bureaucracies. His broad interests included the economics of arts and culture, the study of which he initiated on the Siena campus.

Ugo Pagano is Professor of Economics at the University of Siena and Recurrent Visiting Professor at the Central European University (Budapest). He is the author of *Work and Welfare in Economic Theory* and has recently co-edited the books *Democracy and Efficiency in the Economic Enterprise*, *The Politics and the Economics of Power* and *The Evolution of Economic Diversity*.

Lionello Franco Punzo, Professor of Economics, Department of Political Economy, University of Siena, and Director of the University Diploma in Economics of Tourism, University of Siena at Grosseto; co-ordinator of the EUCompEcs and LACompEcs HCM research networks (1996–8). Visiting professor in a number of Universities and research centres abroad. Currently involved in IDEE, a EU research project financed as part of the Targeted Socio-Economic Research within the Fourth Framework Programme for Science and Technology. His interests are in the field of the study of structural change from the point of view of industrial and production dynamics, mathematical modelling of economic dynamics, and mathematical methodology.

Michel Quéré is research fellow at CNRS-IDEFI/LATAPSES. His main field of research is economics of innovation and, more specifically, the analysis of R&D strategies of companies, inter-firm partnerships and science-industry relationships.

Irena Woroniecka is a research worker in Systems Research Institute of Polish Academy of Sciences, Ph.D. in economics (Warsaw University Faculty of Economics). Her main field of research is modelling of the national economy with particular emphasis on modelling of the Polish economy in the transition period, inflation processes and macroeconomic policies.