The Future for Britain and Europe

JULIAN HODGE INSTITUTE OF APPLIED MACROECONOMICS

ANNUAL LECTURE

Thursday 24th March 2011 at the Parc Thistle Hotel, Park Place, Cardiff
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Akos Valentinyi has been the Head of Research at the National Bank of Hungary over the past two years and recently arrived in Cardiff to take up a chair in economics at Cardiff Business School. He is a graduate of the University of Economics in Budapest in 1987 and completed his PhD studies in Economics at the European University Institute in Florence. He was on the faculty of the University of Southampton from 1996, becoming Professor of Economics there in 2004. He has also been a visiting professor at the Central European University in Budapest and Universidad Carlos III in Madrid. His research primarily focuses on macroeconomic issues, in particular, issues of long run growth and development.

Outline of the Lecture

The member countries of the Europe Union have diverse historical experiences, have different institutional structures, and are at different stages in their development.Some countries like Britain have strong states where institutions and the rule of law have evolved slowly towards a relatively efficient structure, with governments generally supporting the market economy. In contrast, some other countries have weak states where the rule of law does not always prevail, where institutions do not work well, the state does not support the market economy, and government is highly inefficient. These different groups of countries have a quite different relationship with the European Union. Countries in the first group benefit from the free flow of goods, capital and labour across countries, but it is hard to see what benefit they could get from harmonising various rules and regulations given that they already have working rules and regulations. Harmonisation for them only imposes costs with no clear benefits. In contrast, countries in the second group benefit not only from the free flow of goods, capital and labour, but also from the rules and regulations imposed by the European Union which make their states and governments more efficient. The recent crises have exposed rather strongly the differences between countries in terms of their institutional weaknesses. The future of Europe very much depends on how much the Union accepts that some members need much less intervention in their affairs than some others.

Julian Hodge Institute of Applied Macroeconomics

In May 1999, Cardiff Business School and Julian Hodge Bank entered into a significant collaboration, resulting in the establishment of the Julian Hodge Institute of Applied Macroeconomics. The main aim of the Institute is to carry out research into the behaviour of the UK economy, and to study in particular its relationship with the other economies of Europe. The Institute's research work further extends across international trade, money and banking, international finance and econometrics, in a collaboration between around twenty academics, mostly in Cardiff, and some thirty PhD students.

The institute's director since it was founded has been Professor Patrick Minford, of Cardiff Business School, who is also the Economic Adviser to Julian Hodge Bank. Apart from its research projects the institute carries on the forecasting and modelling work which Minford began at Liverpool University and has been based mainly in Cardiff for more than a decade, producing forecasts and policy analysis of the UK and other major economies.

The Future for Britain and Europe

The European Union currently has 27 members and more than 500 million inhabitants. Given that it was founded by 6 countries in 1958, the European project has been successful in the sense that it has increased in size. The desire to get in is stronger than the desire to get out of this club. However, the European Union faces serious challenges. The more obvious and immediate challenge is how to deal with consequences of the financial and economic crises of 2008-2010, which have by now evolved into a full blown sovereign crisis in several Eurozone countries. But there are less obvious, less urgent but no less important challenges in the Eurozone. How to revive economic growth in the European Union which has been sluggish for more than a decade, and how and to what extent the national social and economic policies should be coordinated across member states.

In first part of this lecture I will discuss some empirical evidence on the slow growth in the European Union to demonstrate how important this issue is. One important lesson we can draw from this experience is that the key to reviving growth in Europe is to use regulations to support markets rather than to replace them. In the second part of this lecture I will discuss the scope for harmonisation of economic and social policies from the British point of view. In particular, I will emphasize that British institutions and legal traditions are very different from the traditions of the continent. Therefore the laws and regulations proposed by the European union is much more costly for Britain to adopt than for many of the other member states. Consequently, Britain should limit the influence of the European union on its institutions and legal system more than it has done so in the past.

