

## Restoring Europe's Lustre

Fifty years ago, the American Economic Review published a short article titled "The Golden Rule of Accumulation". In it, Edmund Phelps, an American economist, proposed a simple rule for a nation's wealth to grow and provide the highest standard of living for its citizens—present and future. The rule essentially specified how much people had to work, save, and invest today so that future generations could be at least as well off as they were. The paper used the insights of economists from around the world, including France, Germany, Hungary, the Netherlands, and the United Kingdom.<sup>1</sup> All were to have distinguished careers, and some would get the Nobel Prize. In 2006, the Nobel Committee awarded the prize to Phelps for "his analysis of intertemporal tradeoffs in macroeconomic policy."

Many economists still consider the golden rule the most basic proposition of optimum growth theory. It is the inspiration for the title of this report, and forms the roots of its policy prescriptions. Following the golden rule means that today's Europeans work and consume just so much that future generations do not resent them for consuming too much, nor pity them for consuming too little. Keeping to the rule is perhaps the most telling sign of a country's—or a continent's—economic maturity.

Europe's growth is already different from other economies' in two aspects, reflecting its cultural and demographic maturity. Perhaps more than others around the world, Europeans want economic growth to be smarter, kinder, and cleaner, and they are willing to accept less for "better" growth. The single word that summarizes these ideals might be "golden."

Europe's growth will have to be golden in yet another sense. Economic prosperity has brought to Europeans the gift of longer lives, and the continent's population has aged a lot over the last five decades. Over the next five, it will age even more: by 2060, almost a third of Europeans will be older than 65 years. Europe will have to rebuild its structures to make fuller use of the energies and experience of its more mature populations—people in their golden years.

These desires and developments already make the European growth model distinct. Keeping to the discipline of the golden rule would make it distinguished. This report shows how Europeans have organized the six principal economic activities—trade, finance, enterprise, innovation, labor, and government—in unique ways. But policies in parts of Europe do not recognize the imperatives of demographic maturity and clash with growth's golden rule. Conforming growth across the continent to Europe's ideals and the iron laws of economics will require difficult decisions. This report was written to inform them. Its findings: the changes needed to make trade and finance will not be as hard as those to improve enterprise and innovation; these in turn are not as arduous and urgent as the changes needed to restructure work and government. Its message: the remedies are not out of reach for a part of the world that has proven itself both intrepid and inclusive.

## A distinctive model

It is common these days to hear Europeans calling for a “new growth model.” The public debt crisis has shaken confidence not just in the euro but in Europe.<sup>2</sup> Aging Europeans are being squeezed between innovative Americans and efficient Asians, it is said. With debt and demographics weighing down European economies, the argument runs that they will not grow much unless they discover radically new ways.

The end of complacency among Europeans is good, because developments in and outside the continent have made changes necessary. But loss of confidence could be dangerous. The danger is that in rushing to restructure and restart growth, Europe may throw out the attractive attributes of its development model with the weak ones. In fact, the European growth model has many strong points and enviable accomplishments.

Between 1950 and 1973, Western European incomes converged quickly towards those in the United States. Then, until the early 1990s, the incomes of more than 100 million people in the poorer southern periphery—Greece, southern Italy, Portugal, and Spain—grew closer to those in advanced Europe. With the first association agreements with Hungary and Poland in 1994, another 100 million people in Central and Eastern Europe were absorbed into the European Union, and their incomes increased quickly. Another 100 million in the candidate countries in Southeastern Europe are already benefiting from the same aspirations and similar institutions that have helped almost half a billion people achieve the highest standards of living on the planet. If European integration continues, the 75 million people in the eastern partnership will profit in ways that are similar in scope and speed.

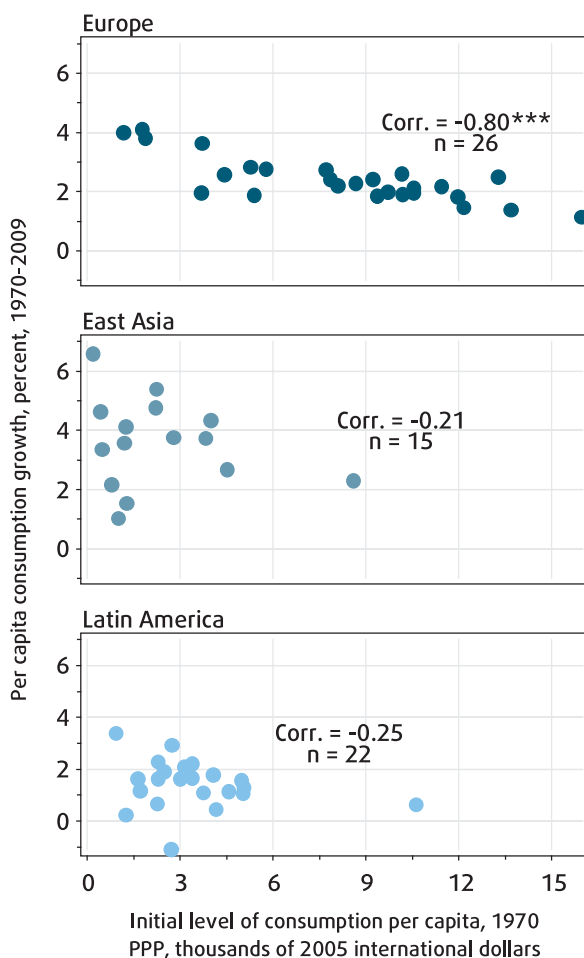
It is no exaggeration to say that Europe invented a “convergence machine,” taking in poor countries and helping them become high-income economies. Over the last four decades, the countries in Europe experienced a convergence in consumption levels that is unmatched (figure 1). Annual per capita consumption in the poorer parts of Europe grew by 4 percent while in the wealthier countries it increased at a still-impressive 2 percent. The rest of the world—except for East Asia—has seen little or no convergence. That is why the European model was so attractive. That is why European growth is unique.

Given Europe’s diversity, it is not easy to identify a single “European growth model.” There are big differences in how Italy and Ireland regulate work and enterprise, and how Greece and Germany balance fiscal policies and social objectives. There are big differences in what Spain and Sweden export, and

how they regulate commerce. There are differences in how Portugal and Poland have regulated their banks, and not just because one of them shares a common currency while the other has one of its own. And there are differences in how Finland and France provide government services such as education and health.

### Figure 1: In Europe, a rapid convergence in living standards—not much elsewhere

(growth of consumption per capita between 1970 and 2009, by level of consumption in 1970)



Source: World Bank staff calculations based on Heston et. al. (2011); n=number of countries. See chapter 1.

But these differences in specifics do not rule out the existence of a common approach to economic growth and social progress. This approach consists of policies and institutions that govern trade and finance, enterprise and innovation, and labor and government that have common elements. Together,

these elements define an economic and social model distinctly European (see chapter 1).

These elements have been associated with Europe's biggest successes since World War II: unprecedented regional integration, global economic power, and the attainment of the highest quality of life in human history.

- **Trade, finance, and unprecedented regional integration:** Europe's rich and poorer economies are more integrated through trade in goods and services than in any other part of the world, resulting in quicker convergence in incomes and living standards. Private capital in all its forms—foreign direct investment (FDI), financial FDI, and portfolio funds—has flowed from richer to poorer countries, and from low- to high-growth economies. Trade and finance—facilitated by the single market instituted by the European Union and its forebears—have fueled convergence in incomes and living standards.
- **Enterprise, innovation, and global economic influence:** Private enterprises are held accountable for profits by shareholders, but are also more socially and environmentally responsible than companies in most other parts of the world. Research and development and tertiary education, recognized around the globe for their economic spillovers, are seen as a responsibility not just of firms but also the state. Enterprise and innovation—aided by deep and comprehensive regional economic integration—enable Europe to account for about a third of world gross domestic product (GDP) with less than one-tenth of its population.
- **Labor, government, and high living standards.** Workers in Europe are accorded strong protection against abuse by employers, and have unprecedented income security after job loss and in old age. European governments are the most decentralized and representative of local interests and Europe has developed the most effective institutions for regional coordination in human history. Europe's model of labor and government—facilitated by the growing consensus for continental cohesion and made affordable by its economic heft—has made the European lifestyle admired and envied around the world.

What has Europe accomplished that other parts of the world could not? Which aspects of the model are no longer sustainable, either because of unanticipated changes in Europe and elsewhere or because some European countries have transformed themselves too fast? Which changes are needed now, and which can wait? These are the questions that this report asks.

The short answers: Europe has achieved economic growth and convergence that is unprecedented (table 1 and spotlight one). Most countries in Europe



are doing well in trade and finance, many in enterprise and innovation, but far fewer are doing well in labor and government. So Europe needs many changes to make its governments and labor markets work better, fewer to foster innovation and productivity growth in enterprises, and fewer still to reform finance and trade. These deficiencies are rooted in how some activities are organized—and they will need to be reorganized. Stalled productivity, declining populations, and growing fiscal imbalances have made some changes urgent.

### Table 1: Relentless growth in the United States, revival in Asia, and a postwar miracle in Europe

(average annual compound growth rates, GDP per capita, 1820–2008, US\$ 1990 Geary-Khamis PPP estimates)

Year	Western Europe	Southern Europe	Eastern Europe	Former Soviet Union	United States	Japan	East Asia	Latin America
1820–1970	1.0	0.6	0.6	0.6	1.3	0.2	–0.1	0.0
1870–1913	1.3	1.0	1.4	1.0	1.8	1.4	0.8	1.8
1913–1950	0.8	0.4	0.6	1.7	1.6	0.9	–0.2	1.4
1950–1973	3.8	4.5	3.6	3.2	2.3	7.7	2.3	2.5
1973–1994	1.7	1.9	–0.2	–1.6	1.7	2.5	0.3	0.9
1994–2008	1.6	2.7	4.0	4.2	1.7	1.0	3.9	1.6

Note: Regional aggregates are population weighted. See spotlight one for details.

