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# EconomicLetter

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FEDERAL RESERVE BANK OF DALLAS

*As technology and freer trade integrate economies, the European Union stands at a policy crossroads. Two conflicting strategies of integration are facing off to see which will guide Europe's future.*

## Integration and Globalization:

### *The European Bellwether*

by Jason L. Saving

The European Union owes its very existence to the economic integration that defines today's increasingly global economy. From the ashes of World War II, six core European nations forged a coal-and-steel community designed to foster industrial competitiveness. Over time, the nations realized that a common market would best promote European growth, and the mission gradually broadened to include the general goal of ever-closer union.

Successive waves of integration raised membership to 15 countries a decade ago, then to 25 today, with Turkey and several other nations eager to join in the near future (*see map*). Along the way, Europe has seen significant increases in its standard of living as it became economically freer and more integrated.



Creating a common market has brought benefits. At the same time, it has meant exposure to worldwide competition, which creates difficulties for nations with high taxes and inflexible labor markets. EU members maintain less competitive economic policies than the United States, and globalization has exacerbated the consequences of these policies for their economies. Some analysts question

whether further economic liberalization offers the best path to future prosperity, advocating instead greater policy coordination to bring taxes, regulations and other measures into even closer alignment.

Should EU members integrate their economies in a way that resists global economic pressures? Or should they embrace globalization through greater economic freedom, with each

nation vying to compete effectively in the world economy? As technology and freer trade integrate economies, the EU stands at a policy crossroads. Two conflicting strategies of integration are facing off to see which will guide Europe's future. The stakes are nothing less than the continued advance of globalization and its consequences for national and regional economies.

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## Integration's Costs and Benefits

Economic integration is the process through which nations lessen the economic significance of their borders. It can take the form of pacts—such as the North American Free Trade Agreement and the World Trade Organization—that reduce tariffs and other barriers, letting goods and services move more freely. It can take the form of investor protections that foster capital mobility or visa programs that help firms find willing workers. When goods, services, capital and labor can move to where they are most efficiently employed, economies can grow at faster rates than they otherwise could.<sup>1</sup>

But increasing mobility for goods, labor and capital entails greater exposure to global economic pressures. When nations in a common market choose different labor policies, for example, those who receive government benefits have an incentive to move from less generous nations to more generous ones. When tax policies differ, workers and businesses have an incentive to move from high-tax nations to low-tax ones.<sup>2</sup> High-tax, high-benefit nations find themselves in a squeeze, simultaneously facing increases in the amount they must spend and reductions in the tax revenue available to meet their obligations. The more economically integrated the world, the greater this penalty becomes because firms, workers and capital can search for greener pastures more readily than ever before.

Does this apply to Europe? Let's look at the competitiveness of Europe's 15-nation core compared with the U.S. (*Chart 1*). The Fraser Institute compiles an annual ranking of economic freedom, based on such factors as size of government, legal structure and security of property rights, access to sound money, freedom to exchange with foreigners, and regulation of credit, labor and business. The latest readings show that the United States eclipses any current EU member. Past years also reflect this pattern. While some economists may question the

precise placement of particular countries, few would dispute the overall conclusion that Europe's economy is less free than the United States'.

The consequences are evident in broad measures of economic performance. Over the past decade, for example, the U.S. economy has grown at an annual rate of 3 percent—relatively healthy by postwar standards (*Chart 2*). In contrast, the EU has grown by barely 2 percent a year, a rate disappointing to economists and policymakers alike. The U.S. doesn't grow faster than every European nation in every year, but it does better than most EU members most of the time.

