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Comment on “The Lisbon National Reform Programs: New Ideas for Austria’s Economic Policy”

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1. Insufficient Growth in a Period of Buoyant World Demand

Economic growth in Europe has been disappointing over the past ten to fifteen years. In a period in which the world economy is growing at a rate between 4% and 5%, European growth is only about 2%. Cumulating the five years from 2002 to 2007 world output increased or is expected to increase by a steep of 25%, GDP of the EU-15 by a humble 8%. Three documents present recommendations for higher growth in Austria: Organisation for Economic Co-operation and Development (OECD) 2005, The National Lisbon Plan (2005) and Aiginger (2005).

2. The Country Report on Austria 2005

The latest report of the OECD on Austria stresses that “…. the Austrian economy is maintaining its position among the top performing European economies” – with some distance to the very best countries. The report then claims that the growth rate of Austria would still be higher if (i) obstacles for higher labor participation specifically for older workers would be removed, (ii) if productivity in services would increase faster and if (iii) the innovation system would not be “sub-optimal”.

I agree in principle with these recommendations, but would put the priorities differently. The main economic problem of Austria today is the underutilization of the existing labor force - as mirrored by an unemployment rate which is high in historical perspective and increasing (even if it is low in international comparison). The reason for unemployment is on the one hand the sluggish macroeconomic growth (which very much in parallel with the EU-15 is about 2%), combined with a rather steep increase of labor supply. Labor supply has increased about half a percentage per annum over the past years, and lately even by a full percentage point. These are extraordinary high growth rates, specifically for a period of sluggish demand. Adding up a labor productivity trend as of 2% (or a little below) to the given increase in labor supply gives a rate of growth of 2.5% as the benchmark to be surpassed for decreasing unemployment.

The OECD recommendation to make a better use of the existing labor force and specifically to remove obstacles for the elder to work, maybe a good recommendation in the long run, specifically in the time to come in which endogenous labor supply will decrease. In the short run however, forcing people to work longer and to start earlier will increase unemployment. Even higher increases in labor supply may raise per capita income marginally, but it will increase unemployment by a larger amount, since to some extent the older workers substitute the younger ones.

3. Does the Tail Wag the Dog?

The fundamental theoretical difference between the OECD point of view and my own is that the OECD believes in principle that increasing labor supply (L) leads to higher growth (Y) (higher labor supply causes higher Y), while I believe that higher growth of output and demand leads to higher employment (higher Y leads to higher labor demand). This difference replicates the old controversy whether the "output market dominates the labor market", or "the labor market dominates the output market". I acknowledge that there are periods in which the quantity of labor supplied is decisive for growth; this is specifically the case in periods of high demand. This is however not the situation of today. Even now a better qualified labor force will lead to higher growth. The main objective for economic policy today is to raise aggregate demand (by a growth oriented macroeconomic policy) and the medium-term growth path (by fostering innovation, education and intangible infrastructure). The medium-term growth rate is less than 2% in Europe, and about 3% in the US. Unemployment is higher, employment rate lower in Europe. The opposite was true in the seventies and eighties of the 20th century.

If we ask how to raise economic growth, than there are short-run strategies, like public deficits in periods of low demand, or medium-term strategies like smoothing consumption or increasing incentives for investments. In the long run growth theory tells us that the most important strategies are investing into research, education, lifelong learning and modern infrastructure. A necessary help should come from flexibilization of the labor market and of deregulation of product markets. However, flexibilization and deregulation will increase economic growth specifically more effectively in periods of increasing demand and if supported by pro active innovation policies.

Table: The Question of Causality

Position A:	Y (or ΔY) $\rightarrow L$ (or ΔL); Growth is necessary or at least helpful for employment	
Position B:	Y (or ΔY) $\leftarrow L$ (or ΔL); labor supply increases are sufficient for higher growth	
Synthesis:	(1) ΔY leads to ΔL; ΔY depends on growth drivers (K, R&D, H, TP) Macroeconomic stability, Trust, Institutions	
	(2) L supports Y; specifically upgrading skills, re-qualification, sometimes subsidizing wages (price of L)	
Qualifications:		
	(2) ΔL	more important if labour shortage exists; if qualifications are widely wrong (frictions, mismatch)
	(1) ΔY	more important if output demand is weak; if new technologies are underutilized; if other countries are climbing up the quality ladder, and threaten historical competitive advantages

Current European problem: $\Delta Y < [\Delta L + \text{technical progress}]$

4. How to Raise Economic Growth?

The recommendations of the OECD Report on Austria stress the importance of deregulation, specifically in the legal professions. This is an important issue, and there are chances to promote growth and employment by deregulation, by internal market programs, flexibilization etc. What is important however is that these policies usually have a considerable lag, and work far better in periods of growing demand. Or to say it more technically, flexibilization and deregulation is a necessary condition for higher growth but not a sufficient one. Pains precede gains; and the upfront disadvantages of deregulation are rather concentrated in some firms, regions and professions, while the advantages come later, are dispersed and benefit different groups (the more skilled employees). This does not mean that structural policies should not be followed, they are very important for long-term competitiveness. But they should be integrated into a broader strategy in which macroeconomic growth is stimulated by a growth and quality oriented fiscal policy and a balanced monetary policy. Secondly the technology driven potential growth should be supported by a pro active policy.