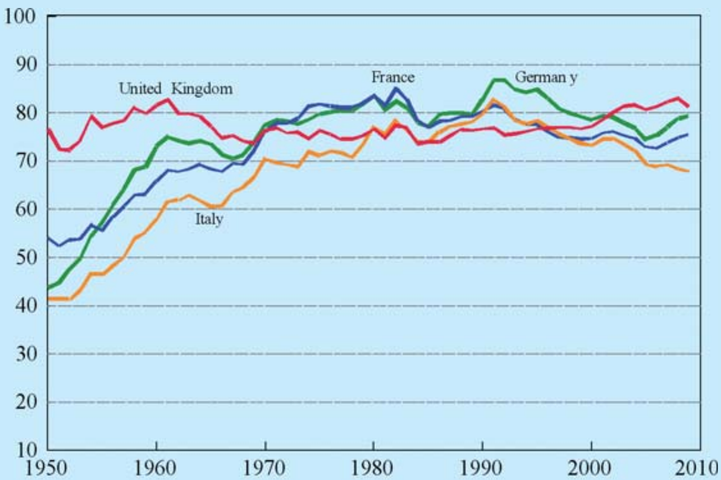
First look at some facts about the European Union in two key areas. One area is economic growth, the other is employment. These are two areas of key concern to policy makers in Europe. The first graph shows the GDP per capita relative to the United States in the four large European economies: the UK, France, Germany and Italy. The US is a useful benchmark. In a growing world economy most countries are growing, hence achieving growth is not enough. One way to measure whether a country is growing fast enough is to compare it to the technological leader, to the US. The graph shows that from the 1950s until the late 80s France, Germany Italy were performing well, catching up with the US while the UK fell behind. But in the late 80s and the early 90s the performance of these countries changed.

France and Germany stagnated or somewhat declined, and Italy started falling behind the US significantly. The productivity or income gap between Italy and the US has been increasing for 20 years now.

In contrast the UK did stabilise its position relative to the US in the 80s and started to close the gap from the early 90s.

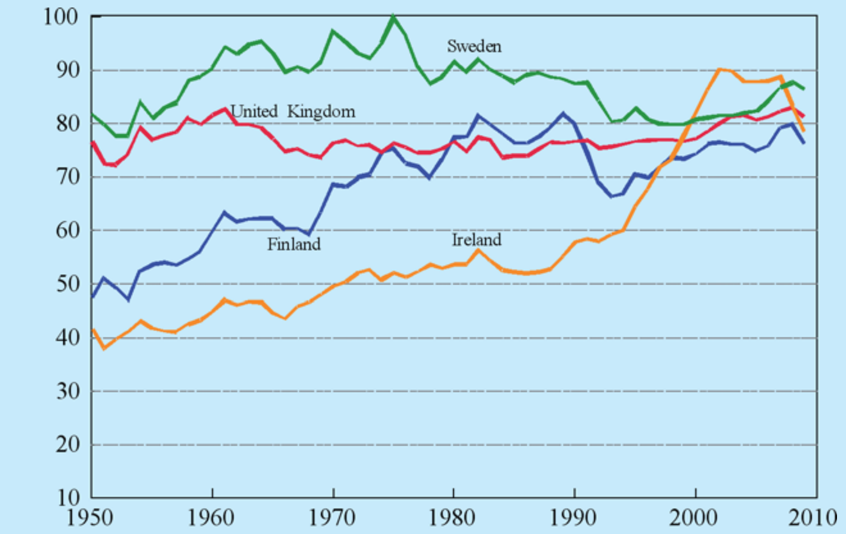
If we turn to Northern Europe we can see that the Swedish economy performed better than the four large EU economies on this measure. This is true even though the gap between Sweden and the US did increase after the late 70s. On the other hand, Finland did close the gap with the US except in the period in which the Soviet Union collapsed, hitting Finland's trade and economy very hard. The big success story is that of Ireland. Whereas in the late 80s