Source: Maddison 1996; Groningen Growth and Development Centre and The Conference Board (2011) Total Economy Database.

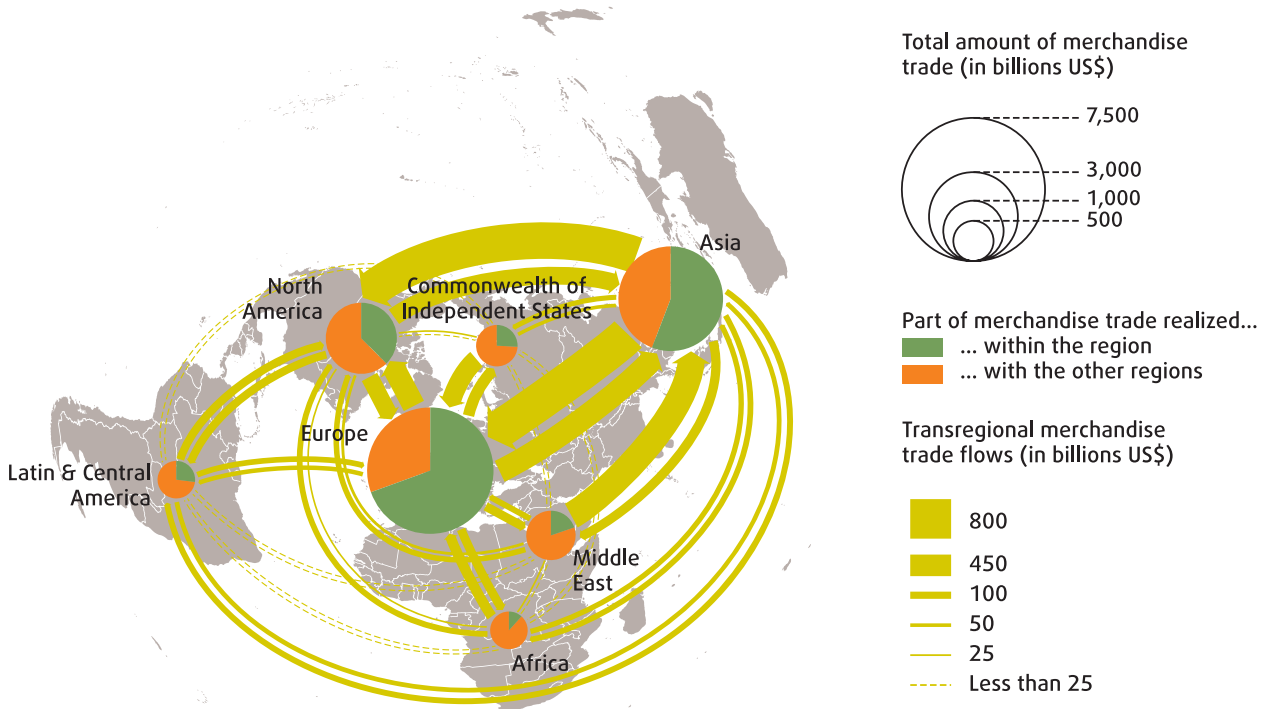
But in addressing these shortcomings, Europeans should not forget the singular successes of their growth model. By fostering a regional economic integration unique in both depth and scope, Europe has become a “convergence machine”. By engineering entrepreneurial dynamism in the countries that balanced market forces and social responsibility, it has made “brand Europe” globally recognized and valued. And by allowing a balance between life and work, it made Europe the world’s “lifestyle superpower”. To continue the progress of the last five decades, Europeans now have to do three progressively tougher tasks: restart the convergence machine, rebuild Europe’s global brand, and recalibrate the balance between work and leisure to make their lifestyles affordable.

## The convergence machine

An increasingly vigorous flow of goods, services, and finance over the last five decades has fueled European growth. Europe’s economies are the most open in the world. Before the global crisis of 2008–09, half of the world’s approximately \$15 trillion trade in goods and services involved Europe (figure 2). Two-thirds

of it was among the 45 countries discussed in this report. Financial flows have been equally vigorous. In 2007, for example, annual FDI in Europe exceeded \$1 trillion. Big and growing trade and financial links facilitated by the single market form the core of the European convergence machine.

**Figure 2: Almost half of the global goods trade involves Europe**  
(merchandise trade in 2008, US\$ billion)



Source: World Bank staff, based on WTO (2009); see chapter 2.

## INCREASINGLY SOPHISTICATED TRADE

During the last two decades, the new member states of the European Union have done especially well at taking advantage of the opportunities offered to them, integrating westward by trading goods and modern business services. During the last decade, the candidate countries of Southeastern Europe have been doing it through trade in merchandise and more traditional services such as travel and transport. This has helped enterprises in Western Europe too. With FDI and offshoring, enterprises in Western Europe such as Fiat, Renault, and Volkswagen have made themselves and eastern enterprises like Yugo, Dacia, and Škoda more efficient and sophisticated. Simpler tasks are being given to countries outside Europe; advanced Europe is getting emerging Europe to do more difficult things, and both regions are benefiting (see chapter 2).



The goods trade between advanced and emerging Europe has grown rapidly since the mid-1990s—when the European Union signed its first association agreements with Hungary and Poland—and this does not appear to be injuring trade with other parts of the world. Europe does a brisk goods trade with North America, Asia, the former Soviet Union, and Africa (see figure 2). But trade within the region has grown much more sophisticated over the last decade, aiding quick convergence in productive capacity and living standards. It is helping to create a bigger and stronger economic union between the European Free Trade Association (EFTA), the EU15, the new member states, the EU candidate countries, and even the eastern partnership economies.

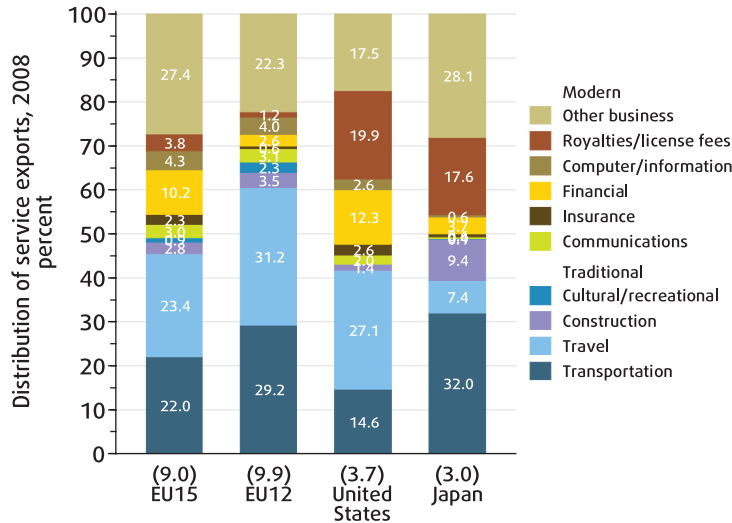
Factory Europe may not be expanding as fast as Factory Asia, but it has become smarter. And it could expand a lot too. With economic recovery and better trade facilities—especially information and communications infrastructure in the European Union’s new member states and the candidate countries—regional goods trade could double over the next decade.

The trade in modern services in Europe is increasing too, but not fast enough for many Europeans. The benchmark for merchandise trade is East Asia, a developing region, but the European Union gauges the single market for services against the United States, a developed country. Trading services is not easy: it often requires movement of people across borders, ease in establishing a local presence, and harmonious home–host regulations. Given all this, Europe’s trade in services does not seem stunted (figure 3). But progress is mixed: travel and financial services have done well but transport and other business services—especially those involving new technologies and the Internet—have not. With reforms that make adopting newer technologies easier, better regulations, and greater mobility of workers, Europe’s trade in services could triple in size over the next decade. More important, productivity in the general services sector—which is about 70 percent of the GDP in Europe—would increase.

The opportunity that Europe might really be missing involves regional trade in agriculture. The European Union pays for its agricultural trade policies not just with the roughly €50 billion a year the European Commission spends on agriculture and rural development and their large indirect efficiency costs, but also through missed opportunities for closer economic integration with eastern partnership countries. In Georgia and Ukraine, a third of all workers still depend on agriculture for a living. Allowing better access to European farm markets would aid their development, win friends, and influence policies in the countries of the eastern partnership.

### Figure 3: More trade in services in Europe, but apparently in more traditional activities

(service exports in the European Union, United States and Japan, 2008)



Note: The numbers in parentheses refer to the sum of traditional and modern service exports as a percentage of GDP.

Source: World Bank staff calculations, based on IMF Balance of Payment Statistics Yearbook; see chapter 2.

Despite these weaknesses, the overall assessment of European trade is positive. In 2009, Europe's merchandise trade was worth about \$4.5 trillion, more than East Asia's and North America's combined. Its trade in services was worth \$2.25 trillion, more than the rest of the world combined. Trade is the mainstay of the European economic model, and its most attractive attribute.

### FINANCE THAT FLOWS DOWNHILL

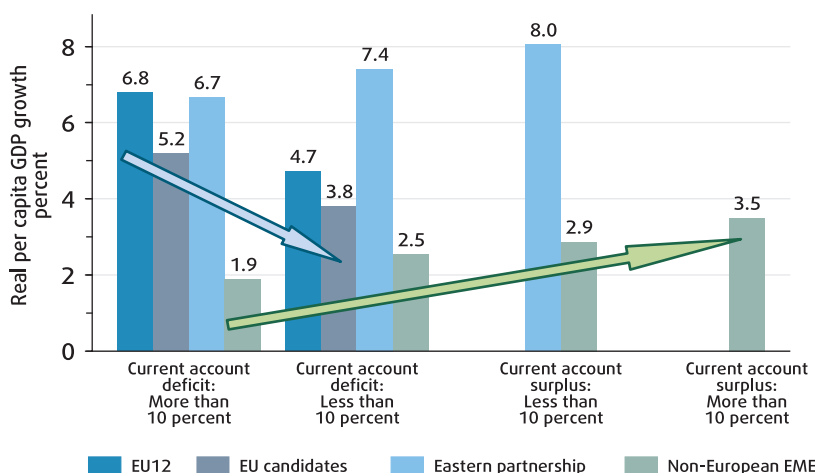
Financial integration is the second part of the convergence machine. Finance has served Europe well. This may come as a surprise to those who blame the current crisis in the eurozone on banks that lent money to spendthrift governments. But European finance has a desirable attribute: capital of all types flows from richer to poorer countries, from low- to high-growth countries. Financial FDI—big investments by Austrian, French, Italian, and Swedish banks in Central and Eastern Europe—is a unique feature of Europe. In the east, it has helped (see chapter 3).

