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Promoting Competitive Knowledge-based Innovative Economies in the Wider European Region

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This meeting is taking place against the background of a severe financial and economic crisis which has raised questions about the sustainability of our economic system. Robert Shiller, a sharp observer of financial markets and one who issued repeated warnings about the real estate bubble in the US, thinks that "capitalist economies, left to their own devices, without the balancing of governments, are essentially unstable."[1] Earlier this month the *FT* run a series on the future of capitalism, arguing that with faith in the market shaken, it was important to ask "where do we go from here."

I would like to put to you the notion that, in fact, this soul-searching has been going on for quite some time; perhaps the better part of the past quarter century. I think that what the financial crisis has done is to highlight some of the vulnerabilities of the global economy associated with our inability to introduce the kinds of reforms which we know—from the insights of leading thinkers like Amartya Sen, from decades of empirical experience—are essential to establish a firmer foundation for sustainable economic development.

In his contribution to the *Financial Times* two weeks ago, Sen reminded us that Adam Smith "talked about the importance of institutions." "But it was in his first book—Sen adds—*The Theory of Moral Sentiments*, that he extensively investigated the powerful role of non-profit values. While stating that "prudence" was 'of all virtues that which is most helpful to the individual', Smith went on to argue that 'humanity, justice, generosity, and public spirit, are the qualities most useful to others.'"[2]

Let me, in fact, give you a few examples of ways in which our thinking about what is important for economic development and hence for the development of innovative economies has evolved in fairly important ways over the past couple of decades. I want to focus my attention on 4 key areas: institutions, education, governance, and the role of technology and innovation.

Institutions

It is of fundamental importance whether governments are accountable to their respective populations. Investors care enormously whether judges and courts are reasonably independent, or whether they are subject to undue interference or are for sale to the highest

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[1] Shiller, Robert, "A failure to control the animal spirits", *Financial Times*, 9 March, 2009.
[2] Sen, Amartya, "Adam Smith's market never stood alone", *Financial Times*, 11 March, 2009.

bidder. Do businesses have to pay bribes to settle their tax obligations? Do they have to hire private security details because police services are unreliable? Are governments fairly even-handed in their relations with the business community, playing more the role of impartial formulators of transparent rules? Are public resources being allocated to education and essential infrastructure, or spent on wasteful and unproductive projects? Is the regulatory burden light and effective or heavy and corruption-ridden?

Work done by Easterly and others show that differences in institutions explain much of the growth differential between countries, well beyond simply getting inflation right or addressing other macroeconomic weaknesses.[3]

Of course, laying a sound institutional foundation is not an easy task, nor something whose results can be observed quickly, as is often the case with purely macroeconomic measures, an interest rate hike here, a tax cut there. Attempts at institutional reform often run against strong opposition, as such reforms often challenge powerful, deeply entrenched vested interests.

Education

We know, of course, that lack of basic skills severely limits the possibilities of citizens to participate in the development process, to be gainfully employed, to be well-informed judges of government policies and the politicians that formulate them. From a business perspective, without access to workers with a solid education, companies are limited to resource- or basic labor-intensive industries, and constrained in their ability to grow and to move up the value chain.

However, enrolment rates in themselves do not tell the whole story, as they disguise important differences in the *quality* of education. An artificial focus on quantitative targets, such as enrolment rates, has often obscured the importance of the quality of learning, and the role of incentives and motivation. Education and training are emerging as key drivers of competitiveness. As the global economy has become more complex, it has become evident that to compete and maintain a presence in global markets it is essential to boost the human capital endowments of the labor force, whose members must have access to new knowledge, be constantly trained in new processes and in the operation of the latest technologies.

Countries which have invested heavily in creating a well-developed infrastructure for higher education have reaped huge benefits in terms of growth. Education has been a particularly important driver in the development of the capacity for technological innovation, as the experience of Finland, Korea, Taiwan, and Israel clearly shows. Without doubt, today's globalizing economy requires economies to nurture pools of well-educated workers, who are able to adapt rapidly to their changing environment.

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[3] See Easterly, 2005, "National Policies and Economic Growth: A Reappraisal". Handbook of Economic Growth, ed. By Philippe Aghion and Steven Durlauf. Elsevier, pp. 187–196.

Governance

Governance is the term that is used now in the development community to underscore the fundamental role of the *quality* of government. Let me identify a few basic elements:

Sen convincingly argues that those countries in which governments operate in an environment of political legitimacy tend to be much better at allowing the formation of vital understandings and beliefs among the population that directly impinge upon aspects of the development process; for instance, the notion that female education, employment and ownership rights exert powerful influences on women's ability to control her environment and improve her condition and thus to better contribute to national prosperity.

Daniel Kaufmann and a number of other researchers have shown the central importance of the establishment of an institutional environment characterized by openness and transparency in the management of public resources. Corruption poisons the development process. It leads to resource misallocation as funds are no longer directed toward their most productive ends, but are instead captured for private gain. It undermines the credibility of those who are perceived as being its beneficiaries and thus sharply limits their ability to gain public support for economic and other reforms.

I need not remind you that lack of transparency in the workings of the global financial system has been very much at the heart of the present crisis. Had the authorities been more effective in monitoring the explosive growth of increasingly sophisticated financial instruments (the so-called "weapons of financial mass destruction"), it is quite conceivable that the current crisis might not have been so severe in its intensity. Sen notes that societies operate better under some presumption of trust. In his *Financial Times* piece he observed: "the far-reaching consequences of mistrust and lack of confidence in others, which have contributed to generating this crisis and are making a recovery so very difficult, would not have puzzled Adam Smith."

Closely linked to the issue of accountability is the need for the rule of law, the notion that the rules which govern a society are applicable to all. The absence of an adequate legal framework and judicial system will increase business costs, discourage investment, and introduce an element of uncertainty into economic activity which will be detrimental.

The potential benefits of an approach to development that seeks to incorporate the above mutually reinforcing elements should not be underestimated. To take an example: in an environment of accountability and political legitimacy, people will be far more likely to become active participants in the economy. A broadly shared sense of entitlement to economic transactions will then become an engine of economic growth. A growing economy will boost private incomes and enable the state to collect taxes out of which it will be able to finance expenditures, including in vitally important social areas, such as education and research and development. Higher levels of spending on education and health care have been shown to be associated with reductions in infant mortality and a fall in birth rates. Female literacy and improved schooling change women's fertility behavior and end up having widespread implications for the environment, the pressures on which are often linked to rapid population growth.

Technology and innovation

An increasingly important factor in explaining successful economic development concerns the agility with which an economy adopts existing technologies to enhance the productivity of its industries. This is a critical because technological differences have been shown to explain much of the variation in productivity between countries. In fact, the relative importance of technology for competitiveness has been increasing in recent years, as progress in the dissemination of knowledge and the increasing use of information and communications technologies have become increasingly widespread.

Innovation, of course, is particularly important for countries that have reached the high-tech frontier, as it is the main self-sustaining driver of growth. While less advanced countries can still improve their productivity by adopting existing technologies or making incremental improvements in other areas, for higher income countries, this is no longer sufficient to increase productivity. Firms in these countries must design and develop cutting-edge products and processes to maintain a competitive advantage. This requires an environment that is conducive to innovative activity, supported by both the public and the private sectors. In particular, this means sufficient business investment in research and development, high-quality scientific research institutions, collaboration in research between universities and industry, and protection of intellectual property.