Mind the Gap: Can the New Europe Overtake the U.S. Economy?
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Mind the Gap

Can the New Europe Overtake the U.S. Economy?

Robert C. Pozen

Most Americans consider the United States far ahead of Europe economically. Over the last 30 years, real per capita income (based on purchasing power parity) has consistently been 30 percent higher in the United States than in the 15 "western" countries of the European Union (the EU15). In the last decade, the U.S. economy has expanded much faster than that of the EU15, and demographic trends suggest that this disparity will continue.

The recent addition of ten eastern European countries (the EU10), however, offers the EU an opportunity to overcome several critical constraints on its economy. Meanwhile, the usually high productivity growth that has driven the U.S. economy over the last decade is not likely to continue at such a torrid rate, while the sluggish rate of productivity gains in the EU15 could rise sharply. If the EU can successfully integrate the EU10, and the United States fails to find new ways to increase productivity, then the economic gap between Europe and the United States will start to narrow for the first time since 1970.

AMERICAN ADVANTAGES

Gross domestic product has grown at an average rate of 3.3 percent a year in the United States over the last decade, compared to 2.1 percent a year in the EU15. Per capita GDP growth, however, has been very similar: 1.8 percent a year in the United States, 1.7 percent in the EU15. The main factor driving higher U.S. economic growth is not greater productivity gains; it is a more rapidly expanding population.

These demographic differences will likely keep GDP growth higher in the United States than in the EU15 over the next few decades. The average fertility rate in the United States is 2.1 children per couple, almost 50 percent higher than in the EU15. This means that the U.S. population will grow from 290 million today to approximately 370 million by 2030, whereas the population of the EU15 will stay roughly flat—at 380 million—in the same period.

A second, and related, factor behind differences in American and western European economic growth is the financing of retirement benefits in the context of the aging of the baby boomers. The "support

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ratio"—the ratio of workers paying into retirement plans to retirees drawing out benefits—will erode more quickly in the EU15 than it will in the United States, directly undermining the pay-as-you-go approach to financing retirement benefits. Despite this impending demographic crisis, the EU15 has been much slower than the United States to adopt the alternative approach: financing retirement benefits through advanced funding of pensions. Most pensions in the EU are structured as defined benefit plans (rather than defined contribution plans), and outside of the United Kingdom most of these are funded by current company earnings. In the United States, by contrast, defined benefit plans must be funded by separate trusts maintained by individual companies, and they are far less common than defined contribution plans, which are fully funded each year by employee and employer contributions.

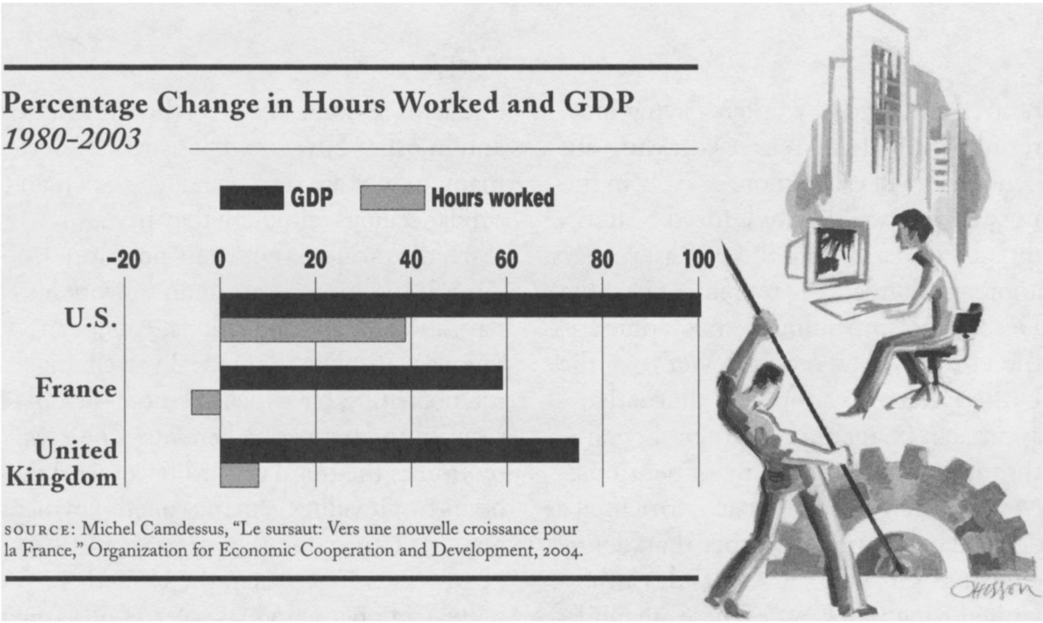
A third key factor explaining differences in U.S. and EU15 GDP growth is the disparity in the number of hours each worker works. In the last 30 years, the EU15 has made dramatic improvements in its relative productivity (in France, GDP per hour has gone from 73 to 105 percent of the U.S. figure), but its per capita GDP has remained just 70 percent that of the United States. This is explained by the fact that workers in the EU15, and in France in particular, log far fewer hours on the job than do U.S. workers. Since 1980, the average number of hours worked in a year has actually fallen in France, while increasing slightly in the United Kingdom and by almost 40 percent in the United States. Over his or her lifetime, the typical American works 40 percent more than the typical European.