Figure 1 **Real GDP per capita in the four largest European economies**



Source: Penn World Tables 7.0

Figure 2 **Real GDP per capita in Northern European economies**



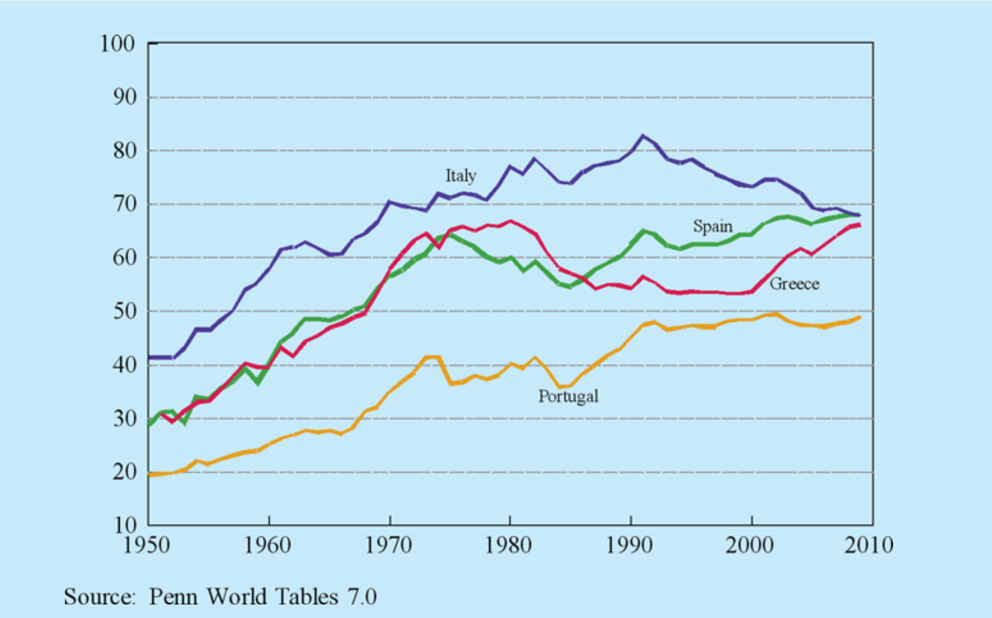
Source: Penn World Tables 7.0

its per capita GDP was hovering at about 50% of the US level, within 20 years this had reached 90%. Although the Irish economy was hit hard by the recent crisis, its per capita GDP was still 80% of the US level in 2009.

If we turn to Southern Europe, we see that Italy is falling behind the US and Portugal has been stagnating since the early 90s. Spain has been doing somewhat better. Greece first fell behind the US, and after more than a decade of stagnation it started catching up at a very fast speed after 2000. Now we know the source of that growth: excessive government spending.

And finally we turn to the countries of Eastern Europe. Their data series are shorter than those of the old EU member states. However, we can make a few interesting observations. Their output fell in the late 80s and early 90s as they adjusted to the market economy. After this period, most of these countries were catching up rapidly. The only exception is Hungary

Figure 3 **Real GDP per capita in Southern European economies**

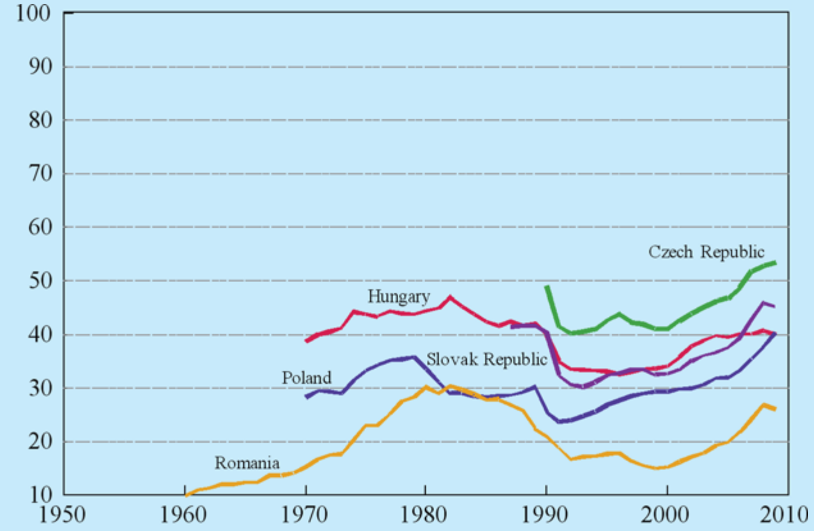


whose relative output has stagnated for the last few years.

To summarize the growth performance of the European Union, we can say that it has fallen behind the US since the early 90s. However, growth is very uneven across Europe with the large economies and Southern Europe stagnating or declining relative to US, and only Eastern Europe showing rapid growth in the last two decades.

