



# Four Economic Issues That Environmentalists Should Care About

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## 1. The American versus the European Model

Hardly a week goes by without articles in the major international newspapers — including the *New York Times*, *Washington Post*, *Financial Times*, and the *Wall Street Journal* — about Europe’s frustrating efforts at economic “reform.” The articles are about different events in the news, but their underlying (and often stated) assumptions are pretty consistent: the high-income European Union (EU) countries<sup>1</sup> are in need of serious structural reforms in order to increase economic growth, raise living standards, build a more dynamic, competitive economy, and deal with the problems of an aging population (more on the last point below).

The general agreement among policy-makers on these assumptions is so strong that even when the voters repeatedly reject the proposed reforms — as they have in Germany, or more recently in the French and Dutch votes against the European constitution — it is assumed that they are just trying to hold on to a way of life that is impossible in a “global economy.” The attitude of their leaders and the international press is that they simply have to be “educated” to accept the new reality. So strong is this consensus among Europe’s elite that the German Social Democratic Party is committing what looks like political suicide, having called early elections for this month after failing to convince either the public or its own shrinking political base of the need to “reform” the German welfare state.

The press and pundits in the United States couldn’t agree more, and so there is a “TransAtlantic Consensus” that Europe needs to become more like the United States: more “labor market flexibility,” including increased latitude of employers to fire employees,<sup>2</sup> less regulation of business, lower payroll taxes, reduced public pension, unemployment compensation, and other payments, lower wages and benefits attached to employment, and a reduced influence of unions.

As it turns out, the bulk of the economic evidence does not support the underlying assumptions of the TransAtlantic Consensus. For example, according to the most obvious market-based measure, the EU economy is more internationally competitive than that of the United States: Europe has a trade surplus, while the United States is running a huge, unsustainable trade deficit of 6 percent of GDP.

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As for living standards, the idea that European living standards are lower is based on the standard measure of per capita GDP (or income per person). This would be a reasonable approximation (ignoring the things that income doesn't measure, such as life expectancy or other health outcomes, or distribution) if Europeans worked the same number of hours as Americans. But they don't. France has a per capita GDP that is about 30 percent less than ours. But productivity — output per hour of labor — is actually higher in France than in the U.S.<sup>3</sup> This means that if the French worked as many hours as we did, they would actually have more income than Americans. So they have chosen to take their productivity gains in the form of shorter hours, longer vacations, and more leisure time.

The argument that higher European unemployment (currently 8 percent in the 15 high-income EU countries, as compared to 4.9 percent in the U.S.) is a result of their labor market protections is also lacking in economic evidence.<sup>4</sup> There are a number of countries with high levels of labor market protections that have achieved low levels of unemployment: Austria (5.1 percent), Denmark (4.8 percent), Ireland (4.8 percent), the Netherlands (4.8 percent), and Norway (4.6 percent). And there is no obvious relationship in general between various measures of labor market protection (e.g. unemployment compensation, coordinated bargaining, percentage of union members, protection from firing) and the unemployment rate.

The environmental consequences of the debate over the American versus the European model are potentially enormous. Imagine that the conventional wisdom continues to trump the economic evidence, and Europe increasingly moves toward an American-style economy where people work more hours so that they can buy more things (despite lower wages). Europe's energy consumption per person is currently less than half that of the United States.<sup>5</sup> This number will rise considerably if Europe becomes more like the United States. First, energy consumption will rise as per capita output (GDP) rises, even if overall energy efficiency (per unit of GDP) remains the same. In other words, if French GDP per capita rose by 30 percent because of more hours worked, we would expect the country's energy consumption to rise proportionately. Second, it might even rise more than proportionately if the country's welfare state is cut back. Publicly provided goods such as education and mass transit are less energy intensive than private consumption, for example cars.

The flip side of this debate is the United States: imagine, as is the case today, that the American model continues to be accepted as economically most successful (even if some journalists and policy makers recognize its greater problems with poverty, health outcomes, and inequality). This means that a high-consumption economy will prevail, in spite of the fact that many Americans say they would prefer to have shorter hours and more time to spend with their families. It will remain difficult to reduce U.S. energy consumption.