5. Following the "Paris Consensus": Soft on Innovation Policy

The current OECD report on Austria does not forget innovation and education totally. However, the recommendations about regulation and fiscal policy issues are very explicit and concrete. The recommendations in the innovation part are rather soft, relative to the recommendations in other parts. Let us repeat the headlines in the "Policy assessment box on innovation":

- Framework conditions for start ups should be improved
- Competition in product markets should be further encouraged
- The flexibility of the labor market should be raised
- Hurdles for the supply of risk capital should be raised
- Government support for innovation should be streamlined
- Secondary education should be reformed
- University reforms should proceed further

While these flexibility and competition increasing measures may always be advisable and necessary to increase economic growth, this is not a set of recommendation sufficient to boost research expenditures or investment into human capital in Europe to the extent needed to bridge the gap to the U.S.A. or to accelerate economic growth at any significant dimension. It reflects what I call the Paris Consensus on Economic Policy: "Let us liberalize and then wait for innovations and growth to come". The report however contains some useful home exercises for the economy in the waiting room.[1]

6. Lisbon Strategy Relaunched

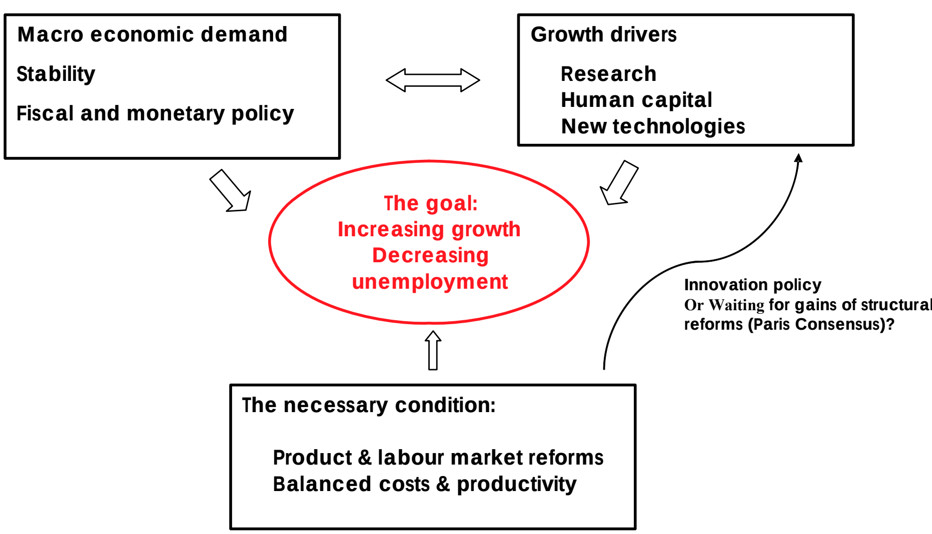
Growth enhancing policies are at the heart of the Lisbon Strategy of the European Union, a strategy which has lately been relaunched. The 2005 relaunch asks the individual countries to present their own National Lisbon Plans. Jürgen Janger accurately describes the priorities of the Austrian Lisbon plan. He criticizes that the

[1] The term OECD consensus on Economic policy has been labelled to my knowledge by David Dodge, the Governor of the Bank of Canada in a speech on March 13th (see internet label: http://www.banxico.org.mx/gPublicaciones/Seminarios/esp/dgie/estamacromer/DavidDodge.pdf). The consensus delineates four principles optimal for economic growth: Trade liberalization, structural reforms (flexibilization), fiscal prudence, and inflation control as priority for monetary policy. This strategy contains nothing about education, innovation, infrastructure; fiscal prudence is defined without reference to the quality of budgets, monetary policy without referring to the stabilizing component of monetary policy in a low growth/low inflation period. I am grateful to Andreas Wörgötter to provide me with the reference to the OECD consensus.

Austrian National Plan is analyzing past measures and initiatives more than presenting future goals or milestones to be achieved. I agree with Jürgen Janger that the chapter on the innovation strategy is the best one, since it contains the objective of a 3% R&D-expenditure rate in 2010 and it presents the institution to delineate the strategy, the instruments, and players. Similar strategies are lacking of education and life-long learning. Jürgen Janger furthermore collects innovative proposals in other countries reports, which could be relevant for Austria, too. Among them are a proactive competition policy, goals for tertiary attainment, specific allowances for firms giving research endowments to universities, strategies to combine work and child rearing and public sector reforms.

The recommendations of the OECD country report and the goals of the Lisbon strategies - those of Austria and of other countries - provide a set of strategies which may help to increase growth and employment in Austria. This needs a combination of strategies: (i) making the economy more flexible and more competitive, (ii) stabilizing macroeconomic demand and (iii) boosting new technologies and better qualifications, education and lifelong learning. These steps are required specifically in case labor supply increases by one percentage point per annum, and given that many of our neighbors are high growth economies with much lower incomes. A more detailed policy to enhance economic growth and employment is presented in Aiginger (2005). It contains seven sub-strategies: innovation, education, lifelong learning, modern infrastructure, labor market flexibilization and activation, headquarters and new firms and environmental technologies.

Chart: The Three Elements of a Growth Strategy



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