We turn now to labour markets. Unemployment is a major concern in any country. One reason for this is, as Figure 5 shows, that higher unemployment is usually accompanied by higher long term unemployment, thus with workers who are unemployed for more than a year. The figure also shows that more than half of the EU countries have unemployment rate typically above 7%. In addition, more than 40% of the unemployed are long term unemployed in more half of the EU countries. But it is also

Figure 4 **Real GDP per capita in Eastern European economies**

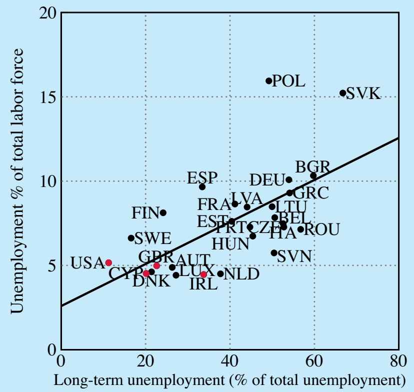


Source: Penn World Tables 7.0

important to note that the US, Cyprus, Great Britain and Ireland have relatively low totals for both unemployment and long term unemployment.

European policy makers are aware of the weaknesses of European economies both in terms of growth and employment. One response to this challenge has been to attempt to liberalise markets. Brussels pushed for liberalisation of the energy markets and service markets. They succeeded with the former but failed with the latter. The service directive would have allowed for service providers registered in one EU member state to provide services in another one. This would have created more competition and more jobs across the EU. But politicians of several countries managed to block it using the

Figure 5 **Unemployment in the EU and the US (period averages 2003-2007)**



Source: World Development Indicators, 2010

argument of quality control (e. g. Spanish construction companies would undermine the quality of construction work in Germany); in fact of course they were only representing their own country's special interest groups.

Another response to the growth and employment challenge has been to push for more harmonisation of laws and regulations across member states. This may be a good idea for some EU countries, but I will argue in the second half of the lecture that it is a bad idea for Britain and it should not go along with it. The main reason is that the legal system of Britain as well as those of Ireland and Cyprus are based on Common Law while those of the rest of the European Union are based on Civil Law.[1] The laws and regulations proposed by Brussels are typically in the spirit of the civil law tradition. Therefore to adopt those laws and regulations is more costly for Britain than for other EU member states.[2] It is important to think about this problem of legal systems because decision makers in Britain do not seem to be aware of it when they sign up for a new European law or regulation.

[1] The United States as a common law country is also displayed on the subsequent figures.

[2] The second half of the lecture is based on research about the economic consequences of legal origin published by various economists published over the last 20 years. This literature includes:
Botero, Juan C., Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer. 2004. "The Regulation of Labor." Quarterly Journal of Economics, 119(4): 1339–82.
Djankov, Simeon, Oliver D. Hart, CaraleeMcLiesh, and Andrei Shleifer. 2006. "Debt Enforcement around the World." National Bureau of Economic Research Working Paper 12807.
Gennaioli, Nicola, and Andrei Shleifer. 2007. "The Evolution of Common Law." Journal of Political Economy, 115(1): 43–68.
Glaeser, Edward L., and Andrei Shleifer. 2002. "Legal Origins." Quarterly Journal of Economics, 117(4): 1193–1229.
For an overview of the literature see
La Porta,Rafael, Florencio López-de-Silanes and Andrei Shleifer, "The Economic Consequences of Legal Origins.", Journal of Economic Literature 2008, 46:2, 285–332.
The debate about the merit of this research is still ongoing, but it provides valuable insights into how legal systems determine economic outcomes.

Legal scholars distinguish two main secular legal traditions: common and civil law. In civil law there are four sub-traditions: the French, the German, the Scandinavian and the socialist. These legal traditions have spread across the globe over a long period of time. Some countries adopted a legal system voluntarily: for example in the 19th century, Japan adopted German civil law and Russia adopted French civil law. BOTH 19th century? Colonial powers typically imposed their legal system on their colonies. Consequently British common law and French civil law were adopted most widely because Scandinavia did not have any colonies and Germany's colonial ambitions were short lived. In Europe Napoleon implanted the French legal tradition in Portugal, Italy and Spain; and Germany implanted its civil law YES?? in several Central-European countries. Importantly, there are only three countries in Europe whose legal tradition follows the common law tradition: Cyprus, Ireland, and Britain.

