Economics focus

Closing the growth gap
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A theory to explain why Europe has fallen behind America, and how it might catch up

IN THE past ten years, the economies of what is now the euro area have grown by around 2% a year. America has managed a full percentage point more. Lots of reasonable explanations of the gap are on offer: America has freer markets than Europe; it is better at finding and using new technology; its fiscal and monetary policies have been more supportive of growth; and so forth.

You might expect such explanations, and a bundle of policy recommendations, to tumble out of theories of growth—the branch of economics concerned with the medium- and long-term fortunes of economies. You'd be disappointed. Growth theory is good at explaining why rich countries are rich and poor ones poor, but much less so at divining why some rich countries (eg, America) grow faster than others (eg, much of Europe) and telling the laggards how to catch up.

A recent paper* by Philippe Aghion, of Harvard University, and Peter Howitt, of Brown University, attempts to fill the spaces between fact, theory and policy. One branch of theory emphasises the role of capital accumulation in generating growth: save more, is the implication. This might help to explain why, say, East Asia sped past Latin America in the last part of the 20th century, but not why Europe has been trailing America: Europe, after all, has a higher saving rate. Another line of thought holds that good “institutions”—the rule of law and all that—are essential. This can account for much of the chasm between rich and poor, but not the fine variations among rich countries with sound legal and political systems. A third angle identifies innovation as the fuel for economic advance. Messrs Aghion and Howitt argue that models of this type have hitherto had little to say about how economic laggards catch up and then keep up (or not) with the latest technology—and thus about why Europe, having grown faster than America for 30 years after the second world war, stopped closing the gap and fell farther behind.

Technological advance, though, is at the core of their own approach. In essence, a given industry in a given country can use either the best technology available or an older, less efficient version. In countries already at the cutting edge, innovation is the source of growth. Those not at the frontier advance by implementing existing, but still better, methods of production.

From this, two observations follow. The first is that the institutions and policies best suited to countries at the leading edge need not be the right ones in less advanced places. Education, say Messrs Aghion and Howitt, is a case in point. The closer a country is to the technological frontier, the more growth depends on having a highly educated workforce. Further back from the frontier, education still matters; but university degrees matter relatively less and good primary and secondary education count for relatively more. Evidence from different countries and from American states appears to bear this out. And what does this imply for the transatlantic growth gap? America spends around 3% of its GDP on tertiary education; the European Union only 1.4%. More than a third of Americans have degrees; fewer than a quarter of Europeans do. Against that,
many EU countries are considered to have stronger secondary education than America does. Europe may therefore have been well equipped for its post-war decades of chasing the United States, but did not adopt the policies needed to push back the technological limits.

The second observation is that, whereas most theories of growth laud the accumulation of capital, it is sometimes good to see it destroyed. Growth is likely to be higher if markets are open to new entrants, which either drive less efficient incumbents out of business or scare others into investing, updating their technology and seeing off the raiders. Again, this is likely to matter more the closer countries are to the limits of technology. And again, the destructive process appears to have a freer rein in America than in Europe. For example, say the authors, half of all America's new pharmaceutical products are introduced by firms less than ten years old; the proportion in the EU is only 10%.

**Budgeting for growth**

More controversially, Messrs Aghion and Howitt also turn their attention to macroeconomic policy. Most economists think that budgets and interest rates ought to be geared mainly to the short-run course of the economy. Not necessarily so, say the authors: countercyclical budgetary policy can be aimed at long-term growth, and the case is stronger in Europe than in America.

If capital markets are well developed, they argue, sound companies can borrow to tide them over in recessions; if those markets are thin, good businesses will sink. And where capital markets are less well-developed, policies that dampen the business cycle can help more good firms to survive. Econometric tests suggest that well-targeted fiscal policy—investment, rather than government consumption—might work. Because Europe's capital markets are less deep than America's (its ratio of private credit to GDP, for example, is much lower), budgetary policy ought to lean against the cycle more in Europe than in America. In recent years, however, the opposite has been true.

When Mr Aghion proposed this idea last month, at the annual conference of the Centre for Economic Policy Research and the European Summer Institute in Frankfurt, he met a fair bit of scepticism. It is easy to see why. Countercyclical policy is much harder to get right on purpose than by accident. And, as one economist there remarked, America's growth rate has actually been more volatile than Europe's—implying that Europe has less need to smooth out cycles to encourage growth. Still, Mr Aghion and Mr Howitt have produced some provocative research. More—and more arguments—will surely follow.


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