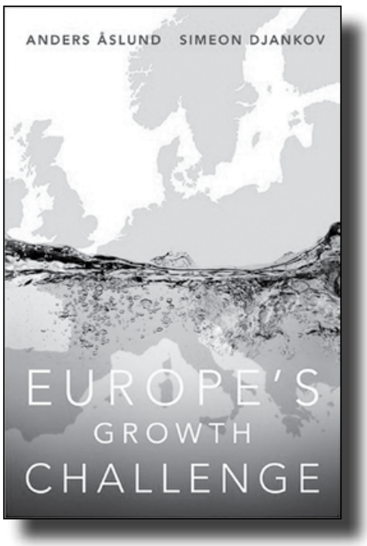
European Turnaround Plan

In this excerpt from their new book, economists Anders Åslund and Simeon Djankov lay out the steps for an additional one percent growth.



Europe's Growth Challenge
by **Anders Åslund and Simeon Djankov**
(Oxford University Press, 2017)

Europe can break out of its low growth trap and grow faster again. We suggest steps to increase annual GDP growth by one percentage point. If national governments and European institutions implement the policies suggested in this book, Europe can become as competitive as the United States, so that it can maintain its high living standards and social welfare state.

After eight years of stagnation, most Europeans want change. Europe has been confronted with a major inflow of refugees from North Africa and the Middle East, which offers an additional impetus for change. The result of the Brexit referendum in June 2016 is the starkest manifestation yet that Europe's economic and migration policy deserves a thorough rethink. In each area, some European countries have good practices that can be adopted as benchmarks by the rest of Europe as well.

The aim of this book is to formulate a reform agenda suggesting how the European economy can speed up its anemic growth. Our intention is to bring the attention of policymakers and European citizens to key changes that could make a difference. The following list of recommendations is a summary of the key insights of this book, focusing on common factors that can promote growth.

1. Limit public expenditures to 42 percent of GDP. Public expenditures in Europe are on average one-tenth of GDP higher than in other highly

Anders Åslund is a senior fellow at the Atlantic Council. Simeon Djankov is a nonresident senior fellow at the Peterson Institute for International Economics, and formerly deputy prime minister and minister of finance of Bulgaria.

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220 I Street, N.E., Suite 200
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Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

developed countries. These excess public expenditures go almost entirely to social transfers, which should be tightened since they distort incentives. Controlling for other conditions, very high public expenditures depress growth.

Most EU countries have allowed their public expenses to swell simply because they could collect the taxes or sell bonds without considering whether the spending would be beneficial for their economic growth or welfare.

Europe can become as competitive as the United States.

Poorer European countries need to be careful not to expand public expenditures excessively to avoid fiscal crises and high levels of unemployment.

A level of public expenditures in the range of 35–42 percent of GDP seems optimal for Europe. One-third of Europe already fulfills this criterion (Bulgaria, Estonia, Ireland, Latvia, Lithuania, Romania, Slovakia, Poland, and the Czech Republic), and these countries grow faster than the rest. We suggest a European-wide ceiling of public expenditures in peacetime of 42 percent of GDP, like the Maastricht criteria of annual budget deficits of no more than 3 percent of GDP and public debt of no more than 60 percent of GDP.

2. Open up services and digital trade. Trade in services offers the greatest growth potential for Europe, because services account for 70 percent of modern economies, but service trade remains fragmented and has been surprisingly neglected. The situation is even worse for fast-growing digital services. The European Parliamentary Research Service found that the greatest cost of weak EU cooperation in 2014–2019 was the missing digital single market (€340 billion, 1.8 percent of EU GDP) and single market for services (€330 billion, 1.8 percent of GDP).

The digital market is not only fragmented, but there is no single market for digital services, which requires unification to open up. Fortunately, new technologies and business practices, notably in digital trade, render the old protectionism untenable, but the EU needs to open this market.