Figure 4 shows the relationship between economic growth and current account deficits in the new member states of the European Union, its candidates, the eastern partnership countries, and other emerging economies. An upward sloping arrow means that countries that ran smaller deficits or larger external account surpluses grew faster. In other words, a country grew faster if it lent

rather than borrowed abroad. And for emerging economies outside Europe, this is indeed what we see: capital flows from poorer, high-growth countries to richer, low-growth countries (green arrow). Call this the “China syndrome.”

#### Figure 4: In Europe, foreign capital has boosted growth in emerging economies

(current account deficits and per capita growth, by groups of countries, percent)



Note: Average growth rates calculated using 3 four-year periods in 1997–2008.

Source: World Bank staff calculations based on IMF World Economic Outlook; see chapter 3.

In Europe, capital behaves the way it should: it flows from richer to poorer economies, and countries receiving more capital grow faster. The laws of economics have held in Europe. They hold more firmly the more institutionally integrated the economies have become with Western Europe—by membership in the European Union or by signaling the intention to join. Belarus and Ukraine, for example, have done neither, and they look a lot like emerging market economies outside Europe, growing faster when they have external account surpluses (capital outflows) or smaller current account deficits.

In 2008, when the financial crisis hit, people who were familiar with earlier crises in Asia and Latin America expected a massive pullout by western banks. It did not happen: foreign banks stayed, renewing 90 percent of the loans they had made, a much higher proportion than in previous crises. Of course, during the preceding boom some governments, enterprises, banks, and households abused the opportunities provided by this model of financial integration. And today, as western banks face pressures to offset losses in southern Europe, they may have to sell their profitable businesses in Eastern Europe. But the benefits have been greater than the excesses, and some reforms can make the flows more stable and their benefits even greater: better management of

public finance during booms in both advanced and emerging Europe, and more adept regulatory structures to crisis-proof private finance. To grow at high and steady rates, economies in emerging Europe have not had to “become Asian.” Nor should they have to now.

### RESTARTING THE CONVERGENCE MACHINE

In the early 2000s, an important debate took place. For two decades, economists had been puzzled by the finding that a country was able to invest only as much as what it could itself save. In theory, capital flows should allow savers in wealthier, or low-growth, countries to finance investment in poorer, or high-growth, economies. They would get a higher return on their money, and these financial flows would allow the people in developing nations to save less and consume more, and invest more and grow faster. Unfortunately, it did not seem to happen; instead, there was a strong correlation between saving and investment across countries (Feldstein and Horioka, 1980). But in the European Union between 1992 and 2001, especially the eurozone, research showed that something had changed. Greece and Portugal had run large current account deficits financed by foreign capital inflows; their savings had fallen, investment had increased, and their economies had grown (Blanchard and Giavazzi, 2002). The question was whether policymakers—national governments, the European Union, and the European Central Bank—should welcome these growing imbalances, or worry about them.

With the benefit of hindsight the answer is, of course, both. The capital inflows were the result of trade and financial integration, and they were supposed to make Greece and Portugal more productive and richer economies. Until about 2001, they did, and their living standards converged to those of more advanced European economies. But since 2002, labor productivity in Europe’s southern countries has been falling. The sheer volume of flows meant that inflows replaced domestic saving. Increasingly, though, they did not fund productive investment. Obviously, the borrowed money had not always been used well. It had flowed in on the belief that Greek and Portuguese debts would be serviced or repaid. By 2009, it was clear that this was going to be difficult.

In the new member states, the same story was being played out, but with many more happy endings than sad. In countries such as the Czech Republic and Poland, foreign savings flowed into productive uses, and both Western European savers and Eastern European investors benefited. In some others, ever larger flows began to finance consumption, sometimes by the government but more often by households. In these countries, economic growth went into reverse during the global financial crisis.



Restarting the convergence machine will not be difficult. The single market for services is becoming more efficient, and national governments can accelerate the process by fully implementing the European Union's Services Directive. For many services, measures to increase mobility of labor among countries will help greatly. For other more modern services that can be sold digitally, harmonious regulations may be much of what is needed. New member states of the European Union and the candidate countries in southeastern Europe will have to continue easing the bottlenecks in transport and communication infrastructure and modern services, so that trade in manufactures can facilitate the production networks that have been growing in size and sophistication. The European Union can also help millions of people in the eastern partnership countries—whose combined GDP is less than \$0.5 trillion—by giving better access to its \$1 trillion market for food and other farm products.

A lot of this is happening. It is the finance, the fuel for the machine, which needs more attention. Europe's convergence machine needs a better regulator of financial flows. Finance flows in the right direction in Europe—proof positive of the soundness of the system. But the flows are erratic, flooding Europe's less advanced economies when finance is plentiful, and starving them of finance when savers and investors in advanced countries become skittish. Financial flows could be made steadier through conservative fiscal policies and prudential regulations, so that they do not suddenly stop when growth slows. Canada, Czech Republic, Croatia, and Poland showed what can be done during good times, and Sweden and Republic of Korea have shown ways to quickly get firms and households out from under a debt overhang when boom-time finance fuel excesses and cause busts (Iwulska, 2011).

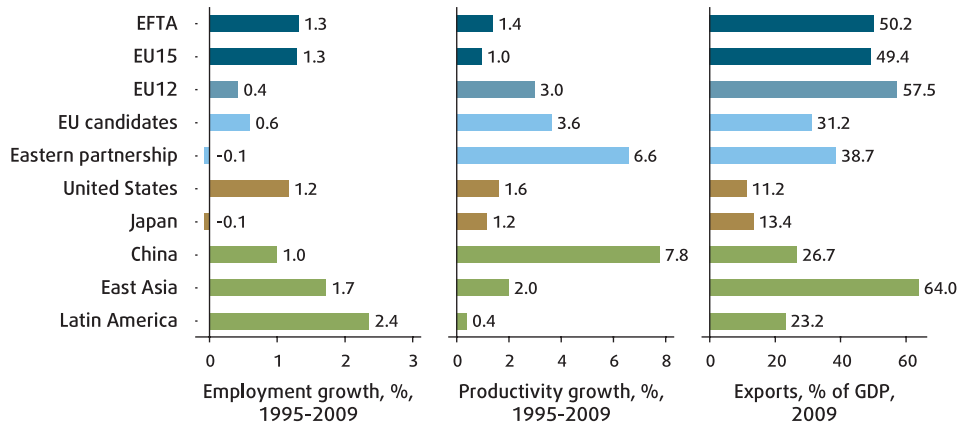
## “Europe”—A global brand

As convergence has slowed and even gone into reverse in parts of Europe, the entire region is getting a bad press. Europe's best days are behind it, it is now said. High unemployment among young people, stagnant worker productivity, unsustainable public finances, and archaic social protection and innovation systems that are unsuited for a globalized economy are all presented as symptoms of economic decay. But the heart of an economy is neither labor nor government—it is enterprise. Since the mid-1990s, during a period when Asia had a huge financial crisis and bigger recovery, and the United States had a spectacular technology boom and a massive financial crisis, European enterprise has quietly flourished.

This is no mean achievement, because Europe expects much from its enterprises. Their shareholders expect them to add value and turn a profit, workers

expect them to create jobs, and governments want them to bring in export earnings. Remarkably, over the last decade and a half, European enterprises have delivered all three (figure 5). Between 1995 and 2009, job growth in advanced Europe outstripped that in the United States. The new member states of the European Union and the candidate countries engineered productivity increases that outstripped those in East Asia and Latin America. Exports of goods and services in advanced and emerging Europe rose faster than output, and exceeded the growth rates even of the heralded BRIC economies (see chapter 4). German and Swedish manufactures, produce from France and the Netherlands, and British and Italian banks have global reach and reputation. Czech engineering, Estonian information technology, and Turkish construction companies are quickly acquiring them. These are not the signs of a region in decay.

**Figure 5: European enterprises have delivered jobs, productivity, and exports**  
(performance of European sub-regions and benchmark countries, 1995–2009)



Note: Growth rates in employment and productivity are compound annual growth rates. Average values by group are shown. China and Japan are also included in the calculation of East Asia regional average.  
Source: World Bank staff calculations, based on World Bank (2011) and ILO (2011); see chapter 4.

With Asian enterprises becoming more active globally, the next few decades might well require European enterprises to make changes in how and where they do business. For now, the numbers show that in aggregate, European enterprise has been a reliable component of the economic model.

