Summary for non-specialists
Economic Papers No. 481 / April 2013
Economic Papers index

Innovation Policy and Economic Growth

by Dirk Czarnitzki and Otto Toivanen, KU Leuven

This pair of essays is concerned with equitable growth in the EU and the achievement of the Europe 2020 target for social inclusion. The EU has set an ambitious objective, seeking to ensure that, by 2020, 20 million fewer people are at risk of poverty and social exclusion. Concretely, this means a significant reduction in the number of people with low relative incomes, or who are severely materially deprived, or who are living in households with very low work intensity. There are however already serious reservations as to whether this can be achieved. The scale of the challenge is being increased as a result of changes in the European labour and capital markets (the subject of Part I) and calls into question the current priorities of the EU (the subject of Part II).

In seeking to respond positively to these challenges, we need a more refined understanding of the underlying economic mechanisms and of the relation between market forces and the European social model. The challenge to securing equitable growth is typically framed in terms of a European labour market that faces twin threats: ever-increasing competition from newly-industrialising countries ("globalization") and rapid technological development ("ICT"). The standard story argues that these forces are raising the demand for skilled workers and destroying the jobs of unskilled workers. Market pressures threaten the survival of the welfare state. I argue however that this "standard model" of globalization and technical progress is an inadequate basis for exploring the relationship between the economy and social justice. There are five major shortcomings and addressing these shortcomings points to a richer set of policy conclusions.

The first objection to the standard model is that there is a logical inconsistency in applying the standard model to a world where there is both the United States and Europe, in addition to the newly-industrialising counties. The inconsistency arises because the model implies, with Europe and the United States both trading the two goods, that their relative price on world markets determines the same skill premium. We have therefore to enrich the model by taking account of the non-traded service sector. While some services are actively traded, there are distinct limits to outsourcing and for many services there remains an essential local ingredient. In considering the future prospects for employment in Europe, we have to pay particular attention to service sector jobs.

The second major shortcoming is that the standard model fails to take account of the changing nature of employment. It assumes the continuation of the "modern employment relationship" where employment is a (0,1) phenomenon up to retirement: you are in a job or you are not. In reality, for many people employment is increasingly fractional and less well-defined. By choice, or perforce, people are working part-time, or holding portfolios of activities. Increasingly, young people are interns or on zero-hours contracts. If such developments become widespread in the EU, we have to re-consider the notion of a "job". The Europe 2020 employment objective, for example, is defined in terms of (0,1) employment rates, and this needs to be re-evaluated.

The third limitation of the textbook story is that it fails to capture adequately the institutional structure of social protection. The treatment of unemployment benefit, for example, fails to include the conditions under which it is paid. To treat unemployment benefit as "the wage when not working" is to ignore the precise features that have been introduced to help social policy work with – rather than against – the grain of economic policy. In considering the future of social protection in Europe, such as an EU-wide unemployment insurance, it is essential to consider the details of institutional design.

The fourth limitation of the standard model is that it fails to treat the capital market. The capital market, and the associated question of the share of profits in total income, was in the past a central element in the analysis of the distribution of income. It has been given less prominence in recent decades. The capital market needs to be restored to a central position in our analysis for three reasons. The first is the rising share of profits at the macro-level over recent decades. The second is that private wealth has become much more important: private wealth in Europe was less than two and a half times national income in 1950, but in the

past 60 years has risen sharply to reach more than 5 times national income. The third reason is the return of inherited wealth. Material wealth is becoming again a significant element in the transmission of advantage.

The fifth limitation of the standard model considered here is that it fails to take account of market power. The model assumes that all agents act as price-takers: that we have perfect competition. In the real-world, there are firms that have market power, as do collective organisations such as trade unions. The relative bargaining power of different actors determines the way in which economic rents are shared and hence the distribution of income. It also means that, in tackling social exclusion, we need to look, not only at the labour and capital markets, but also at the product market. Consideration should be given to the supply-side of markets providing goods and services that enter the indicators of material deprivation: concerned with food, housing, lighting, heating and communication.

A central theme of the paper is that our choice of economic model has often a profound effect on our assessment of the extent to which welfare state inclusion policies compete with, or complement, economic performance. It therefore influences the conclusions drawn with regard to policy options. The paper considers a number of radical initiatives at the EU-level. But the economic analysis of the labour and capital markets also demonstrates that the achievement of the Europe 2020 social inclusion objective depends as much on what happens to the pre-redistribution distribution of income as on social transfers. I discuss the possibilities for actions in the labour market, the capital market and the product market. Specifically, serious consideration should be given to:

- Measures to encourage service sector employment, with particular reference to the demand side and the financing of new jobs;
- An EU unemployment insurance scheme, involving extended duration benefits, and possibly a X+1th state;
- An EU-wide child basic income, and possibly an EU basic income for all;
- Taxation of lifetime capital receipts, and, possibly, EU child trust funds
- Product market regulation requiring universal access, to ensure that poor consumers are not excluded.

Part II of the paper turns to the objectives of EU policy and the indicators by which macro-economic progress is assessed. The principal message of this part of the paper is that, rather than starting with Gross Domestic Product (GDP) and the instruments of economic policy, and then considering the social consequences, the policy-making process should be turned on its head. The starting point should be the living standards and well-being of individuals and their families. Macro-economic policies, and indeed all policies, are means to an end, not ends in themselves.

With this shift in perspective our assessment of economic performance can differ from that indicated by GDP per capita for five reasons:

- Changes in the share of households in total national income;
- Spendable income may have moved differently from total household income, notably on account of the imputations made in arriving at the latter total;
- Changes in national accounts procedures that have no counterpart in household surveys;
- Changes in household composition affecting the equivalised income of households;
- Increased or decreased inequality of income.

The rate of growth measured in this way may be quite different, as we can see in the Eurozone both before and after the onset of the economic crisis. Put in reverse, if the headline indicator becomes distributionally adjusted equivalised household disposable spendable income, then we can work back to see how the different elements have contributed to an improvement or a worsening of performance.

In short, if we wish to avoid a total "disconnect" between the discourse on economic policy and the experience of citizens, then the headline indicator should be a measure of household living standards taking account of distributional concerns. Such a re-positioning is, in my judgment, essential if the EU and Member State governments are to secure the support of their voters.