Only in 2006 did the EU adopt its Services Directive, but it contained too many loopholes to effectively create a single European market for services. In addition, it encountered great resistance from vested interests, such as regulated professions. The variety of cultures and customs in European countries has ensured that services have been treated as local in nature. The EU Services Directive needs to be expanded to nearly all services, with firmer rules to open up EU service markets. Europe would benefit from abolishing unnecessary regulation of professions. The establishment of service companies in other EU countries should be facilitated, and one-stop shops for registration ought to be instituted throughout Europe. If the European Commission implements the Services Directive more forcefully it could become an effective support for the evolution of intra-European service markets.

Much can be achieved through integrated public procurement. Once Europe starts using one single procurement system for municipal, national, and cross-national projects, the many services involved in making this procurement successful will also be integrated.

3. Reduce the burdens on labor. One of Europe's greatest social ailments is the high unemployment rate, persistently exceeding 8 percent of the active labor force. An even greater concern is high youth unemployment, especially in Southern Europe. Few policies can do more to improve Europe's economic growth and welfare than policies creating more jobs. Many measures are desirable.

In 2015, the European employment rate was 4.3 percentage points less than that in the United States. Not only do fewer Europeans work, but those who do work on average 4.9 percent less than that in the United States. If Europe had the same employment rate as the United States, and Europeans worked as many hours as Americans, the addition to the European labor force would be 9.4 percent.

At the same time, Europe suffers from a shortage and mismatch of labor. Europe taxes labor heavily, which is both unjust and inefficient. Personal income taxes and payroll taxes are too high. They hamper innovation and discourage official work, preventing job seekers from finding their first employment. Marginal income taxes are excessive in many European countries, causing large tax wedges. Nor is it just that labor is taxed more heavily than capital gains. It appears a matter of justice and efficiency to reduce taxation of labor and equalize it with the taxation of capital gains, as many East European countries have done. Such a policy would also encourage participation in the labor force, especially among European women, and stimulate people to work more in the formal economy rather than in the informal sector.

West European countries can draw on the new thinking on taxation from Eastern Europe. The Baltic countries, Slovakia, Romania, and Bulgaria, have only the taxes we have advocated here. European corporate profit taxes have fallen through tax competition, and the new lower taxes reap more revenues. Most East European countries have opted for a low, flat income tax that is equal to the corporate profit tax to avoid discrimination against labor. The EU has greatly harmonized value-added taxes, which function well.

Most of Europe's labor markets remain overregulated, particularly in Southern Europe. These countries have opened up somewhat, but more is needed. If it were easier to hire and lay off workers, employers would employ more new workers, instead of pushing their workers to work overtime. One positive example is Ireland, with its highly flexible labor market. Others are Denmark and Germany, which have successfully combined increased flexibility with the maintenance of substantial social support. Impressively, these countries have similarly low unemployment around 5 percent.

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Germany and Austria have kept youth unemployment at bay thanks to a sophisticated policy of apprenticeships, offering excellent vocational training. Other countries would be well advised to follow their examples. The four Southern European countries, however, need to expand their high school education to enhance their competitiveness.

The participation of women in the labor force varies dramatically. Many measures can be used to attract women into the labor force. Equal rights for men and women are a start, but child care and flexible work arrangements render them more effective. The Scandinavian countries have been most successful in engaging women in the labor force, though this has taken place at substantial fiscal cost.

Europe has considerable experience in absorbing immigrants, but it has little choice but to control immigration and develop a politically acceptable immigration policy. Europe can learn from Australia and Canada how to find the right balance between immigration based on labor market requirements, family reunification, and humanitarian considerations. Ireland, which used to be the main emigration country in Europe, has probably adopted the best policy for immigrants: tolerance, limited regulations, a welcome to skilled immigrants and foreign direct investment, low taxes, and limited but vital social benefits. Social benefits need to be exportable, and earned benefits should be transportable.