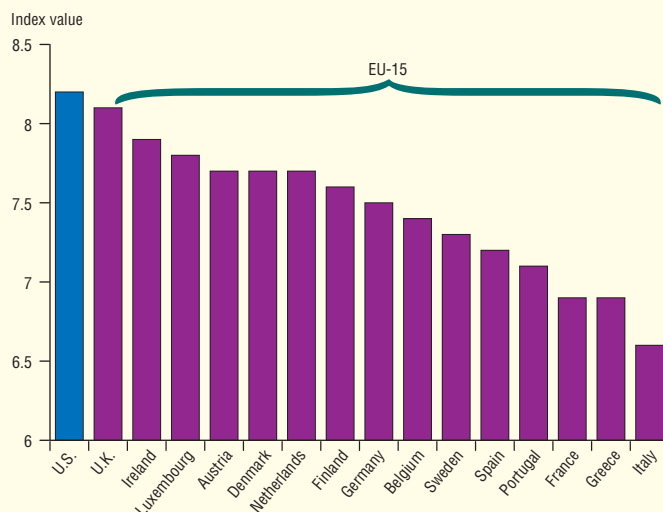
The unemployment rate also shows America's edge in economic performance. In the U.S., it has hovered around 5 percent for most of the decade, a rate many economists consider close to full employment (*Chart 3*). In contrast, Europe's relatively inflexible labor markets have pro-

*Increasing mobility for goods, labor and capital entails greater exposure to global economic pressures.*

Chart 1

### EU Economies Trail in Economic Freedom

*U.S. and EU-15 economic freedom*

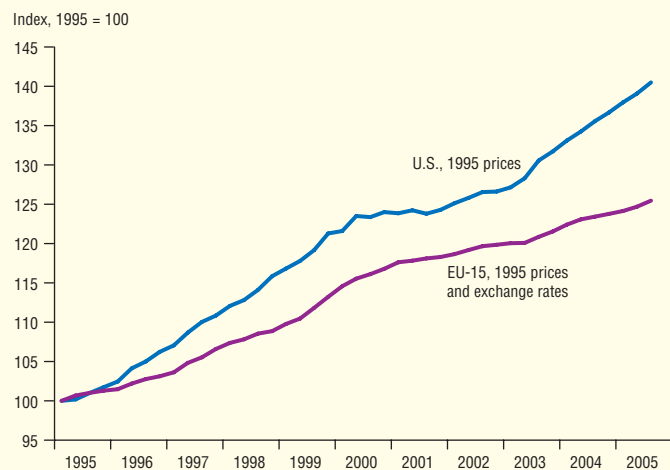


SOURCE: The Fraser Institute.



## Chart 2 EU Has Relatively Low Growth

*U.S. and EU-15 real output*



SOURCE: Organization for Economic Cooperation and Development.

duced an unemployment rate 3 to 5 percentage points higher. Unemployment rates in France and Germany remain around 10 percent, despite several initiatives over the past few years to deal with the issue.

Perhaps the single most telling statistic is productivity—the amount of output per hour worked. Largely dependent on the extent to which government policies foster a dynamic economy, productivity has grown by roughly 2.5 percent annually in the U.S. over the past decade but only 1.4 percent in Europe (*Chart 4*).

It has not always been so. In the heady days of postwar reconstruction and the formation of the common market, some economists spoke of a permanent productivity advantage for Europe. Now, an emerging consensus holds that labor and tax policies have combined with the relatively sluggish introduction of new technologies to produce a sustained productivity deficit for the European economies.

Commentators may point to the current economic performance of France and Germany as proof of the “Eurosclerosis” that besets the continent’s major economies, but a snapshot in time can’t tell the whole story of economic fundamentals or future prospects. It is the sustained differences that suggest something more fundamental—namely, a gap in competitiveness—has been at work here.