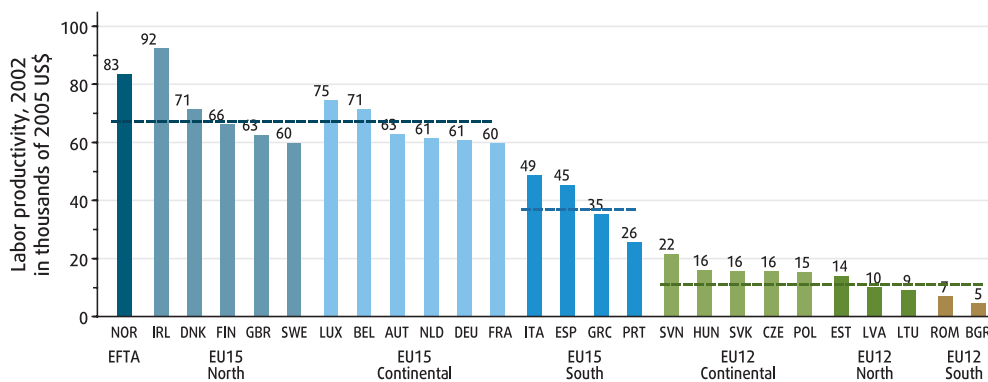
### SOUTHERN ENTERPRISE FALTERS

But not all is well. Employment growth in the EU12 could have been quicker, productivity growth in the EU15 should have been faster, and EU candidate and eastern partnership countries should raise exports to levels seen in the

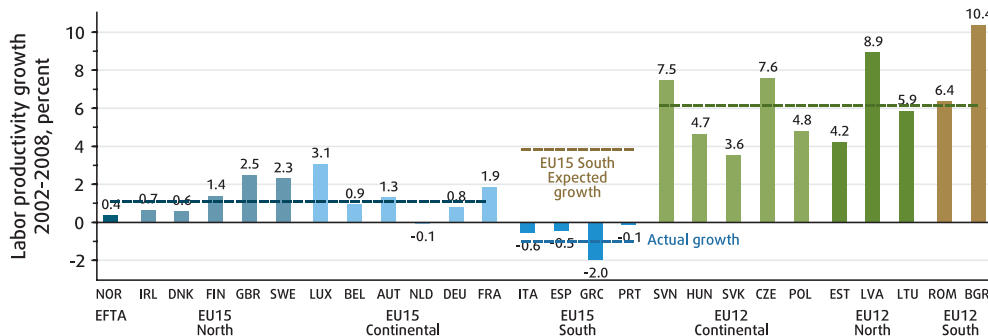
rest of Europe (see top five bars in figure 5). Perhaps most worrisome are the productivity patterns since 2002, which show that parts of Europe have been faltering (figure 6). Northern countries such as Finland, Sweden, and the United Kingdom—and later the Baltic economies—have done well, and continental economies such as Austria, France, Luxembourg, and Germany—and later the Czech Republic, Poland, and others—have been doing well too. But Southern Europe—Greece, Italy, Portugal, and Spain—have not. From 2002 to 2008, they created jobs, but mainly in cyclical activities like construction or in less productive enterprises (like micro and family firms). And the productivity of their workers has been falling.

### Figure 6: Much of Europe is becoming more productive, but the south has fallen behind

(productivity levels in 2002, thousands of 2005 US\$)



(labor productivity growth, 2002–08, annual percentage increase)



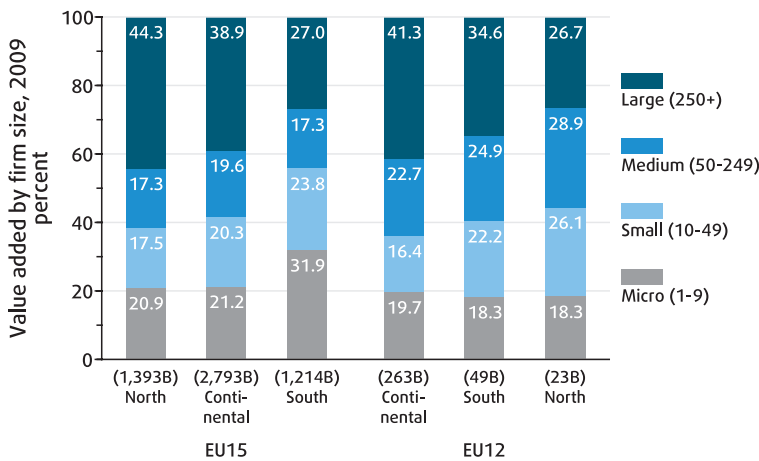
Note: For Belgium, Greece, and Norway, productivity levels refer to 2003 (top panel). In the bottom panel, the period considered varies: Belgium and Norway (2003–08), Greece (2003–07), and Czech Republic, France, Latvia, Romania, and the United Kingdom (2002–07). The three lines in each panel show average values for countries covered by each line. Expected growth for EU15 South is obtained by computing gaps in productivity levels between EU15 South and each of the other two groups and then applying these shares to the difference in growth between the first (that is, EFTA, EU15 North, and EU15 Continental) and the third (EU12) groups.

Source: World Bank staff calculations, based on Eurostat structural business statistics; see chapter 4.

A premature adoption of the euro by southern economies is sometimes blamed for this reversal of fortune. Others say that letting the formerly communist countries into the European Union so soon did not give the south enough time to become competitive. But perhaps the most likely explanation is that of all the economies in Europe, the entrepreneurial structures of Greece, Italy, Portugal, and Spain were least suited for the wider European economy. For one thing, a sizable part of net output in southern economies is generated in small firms—almost a third of it in tiny enterprises (with fewer than 10 workers; figure 7). This is not an entrepreneurial profile suited for a big market. Unsurprisingly, with the expansion of the single market in the 2000s, foreign capital from the richer economies of Continental Europe quickly changed direction, going east instead of south as it had done in the 1990s (figure 8).

**Figure 7: Smaller firms contribute half of value added in the EU15 South, but just a third elsewhere**

(contributions to value added by size of enterprises, 2009)

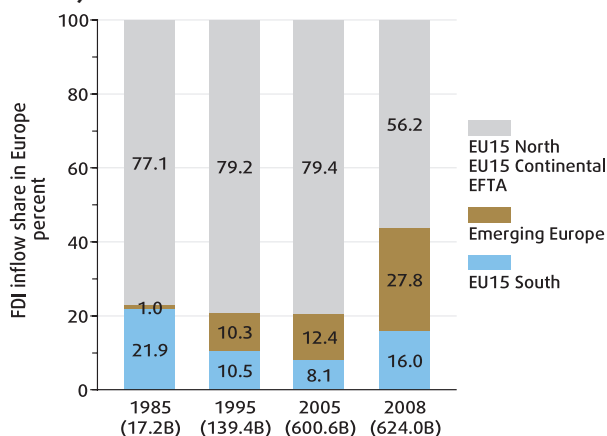


Note: The numbers in parentheses are the total value added expressed in billions of constant 2005 U.S. dollars. The EU15 comprises Denmark, Finland, Ireland, Sweden, and the United Kingdom (North); Austria, Belgium, France, Germany, Luxembourg and the Netherlands (Continental); and Greece, Italy, Portugal, and Spain (South). EU12 comprises Estonia, Latvia, and Lithuania (North); the Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia (Continental); and Bulgaria, Cyprus, and Romania (South).

Source: World Bank staff calculations, based on Eurostat structural business statistics; see chapter 4.

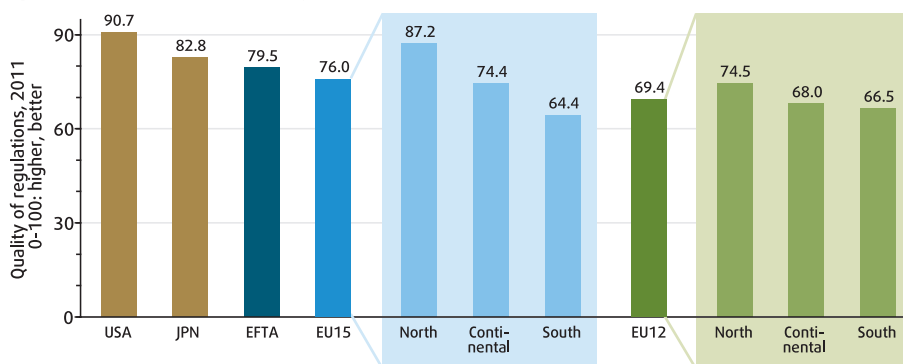
Did the south need more time to adjust, or did it squander opportunities? The latter seems more plausible. Ireland has shown that EU institutions and resources can be translated quickly into competitiveness. The Baltic economies are now doing the same. The chief culprits for the south's poor performance were high taxes and too many regulations, often poorly administered. While these mattered less when its eastern neighbors were communist and China and India suffered the least business-friendly systems in the world, they are now crippling southern enterprise (figure 9).

**Figure 8: Western European investors have been looking east, not south**  
(foreign direct investment inflows in Europe, percent, 1985, 1995, 2005 and 2008)



Note: The numbers in parentheses are the amount of inflows expressed in billions of US dollars.  
Source: World Bank staff calculations based on UNCTAD (2010); see chapter 4.

**Figure 9: Southern and Eastern Europe must make it easier to do business**  
(principal components index of the ease of doing business in 2011, scaled from 0 [poor] to 100 [excellent])



Note: Averages computed using principal component analysis. EFTA here comprises Iceland, Norway, and Switzerland. The EU15 comprises Denmark, Finland, Ireland, Sweden, and the United Kingdom (North); Austria, Belgium, France, Germany, Luxembourg, and the Netherlands (Continental); and Greece, Italy, Portugal, and Spain (South). EU12 comprises Estonia, Latvia, and Lithuania (North); Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia (Continental); and Bulgaria, Cyprus, and Romania (South).

Source: World Bank staff calculations, based on Doing Business 2012; see chapter 4.

But there are reasons to be optimistic. The sovereign debt crisis has led to a resumption of regulatory reform in these countries, and the experience of countries such as Latvia and Lithuania shows that the necessary improvements can be done over years, not decades. And they need to be done quickly. From 2003 to 2006, Europeans who felt that globalization was an opportunity for

their enterprises fell from 56 to 37 percent (Eurobarometer 2006). By 2006, the share of people who felt it was a threat to European enterprises and employment was almost half. The Danes, Swedes, Dutch, and Estonians were the most positively disposed to globalization; the French, Greeks, Belgians, and Cypriots the least. It is not a coincidence that the countries where people are wary of competition have the worst business climate in Europe.