4. Improve higher education and create better conditions for innovation. Increasingly, Europe is falling behind in innovation and high-tech development. This is the greatest and most difficult challenge to Europe, involving many elements. Elite universities are a precondition. Top-level innovation thrives in ecosystems built up around world-class universities, which are largely located in the United States and the UK. European continental universities need to catch up. First of all, the very goal of developing elite universities must be accepted. Next, independence from the state makes top universities truly great. They also require large financing that is not stifled by state regulation. American and British universities have substantial revenues from tuition fees, which ought to be allowed in the rest of Europe. State financing is best based on quality. Universities thrive when allowed to abandon strict salary regulation and to pay top professors according to merit. It takes time to build a university of top quality, finding the right combination of freedom and stimulus.

Leading universities also need to develop innovative links with start-ups. They must have a reasonable approach to intellectual property rights so that start-ups can gather around them. Start-ups require venture capital that can only be private equity capital. An accommodating tax regime and regulatory framework is preferable, and the immigration of talent offers great advantages. European universities can once again become the centers of innovation they were in the first decades of the 20th century.

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Most of Europe spends too little on research and development. Almost unanimously international studies recommend more such spending. One way of boosting it is to stimulate private R&D through tax incentives.

5. Reform pensions. Public pension spending is excessive in many EU countries, which endangers financial sustainability, drives up taxes, distorts incentives, and undermines economic growth. Public pensions are neither just nor secure, often being subject to political tampering. Greece and Italy stand out for the largest public pension expenditures, which have greatly contributed to stalling economic growth in these countries.

Pension reforms have many goals: to limit public pension costs to around 8 percent of GDP to ease the fiscal burden; to provide sufficient security with sound regulation to render most of the public pensions actuarially correct and transparent; and to promote solid private pension savings, whether mandatory or voluntary. Apart from a flat subsistence pension, public pensions should be actuarially appropriate, offering pensioners disbursements related to their contributions. Early retirement schemes must be reined in to what is really necessary, and the retirement age can rise with life expectancy. Private pension savings, whether mandatory or voluntary, ought to be encouraged and shielded.

The Dutch pension system appears the example to follow. It combines all the best features. It is secure and affordable, generates high pensions, encourages private savings, and contributes to sound economic growth. Its first pillar is a public old-age pension financed with a payroll tax in a pay-as-you-go system. It provides all residents with a flat minimum pension amounting to 70 percent of the minimum income, rendering it very stable. Its outstanding feature is the second pillar, a large private occupational pension for both private and public employees financed with 18 percent of employees' earnings, giving the Netherlands the largest private pension funds in Europe, far exceeding the country's GDP. Together with the state pension, the Dutch occupational pensions offer pensioners 70 percent of their prior salary. Since the occupational pensions are agreed through collective bargaining between employers and trade unions, their institutional arrangement is remarkably stable.

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6. Complete the European energy union. The evolution of the European single market for energy has been slow because the European Commission has encountered significant resistance from the old national energy champions and several large member states. The European Commission has taken important steps to gain momentum toward achieving an energy union.

With the adoption of its third energy package of 2009 and the energy union of 2015, the European Commission has insisted on open markets with consumer choice and open transmission networks. This aim requires adequate infrastructure to allow energy to be transported in any direction the market demands. The challenge of the EU is to prove that it has sufficient strength to attain these goals.

Europe has been too tolerant of state-owned national champions in energy. They can be privatized as in Britain, which stands out as the most open and diversified and also successful energy market, with low prices and secure supplies. European states would greatly benefit from allowing the access to natural resources to private entrepreneurs. In EU countries, the state owns all resources underground, depriving private landowners of the incentive to promote energy production. Resource rents can be properly taxed, which remains a national issue.

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The essence of our recommendations may be summarized: to ease the fiscal and regulatory burden on the economy, to get incentives right, to complete the missing markets for services, digital trade, and energy, and to stimulate high-tech development and innovation. ◆