There are a number of reasons for this disparity. In France, the legislature imposes a general 35-hour ceiling on the workweek, and in other EU15 countries such as Germany, unions are strong enough to demand similar ceilings (although they have recently started to tone down their positions). Americans, by contrast, tend to work long days and take short vacations. American unions, with their dramatically declining memberships, have focused more on job security and protecting benefits. The EU15 reinforces the trend toward fewer working hours by providing generous unemployment benefits (from one to two years in the EU15, versus 26 weeks in the United States). Higher marginal tax rates on earned income also tend to suppress the number of hours worked. The Nobel laureate Edward Prescott has recently argued that higher taxes account for most of the difference in labor supply across time periods and between countries, although other distinguished economists, such as Northwestern's Robert Gordon, dispute his conclusions.

A fourth factor critical to GDP growth, and closely related to labor flexibility, is receptivity to immigration. Immigrants have been major contributors to U.S. population growth. Often willing to work long hours at whatever jobs are available, they have filled both low-wage and high-skill positions. The United States has successfully absorbed many waves of immigrants, whereas the EU15 has struggled to integrate Muslim and African newcomers. The percentage of foreign-born citizens is now ten times higher in the United States than it is in the EU15.

DIMINISHING RETURNS

Despite these demographic realities, other factors that have driven recent gains in U.S. productivity are likely to start bringing diminishing returns. First, the spread between U.S. and European military spending is



Percentage Change in Hours Worked and GDP
1980-2003

SOURCE: Michel Camdessus, "Le sursaut: Vers une nouvelle croissance pour la France," Organization for Economic Cooperation and Development, 2004.

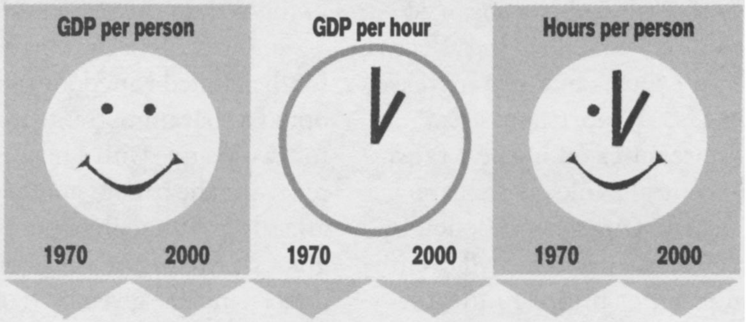
widening. Defense spending as a percentage of GDP is now two to three times higher in the United States than in European countries. Shifting economic resources from private companies to less efficient public bureaucracies tends to reduce productivity. Increased security, although often necessary, also hurts productivity: searches of airline passengers slow down business travel, and searches of imported goods constrain the use of just-in-time inventories.

Second, most of the productivity gains from the entry of women into the work force have already been realized in the United States, whereas Europe is just starting to reap the benefits. Higher female employment has increased payrolls and hours worked and has enhanced productivity by bringing diverse skills to the workplace. In the United States, the percentage of women who do not work outside the home rose to nearly 25 percent in 2001 after falling for half a century. In Europe, at least outside of the Nordic countries, women have only recently begun to enjoy equal access to many jobs and enter the workforce in large numbers.

Third, U.S. investment in information technology (IT), which has been a key driver of productivity gains over the last decade, is likely to flatten out. As David Owens at the investment bank Dresdner Kleinwort Wasserstein has explained, the integration of IT equipment into business processes has accounted for much of the recent productivity growth in U.S. firms. Because most EU firms have not fully realized the potential of IT, they can now achieve quick gains by becoming "fast followers" of their American counterparts.

