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Ricardo G. Barcelona

S. Ramakrishna Velamuri

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**IESE Business School – University of Navarra**

Av. Pearson, 21 – 08034 Barcelona, Spain. Tel.: (+34) 93 253 42 00 Fax: (+34) 93 253 43 43

Camino del Cerro del Águila, 3 (Ctra. de Castilla, km 5,180) – 28023 Madrid, Spain. Tel.: (+34) 91 357 08 09 Fax: (+34) 91 357 29 13

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# A EUROPEAN DILEMMA: THE TOUGH CHOICES TO GREATER ECONOMIC FREEDOM

Ricardo G. Barcelona\*

S. Ramakrishna Velamuri\*\*

## Abstract

The social and economic challenges facing the European Union in an increasingly integrated world have become more salient since the French and Dutch rejection of the European Constitution in 2005. In this essay, we explore the nature of these challenges and suggest three broad policy areas in which they can be tackled: proactive immigration policy, labor market regulation, and lowering of capital and entrepreneurial barriers.

\* Royal Dutch Schell

\*\* Profesor of Entrepreneurship, IESE

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## A EUROPEAN DILEMMA: THE TOUGH CHOICES TO GREATER ECONOMIC FREEDOM

The French and Dutch rejection of the European Constitution could conceivably usher in a more progressive Europe. European political tradition appears to favour a consensus that often sidesteps the difficult choices, in particular those relating to market liberalisation and competition. Such an approach to policy making (or policy tinkering) has had its day. Europeans have spoken, and politicians of all persuasions should not waste the opportunity this crisis offers to confront the task of making Europe's institutions fit for the twenty-first century.

The European journey towards establishing a cohesive market is seen by the British Prime Minister, Tony Blair, as a "political project with a strong and caring social dimension". To this he added that he "would never accept a Europe that was simply an economic market".<sup>1</sup> On the face of it, this position – of embracing only those market reforms that are consistent with social cohesion – is consistent with that of France and Germany. However, Blair's government has been pragmatic in applying this ideal to its policy making, so much so that it has been accused of having appropriated the Conservative Party's policy agenda in many areas. France and Germany, on the other hand, have found it difficult to allow their policymaking to move beyond their ideological commitment to social cohesion towards greater economic liberalization.

Years of corporate restructuring and market liberalization, particularly in telecommunications and energy, have improved consumer welfare in the United Kingdom, Spain, Scandinavian countries – and even in Germany and Portugal, which embraced liberalisation at a much later stage. These are successes that should be built upon. Otherwise, the benefits of liberalization may turn out to be another fleeting moment of prosperity, followed by persistent under-performance of Europe as a society.

Yet, the progress towards greater economic freedom over the past three decades has not always been matched by a similar development of political institutions in the European Union. Politics appears at best to be marred by intermittent brawls over budgets, subsidies, and protection of national interests, rather than attempting to advance Europe's interests in a global economic and political system.

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<sup>1</sup> Blair's vision for Europe wins praise of MEPs, *Financial Times*, June 24, 2005, p.1.

Tensions in the political sphere, such as disputes over the European budget, while important and requiring resolution, are often characterized by a narrow framing of the issues to suit particular national interests. Two such instances could be cited:

- **Social vs. Economic Europe** represents a false dichotomy, given that Europe's strong economic foundation is a necessary element to sustain its social and political integrity. By forcing a false choice, the vision of an economically strong Europe with a dynamic social and political agenda is turned into a battle between an Anglo and a Franco-German model of Europe.
- **Anachronistic funding approaches** encourage a view of the European Union as a "milking cow", whereby the ability to win subsidies is often the measure of a politician's effectiveness in European affairs – at least from the perspective of narrowly defined national interests.

Europe's challenge lies in modernising a political system that was perhaps a legacy of an emerging economic community. Consensus among a party of six may have worked in the early days, but the inefficiency inherent in a community of twelve already tested Europe's limits. Perhaps for this reason, European economic progress was achieved *in spite of*, rather than *as a result of*, its cumbersome institutional arrangements.

The fact that Europe continues to under-perform the United States (see **Table 1** for a US-Europe comparison) could be explained by its lagging performance in economic freedom. In this context, we contend that:

- Europe's ability to keep pace with the United States and the Asian Tigers in terms of economic growth depends on a political approach that sustains market liberalization, such that economic choices are largely the basis for allocation of social benefits.
- Fiscal burdens and regulation, where European countries broadly fail to make the grade, are indicative of the questionable sustainability of existing social programmes, which still need to catch up with the realities of the 21<sup>st</sup> century.
- Regional subsidies, while successful in spurring developments in such countries as Spain and Ireland in the past, may not on their own guarantee a more prosperous future for the poorer countries in Europe. Institutional reforms and development, consistent with a global economy, are what made Spain and Ireland successful.