### Globalization and Growth

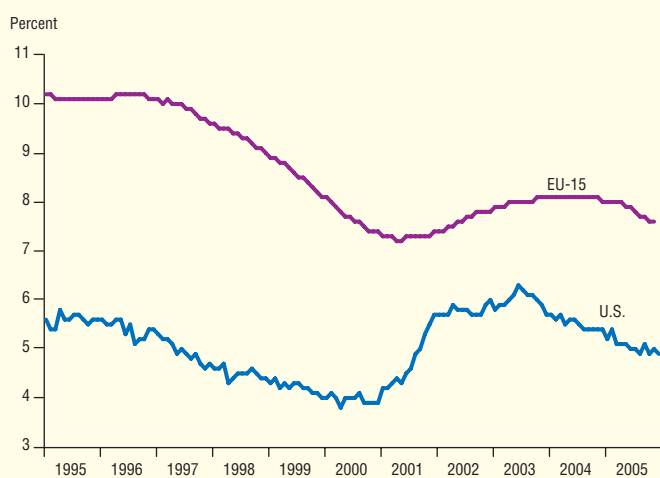
Europe once kept pace with the United States. Tracking GDP back to the early 1970s shows that Europe managed to keep up with the U.S. until diverging markedly in the 1980s (*Chart 5*). This raises an interesting question. If more competitive economic policies enabled the U.S. to outperform Europe in the 1980s and 1990s, why didn’t they also enable us to outperform Europe before then?

The answer boils down to one word: globalization.

In earlier decades, the world simply wasn’t as global as it is today. The

## Chart 3 EU Has Relatively High Unemployment

*U.S. and EU-15 unemployment*



SOURCES: Bureau of Labor Statistics (U.S.), EuroStat (EU).



consequences of high taxes and inflexible labor markets weren't especially severe in the low-tech, low-mobility 1960s and 1970s. As globalization heated up in the 1980s and 1990s, the cost of these policy decisions—in lost output, slower job creation and forgone productivity—became plain for all to see.

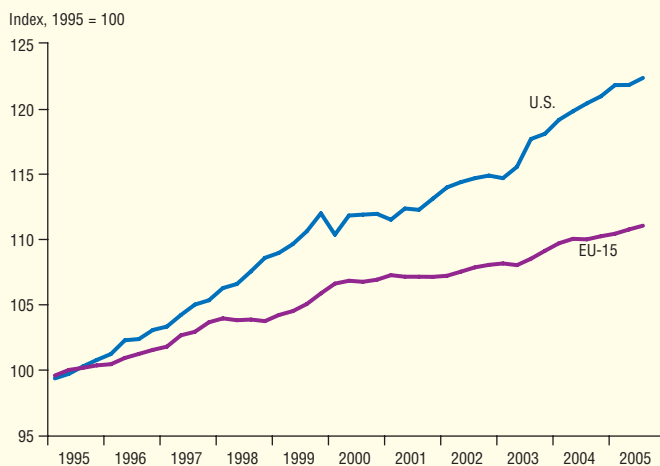
Empirical evidence supports this globalization story. The U.S. leads all 25 EU members in the Harvard Business School rankings of national policies that foster innovation (*Chart 6A*). The entire EU, on the other hand, does worse than the U.S. on the World Bank's measure of labor-market policies that inhibit growth (*Chart 6B*). Business-climate indicators paint a similar picture: For example, an entrepreneur can create a new U.S. firm in five days, but it requires an average of 37 days to start one in the EU. Such data indicate the U.S. should participate more fully in the global economy, and a globalization index devised by A.T. Kearney and *Foreign Policy* magazine does indeed show the U.S. ahead of all but one EU member (*Chart 6C*).

The underlying message is as simple as it is accurate: Nations that offer more competitive economic environments will reap greater benefits from a more open world economy.

Globalization places a premium on economic freedom and gives nations greater incentive to engage in policy competition aimed at liberalizing their economies. But some worry that policy competition has gone too far. A recent report from the Organization for Economic Cooperation and Development, for example, concludes that the developed world should eliminate the "harmful tax competition" that tempts firms to move in search of better business climates. A few months ago, the finance minister of Germany's new coalition government echoed this concern when he urged the 10 newest EU members to raise taxes in the name of fairness.