Last but not least, there is the question of which direction the middle-income developing countries of the world — especially the fast-growing countries of Asia — will choose as they reach the levels of economic development that the rich countries have today. South Korea and Taiwan are already at European levels of GDP per capita. China (at \$6100 per person) is still far behind but it is huge and growing very fast (its economy will be bigger than ours within about 11 years). Will these countries seek to emulate European consumption patterns or those of the United States? As it stands now, the

American model is pretty consistently portrayed — despite international criticism of U.S. foreign policy or social problems — as economically superior. How long will this view prevail, and at what cost to the environment? Much will depend on the outcome of this crucial debate over economic policy.

## **2. “Free Trade” and “Free Markets” versus Protectionism: Who Wants What?**

The term “free trade” is a marketing slogan, like “Lose the carbs ... not the taste” or McDonalds’ “I’m loving it.” Yet it has been accepted by non-governmental organizations across the political spectrum, as well as by the press. It is almost as if, when former President Ronald Reagan decided to call the MX missile “The Peacekeeper,” everyone adopted this as its official name, regardless of their view of the arms race at the time.

The term “free trade” is not just a one-sided slogan; it is also inaccurate and misleading as a description of current commercial agreements such as the WTO or NAFTA, from an economic point of view. This is not a technicality: this is an economic misunderstanding that is so huge that if it were corrected, the entire debate over trade and global economic integration would change considerably. The easiest way to see this is to look at our own government’s most important foreign commercial policy objective today, which is getting the rest of the world (mainly low and middle-income countries) to enforce U.S.-style patent and copyright laws. This goal is embodied in the TRIPS (Trade-Related Aspects of Intellectual Property Rights) agreement of the World Trade Organization (WTO).

This goal is the exact opposite of “free trade.” As almost any economist would acknowledge, it is a form of protectionism. And it is the most costly form of protectionism in the world today. The economic losses from protectionism, whether in the form of a tariff on steel, a quota on sugar imports, or a patent on pharmaceutical drugs, is proportional to how much the restriction raises the price of the protected good above its competitive price. Tariffs rarely raise the price of protected goods by more than 30 percent. But pharmaceutical patents can add hundreds or even thousands of percentage points to the price of particular drugs.

So if we think about all the economic arguments for free trade in certain goods and services that have been used to change the world over the past 30 years, and multiply them by 50 or 60, those are the arguments against patent and other monopolies due to “intellectual property.” The WTO is increasing some (very costly) barriers to international trade, while lowering others. It therefore cannot be accurately described as “an organization that promotes free trade.”

There are numerous other examples of policy-makers carrying the banner of “free trade” or “free markets,” when this redistributes income upward, while advocating protectionism when international competition would benefit the majority. While most policy-makers and political leaders have been willing to negotiate agreements that have exposed the bottom 70 percent of the U.S. labor force to fierce international competition, they have pursued the opposite course — protectionism — for highly paid professions such as doctors, lawyers, dentists, or lawyers. This is in spite of the fact that the gains from international liberalization in these services would be many times greater than those from

liberalizing trade in manufactured goods.<sup>6</sup> Similarly, the IMF and other “free-market” institutions made some of the most costly economic errors in the last decade — in Russia, Brazil, and Argentina — defending fixed exchange rates rather than allowing the pegged currencies to float, as would be the “free market” solution. There are any number of issues where NGOs concerned with the needs of the majority would favor market solutions, while powerful elites favor protectionism.

By getting its opponents to accept the terms “free trade” and “free markets” as descriptions of current commercial policies, the advocates of these policies have, for now, won most of the public relations battle. It allows them to portray their policies as protecting the public interest in promoting economic efficiency, and their critics as special pleaders seeking to impose economic costs on society for their own narrow interests.

This misleading framework must be jettisoned, if environmental, or public interest groups generally are to have a chance at winning these crucial policy debates.

### **3. Falling Birth Rates in High-Income Countries: Should We Be Worried?**

The rate of population growth in high-income countries continues to slow, with the Japanese population, for the first time, actually declining for the first 6 months of this year. Western Europe’s population growth rate has fallen from 0.8 percent in the 1960s, to about 0.2 percent today. In the United States, fertility rates dropped from 3.61 in 1960 to 2.02 today.<sup>7</sup>

From an environmental point of view, this can only be seen as good news. Population growth rates in developing countries are higher, but they have also slowed considerably in recent decades. But people in high-income countries, who comprise less than 20 percent of the world’s population, account for at least three-quarters of the world’s consumption. The United States has only about a quarter of the population of India, yet puts about three times the amount of carbon emissions into the air. To slow the rate of environmental destruction, a slower-growing or even shrinking population in the rich countries is enormously positive.

