Articles & Commentaries

p-Watch — Europe

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Protectionism and Productivity

Well over two centuries ago, Adam Smith demonstrated that a nation's wealth grows if it manufactures the goods it can produce most efficiently, trading them in return for those where others have a comparative advantage. Since then "comparative advantage" has become the broadly, albeit haltingly, accepted linchpin of economic policy, boosting nations' productivity and hence prosperity.

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This philosophy stands in contrast to the one it superseded: protectionism. Not that protectionism has by any means been eclipsed. Indeed, in times of slow growth, it flourishes, for governments proclaim that jobs can be saved and industries more easily restructured if a nation's agriculture or manufacturing sectors, wholly or partially, can be shielded from the inflow of specific foreign products. To stymie foreign critics, they pronounce that protection will only be offered temporarily, knowing full well that law enforcement procedures, international or even of the EU, only kick in one or more years after protectionist measures have been introduced.

Protectionism takes two forms: imposing tariffs and other barriers to trade (including environmental and health standards) to make imports more expensive and subsidizing domestic producers. Both types undermine productivity increases since they curb competition, and without competition the drive to greater efficiency and innovation is dampened. True, jobs might be saved in the short term, at least in the industries directly concerned. But consumers pay more for their goods and services for which the world price is lower; and citizens subsidize the higher prices through taxes—a "double whammy." Yet as Europe's blatant protectionism of agriculture shows, decisions are often less the outcome of economic rationality and the "voice of the people" than of the influence of vested interests.

Europe experienced the impact of and indulged in protectionism in 2003. On the one hand, US steel tariffs meant that the products of European (and Asian) exporters suddenly became 30% more expensive in the USA, thereby significantly reducing their competitiveness. On the other hand, and despite European law (in any case often flouted by large countries), governments continue to dole out state subsidies to maintain specific industries or companies in businesses which are not competitive. Such has recently been the case of German coal mining and some major French and Italian companies. And more insidiously still, Europe subsidizes farm exports, putting local producers in developing countries out of business.

A major problem is that subsidies are at the very core of the EU's philosophy. Thus, to reach its goal of redistributing wealth from its rich to its poorer nations and regions—a laudable purpose per se—it proffers subsidies of €30 billion annually. They are a means both to smooth the processes of restructuring areas experiencing industrial decline and to help construct the requisite infrastructure, such as transport, communications, power, water, education, etc., to boost future growth in traditionally poor regions.

The results are, however, ambivalent. Of all the countries that have benefited from large subsidies in the last two decades only Ireland has significantly increased its productivity and prosperity; the others' relative position has hardly budged. Ireland's achievements, however, are attributable less to subsidies, even though they have been efficiently used, than to foreign direct investment, education, and social partnership. Pouring money into improving the infrastructure by no means necessarily attracts sustainable employment. Thus, Germany has coughed up €1,000 billion (yes, billion) in transfers to its eastern provinces since reunification, yet their productivity remains only 70% of that of the country as a whole and their unemployment is double the national average.

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World Bank studies show that subsidies for both labor and capital are much less effective in raising growth and productivity than reducing taxation and enhancing labor mobility, despite all the dislocations that such mobility entails. For subsidies attract investment to areas for nonsustainable economic reasons, not least short-term financial windfalls. And being very footloose, corporate investment rapidly moves to still lower labor-cost areas, both the new EU member countries of Eastern Europe—where Slovakia has just introduced a novel, productivity-inducing single tax rate on persons and companies of 19%—and, increasingly, China. Finally, anyone offering subsidies opens up vast opportunities for fraud, as was also seen in Europe in 2003.

But all is not gloom and doom. Despite their decline in numbers, high-productivity manufacturing companies are still thriving in Western Europe. Europe's manufacturing output in 2003 was, like the USA's, 50% higher than in 1990, with a smaller workforce. This is partly attributable to the great number of jobs which has been shed and outsourced so that today labor accounts for 15% or less of industrial companies' total costs. But manufacturing overseas brings with it extra costs, not just for transportation and inventory, but also the (often hidden) social, political, and security risks—"offshoring" has its downsides.

There is more hope at the European level. The EU itself is moving, albeit slowly, in the "productivity direction." For it is emphasizing that to be more productive, European funds (subsidies) should go not to individual industries but rather to broader efforts to promote innovation. However, agreeing on common policies between 15 governments has proved difficult, and in May 2004 the number will rise to 25. Each of the 10 new members is eager to get its "fair share of the pie," while protecting its existing interests. That never was a good productivity policy. Rather, all should strive to increase the size of the pie. However forlorn such a hope might sometimes seem, there are at present more positive than negative signs.

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