Europe’s unexploited potential

Unlike the US, which has eliminated most of its inefficiencies and must now look to inventions and innovation for growth, Europe still has considerable possibilities for rapid expansion

By Jan Svejnar

The European economy has been getting bad reviews. There is a broad perception that American businesses do better than those located in Europe, in part because they operate in a more flexible and less burdensome institutional and legal setting. New ideas and initiatives come mostly from America and Europe at best follows. While many indicators support this view, on the whole this picture may be seriously misleading.

Between the late 1940s and early 1990s, Western Europe experienced an extended period of gradually catching up with the United States in productivity, technological sophistication and living standards. A number of analysts, including Nelson and Wright (1992), even predicted that Western Europe would catch up and start overtaking the US in the late 1990s or early 2000s. For a number of reasons, related primarily to rapid globalisation and a wave of technological and financial innovations that originated in the US, these prophecies have not materialised, at least not yet. But one should not be despondent about Europe’s potential. Its businesses and economies have a number of important strengths and unexploited potential that can be converted
into superior corporate and overall economic performance. In sum, the race for competitiveness is Europe’s to lose.

**The facts**

Let’s start with the facts. It is true that since the early 1990s the EU’s position relative to the US has weakened in terms of the rate of growth of gross domestic product (GDP). What is less advertised is the fact that in terms of GDP per capita and labour productivity in the business sector, the EU and the US achieved comparable rates of growth between 1990 and the early 2000s. The US experienced a major wave of immigration, with the new labour force entrants serving as an important driver of the American GDP increase. Europe’s population remained roughly constant and GDP increases corresponded more closely to the rise in productivity (though the EU’s economy was slower to create jobs, thus generating higher unemployment rates than the US).

Moreover, sweeping generalisations also ignore Europe’s heterogeneity, with productivity and employment growth in a number of the smaller states being faster than in the larger ones. Finally, Europe has carried out major structural changes, notably the introduction of the euro and enlargement of the union, which will have beneficial economic effects over time.

For most practical purposes, by the early 1990s the US and Western Europe had achieved similar levels of development and the US was more first among equals than a leader that was substantially ahead of others. In business, the US and Japan led in some sectors and Europe started leading in others (eg GSM technology, civil aircraft production, specialty chemicals, and areas of biotechnology). Moreover, during the 1990s, acquisitions such as that of Chrysler by Daimler Benz and Random House by Bertelsmann showed that substantial transatlantic investment flows went in both directions. Finally, the European Commission’s decisions, notably its disapproval of GE’s acquisition of Honeywell, projected the EU’s regulatory might – even when it
came to seemingly external business activities such as mergers between non-EU companies.

What has allowed the US to generate the impression that it has pulled ahead is its ability to capitalize on several important global developments. Identifying them is useful for the design of an effective business strategy and public policy.

**Entrepreneurship and Venture Capital**

The financial bubble of the 1990s generated larger amounts of venture capital, risk taking and innovation in the US than in Europe. Venture capitalists and entrepreneurs in Europe moved in the same direction but they were less numerous and proceeded slower. As a result, when the financial bubble burst and the availability of venture capital shrank in the early 2000s, US companies were ahead in terms of reaping the benefits of accumulated inventions and innovations. Going forward, it is important for business leaders in Europe to recognise and exploit new entrepreneurial opportunities.

**Regulation – Costs of Doing Business**

Businesses in Europe have suffered because traditionally heavier government regulation became more burdensome in an increasingly competitive, global environment. High and rising labour costs, combined with relatively rigid labour market (employment protection) regulations, has made large parts of the EU less competitive relative to the US and has contributed to the rise in unemployment. This constitutes a major departure from the 1970s, when the unemployment rate was almost twice as high in the US as it was in Europe. Since the 1970s, the US labour markets and their institutions have become more flexible as trade unions diminished in importance and real wages rose very slowly. US capital market deregulation was
also substantial, especially in the 1990s. These developments were much less pronounced in Europe. Moreover, stricter product market regulations in Europe have slowed down firm entry and exacerbated the effects of labour and capital market regulation. The inability of the EU to implement reforms such as the introduction of a single community patent and the recognition of professional degrees exemplify the burdens and restrictions Europe has been imposing on its firms and workers.

While enhancing the functioning of the common market, the EU has also generated additional red tape associated with the need to co-ordinate national and Community-wide jurisdictions. At the same time, the US government has pursued policies conducive to business and growth, including the development of the internet (which shifted through the government’s National Science Foundation to the universities and then transferred to the private sector for final development and dissemination in practical use).

Important steps have already been taken to make the EU and national government institutions more conducive and less restrictive for business. More needs to be done, however, in further developing financial markets, reducing and reorienting government intervention, improving the functioning of the labour markets, and generally reducing the cost of doing business.

