

Five steps for closing the transatlantic productivity gap

American companies embraced new information technologies 20 years ago, while Europeans are still hesitating. **Bruno Mações** sets out a digital catch-up strategy

The productivity gap between the United States and Europe has been widening steadily for 20 years. Labour productivity growth in the U.S. has accelerated from an annual 1.2% during 1973-1995 to 2.3% for 1995-2006. In the European Union, it declined from 2.4% to 1.5% during the latter period. Even if the two regions' business cycles are not completely synchronised, the benefits they've derived from the Information and Communication Technologies (ICT) revolution clearly diverge.

Europe's productivity slowdown is due to the later emergence and smaller size of IT investment in EU economies compared to the United States. In the U.S., productivity has grown faster than in the EU because of a larger share there of employment in the ICT producing sector, and faster productivity growth in services industries that make intensive use of ICT.

Post-World War II Europe had a relatively well-educated population and strong institutions that favoured the rapid transfer and use of mainly U.S.-made new technologies. But since the mid-1990s, the patterns of productivity growth between Europe and the U.S. have changed dramatically. Labour market reforms meant that Europe's labour input growth led to a decline in relative capital intensity. In the U.S. there was strong growth in industries producing information and communications technology equipment and a capital-deepening effect from investing in information and communications technology. In other words, for Europe the advent of the knowledge economy has been much slower.

Since the onset of the financial and economic crisis in Europe, there has been widespread agreement that reforms are needed to boost the EU economy. GDP growth in the eurozone is stuck below



Bruno Mações
is Portugal's
Secretary
of State for
European Affairs

1%, unemployment above 11% and inflation is still falling, and at 0.3% in November 2014 was far from the European Central Bank's 2% target. It is now dangerously near outright deflation. From a monetary standpoint, the ECB has been called to do its part by getting inflation back on track, but it cannot do everything on its own.

The importance of completing the Single Market for services, and of reforming labour markets and social policies, has been long emphasised by economists. But now we are being forced to seriously consider the possibility that growth will ultimately depend on encouraging the more widespread use of new technologies. Faster productivity growth will not only allow the EU to support a growing number of retired people without imposing higher taxes on those in work, but will also help maintain Europe's global competitiveness.

Along with the EU's productivity slowdown, there have also been low levels of investment. The EU is facing an investment gap that will hamper short-term recovery and long-term growth. The traditional catch-up and convergence model of the 1950s and 1960s has proved unsuccessful under some very different conditions, so it now appears that ICT's increased adoption could become the key driver of productivity growth and an overall improvement in living standards. Over the last decade, and with the encouragement of the European Commission, significant progress has been made by national governments with initiatives for improving productivity and competitiveness through ICT. The EU's Digital Agenda is an example of how policymakers have tried to tackle the issue, but more work still needs to be done if suitable conditions for ICT investment are to be created.

First, EU governments must place productivity improvements at the core of their economic policies. There can be no negative relationship between higher productivity and job growth. The misguided argument that the more efficiently we work, the less work there is for workers to do must be abandoned. It is a view that fails to identify critical second order effects in which the savings from increased productivity are recycled back into the economy to create more demand that in turn creates more jobs. To improve living standards, EU governments must stop creating or maintaining inefficiencies through their neglect of ICT investment, and must instead engage in clear EU productivity enhancement policies.

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Second, the EU should deepen the scope of its investments beyond ICT capital. Intangible capital may in many ways prove more important as it covers a broad spectrum of factors that include labour force skills, ICT training and institutional knowledge passed on across company divisions. Creating a skilled workforce and a school curriculum that has been designed in partnership with the ICT industry would help create the right environment for ICT investment.

Commentary

Europe’s greatest handicap is the absence of

As we at the Information Technology & Innovation Foundation repeated not long ago, European productivity has grown more slowly than American productivity every year since 1995. A key cause of this widening gap, as Bruno Maçães rightly points out, is that European companies invest less in ICT than do Americans, and get less “bang for the buck” for those investments they do make. This isn’t about which countries have more Google or Facebook jobs, but about whether their businesses use ICT to the best effect.