Legal systems differ in terms of the main features that are relevant to economic outcomes. Common law is based on precedent established by judges in solving specific legal disputes. Dispute resolution is adversarial rather than inquisitorial which means that judges are impartial figures. Finally, judicial independence is a key feature; this includes the power to review administrative acts of the state.

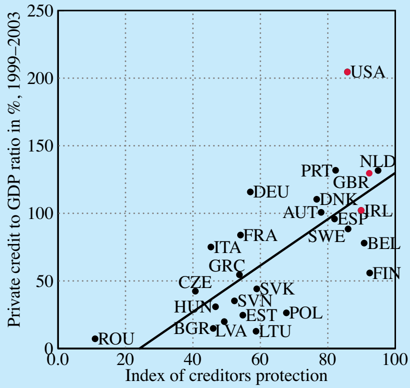
In contrast, civil law is based on statutes and a comprehensive code. Dispute resolution is inquisitorial rather than adversarial. Judicial independence is less important since judges are viewed as the instrument of the state enforcing the statutes and codebooks. This description puts the emphasis on the differences in the two systems rather than their common elements to sharpen the contrast. In reality the different legal traditions have shared features: common law countries use statutes and civil law countries allow for some flexibility in judicial decisions. However, the differences between the two systems are of great importance.

These differences in particular have implications for economic outcomes. First, the precedent-based judicial ruling allows for more flexibility. For example, common law judges are willing to enforce more flexible financial contracts than civil law judges. In civil law countries such contracts are harder to enforce if they are not on the statute book. In a changing environment flexibility in contract enforcement is desirable. If judges are willing to enforce complex contracts designed for a specific situation, resources are allocated more efficiently. This is especially true in rapidly changing financial markets. This is the reason why international financial contracts are typically signed under English law or US law. Second, civil law tends to create more legal formalism than common law: this slows down judicial decisions. Less judicial flexibility tends to be accompanied with more detailed and precise statute and code books, which in turn on average lengthen the time needed to resolve legal disputes in civil law countries. Third, property rights are more respected, and there is stronger protection against state expropriation, under common law than under civil law. In Britain this goes back to the Magna Carta which explicitly limited the king's power to expropriate individuals without due process.

Finally, social problems tend to be solved through courts in common law countries rather than by passing new legislation or regulation as in civil law countries. There is more emphasis on private contracts and less emphasis on government regulations in common law countries relative to civil law countries. If you have a problem in Britain, you go to court to try to resolve it. If you have a problem in France, you make take the streets with others with similar problems to force the government to legislate on it.

Consequently, in time of economic crisis, civil law countries tend to introduce regulation to suppress markets whereas common law countries tend to introduce regulations to support markets. For example, during the recent financial crisis France and Germany

Figure 6 **Creditor Protection and Lending**



Source: World Development Indicators, 2010
Djankov–Hart–McLiesh–Shleifer (2006)

wanted to limit short sales on financial markets. Thus, if a type of transaction leads to problems because of market failure, the reaction is to ban the transaction instead of correcting the market failure. In contrast, the regulatory reaction to securitization after the crisis was different in the US. Observers agreed that the main problem during the run-up to the crisis was that the market for securitized mortgages was opaque. It was not clear what the value of these assets was or how the risk was distributed across investors. The main reason for this was that the market for these securitized mortgages was primarily an over-the-counter market without any central

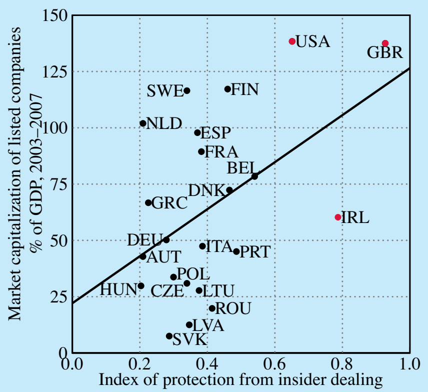
clearing house facility. The primary effort US regulators are making it to ensure that this market becomes more transparent.