Yet in most discussion and even reporting of these issues, falling birth rates are portrayed as a problem,<sup>8</sup> based on alleged economic arguments. The public in rich countries is told repeatedly that an aging population will place insurmountable burdens on future generations in caring for elderly populations that will be larger in both absolute numbers and as a percentage of the population. Projected increases in life expectancy are seen as compounding the “problem.” As a result, many people — including policy-makers — believe that the declining birth rates in high-income countries are a serious long-term economic threat.

We can see how easily these demographic problems are exaggerated beyond recognition by looking at the current debate over Social Security in the United States. For almost a year we have witnessed a debate over how to “reform” Social Security, based on the idea that it was not affordable because of demographic changes. But in fact all projections, including those used by President Bush, show that Social Security will always be able to pay a benefit that is higher — in real, inflation-adjusted terms — than what retirees receive today. This is true even if nothing is ever done to cut benefits or to raise tax

revenues. To pay all promised benefits and close the projected shortfall over the next 75 years would require additional revenue of less than three-fourths of one percent of GDP.<sup>9</sup> Since the average real (after inflation) wage 45 years from now will be 68 percent higher than it is today, it is assured that future generations will still have much higher living standards than we enjoy currently, even if taxes have to be raised to cover any shortfall.

While some of the European countries have bigger gaps to cover, the basic story is still the same: no future generation in the rich countries is going to suffer reduced living standards as a result of caring for aging populations.<sup>10</sup> The simple economic fact that most people don't take into account is that productivity (output per labor hour) rises almost every year — and that allows for a work force over time to support a much larger retired population. (That's why all the warnings about how the United States will have only 2.1 workers per retiree in 2035, as compared to 3.3 today, are about as useful as one-half of a baseball score — they are ignoring the productivity increases). And in addition, standard economic theory predicts that slower population growth would raise productivity and wages, because it increases the ratio of capital to labor. So most people would be economically better off as a result of slowing population growth.

The fact that economic progress, social and cultural changes (especially the increasing economic opportunities and education available to women) have substantially lowered birth rates in the high-income countries is a very important and positive trend for the environment. Yet it is portrayed, on the basis of widely accepted arguments that have no foundation in standard economic analysis, as a threat to the economic future of the developed countries. And there are efforts under way to reverse these trends — for example in Japan, a country smaller than California with more than three times its population, as well as in some European countries. While policies such as state-sponsored day care, paid parental leave, and other efforts to ease the burden of child care and promote equal opportunities for women are absolutely to be welcomed, there is no need to try to convince people to have more children. The environmental movement has an important stake in refuting the fallacious economic arguments that have been used to persuade the public that higher birth rates are necessary and economically beneficial in high-income countries.

#### **4. The Cost of Reducing Global Climate Change**

The main argument used against the United States' complying with the Kyoto treaty is that the economic costs are too high. Sometimes this is expressed in terms of employment losses, but this is the same thing as reduced output, although fear of job losses has more of a political appeal.

Most of the major economic models estimate the losses for the United States due to compliance with the Kyoto treaty to be in the range of 1 to 3 percent of GDP.<sup>11</sup> This is a fairly large range, and the estimates do not take into account the benefits of reduced pollution or even the reduction in insurance costs that may result from reducing climate change. But the costs of compliance according to the economic models is significant, and so this argument must be answered.

One way to address the argument is to put these costs in perspective. Although no one has yet done the necessary economic modeling exercise, if one were to carry out the same studies looking at the effect of increases in military spending over the last four years, the cost to the economy (and lost jobs) would very likely fall in the same range. This seems counter-intuitive to most people, since most people would assume that increased military spending, however wasteful, actually increases output and employment. This is based on the idea that there is some amount of unemployed labor and unused capacity, and the military spending acts as a stimulus to the economy by employing unused resources. But that is not the way the models used to estimate the impact of reducing carbon emissions are set up. In these models, the economy's resources, including labor, are fully employed to start out with. The reduction in fossil fuel usage reduces output and employment because it reduces overall productivity in the economy, and therefore the real wage.<sup>12</sup> At a lower real wage, fewer people are willing to work, although there is still a (new) full employment equilibrium where everyone who is willing to work at the (lower) real wage is employed. The economy settles at a lower level of output and employment.