Europe will get even more from its enterprises if it made doing business easier. Southern Europe must start doing this now, and Central and Eastern Europe should continue improving the investment climate. Otherwise, enterprises will remain small and unproductive—increasingly unable to attract foreign investors, incapable of taking advantage of a pan-European market that will only get bigger and more competitive, and progressively uncompetitive in global markets where they have to contend with enterprises from East Asia and North America. A better business climate will help to stem the growth of imbalances within Europe, restart the convergence machine, and make European enterprises globally competitive. Countries such as Denmark, Germany, Finland, Ireland, Sweden, and the United Kingdom show how it can be done (Iwulska, 2011).

### THE NORTH INNOVATES

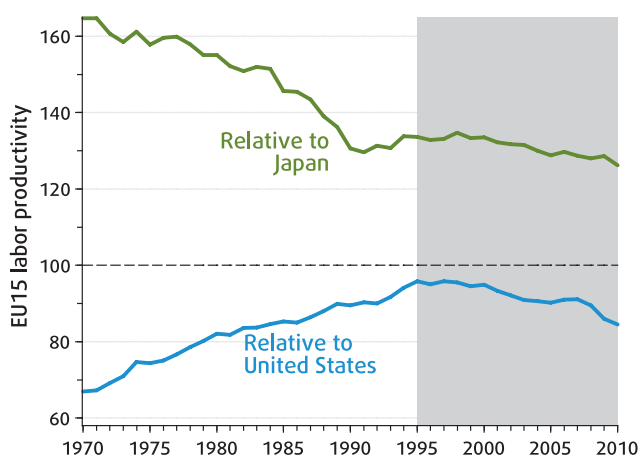
But making it easier to do business will not be enough on its own. When productivity gaps were growing within Europe, the gap between the advanced economies of Europe and the United States started to widen after almost disappearing in the mid-1990s. Indeed, the 2000s were a decade of declining productivity in the EU15 relative to both the United States and Japan, the world's next two largest economies after the European Union during that time (figure 10). Between 1995 and 2009, labor productivity in the United States grew at 1.6 percent annually, in Japan at 1.2 percent, and in the EU15 at just 1 percent (see figure 5).

Reassuringly, productivity in northern Europe grew at 1.7 percent per year during the same period. What has the north done to encourage enterprise and innovation? Much of its success has come from creating a good climate for doing business. All the northern economies are in the top 15 countries of 183 in the World Bank's *Doing Business* rankings; at 14th, Sweden is the lowest ranked among them. They have given their enterprises considerable economic freedom. Their governments are doing a lot more. They have speeded up innovation by downloading the "killer applications" that have made the United States the global leader in technology: better incentives for enterprise-sponsored research and development (R&D), public funding mechanisms and intellectual property regimes to foster profitable relations between

universities and firms, and a steady supply of workers with tertiary education. Tellingly, Europe's innovation leaders perform especially well in areas where Europe as a whole lags the United States the most. These features make them global leaders; combining them with generous government spending on R&D and public education systems makes their innovation systems distinctively European (see chapter 5).

### Figure 10: Productivity growth in Europe's larger economies has slowed down since the mid-1990s

(EU15 labor productivity, indexed to the United States and Japan)



Source: World Bank staff calculations, based on the Organisation for Economic Co-operation and Development; see chapter 5.

For Europe's larger continental economies that have reached or exceeded U.S. standards in physical, financial, and human capital, R&D and other innovation deficits are likely to be growth inhibitors. In dynamic Eastern Europe, countries need not invest much more in R&D and the production of knowledge. But they must still innovate through osmosis: they have considerable scope for the quick adoption of existing technologies, using FDI and trade links as conduits. The south is becoming slower in importing new technologies: FDI inflows and outflows have been falling since the economies in emerging Europe integrated with Continental and Northern Europe. For these increasingly service-oriented economies, reform of domestic regulations—not more R&D spending—may be the best way to speed up innovation.

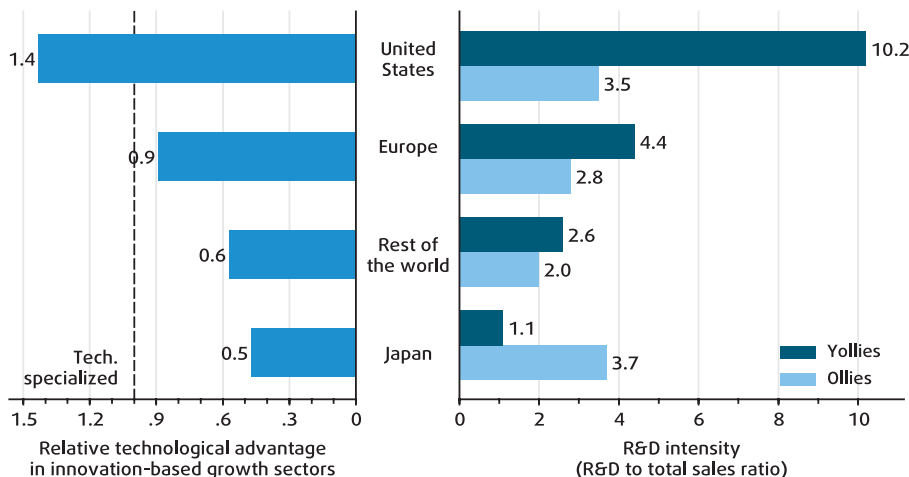
What has been more perplexing is Europe's generally poor performance in the most technology-intensive sectors—the Internet, biotechnology, computer software, health care equipment, and semiconductors. Put another way, the United States, the Republic of Korea, and Taiwan, China, have been doing well in sectors that are huge now but barely existed in 1975. Europe has been doing

better in the more established sectors, especially industrial machinery, electrical equipment, telecommunications, aerospace, automobiles, and personal goods. The United States has young firms like Amazon, Amgen, Apple, Google, Intel, and Microsoft; Europe has Airbus, Mercedes, Nokia, and Volkswagen.

Europe's young leading innovators (called "Yollies" for short) are as R&D intensive as those in the United States. Europe just has a lot fewer Yollies. As a result, while more than a third of U.S. R&D spending is by Yollies, it is less than one-fifteenth in Europe. The United States focuses its R&D efforts on innovation-based growth sectors (figure 11). Europe specializes in sectors with medium R&D intensity. Japan is showing other East Asian countries how productivity growth can be maintained in established industries such as automobiles and electronics, and Germany may be doing the same. With the size and diversity of European economy, productivity growth will likely come both from doing what Japan has done and adopting parts of the American innovation system. But to do either, the common market will have to become more of a single economy.

### Figure 11: The United States specializes in younger, more R&D intensive products

(relative technological advantage and R&D efforts by young and old innovation leaders in the United States, Europe and the rest of the world)



Note: R&D intensity is measured as the ratio of R&D spending to total sales, for firms established after 1975 (young leading innovators or "Yollies") or before 1975 ("Ollies"). The relative technological advantage is calculated as the share of each region or country (say Europe) in the R&D of a particular sector (say the Internet) relative to the share of Europe in world R&D; values greater than 1 indicate the region is technology specialized in the sector.

Source: Bruegel and World Bank staff calculations based on the Institute for Prospective Technological Studies R&D Scoreboard; see chapter 5.



All European countries should have the friendly business climate that Denmark, Ireland, and Norway have. It is not a coincidence that the only large European economies that rival the United States and Japan in innovation are Germany and the United Kingdom, which were both ranked in the top 20 countries for ease of doing business in 2011. Many more European countries should have the universities like those in the United States and Japan, where more than one out of two people ages 30–34 have completed college; in Europe, only Ireland, Denmark, Norway, Luxembourg, and Finland exceed 45 percent. More countries will have to improve their business–science links to rival those in the United States and Japan; currently, only Switzerland and Scandinavia do as well.

### **BURNISHING THE BRAND**

Perhaps the simplest and most reliable way to assess how innovative a country is to see how much more productive its enterprises become every year—that is, how much better they are in buying, producing, and selling. During the last decade, two things have happened that should worry Europeans. The first is that since the mid-1990s, labor productivity in Europe’s advanced economies has been falling relative to the United States (and Japan). The second is that productivity in Southern Europe has been falling compared with both the advanced countries in Western Europe and the less well-off countries in emerging Europe. How can these gaps be closed?

It depends on the gap. For reducing that between the south and the north, the most important steps involve improving business regulations. Countries in the EU12 South—notably Bulgaria—and Georgia have been showing that this can be done even in poorest parts of Europe. For closing the transatlantic productivity gap, more is necessary. Leading European economies such as Switzerland, Sweden, Finland, Denmark, and Germany are showing what works. Following their example would mean giving up the fixation on public R&D spending targets, and focusing instead on improving competition among enterprises, increasing private funding of universities, changing the way research is funded so that business–university linkages become stronger, and making the single market work for services so that Europe’s entrepreneurs view the entire continent as their domestic economy.

There are reasons to be optimistic. During the last two decades, countries in the EFTA—Iceland, Norway, and Switzerland principally—have actually done better in improving productivity than the United States. Northern parts of the EU15—especially Denmark, Finland, Ireland, and Sweden—have also been doing well. The trouble is that their economies add up to less than \$1.5 trillion in purchasing power terms, roughly the GDP of Spain or Texas and just a tenth

of the European Union's economy (see the Selected Indicators tables in the annex). If the rest of Europe could benefit from the dynamism of northern economies—by learning from them or leaning on them—Europe's innovation goals might quickly be reached.