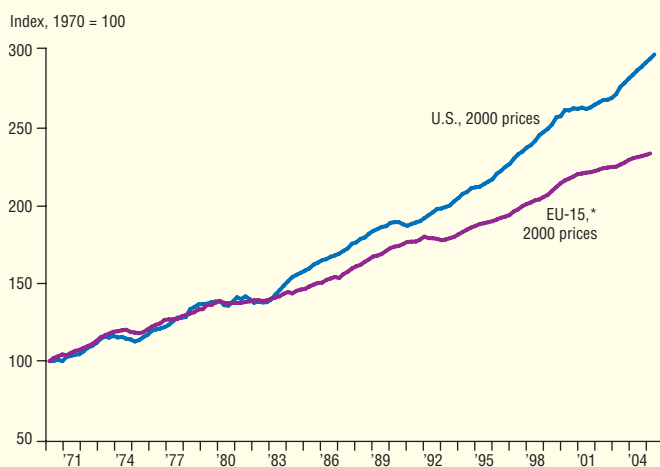
Can economics contemplate a means to thwart cross-border policy

**Chart 4**  
**EU Has Low Productivity Growth**  
*U.S. and EU-15 productivity*



SOURCES: Bureau of Economic Analysis (U.S.); Statistical Office of European Communities (EU); Haver Analytics.

**Chart 5**  
**Europe Didn't Always Lag the U.S.**  
*U.S. and EU-15 real output*

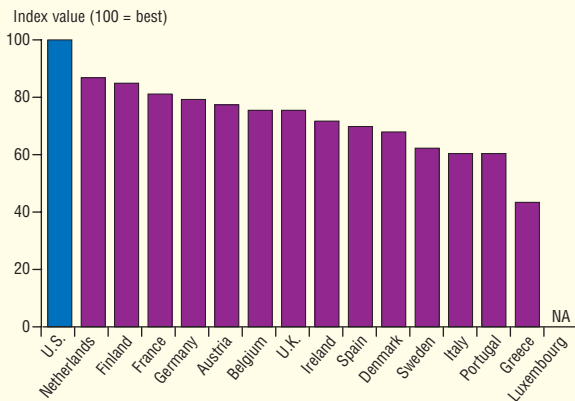


\*Purchasing power parity.  
SOURCE: Organization for Economic Cooperation and Development.



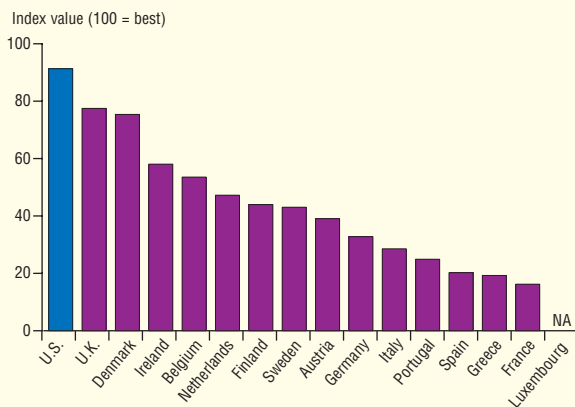
## Chart 6 U.S. Bests EU in Globalization

### A. Innovation Policy Index



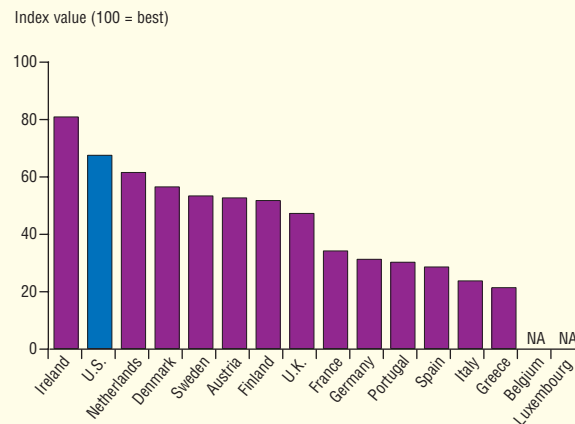
SOURCE: Harvard Business School.

### B. Labor Rigidity Index



SOURCE: The World Bank.

### C. Globalization Index



SOURCE: A.T. Kearney.

competition? Yes. A federation could impose minimum tax rates and labor standards—or even mandate a single set of tax rates and labor standards—so no nation could “unfairly” undercut another and “poach” workers and businesses.<sup>3</sup> Under this view, Europe would need an integration that discourages rather than encourages further liberalization.