U.S. investment in IT equipment was facilitated by a fourth factor: abnormally low real interest rates, which have favored capital over labor in recent years. Real interest rates are now likely to rise in the United States because of the growing federal budget deficit—which is edging toward 4 percent of GDP and may increase more if the Bush tax cuts, slated to expire in 2011, become permanent. (According to the Brookings Institution, making the cuts permanent would add $1.8 trillion to the deficit over the next decade; of that amount, only $500 million is politically at issue because some view that portion as a "benefit for the wealthy.") Although rising deficits do not automati-

Relative Productivity *(U.S.=100)*



	GDP per person 1970	GDP per person 2000	GDP per hour 1970	GDP per hour 2000	Hours per person 1970	Hours per person 2000
U.S.	100	100	100	100	100	100
EU15	69	70	65	91	101	77
France	73	71	73	105	99	67

SOURCE: Oliver Blanchard, "The Economic Future of Europe," working paper 10310, National Bureau of Economic Research, 2004.

cally result in higher interest rates, they put upward pressure on rates, because the U.S. Treasury must compete with other borrowers for funding at the same time as the pool of private savings in the United States has been contracting. The rate of household savings stands at a historic low of 2 percent of GDP, and U.S. household debt has risen to 84 percent of GDP.

The picture for public and private savings is much brighter in Europe. The average budget deficit in EU countries is 2.6 percent of GDP—despite all the hand wringing when Germany and France exceeded the EU's 3-percent ceiling. Similarly, the pool of personal savings is much larger in the EU15 than in the United States. The average personal savings rate in Europe is 12 percent, and Europeans' household debt is 50 percent of GDP. As a result, domestic pressure on interest rates is less likely to threaten growth rates there.

Thus, the large recent gains in American productivity face multiple threats: from more resources being shifted to defense and security matters, from diminishing returns from female participation in the work force, from fewer gains being realized from incremental investments in IT equipment, and from upward pressures on interest rates. On all four fronts, the EU is in a stronger position: devoting fewer resources to defense and security programs and improving female access to jobs, while beginning to integrate IT into business processes and facing less upward pressures on interest rates.

One additional consideration, with complex implications on both sides of the Atlantic, is the current account deficit. The U.S. current account deficit is approaching a record-high 6 percent of GDP, as U.S. imports exceed U.S. exports by almost $600 billion this year. By contrast, the current account deficit is slightly positive throughout most of Europe; in fact, the eurozone now has larger total exports than the United States. This contrast is reflected in the relative value of their currencies: the dollar is down by 35 percent against the euro since 2002.

The falling U.S. dollar will have mixed effects on both U.S. and European economic growth. It will reduce the effective prices of U.S. exports but also increase the price of U.S. imports and create inflationary pressures on interest rates. (The Asian central banks, which are financing the current account deficit by buying U.S. Treasury bonds, will eventually demand higher interest rates to compensate them for the risks involved in holding U.S. dollar-denominated assets.) The stronger euro, meanwhile, will dampen the flow of European exports to the rest of the world, but it will also have positive effects on capital allocation and labor flexibility. European companies will push for more flexible labor policies at existing facilities, as Siemens recently did when it persuaded its main German union to add five hours to the workweek without additional pay. Under the Hartz reforms currently being implemented in Germany, the duration of unemployment benefits will drop from two or three years to one year for workers under 55 and to 18 months for workers 55 and older.

A FORK IN THE ROAD

On all fronts, the enlargement of the EU on May 1, 2004, represents a huge opportunity. The 75 million people in the EU10 can supply the population growth needed by western Europe, particularly an influx of younger workers to support the expanding base of retirees. The workers from the EU10 can also provide much-needed flexibility to the European labor market: they are prepared to relocate for jobs and willing to work long hours. The EU10's annual rate of productivity growth increased by 4.2 percent between 1995 and 2003—twice the annual rate increase in the United States and three times the annual rate increase in the EU15 in the same period.

Unfortunately, the EU15 countries, except for the United Kingdom and Ireland, have opted to bar immigrants from the EU10 for two years—with a high probability of renewing the ban for another three years after that. Although opposition to immigration from organized labor in the EU15 is understandable given high unemployment rates, it may ultimately backfire. If German and French firms need to build plants, they will have many reasons to build them in the EU10 instead of locally: more flexible labor, less expensive land, and lower taxes. Indeed, German and French firms may prefer the EU10 countries to locations in China or India for many types of outsourcing, thanks to lower shipping costs, lower tariffs, and better contractual enforcement under the EU legal system. (One bright spot in the immigration picture is that the United Kingdom and Germany have become increasingly popular destinations for graduate students, thanks in large part to stricter U.S. immigration policies. Many of these students will stay and contribute significantly to economic growth.)

The EU's enlargement has the potential to remove several of the historic drags on European economic growth: low fertility rates, declining support ratios, and ossified labor markets. On the other hand, if the EU15 cannot successfully integrate the EU10, it will face the continuing constraints of a stagnant population, an inflexible work force, and overhanging pension problems. Moreover, the social and political issues presented by workers moving from eastern to western Europe could raise new barriers to growth. Europe is thus at a key transition point; which road it will take remains to be seen.