I turn now to a series of examples to highlight the implications of legal origin for economic outcomes in EU countries. Figure 6 shows the relationship between creditor protection and private credit lent. The index of creditor protection on the horizontal axis measures the percentage you recover if you lend to someone who does not repay and you go to court get your money back. On the vertical axis the private credit to GDP ratio is displayed which shows how deep the credit market is in a country. We can see that the stronger is creditor protection, the more credit is extended to the private sector. We can also see that in the three common law countries in the sample (Britain, Ireland, and US), creditors are well protected and credit markets are deep.

The next figure, Figure 7, shows how protection from insider dealing and capitalization on the stock market are related. The stronger is the protection from insider dealing, the higher is market capitalization and the more important stock markets become in resource allocation. As before, the three common law countries where protection from insider dealing is stronger, stock market is more important. In countries such as Austria, Germany, Hungary or Poland where the protection from insider dealings is much less, the stock market tends to play a lesser role.

Cheques play an important role in paying for obligations or settling debt. How usable a cheque is as a means of payment depends on

Figure 7 **Protection from Insider Dealing and the Stock Market**

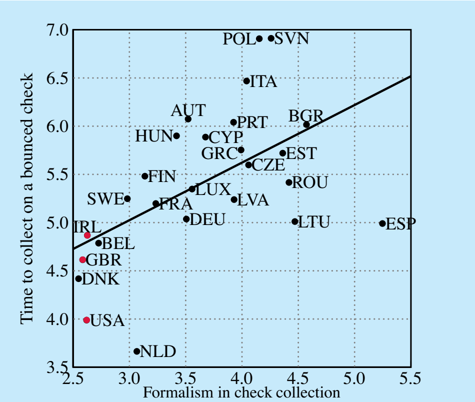


Source: World Development Indicators, 2010
La Porta–Lopez-de-Silanes–Shleifer (2006)

how easy it is to collect. This depends among other things on the legal system. Figure 8 displays the relationship between legal formalism and the time for cheque collection. Legal formalism is measured on the horizontal axis with an index. Higher values mean more formal procedures; they reflect the lawyers' characterization of procedural rules typically applied to a specific legal dispute. On the

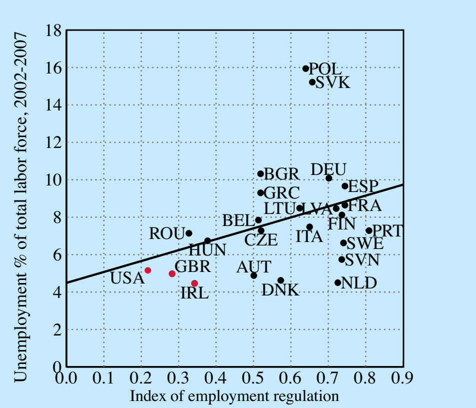
vertical axis we see how much time one needs to collect the cheque. We see that it takes much longer in civil law than in common law countries. This is one reason why, as casual observation suggests, cheques are used less frequently on the continent than in the UK. We turn now to labour market regulations. On Figure 9 we can see the relationship between labour market regulations and

Figure 8 **Legal Formalism and Enforcement of Payments**



Source: Djankov–La Porta–Lopez-de-Silanes–Shleifer (2003)

Figure 9 **Unemployment and labour market regulations**

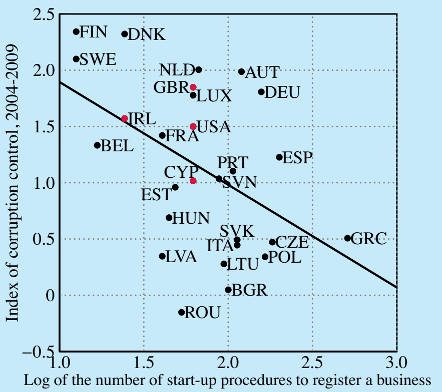


Source: World Development Indicators, 2010
Botero-Djankov–La Porta–Lopez-de-Silanes–Shleifer (2004)

unemployment. On the horizontal is an index of employment regulations. A higher value of the index implies more regulated labour markets: stricter regulations on working hours, firing procedures etc. On the vertical axis is the unemployment rate. As we can see common law countries with less regulated labour markets have relatively low unemployment. In contrast civil law countries have more regulated labour markets and high unemployment.