At times, the EU has done exactly that. In the mid-1990s, Sweden had to raise its farm subsidies as a condition for EU entry. In early 2004, the EU forced the Czech Republic to adopt labor-market regulations the country deemed onerous. And in January 2006, Poland fought a pitched battle with European leaders to keep its tax rates below what EU leaders wanted. In each case, countries shared the goal of binding economies together but diverged over the terms.

Some analysts have cast the great continental debate as a contest between Europhiles desperate to bind EU countries together and Euroskeptics determined to maintain national sovereignty. But integration per se need not be the issue. After all, a uniformly low-tax Europe with flexible labor markets would be just as integrated as a Europe with uniformly high tax rates and inflexible labor markets. The key question centers on the kind of integration Europe ought to undertake. Should it pursue an integration that fosters free markets and the economic growth they bring, or should it pursue an integration in which member states band together to resist the economic consequences of high taxes and heavily regulated labor markets in a global era?

### What Will the Future Hold?

What are the prospects for further liberalization? Last year, the EU considered a proposal for free trade in services. With goods now accounting for a dwindling portion of the EU economy, free trade in services would seem a logical step for a federation dedicated to providing a common market across Europe. Yet, the specter of increased



competition from Eastern Europe's cheap labor undermined public support. Bowing to opposition in several countries, the EU adopted only minimal changes in its services trade policies. More recently, a months-long drama featuring massive street protests forced the French government to withdraw a proposal to increase labor market flexibility with a probationary employment period during which young workers would enjoy fewer benefits and less job security.

These incidents are balanced by signs favorable to reform. Current European Commission President José Manuel Barroso has spoken movingly of the need for Europe to further liberalize its economy to better compete in the global marketplace. And to give just one example where this is happening, Germany has renegotiated labor contracts in a few high-cost sectors and has discussed limiting labor's historic influence over corporate strategy. These and other events within the EU suggest Europe's future policy direction is far from decided.

The EU stands at a crossroads as it debates further economic liberalization. Some EU members wish to preserve and even expand Europe's social protections, so that workers can have much-needed security in an era of ever-more-rapid change. Other EU members want Europe's economy to become more flexible, so that economic growth can equal and perhaps even exceed that of the U.S.

Europe can't simultaneously satisfy these competing visions. Either the EU must liberalize its economy to compete in a globalized world, knowing its workers will have to retrain faster—and become more highly educated—than ever before. Or EU nations can band together to resist further liberalization, knowing that unemployment will become more prevalent and economic growth will remain slow.

The European Union has a clear choice, but the challenge of globalization is an issue for every economic entity on every continent, including

the United States. U.S. labor markets may be somewhat more flexible than Europe's, and the U.S. economy somewhat more open. But make no mistake: In areas ranging from steel to softwood lumber to clothing to autos, the U.S. faces pressure to ward off globalization rather than embrace it.

With technologies knitting economies closer and policies aligned toward openness, globalization has advanced steadily in the postwar era. Future policy choices in the European Union, United States and other entities will determine whether the world continues its progress toward increasing economic integration.

*Saving is a senior economist in the Research Department of the Federal Reserve Bank of Dallas.*

#### Notes

<sup>1</sup> See *International Economics: Theory and Policy*, by Paul R. Krugman and Maurice Obstfeld, 7th ed., Addison-Wesley, 2005, for an overview of this and other economic issues relevant to the global economy.

<sup>2</sup> See "A Pure Theory of Local Expenditures," by Charles M. Tiebout, *Journal of Political Economy*, vol. 64, no. 5, 1956, pp. 416–24, for more on this phenomenon.

<sup>3</sup> "A Single Welfare Benefit Level for Europe? Efficiency Implications of Policy Harmonization in a Federal System," by Jason L. Saving, *Southern Economic Journal*, vol. 70, no. 1, 2003, pp. 184–94, contains a more rigorous examination of the conditions under which economic integration can be harmful rather than helpful.

*The European Union has a clear choice, but the challenge of globalization is an issue for every economic entity on every continent, including the United States.*

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## RACING TO THE TOP

How Global Competition Disciplines Public Policy



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