The present feeling of deep crisis affecting Europe's political leadership could spur action to make the tough choices for Europe. Working towards greater economic freedom requires deep transformation of Europe's often ossified institutions. Without a crisis, attempts at modernising may suffer in the hands of a political leadership that is content with doing the minimum to satisfy narrow national interests.

In the face of a deepening, or even a "profound crisis",<sup>2</sup> the conditions for decisive action to modernize Europe's institutions may just have materialized. At the core of this debate, the progress towards greater economic freedom as the only means of maintaining social cohesion is the starting point – not the false choice between an *economic* or a *social* Europe.

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<sup>2</sup> Luxembourg Prime Minister Jean-Claude Juncker expressed this sentiment after the June 2005 European Union Council meeting, when the budget compromise failed.

**Table 1**

|   | US   | Europe  |
|---|--|---|
| GDP per capita (PPP):   | <b>\$38,093 (2003)</b>                                       | <b>\$27,535 (2003) [EU-15]</b><br>In 2003 the EU-15 lagged the United States by 29 percent in per capita income. For the EU as a whole, the gap in per capita income relative to the US was in the range of 27 to 29 percent between 1990 and 2003. |
| Economic growth:  | <b>2.2% (2002)</b><br><b>3.1% (2003)</b>                     | <b>1.1% (2002) [E-25]</b><br><b>0.8% (2003) [E-25]</b>  |
| Labor Productivity:   | <b>20.7% higher in the US than in Europe (EU-15 average)</b> |   |
| Number of new companies as a Percentage of existing companies:  | <b>11.4%</b>   | <b>9.9% [E-15]</b>  |
| Number of high-growth companies as a percentage of all mid-sized companies:                                       | <b>19%</b>   | <b>4% [E-6]</b>   |
| Nascent Entrepreneurs per 100 adults  | <b>7.05%</b>   | <b>3.44% [E-14]</b>   |
| Entrepreneurship Education and Funding (Average Endowments):  | <b>6 million €</b>   | <b>1 million €</b>  |
| Venture Capital per capita (excl. MBOs):  | <b>290 €</b>   | <b>70 €</b>   |
| From Bankruptcy to Start-up – Length of time in years that creditors still have claims on a bankrupt's assets:    | <b>1</b>   | <b>8.5 [E-12]</b>   |
| Taxation on Business Disposal – Tax rate on sale of small “model” company, based on percentage of wealth created: | <b>9.9%</b>  | <b>18.1% [E-15]</b>   |
| Employment growth:  | <b>0.9% (2003)</b>   | <b>0.2% (2003)</b>  |
| Unemployment rate:  | <b>6.0% (2003)</b>   | <b>8.1% (2003) [E-15]</b><br><b>9.1% (2003) [E-25]</b>  |
| R&D Expenditure in % of GDP:  | <b>2.80% (2001)</b>  | <b>1.98% (2001) [E-15]</b><br><b>1.99% (2002) [E-15]</b>  |
| Number of patents:  | <b>34.3% of all patents</b>                                  | <b>31.4% of all patents</b>   |
| USPTO / EPO 1991:   | <b>107,039 patents</b>                                       | <b>60,104 patents</b>   |
| USPTO / EPO 2000:   | <b>179,658 patents</b>                                       | <b>109,609 patents</b>  |
| Number of high-tech patents per million inhabitants in 2000:  | <b>49*</b>   | <b>30*</b>  |
| Score Innovation Capacity Index 02/03: (Highly correlated with GDP per capita: R <sup>2</sup> =0.8289)            | <b>6.6</b>   | <b>E-15-Average: 4.0</b>  |
| Belief that Entrepreneurship cannot be taught (2002) on a scale 0-10 (with 10= strong):                           | <b>4.5</b>   | <b>5.3</b>  |

Source: Velamuri and Sosna (2005).

## Why economic freedom and choices?

Classical economists such as Adam Smith envisioned a world founded on trade and comparative advantage to create economic choices aimed at achieving mutual prosperity. The *invisible hand* of the market would direct resources where returns are commensurate to risks. Over time, as returns in developed economies decline, partly because of slowing markets, rising costs, lower risks, and abundance of capital, resources should move to the developing economies as a self-adjusting mechanism. That is as far as the theory goes... and yet, the growing gap between rich and poor economies over the past two decades appears to contradict this.