**Research and Development**

Globalisation has also placed a premium on investment in research and development (R&D). Yet, companies in Europe have on average done less research and investment in new technologies than their counterparts in the US (and Japan) – an outcome that
has been driven more by smaller markets (economic segmentation) than by lower research productivity in Europe relative to the US. In some sectors (e.g., chemicals and biotechnology), innovation in Europe has been restricted by policies and US corporations have assumed the lead. In other areas, such as information and communication technology (ICT), the level of investment has been much lower in Europe than in the US, both absolutely and relative to GDP, and the gap has been growing. According to Forrester Research, ICT currently constitutes 6.9 per cent of the European economy as compared to 9.6 per cent in the US. Moreover, a number of large European producers made earlier strategic decisions that have placed Europe behind in production, as well as in use of the sector’s products, although smaller European countries have often been an exception. On average, Europe has also been slower than the US in transferring scientific results into applications, reflecting in part a weaker link between the academic and business worlds.

The evidence indicates that European businesses and governments need to increase R&D investment in key areas such as ICT, integrate more coherently academic and business research facilities, and exploit EU-wide economies of scale and scope. Setting major goals, such as the Lisbon 2010 Knowledge-Based Competitive Challenge, aiming at making Europe the most competitive and technologically most advanced region in the world by 2010, may be an appropriate mechanism. However, the goals must be taken seriously and realised. EU framework programmes aimed at improving competitiveness are also a step in the right direction, as are policies striving to improve intellectual property rights and publicly funded research.

**Human Capital and Europe’s Ageing Population**
The success of companies and economies increasingly depends on deploying effectively various types of human capital. Compared to Europe, the US enjoys low unemployment, high labour force participation and a high level of labour productivity (US workers are roughly one third more productive than workers in the EU). Moreover, the US has been more assertive in its global quest for top talent – even in the Europe-US setting, the net brain drain has been from Europe to the US. While greater financial incentives in the US are an important part of the story, in many instances an even greater reason appears to be the more hierarchical and less attractive working environment for young professionals in European companies and public institutions.

In this context, a growing handicap for Europe’s businesses is Europe’s ageing population. The problem varies across countries, but the rising dependency ratios combined with (mostly) pay-as-you-go pension systems have been increasing tax burdens and hampering business expansion. Yet the structural features that are benefiting the US – the relatively high birth rate, partially privately financed pensions and substantial immigration of young and educated people - have been difficult to institute in much of Europe.

Europe’s business, government and civic leaders will obviously have to find a solution to the human capital and population problems if Europe is to have a vibrant economy. Europe’s educational systems are among the best in the world - the key is to retain domestic and attract external talent.

**Enlargement of the EU**
The accession of the eight Central and East European states, plus Cyprus and Malta, into the EU presents a major opportunity to enhance the competitiveness of companies operating in Europe. The EU is increasing its population approximately from 380m to 450m people and is becoming the largest unified economic area in the world. The enlargement will temporarily reduce the EU’s levels of labour productivity and income per capita, but it also increases its rates of growth. The new EU members have a well-educated labour force with wage rates that go as low as one-fifth to one-tenth of those in the EU. With wise location decisions across the EU, companies can dramatically raise their business advantage *vis a vis* the rest of the world. In sum, the new EU members will constitute an important pole of economic growth in the Union. The challenge lies in integrating them rapidly into the EU’s business, legal and economic network.

**Leadership and Perceptions of Leadership**

An important aspect of Europe’s position in relation to the US is the perception that US companies lead developments in the rest of the world. This is observed in terms of economic growth, in the US economy leading others into and out of business cycles and even in the European stock markets tending to follow Wall Street on a daily basis, despite the fact that they open earlier. One reason for this dependence is real economic leadership of the US, as demonstrated by the concentration and diffusion of major innovations, a single versus fragmented voice and the greater homogeneity of the US market. The accommodating (growth-oriented) monetary policy of the Federal Reserve Bank in comparison with the strictly price stability-oriented monetary policy of the European Central Bank is another differentiating factor. Finally, the US and its corporations act with confidence and a sense of leadership.
An example at the corporate level lies in the finding by Muller and van Tulder (2002) that US firms have profited from the introduction of the single European market at least as much as European core companies, if not more.

Europe can provide much more business and policy leadership than it has done to date. The successful introduction of euro, key acquisitions such as that of Chrysler by Daimler-Benz, the transatlantic projection of regulatory power from Brussels, and the concrete prospect of a European Constitution are steps that reflect such a change in behaviour. Gradually, they should change perceptions as well.

**Prospects for the Future**

At present, the US has the most dynamic and developed economy among the large industrialised countries. Yet, further progress is difficult because the US economy already operates close to its potential. Future US growth therefore cannot come from eliminating sizable inefficiencies because by and large they do not exist; growth must come from further inventions and innovations. Europe, on the other hand, has considerable unexploited possibilities that can propel it rapidly forward. With the introduction of the euro, enlargement and structural reforms, the EU should be increasingly able to act as a unified economic power that provides favourable conditions for business and economic development in general.
References


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