Chapters 4 and 5 make it clear that preserving Europe's global brand will be more difficult than restarting convergence. To stay competitive on world markets, Europe will have to make trade even more vigorous and finance more durable so that the region eventually becomes a single economy. To help redress the continent's growing productivity gaps, governments in Southern Europe will have to quickly improve the climate for doing business. The more dynamic countries in Eastern Europe will have to do all this as well as invest in infrastructure. To close the growing transatlantic productivity divide, continental countries must give their enterprises more economic freedom. Enterprises in the northern and EFTA economies—already among the world's most innovative—will need fuller access to markets in the rest of Europe. Europe will have to become the top destination for those seeking higher education and the opportunity to become entrepreneurs. Only then can European enterprises stay globally competitive, and Europe become the place of choice of entrepreneurs from around the world.

## The lifestyle superpower

In 2008, Europe was already the place of choice for tourists: of the busiest 20 international tourist destinations, more than half were in Europe. The United States had the might and China the momentum, but Europeans had the highest standard of living. Millions of people from around the world visited Europe to see and experience it first hand. In the 1990s, Japan's Prime Minister Kiichi Miyazawa had promised he would make his country the "lifestyle superpower." With average incomes still a quarter short of those in the United States, Europe had become one.

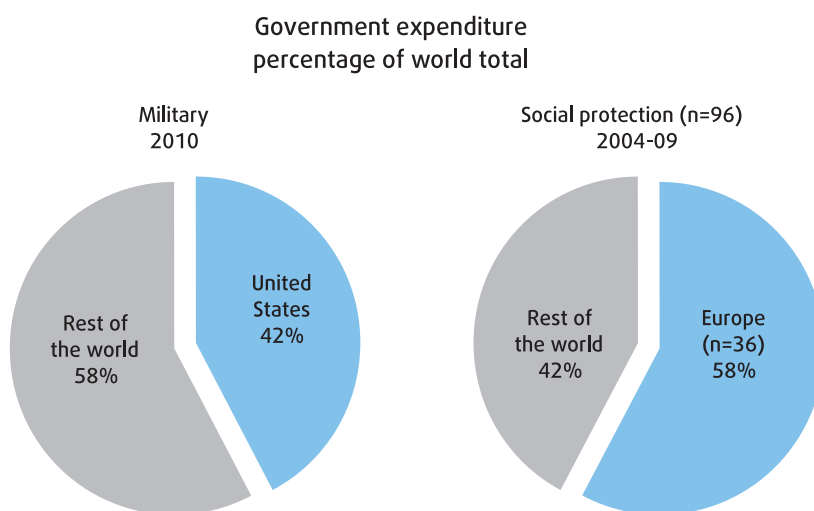
Superpowers tend to spend a lot to protect their interests and project influence. To remain the political superpower, the United States spends almost as much on defense as the next 15 countries do together. To keep its status as the lifestyle superpower, Europe spends more on social protection than the rest of the world combined (figure 12).

### THE DECLINE OF WORK

The hallmark of the European economic model is perhaps the balance between work and life. With prosperity, Americans buy more goods and

services, Europeans more leisure. In the 1950s, Western Europeans worked the equivalent of almost a month more than Americans. By the 1970s, they worked about the same amount. Today, Americans work a month a year more than Dutch, French, Germans, and Swedes, and work notably longer than the less well-off Greeks, Hungarians, Poles, and Spaniards (see chapter 6).

**Figure 12: Outspending the rest of the world**  
(general government spending on defense [United States] and social protection [Europe], 2004–09, share of total world spending)



Notes: For social protection spending, due to the data availability, averages over 2004–09 by country are used. n is the number of countries included in the calculations. Data cover general government but, if unavailable, refer to central government only.

Sources: World Bank staff calculations, based on Stockholm International Peace Research Institute (2011), IMF Government Finance Statistics, World Bank World Development Indicators, and Weigand and Grosh (2008).

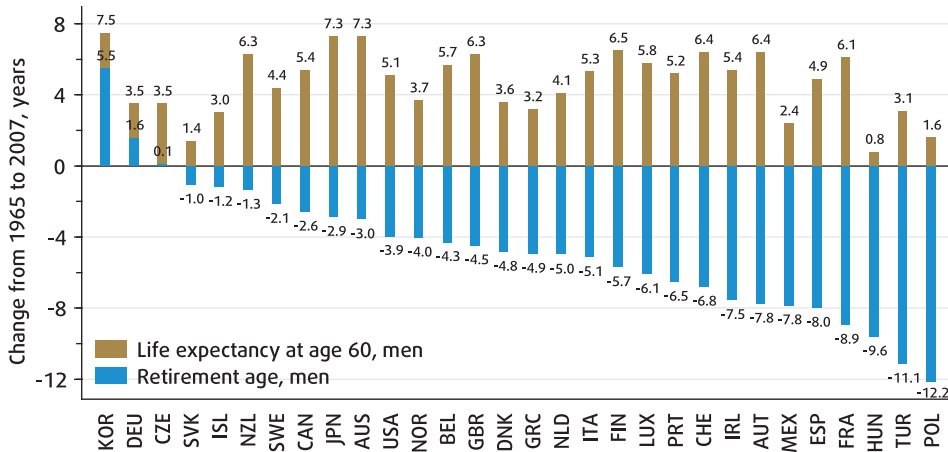
Europeans have also cut the years they work during their (ever-lengthening) lives. Today, men in France, Hungary, Poland, and Turkey effectively retire more than eight years earlier than in the mid-1960s. The average European can also expect to live four years longer. By 2007, Frenchmen expected to draw pensions for 15 more years than in 1965, and Austrian, Polish, Spanish, Swiss, and Turkish men more than a dozen. In Organisation for Economic Co-operation and Development countries, only Korean, German, and Czech men work more years today than they did 50 years ago (figure 13).

American, Australian, and Canadian men also retire about 4 years earlier than they used to. But their countries have more favorable demographics than the typical European country (figure 14). On current immigration and work

participation trends, the 45 countries covered by this report will lose about 50 million workers over the next five decades, and have a workforce of about 275 million by 2060. In the 2030s alone, the labor force will fall by 15 million people. The decline will be most severe for the EU (countries such as France which have high fertility rates today do better), but candidate and neighborhood countries will also lose workers. The exception is Turkey, where the labor force is projected to increase until 2060.

### Figure 13: Europe's pension systems have to support people for many more years

(changes in life expectancy at 60 and effective retirement age, 1965–2007)



Source: OECD Health Data.

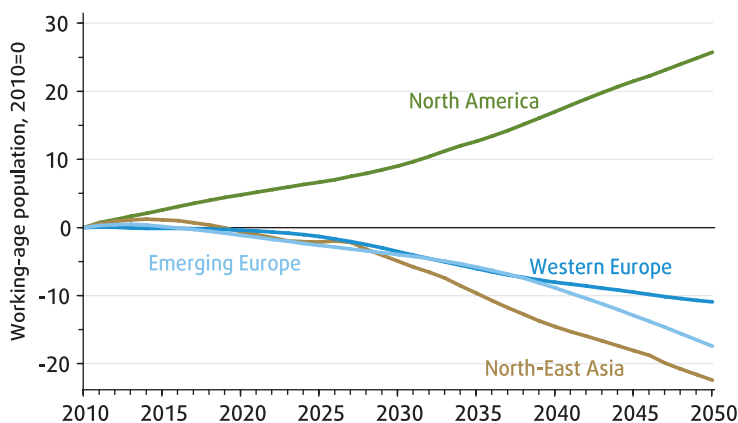
Only with radical changes can Europe counteract the shrinking of its labor force. If participation rates in all countries were to converge with those seen in Northern Europe, or if the retirement age were to increase by 10 years across the board, the European labor force would increase marginally over the next 50 years. If female labor force participation converged with men's, the labor force would still decrease by 5 percent. But none of these changes would completely offset the loss of young workers. For that, Europe will need to integrate Turks into the European labor market and attract talented young workers from around the world. In one plausible scenario, Turkey could contribute 40 percent of the gains in the European labor force, and almost all of the increase in young workers.

Fixing the European labor market will require a lot: increasing the competition for jobs, improving labor mobility within Europe, fixing how work and welfare interact, and rethinking immigration policies. These changes will not happen without a new social consensus, which has yet to be built.

Perhaps the best way to start is to accelerate internal labor mobility in Europe. Mobility in the European Union is the lowest in the developed world (figure 15). There are natural barriers to greater labor mobility associated with language and cultural differences, but there are also policy-induced obstacles. In most of the older EU member states, there are restrictions on the movement of workers from the new member states. Housing markets in many European countries can be inefficient and make moving expensive: the transaction costs of buying or selling a house can be high. Despite measures to ensure the portability of social benefits including pensions and unemployment insurance across the EU, in practice it is limited because of cumbersome rules. Generous unemployment benefits discourage workers from seeking jobs. Labor market signals can be muted by collective bargaining agreements that limit territorial wage differentiation. To make the single market work better, making labor more mobile should be a priority. For the countries that share the common currency, it is a prerequisite (box 1).

#### Figure 14: Europe's labor force will shrink, while North America's will grow by a quarter

(projected change in working-age population, percent, 2010=0, 2010–50)

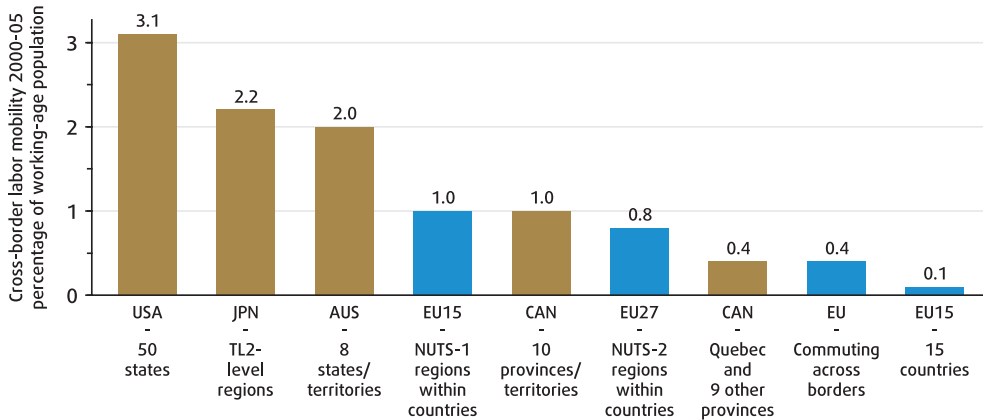


Source: United Nations population projections; see chapter 6.