Political institutions, however, may unknowingly conspire to frustrate the mobility and deployment of resources. Milton Friedman,<sup>3</sup> 1976 Nobel Prize winner for economics, eloquently articulated the “historical evidence that speaks with a single voice on the relation between political freedom and a free market”. He further asserted that he “knows of no example in time or place of a society that has been marked by a large measure of political freedom, and that has not also used something comparable to a free market to organize the bulk of economic activity”.<sup>4</sup>

In a study on the economic freedom of the world,<sup>5</sup> a group of renowned academics examined the objective data comprising 38 indicators on 99 countries from 1980 to 2000. A number of their findings support Friedman’s contention. To highlight:

- Long-term differences in institutional quality, as indicated by institutions and policies consistent with economic freedom, account for more than 75% of inter-country variations in per capita income.
- Various measures of investment flows and levels are positively influenced by variations in each country’s economic freedom index measure. A unit increase in economic freedom measure translated into a 1.25% point rise in long-term growth.
- Contrary to classical economic theory on economic convergence, poor countries with low ratings on economic freedom performed worse than those with high ratings on economic freedom.
- Soundness and predictability of legal protection of property rights is seen as essential for prosperity.

Gwartney and Lawson<sup>6</sup> contend that without the “legal protection of private property, the incentive of individuals to develop productive resources and engage in entrepreneurial activities is eroded. Correspondingly, without the enforcement of contracts, trade and the accompanying realization of gains from division of labour and specialization are stifled”.

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<sup>3</sup> Milton Friedman, *Capitalism and Freedom*, University of Chicago Press, 1962.

<sup>4</sup> Ibid.

<sup>5</sup> James D. Gwartney and Robert A. Lawson, “What Have We Learned from the Measurement of Economic Freedom”, a paper presented at the conference “The Legacy of Milton and Rose Friedman’s *Free to Choose: Economic Liberalism at the turn of the Twenty First Century*”, sponsored by the Federal Reserve Bank of Dallas, October 22-24, 2003.

<sup>6</sup> Ibid., James D. Gwartney and Robert A. Lawson.

Based on its economic performance to date, China may be seen as an exception. While lagging in economic freedom measures, China still managed to deliver in excess of 9% p.a. in GDP growth. The big picture probably belies the highly imbalanced patterns of growth and prosperity. The coastal provinces of Shanghai, Fujian and Guangzhou, for instance, are the main drivers of high growth in China. This contrasts with the stagnation experienced in a number of rural areas that may not have benefited from a capitalist economic system that operates in the high growth areas. This enigma will undoubtedly continue to be debated well into the future, with the jury still out on the sustainability of China's dichotomy of a broadly capitalistic economic system operating under the close scrutiny of a totalitarian political control.

Milton Friedman's observation is reinforced by the findings of the 2005 Index of Economic Freedom.<sup>7</sup> The survey rates 161 countries according to "ten broad factors of economic freedom",<sup>8</sup> with low scores representing higher degrees of economic freedom. Such freedom is measured by the degree of government interference in the economy, either as a direct player or through its influence and regulation.

The correlation between the economic freedom index and the level of prosperity is strong. Countries pursuing economic policies that tend to be "protectionist" tend to have policies that are considered "repressive" or "mostly unfree" in terms of economic freedom. That is, protection often manifests itself by subsidising or favouring "national champions" at the expense of globally competitive industries. As a result, the basis of economic rewards is skewed towards political patronage, rather than a differentiation in economic performance.

In contrast, countries that pursue open economic policies tend to be more prosperous in both economic and social terms. Marc A. Miles<sup>9</sup> may have provided the underlying reasons for such advantage: "Economic freedom is about people. It is about individuals' chances of achieving their goals and satisfying their needs". And he adds, "the more economically free a country is, the higher these chances are".

A study conducted at the Pew Research Center for the People and the Press (see Table 2) indicates that while people in both North America and Europe are broadly in favour of the free market system (Item 1 in Table), they differ substantially in their attitudes regarding what causes individual success (Item 2) and what the role of government in society ought to be (Item 3).

Perhaps, this is where the debate for Europe's future should be framed. Economic freedom depends on people's resilience and ability to pursue their goals, with the government's role being to create an environment in which people's chances of achieving their goals are enhanced. The results of the Pew study presented above are consistent with the deep-rooted concept of the welfare state in Europe, where citizens look to the state to provide basic minimums, such as free healthcare, free education, and job security. The issue is not so much whether this conception of the role of the state is "good" or "bad" in any absolute sense; rather, the issue is whether this conception is consistent with a more and more economically integrated world.