Using the same models to estimate the impact of the recent increases in military spending would show a similar negative impact on the economy. The increase in taxes to pay for the military spending reduces the overall productivity of the economy, which again lowers the real wage. Or alternatively, if the increased military budget is paid for by borrowing, this increases interest rates. The higher interest rates make capital investment more expensive, thus reducing productivity and again the real wage. Either way, the economy then equilibrates at a lower level of employment and output, just as it does in response to the carbon emissions reduction. The quantitative impact of the increased military spending since 2000 would very likely be in the same range as the costs of reducing carbon emissions as agreed to in the Kyoto protocol.

This would be an important thing to demonstrate, since there has been virtually no discussion of these economic effects of increased military spending. Of course, some might argue that such increases were necessary for national security reasons, but even if one believes this, it doesn't change anything. The point is that if these costs have not even been an item for discussion in the decision to increase military spending, then how can they be a major consideration in the debate over global climate change?

The costs of increased military spending to the economy, once established according to these standard economic models, could be used as a benchmark in the debate over reducing carbon emissions. This would make it much more difficult to argue that the economic cost of taking action against climate change, or other measures to protect the environment, is too high.

## Endnotes

<sup>1</sup> This discussion refers to Austria, Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom.

<sup>2</sup> In the United States, unlike most other countries, it is generally legal to fire private sector employees without cause, unless there is a union contract (only 8.0 percent of private sector employees in the United States are in unions), or if there is discrimination that is prohibited by civil rights legislation.

<sup>3</sup> This is according to the OECD Productivity Data Base, February 2005; data for 2003. Other measures (Eurostat and Groningen Growth and Development Centre) also show France with higher productivity than the United States.

<sup>4</sup> See Baker, Dean, Andrew Glyn, David Howell, and John Schmitt. 2004 “Unemployment and Labor Market Institutions: The Failure of the Empirical Case for Deregulation.” New York. <http://www.newschool.edu/cepa/papers/archive/cepa200404.pdf>

<sup>5</sup> World Development Indicators 2005 and author’s calculations

<sup>6</sup> See Baker, Dean. 2003. “Professional Protectionists: The Gains From Free Trade in Highly Paid Professional Services.” Washington, D.C.: Center for Economic and Policy Research. <http://www.cepr.net/publications/protectionists.PDF>

<sup>7</sup> Social Security Administration. 2005. *Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*. Table V.A1. Washington, D.C.: SSA. [http://www.ssa.gov/OACT/TR/TR05/V\\_demographic.html#wp159501](http://www.ssa.gov/OACT/TR/TR05/V_demographic.html#wp159501)  
(In the United States, population growth did not decline with birth rates due to increases in immigration).

<sup>8</sup> See, e.g. Lewis, Leo. 2005. “Decline in population sparks fears for economy.” *Financial Times*, on Japan; see also Longman, Philip. 2004 “The Empty Cradle: How Falling Birthrates Threaten World Prosperity and What to Do About It.” New York: Basic Books.

<sup>9</sup> This is from the Social Security Trustees’ Annual Report (2005). The majority of the Trustees are political appointees of the Bush Administration. The non-partisan CBO estimates the shortfall over 75 years as even smaller — 0.4 percent of GDP.

<sup>10</sup> In the United States, we are facing explosive health care costs, including Medicare; but this is due to our inability to contain health care costs, not to demographic changes.

<sup>11</sup> See Lasky, Mark. 2003. "The Economic Costs of Reducing Emissions of Greenhouse Gases: A Survey of Economic Models." Washington, DC: Congressional Budget Office, Technical Paper Series. The range estimates for models surveyed in this paper is between -0.5 and -4.2 percent of GDP.

<sup>12</sup> In these models, the real wage is equal to the marginal product of labor, which is reduced when firms cut back on energy usage, e.g. in response to a carbon tax.