Then, Europe has to make changes in how work is regulated and social security provided. Many countries in Western Europe had started to reverse the decline in work participation during the late 1990s and early 2000s; many in Central, Eastern, and Southern Europe now must do the same. The main attribute of the European economic model that needs to be reassessed is employment protection legislation, which is lowering participation and reducing employment in many countries. In countries such as Spain, it may be responsible for youth unemployment rates as high as 40 percent. Paradoxically, Europe has impending shortages of young workers and high joblessness among its youth.

Denmark and Germany have shown how this can be remedied (Iwulska, 2011). Other countries like Croatia, Moldova, Poland, Romania, and Turkey may have to learn quickly and carefully implement the lessons. The countries in emerging Europe will also have to decide—based on their cultural and political antecedents—whether to move toward greater job security and join countries such as Belgium and France, or toward greater flexibility and become more like the North Americans and East Asians. To have both as in Denmark, they will have to consider the greater fiscal costs of “flexicurity.” At the moment, most countries have neither.

**Figure 15: Europeans are less mobile, even within their own countries**  
(labor mobility, share of working age population that has moved, 2000-2005)



Source: World Bank staff calculations, based on Eurobarometer (2005), U.S. Census Current Population Survey, Eurostat, Statistics Canada and OECD (2005); see chapter 6.

While all this is being done, Europe’s policymakers could get people to appreciate the need for a new approach to immigration. Europe needs an immigration policy that is more driven by economic need. Today the debate is about how to best manage migration from North Africa. Tomorrow’s debate should be about the policies and practices that will make Europe a global magnet for talent. Countries like Sweden and the United Kingdom have been doing this, but not quite as effectively as Canada and the United States (Iwulska 2011).



### Box 1: The unmet precondition of the common currency—labor mobility

The September 1961 volume of the *American Economic Review* might well be the most influential issue of an economic journal ever. A dozen or so pages after the article on optimum growth paths by Phelps is a short communication from Robert Mundell that outlines a theory of “optimum currency areas.” In it are the conditions that the countries in a monetary union had to have—or quickly institute—to share a single currency profitably. In practical terms, it meant ensuring that the single currency should not lead to persistently high unemployment rates in some parts of the monetary union, nor to unacceptably high rates of inflation in others. In 1999, Mundell was awarded the Nobel Prize for “his analysis of monetary and fiscal policy under different exchange rate regimes and his analysis of optimum currency areas.”

The conditions for a successful monetary union identified in the 1961 article can be distilled to mobility of labor and capital among the member states. To understand why, imagine a fall in economic activity in one part of the union (say the south) and a rise in another (say the north). This would cause unemployment to rise in the south, and inflationary pressures and balance-of-payments surpluses to increase in the north. If the central bank increases the money supply, it might help the south but would aggravate inflation in the north. If it does not, high unemployment in the south would cause suffering. But if capital and labor were quick to move within the monetary union, the dilemma would disappear.

For a practical application of his ideas, Mundell chose Western Europe, presaging today’s debates about the euro. “In Western Europe the creation of the Common Market is regarded by many as an important step toward eventual political union, and the subject of a common currency ... has been much discussed. One can cite the well-known position of J. E. Meade, who argues that the conditions for a common currency in Western Europe do not exist, and that, especially because of the lack of labor mobility, a system of flexible exchange rates would be more effective in promoting balance-of-payments equilibrium and internal stability; and the apparently opposite view of Tibor Scitovsky who

favors a common currency because he believes that it would induce a greater degree of capital mobility, but further adds that steps must be taken to make labor more mobile and to facilitate supranational employment policies.”

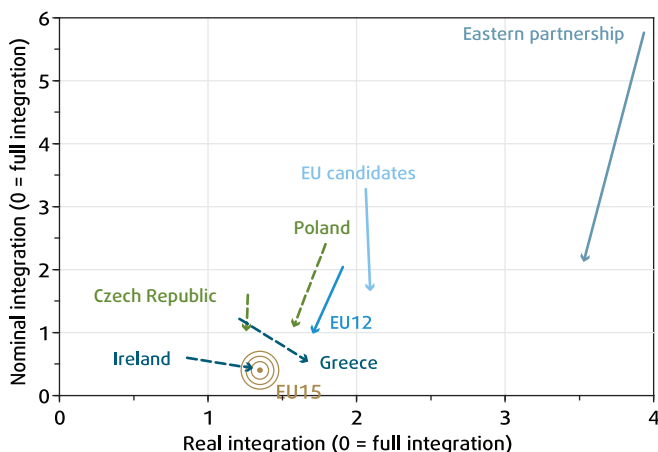
The introduction of the euro undoubtedly increased capital mobility in the eurozone; one can reasonably expect a single currency to greatly facilitate financial integration. The single currency undoubtedly also facilitated the exchange of goods. But a single currency cannot by itself increase people’s mobility. This requires states to harmonize labor regulations, education and training arrangements, and social security and welfare systems. Growing goods trade in the eurozone may reduce the need for labor mobility, but trade in services—now three-quarters of Western Europe’s output—itself often requires movement of people. So does keeping manageable unemployment differences among countries.

In the decade before the global financial crisis, European economic integration showed impressive progress. But for many countries, the progress was unbalanced (box figure 1)—more rapid in financial areas (interest rates and inflation) than in real sectors (trade and incomes). It was more balanced for the new member states. Poland, for example, became more integrated in financial and real terms. The EU candidate countries (represented here by Croatia and Turkey) experienced just financial integration. But while integrating in monetary and financial aspects, Greece became less integrated within the EU15 in real terms.

Labor mobility in Europe is the lowest in the developed world. Mundell’s communication 50 years ago suggests that this will be a serious problem for the eurozone. Increasing labor mobility may be a privilege in Europe, but it is a prerequisite in the eurozone. Countries that integrate their labor markets will be able to share a single currency profitably. Others will have to deal with stressful tradeoffs between inflation and unemployment.

Source: Mundell 1961; Sugawara and Zaldueño 2010.

**Box figure 1: More monetary and financial than real integration in Europe during the last decade** (arrows begin in 1997 and end in 2008; the origin indicates complete nominal and real integration)



Note: The figure shows the extent of economic integration, using the theory of optimum currency areas (Mundell 1961). The vertical axis combines in one index of dissimilarity three indicators of nominal integration—volatility of exchange rates, convergence in inflation rates, and convergence in interest rates. The horizontal axis does the same with three indicators of real integration—extent of synchronization in business cycles measured by indexes of industrial production, trade integration, and per capita income. The origin in the figure represents perfect economic integration, and the arrows show the integration path of each country or group of countries in 1997–2008. EU candidates are represented by Croatia and Turkey; the eastern partnership countries by Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine; and the EU's new member states by Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia.

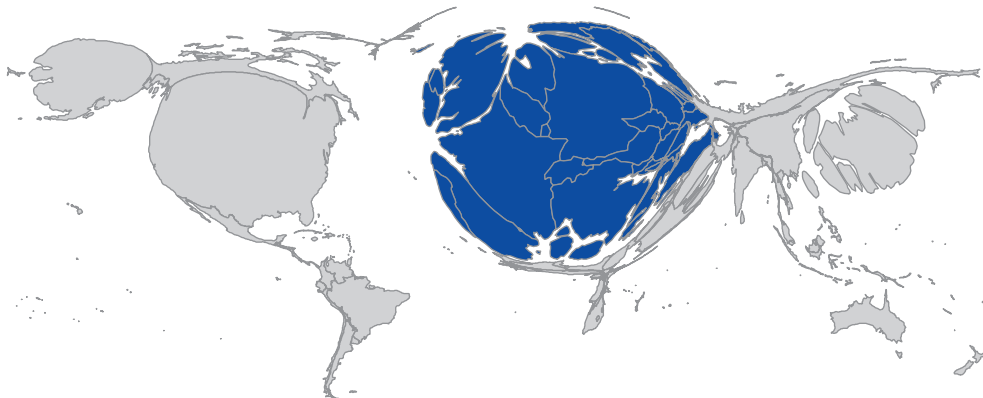
Source: Sugawara and Zaldueño 2010.

## THE PRECIPITATE PROMISE OF SOCIAL PROTECTION

Europe will have to make big changes in how it organizes labor and government. The reasons are becoming ever more obvious: the labor force is shrinking, societies are aging, social security is already a large part of government spending, and fiscal deficits and public debt are often already onerous.

In dealing with government spending, deficits, and debt, it is sensible to start by asking whether European governments are too big; that is, whether they spend too much. They are obviously bigger than their peers. In the EU15, governments spent 50 percent of GDP in 2009; in much of the rest of Europe, this share was about 45 percent—versus less than 40 percent in the United States and Japan, 33 percent in Latin America, and about 25 percent in emerging East Asia. A map of the world resized to reflect government spending instead of land area shows how Europe might look to outsiders (figure 16).