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<sup>7</sup> 2005 Index of Economic Freedom, published by The Heritage Foundation and Dow Jones & Co., United States, 2005.

<sup>8</sup> Ibid.

<sup>9</sup> Ibid., Chapter 1, p. 21.

## Table 2

Attitudes in North America and Western Europe

|  | USA | Canada | Britain | France | Italy | Germany |
|--|-----|--------|---------|--------|-------|---------|
| 1. Most people are better off in a free market economy, even though some people are rich and some are poor   |     |        |         |        |       |         |
| Completely / mostly agree  | 72  | 61     | 66      | 61     | 71    | 69      |
| Completely / mostly disagree   | 21  | 33     | 27      | 35     | 18    | 29      |
|  | USA | Canada | Britain | France | Italy | Germany |
| 2. Success in life is pretty much determined by forces outside our control   |     |        |         |        |       |         |
| Completely / mostly agree  | 32  | 35     | 48      | 54     | 66    | 68      |
| Completely / mostly disagree   | 65  | 63     | 48      | 44     | 31    | 31      |
| 3. What is more important in your society – that everyone be free to pursue their life's goals without interference from the state or government, OR that the state or government play an active role in society so as to guarantee that nobody is in need |     |        |         |        |       |         |
| Free from interference from state  | 58  | 43     | 33      | 36     | 24    | 39      |
| State guarantee nobody in need   | 34  | 52     | 62      | 62     | 71    | 57      |

Source: Pew Global Attitudes Project, 44 Nation Major Survey, 2002.

We pose the question: Is Europe's economic and social well-being safer in the hands of interventionist governments, or with people that assume greater responsibility for their own welfare within a supportive political framework?

## A very European dilemma

The discourse that forces a false choice between an *economic* or a *social* Europe may have originated in a different view of the role of government. The aftermath of the Second World War found Europe so devastated that a massive Marshall Plan was needed to ensure its survival. Perhaps, and not surprisingly, the significant role of government as the principal source of investment and funding was perpetuated well beyond the completion of the Marshall Plan.

What followed is a European Union, in its various manifestations, that somehow persisted in seeing the government's role as being the *financier of first resort* – from subsidising farming and promoting regional development to protecting national industries, among others. Not having weaned themselves from dependence, the “national” champions dwindled or were cast into oblivion by competition from outside Europe.

The squabble over money is an interesting sideshow that appears to have stolen the show. Without a framework to transcend Europe's narrow interests, budget disputes and claims on subsidies may leave the European Union lurching from one crisis to the next.



This unsatisfactory state of affairs highlights Europe's tendency to persist in an interventionist model of government and betrays a distrust of market forces. Here are a few examples:

- Two items account for the bulk of the European Union's €100 bln budget: almost 50% goes to funding the Common Agricultural Policy (CAP), and a further 33% to regional aid.
- Given the lack of transparency, some suspect that CAP funding benefits large agricultural businesses, in contrast to the idyllic view, preferred by some politicians, that it protects Europe's poor farmers from global competition.
- The British rebate, a sum equivalent to 66% of its net contributions to EU budget and receipts from the CAP, started as a means of balancing the burdens of membership given the small farming sector in the United Kingdom, as compared to France.

In all of these broad categories of the annual EU budgetary process, there appears to be an unsustainable yet predictable outcome: to the victors go the spoils.

Seen from the perspective of economic freedom, Europe's dilemma appears to be a question of how far governments can put their trust in the markets and their citizens' and firms' ability to come up with creative responses to competitive pressures. That is, can European politicians trust the markets and focus instead on their principal task of creating a more supportive institutional framework?

## Confronting Europe's challenges

Unlike many developing countries, Europe starts from a position of strength, given its relatively stronger institutions, an educated and skilled workforce, excellent infrastructure, and a large number of dynamic small, medium and large enterprises.

A view of Europe's place in a tri-polar world – broadly comprising the United States, Europe and Asia, dominated by the United States as the centre of gravity – is a starting point. Europe could position itself as a thriving centre for technological innovations and entrepreneurship. Both qualities build on strengths of the European economy that are often ignored, given that political initiatives seek to promote national champions, which often wither away in the face of global competition.

