To Grow or Not to Grow:
Secular Stagnation or Robust Recovery

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The economic performance of nations depends on the global economy as well as on characteristics of nation-states. It is obvious that the health of the global economy, global risks and opportunities, are more important for small and therefore open economies like Slovakia than for much bigger ones. The US or the EU are a major component of the global economy and therefore contribute significantly to its performance. Small countries like Slovakia simply have to make the best out of global opportunities and risks.

My point of departure is a very simple econometric model which I published some years ago in the CATO Journal. The model explains about half of the variation in economic growth rates among nations with only three independent or explanatory variables. The three determinants of growth are: first, the level of economic development or the advantages of backwardness, second the human capital endowment of societies, and third the level of economic freedom. The level of economic development and human capital endowments are much more important determinants of economic growth than the level of economic freedom. Such a finding is likely to surprise and irritate libertarians, adherents of Austrian economics and other friends of economic freedom. Does economic freedom really matter so little for growth? Not, if one looks more carefully at th :! findings.

What does a low level of economic development or a modest GDP per capita mean? The less developed or poorer a country is, the better are its opportunities for growth. China or India are much poorer than the US or Western Europe or Japan and therefore grow much faster than them. Why? They enjoy advantages of backwardness. Backward countries can import foreign technologies and business models. Imitation is easier and faster than invention. Advantages of backwardness improve if one can attract foreign investors with cheap labour, if one can service wealthy markets and customers from such a base. Moreover, poor countries can reallocate labor from relatively unproductive work in agriculture to somewhat more productive work in industry or services. One may exploit the advantages of backwardness or fail to do so, like North Korea or Zimbabwe. In recent decades East Asian countries have been most successful in exploiting these opportunities, more recently India .has become successful, too, Russia, Ukraine, or Greece have not been successful. The main reason is not that they are already much richer than India. They wasted .opportunities.

The basic point to understand is that advantages of backwardness are an external effect of economic freedom elsewhere, of economic freedom in rich and technologically advanced Western societies. If the West had not invented limited government, economic freedom, and capitalism some centuries sago, then hundreds of millions of Asians could not have outgrown poverty as fast as they did. Western capitalism made' it possible. As Hayek recognized more than fifty years ago, economic freedom benefits not only those who enjoy it. It also helps those people where government still withholds it from people. We do have a

selfish interest in the economic freedom and prosperity of others, in particular in freedom and prosperity in neighboring countries. This applies much more to small countries like Slovakia than to big countries like the US. Rich Western countries do most to assist poor countries to grow out of poverty, if they continue to grow and thereby provide advantages of backwardness and catch-up opportunities to poor countries. Slovakia or Poland benefit from German economic growth.

The second determinant of economic growth is human capital endowment. It is important to assess what people can actually do and not to rely on measuring inputs in the human capital formation process, as done by counting years spent at school. For global comparisons one has to rely either on IQ scores or on PISA test scores. Unfortunately, we do not yet have data about non-academic training and skills. Such training and skills are provided by apprenticeships in German-speaking countries and widely believed to be responsible for low youth unemployment in these countries. But it is obvious that intelligent and highly skilled people are more likely to contribute to growth than others. Although this is a plausible and obvious argument, immigration policy in the richer European countries tends to ignore it. European societies have given up the control of their borders and therefore are losing control of the human capital endowments of their societies, too. Within the EU there is freedom of movement. In practice this freedom of movement applies not only to those who can support themselves by their labor or financial assets, but also to those who claim social transfers. Migration within the EU accounts for about three quarters of the immigration into Germany.

Claimants for asylum and refugees from war zones account for another ten percent in Germany. It is extremely hard to send these people home. The great mass of immigrants into Germany, or into other rich West European countries, choose the target country, but they are not chosen according to the national interest of the recipient countries, or invited by prospective ers or rich relatives willing to support them from private resources. That is why Hans-Werner Sinn has recently estimated that immigrants into Germany have been a financial burden on the German taxpayer in the order of magnitude of 79,000 Euros per head. This type of migration into Germany implies a slow deterioration of the human capital endowment of recipient countries. Many migrants move from poorer countries to richer countries with better schools. They frequently possess less skills than the natives of the recipient countries do. Moreover, the act of migration itself frequently implies a devaluation of human capital. Many migrants do not speak the language of the recipient country fluently. Although nations may improve their human capital endowment by an open door for talent and skill as well as a high wall against the unskilled and prospective welfare claimants, most Western European societies do the opposite.

The third determinant of economic growth is the level of economic freedom, as libertarians or adherents of capitalism understand the term. Economically free countries enjoy limited government, low taxes, few social transfers, safe private property rights, a free instead of an over-regulated market for labor without minimum wages or sti ig_ t'otecticqi ainst dismissals, free foreign trade and monetary policies which minimize the risk of inflation. Why does economic freedom at the macro-level, or in cross-national comparisons, predict

economic growth? To answer this question we have to look at the micro-level, at individual decisions and incentives. High taxes, progressive taxation, and generous welfare payments must imply a perverse reinforcement pattern. Economic success is punished by taxation. The better the success is, the worse the punishment becomes. Whoever becomes poor because of a lack of effort or skill is rewarded by transfer payments. This reinforcement pattern also influences young people and their education. Why should parents of modestly or averagely gifted children teach them discipline and to work hard, if the standard of living of poorly paid workers is similar to that of welfare recipients. The tax and welfare state also implies undesirable incentives for migration. Whoever is economically successful and earns a high income, faces a high tax rate and therefore an incentive to emigrate to a lower taxation country. But unskilled people from poor countries want to come. Western welfare states do not only support poor people, but also support enterprises by subsidies where many jobs are at risk. Thereby, they retard structural change or what Schumpeter has called the creative destruction of capitalist economies.

Recently, most Euro-zone countries have grown more slowly than other Western countries, including Sweden, the UK, art he US. Why? The basic problem is the European belief in centralization, regulation, and harmonization, in more government instead of in limited government. Hayek's most important insight, the impossibility to centralize knowledge which is scattered across millions of heads, arohibits not only lannin can ever work. Wherever decision-making is more centralized than knowledge, as has to happen where government or pan-European adrniu;stration expands, there are risks of error, or distorted prices, and perverse incentives which distort the allocation of resources. The bigger national governments or a pan-European administration become, the more likely are poor decisions which cannot easily be corrected.

The introduction of the Euro is the best example for such a poor decision. European politicians simply forgot that Mediterranean countries had to devalue against the Deutsche Mark every few years in order to restore the competitiveness of their economies. This is no longer feasible. So, some Mediterranean countries suffer from youth unemployment rates close to 50%. The mistake of establishing the Euro was accompanied by disregarded criteria, like government debt below 60% of GDP, and regularly overlooked criteria in the growth and stability pact, like the prohibition of deficits beyond 3%. Are legal norms useful, if almost nobody is willing or able to respect them? Similar doubts apply to the no-bail-out provision in the European treaties or the prohibition of central bank financing of governments. What has actually been happening in Europe because of efforts to rescue the Euro is the establishment of a second or European tier of the welfare state. Is this what graying Europe needs? Europe accounts for about 7% of global population, about a quarter of global production, and about half of global transfer payments. Do we need to reward poor governance, as in Greece, by transfer payments from somewhat better governed countries? As long as 'more Europe' comes together with poor incentives, less common sense, and less economic freedom, European policy-makers condemn us to stagnation.