The last example is the relationship between regulation and corruption. On the horizontal axis is the number of start-up procedures you need to complete before you can register a business. On the vertical axis is a corruption

Figure 10 **Corruption and Regulations**



Source: World Development Indicators, 2010
Aggregate Governance Indicators 1996-2009, World Bank

index (a higher value means less corruption). As we can see again common law countries tend to have less regulations and also less corruption: the more steps you need to register a company, the more contact you have with officials, and so the more chance they have to make your life difficult, and the more chance you have to solve this problem with money put in a brown envelope.

We have seen a set of facts about what economic implications legal systems may have. Legislation in the European Union primarily follows the civil law tradition which is different from the common law tradition.

Consequently, while there could be gains from harmonizing legal systems and regulations of the same tradition, harmonizing across different legal tradition is not only difficult, but can be very costly for a country like Britain which has to adjust its legal system to another one with a different legal tradition. Therefore it is natural for Britain to want to limit the European influence on its legal system. One should not blame everything on Brussels since British politicians signed up for European laws. But they might not have been fully aware of the implications of importing European laws and regulations into the British legal system. They should more often have said: No! Negotiations in Brussels are difficult if you are in a minority as Britain often has been. But I think rescue is on the way from Eastern Europe. Although Eastern European member countries share the civil law tradition with the large old EU member states, they are less supportive of harmonization than the old member states for a different reason. As we have seen, they are significantly poorer than the old European member states. They are not keen to harmonize their tax systems with Europe because they want to attract more foreign investment. Several of them have introduced flat taxes over the last few years. Overall, they are less sympathetic to arguments about harmonization, which could help Britain in the future.

The future of the European Union depends on when (in addition to the current sovereign debt crisis) it recognizes that there is a limit to harmonization. I think the European Union will eventually recognise that different member countries have different needs, and willlet them get on with their business in the way they prefer.

A history of past lectures

The first Julian Hodge Institute of Applied Macroeconomics Lecture was delivered in 2000. Since this time the lecture series held in Cardiff has included some of the world's leading economists.

2000 - Sir Alan Walters - former Chief Economic Adviser to Mrs (now Lady) Margaret Thatcher.

2001 - Professor Otmar Issing - Board Member and Chief Economist, European Central Bank

2002 - Sir Alan Budd - Member of the Bank of England's Monetary Policy Committee and Chief Economic Adviser to the Treasury from 1991-1997.

2003 - Professor Bennett T. McCallum - H.J. Heinz Professor of Economics at Carnegie Mellon University, Pittsburgh.

2004 - Professor Danny Quah - Professor of Economics at the London School of Economics and Political Science.

2005 - Professor Nicholas Crafts - Professor of Economic History at the London School of Economics and Political Science.

2006 - Ludovit Odor - Member of the Bank Board of the National Bank of Slovakia.

2007 - Paul De Grauwe - Professor of international Economics at the University of Leuven, Belgium.

2008 - Colin Robinson - Emeritus Professor of Economics, University of Surrey.

2009 - Dale Henderson, Visiting Professor of Economics at Georgetown University.

2010 - Michael Beenstock, Professor of Economics, Hebrew University of Jerusalem.

Before this a series of lectures associated with Sir Julian Hodge commenced in 1970 entitled the Jane Hodge Memorial Lectures.

1970 - The Rt. Hon. Sir Leslie O'Brien GBE , Governor of the Bank of England.

1971 - M. Pierre - Paul Schweitzer, Managing Director of the International Monetary Fund (IMF).

1973 - David Rockefeller LLD, PhD, Chairman, Chase Manhattan Bank.

1973 - H.R.H. The Prince Philip Duke of Edinburgh.

1976 - His Excellency Sheikh Ahmed Zaki Yamani.

1984 - Robin Leigh Pemberton, Governor of the Bank of England.

1990 - Sir George Blunden, Deputy Governor of the Bank of England

The Julian Hodge Institute of Applied Macroeconomics therefore carries on the very proud tradition of promoting debate and understanding of present day economic issues.

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