What socio-economic paradigms is Europe likely to confront in the next two decades? We offer the following possibilities:

- A globally competitive economy where the rate of change in technology and knowledge is more customized and dynamic. This requires flexibility in infrastructures, capital flows and attraction of talent in an increasingly borderless world.
- The gaps between rich and poor are unlikely to be bridged through aid and debt forgiveness. Trade and immigration, conducted equitably, are likely to counter the rising threats of terrorism to the continued wellbeing of the developed world.
- Market cohesion could invariably transfer the choices, and how these choices are made, to the economic agents – further diminishing the omnipresence of the state.

Seen from this perspective, Europe's ability to continue to prosper would increasingly depend on its ability to attract and retain talent. Such talent is likely to flourish in an environment where it is given the institutional support to enhance its chances of success. In our view, this is underpinned by greater economic freedom, not through its erosion by governments that expropriate the fruits of labour and entrepreneurship through their power of taxation, regulation and market interventions.

In practical terms, how could Europe enhance its attractiveness as a destination for capital and labour, in order to secure its rightful place in this tri-polar world? We propose the following policy areas as the focus:

## Proactive immigration policy

This policy targets high human capital immigrants that bring with them a rich source of talent, expertise and a significant capacity to contribute to their new home countries. Such a globally mobile talent pool is likely to gravitate to areas with a friendly environment that gives immigrants a chance to be fully contributing to their adopted society. The experience of Asian immigrants (mainly Chinese and Indian) in California is a case in point. Academic institutions of excellence, which abound in Europe, can serve as the portals of entry for these high human capital immigrants.

The fears surrounding immigration often prove unfounded. The supposed adverse impact of immigration on Europe, painted in terms of an invasion by unwanted foreigners, regularly fails to materialize. On the contrary, immigration often eases skills shortages and helps to kick-start a phase of greater economic dynamism and renewal.

## Labour market flexibility

Europe's protection of labour appears to be consistent with the European expectation that government should play an active role in ensuring that nobody is left in need. This welfare state attitude may have inadvertently contributed to the rigidity of labour legislation that causes Europe to lag US productivity by 20.7%, employment at a quarter of US growth, and a significantly higher unemployment rate.

Perhaps this is the irony of European labour protection. As markets become more protective, governments succeed merely in bestowing their benefits on the shrinking pool of gainfully employed. The experience of highly protective Germany, with one of Europe's highest unemployment rates, contrasts sharply with the *free market* United Kingdom.

## Lowering of capital and entrepreneurial barriers

Market liberalization has eased a number of the barriers to capital access and business formation. Taxation and the bureaucracy relating to creditor protection, patents and funding of new ventures remain as areas for further rationalization.

The tension between trusting in market forces to deploy resources and the government penchant for intervention is often manifested in taxation. Higher taxes are indicative of a

government's perceived need to be seen as the arbiter of resource allocation for the common good – a precept that often translates into an omnipresence of government in socio-economic activities that are better undertaken by the private sector.

A more open market provides access to trade in goods and services. This is where both Europe and the US could play a significant role in forging stronger economic ties with the developing economies on a more equitable basis. Trade is a source of mutual prosperity that could arguably sustain global development. This strikes at the heart of terrorism, which often is born out of perceived exclusion and injustice, among other things.

Public-private initiatives take on a new meaning in the context of tackling the tough choices to greater economic freedom. While the challenge of transforming Europe's ossified institutions appears formidable, the ability of private enterprise to rise to the challenge cannot be underestimated, particularly in times of "great crisis".

In our view, enlightened government facilitates the creation of an institutional framework that enhances economic freedom. The private sector, for its part, pursues activities that are beneficial to all its stakeholders. In such a partnership, public-private initiatives may just prove to be the enduring glue that makes economic and social cohesion feasible – in Europe and globally.

- \* Ricardo G. Barcelona is with a major energy company in The Hague, The Netherlands. His extensive experience includes competition policies, restructuring, privatization and regulatory issues. He was consistently voted as a top rated analyst and adviser to European utilities whilst serving from 1993 to 2000, first, as Executive Director at UBS Warburg and, subsequently, as Director and Global Head, Power, Gas and Water Utilities at ABN AMRO in London, United Kingdom. He obtained his MBA from IESE Business School, University of Navarra, and his BA in Economics from the University of the Philippines.
- \*\* S. Ramakrishna Velamuri is Professor at IESE Business School. His research on entrepreneurship, high growth firms, and business ethics has been published in academic and practitioner publications. Prior to joining academe, he worked for six years in the formulation and implementation of the European strategy of one of Spain's largest manufacturing companies, and for eight years as a management consultant. He obtained his MBA from IESE Business School, and his PhD from the Darden Graduate School of Business at the University of Virginia.