Bruno Maçães notes that Europe desperately needs faster productivity growth, not least to support its growing number of retired people. He also notes that increasing the adoption of information technologies could be the key driver of Europe’s productivity catch-up. Both his diagnosis and prescriptions reflect a growing consensus among experts on what Europe needs to do, including using policy levers that include tax, regulation and

governments’ procurement policies to encourage greater ICT innovation and transformation.

The policies that could lead to Europe’s ICT-led transformation may be increasing clear, but the path to their implementation is anything but. Many of the steps needed to drive ICT-led growth are controversial, and face vocal resistance that is sometimes merely bureaucratic but is also more broadly political.

To take the key issue of companies’ size, Maçães notes that European businesses would benefit more from ICT if they could achieve greater economies of scale. But that means creating a truly European single market that significantly weakens the powers of the EU’s national governments to impose their own labour and markets regulations. None of the EU member states seems to want to volunteer to go first.

A key part of creating a larger ICT market is transatlantic integration with America. Yet the populist narrative that the EU-U.S. TTIP



Robert D. Atkinson is President of the Washington-based Information Technology & Innovation Foundation

Third, European institutions can actively support the digital transformation of industries through their own procurement of ICT products. The EU could purchase ICT goods and services in the early stages of development, and arrange with their suppliers training for officials to spur co-operation with the private sector. By doing so, the EU would address network externalities that exist in many sectors. The argument that ICT's benefits will lead to externalities seems borne out by the concept of network effects

political will

trade and investment deal would lead to a race to the bottom and weaken Europe's protection now risks trumping a more reasoned approach to the pact.

Driving Europe's ICT growth would also mean significantly reducing the array of special benefits and exemptions that favour small and usually less efficient companies at the expense of larger ones. Growth for both ICT-producing and ICT-using industries also requires a top-to-bottom rethink of European privacy rules. Data is the new "oil" of the 21st century and drives innovation, yet the deeply-held view in much of Europe is that privacy is a fundamental human right, and presumably trumps all other rights, including medical research to improve human health. This view is a direct barrier to the effective use of data by enterprises. But how many politicians in the EU are going to speak out for the interests of data users when it's so much easier to demonise American Internet giants?

Finally, Mações points out that regulation within product, labour

and land markets limits possible business models, raises the cost of ICT investment and slows down market forces that can push firms to adopt more productive practices. But again, championing the "Uber's" of this world against huge incumbents in key industries demands great political courage. And how many politicians in Europe would want to campaign on a slogan that says "I have made it easier for your employer to lay you off after using new technology to become more efficient and competitive"?

It's clear Europe needs faster productivity growth, and that ICT use is the key driver. But whether the European public will accept the changes involved, and whether European politicians will help lead this transformation, is still a very open question. ■

ratkinson@itif.org

and the notion that the larger the network, the more valuable it becomes to individual users. EU governments should therefore use their array of policy levers, including tax, regulation and procurement policies, to encourage greater ICT innovation and transformation.

Fourth, tax and trade policies can promote ICT by minimising the tax wedge on it. ICT investment by governments reduces costs and encourages the productivity effect. Trade policies can promote ICT adoption by providing expanded information and technology trade agreements, facilitating market access and increasing technological complementarities and knowledge spillovers.

Fifth, European businesses would be better able to benefit from ICT if they could achieve larger economies of scale. Business leaders have called for a more flexible approach to labour, product and capital markets as that could unlock growth and innovation. Reforms might include tackling obstacles to private investment, the bringing down of energy costs, lower taxes on labour and capital and a degree of harmonisation of corporate tax rules while making labour markets more flexible.

Deepening the European Single Market is crucial if resources are to flow to their most productive use and stimulate improvements in technology. Harmonising data protection laws across the EU would increase legal certainty for companies looking to invest in European markets, particularly in cross-border services. Removing administrative barriers to ICT service providers when they enter EU markets would help to simplify market entry, reduce investors' costs and the inefficiencies that impede investment.

The investment plan announced by the incoming European Commission late last year could do much to drive this strategy, provided the projects selected exploit innovation for greater multifactor productivity growth. The projected Transatlantic Trade and Investment Partnership (TTIP) would expand market access for EU companies and will increase their return on investment on more ICT projects. Europe's future economic competitiveness hinges on its ability to embrace the digital economy much more quickly. Now it is up to governments to set the right conditions. If they promote a political agenda for market reform, investment will follow. ■

gabinete.seaeur@mne.gov.pt