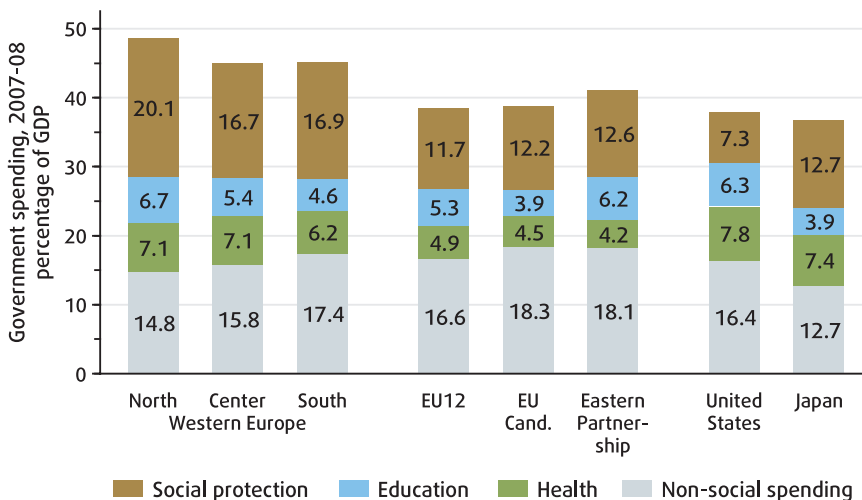
**Figure 16: Governments in Europe are big**  
(the world resized by government spending in dollars, 2009)



Source: World Bank staff, based on IMF Government Financial Statistics.

Governments in Europe spend between 7 and 10 percent of GDP more than their peers elsewhere—viz., countries at similar levels of per capita income. The difference is mostly the spending on social protection. For example, Western European governments spend about 10 percent of GDP more than the United States, Canada, Australia, and Japan. The difference in social protection spending is 9 percent of GDP (figure 17).

**Figure 17: Social protection explains the difference in government size between Europe and its peers**  
(government spending, percentage of GDP, 2007–08)



Note: "Social protection" includes benefits related to sickness and disability, old age, survivors, family and children, unemployment, and housing.

Source: IMF Government Finance Statistics.

There can be good reasons for having bigger governments. If governments are good at supplying essential social services, and if European society wants to redistribute more to protect the welfare of the elderly, infirm or unfortunate, they should provide these amenities. If European populations are older and social security systems have to be bigger, that may be another good reason for high-spending governments. European societies have been more redistributive and to good effect—look at the impressive declines in poverty in Western Europe since World War II and in Eastern Europe since the end of the Cold War.

But social services, social welfare, and social security have to be financed by taxes, and tax rates in Europe are the highest in the world. For example, the tax wedge in the Republic of Korea—the amount that Korean employers pay besides wages when hiring workers—is about a third of what Belgian enterprises pay and half of the taxes paid by businesses in Greece and Turkey. The question that such numbers provoke: is big government a drag on growth in Europe? It appears it is. Over the last 15 years, a 10 percentage point increase in initial government spending in Europe has lowered annual growth by 0.6–0.9 percentage points. Countries with government spending-to-GDP ratios above 40 percent grow by 2 percentage points of GDP less than those with lower ratios (see chapter 7).

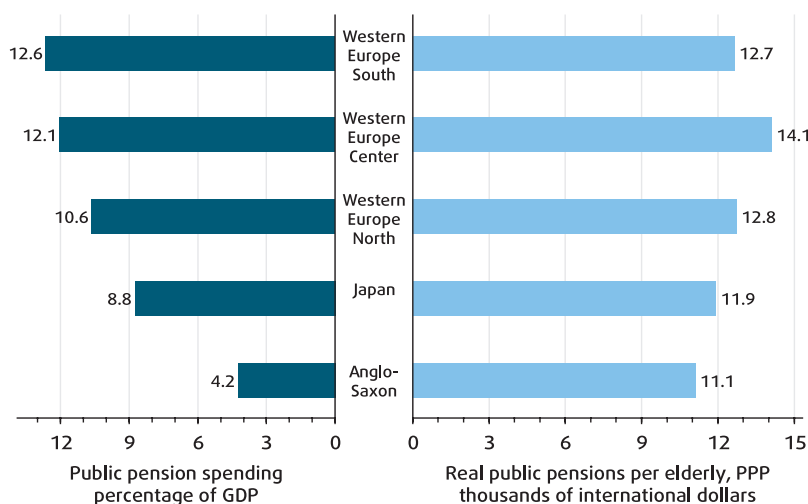
Of course, size is not the only feature that matters. What government does and how it finances its activities is as important. European governments regulate the largest economic area in the world; encourage a vigorous exchange of goods, services, and capital; promote voice and accountability; provide or enable the provision of public goods; and redistribute wealth. Bigger governments are often better at doing these things, especially when social trust ensures that everybody plays by the same rules. As countries like Sweden show, such big governments can go together with thriving, dynamic economies.

But it is not easy being like Sweden. What does it take? Make it so easy to register property, trade across borders, and pay taxes that the World Bank ranks the country one of the top 15 for doing business. Create the conditions that get four out of every five people of working age into jobs, and get almost everybody who works to pay taxes. Have an efficient government that provides high quality social services, so taxpayers get their money's worth. Institute the pension rules that make it difficult to retire before 65 and impossible until you reach your sixties. Cultivate the social trust that allows both a generous social safety net and a transparency in government so that abuse is minimal. The list is long. If a country can do all this, big government will not hurt growth.

Europe's governments will have to become more efficient, or become smaller. Fortunately, even governments that have grown prematurely big have done

so because of just one reason: social protection. Europe's states are not big spenders on either health or education. The variation among countries stems from a difference in spending on pensions and social assistance. Europe's countries also differ how they tax these benefits; Northern European countries tax the social security benefits of people with high incomes more than others in Europe. After taxes are considered, the southern periphery is the biggest social spender in Western Europe. But the reason why Europe spends more than its peer on public pensions is the same in the north, center and south. This is not because Europe has the oldest population (Japan's is much older) nor because of higher pension benefits (annual subsidies per pensioner are about the same in Greece as in Japan). It spends more because of easier and earlier eligibility for pensions (figure 18).

**Figure 18: Small differences in annual pensions per beneficiary, big in overall public pension spending**  
(public pension spending in 2007)



Note: Median values by group are shown.

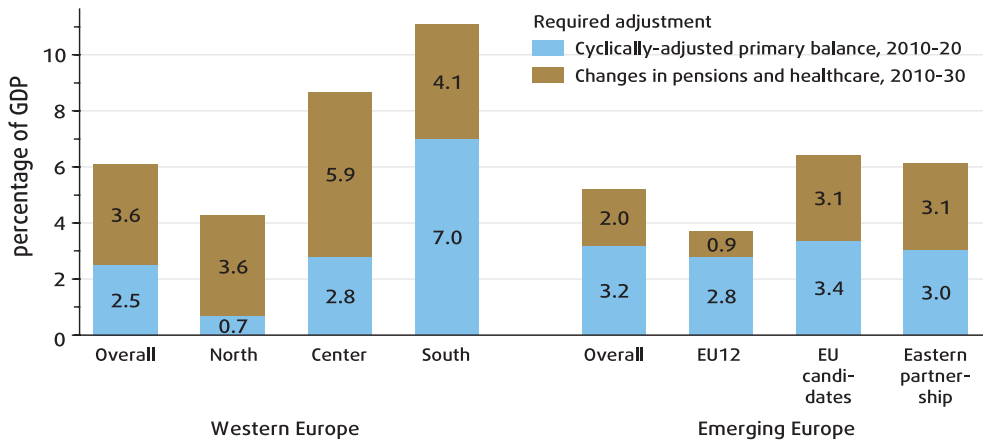
Source: Eurostat; Organisation for Economic Co-operation and Development, see chapter 7.

Fiscal consolidation should be a top priority in Europe during the next decade, and controlling the public expenses related to aging will remain the policy imperative over the next 20 years. Calculations done for this report suggest that Western Europe has to improve its primary balance—adjusted for the business cycle—by about 6 percent of GDP during this decade to reduce public debt to 60 percent of GDP by 2030 (figure 19). Among the countries of Western Europe, the need for consolidating public spending is greatest in the south and lowest in the north. Among Europe's emerging economies, with a lower public debt target of 40 percent of GDP, the adjustment needs are about

5 percent of GDP. They are lowest in the European Union’s new member states. Bigger adjustments will be needed in candidate countries and the economies of the eastern partnership, because many of them have not begun seriously reforming their social protection systems—pensions, unemployment insurance and social assistance.

### Figure 19: Western Europe has to reduce fiscal deficits by 6 percent of GDP, emerging Europe by less

(illustrative fiscal adjustment needs, 2010–30)



Note: The fiscal impacts of aging on pensions and health care systems are missing for EU candidate and eastern partnership countries. For this exercise, the sum of adjustment in health care spending is assumed to be the same as that for the new member states. The adjustment in pension related spending is assumed to be the same as that for southern Europe.

Sources: IMF, Institute of Structural Research (Poland), and World Bank; see Chapter 7.

Public spending related to aging includes the ever-increasing costs of providing health care for the elderly. Without comprehensive reforms to pensions and long term health care, these costs could add more than 3 percent of GDP to the governments’ fiscal imbalance during the next two decades. Governments in Europe that spend more than 10 percent of GDP on such benefits may be risking underinvestment in activities that help economic growth—education, infrastructure, and innovation. Countries such as Serbia and Ukraine which already spend 15 percent or more on social security alone may be jeopardizing the welfare of generations.

### RECALIBRATING THE WORK-LIFE BALANCE

The European model of work provides income security more than any other, and some countries such as Austria, Denmark, Ireland, and Switzerland have adapted it to combine security with flexibility in hiring and firing to foster both efficiency and equity in labor market outcomes. But for much of Europe, the imbalances between work and life need to be mitigated, as do the fiscal



imbalances that have emerged as a result of public spending to protect societies from the rougher facets of private enterprise.

Since the mid-1980s, a billion Asian workers have entered the global marketplace. Over the same period, Europeans have been working fewer hours per week, fewer weeks per year, and fewer years over their lifetimes. It is worrisome that their productivity is not increasing as quickly as it should. In European Union's southern states, for example, productivity during the last decade fell by 1 percent each year, when—given productivity levels relative to continental and northern Europe—it should have increased by about 4 percent annually. It is also worrisome that in many parts of Europe, taxes bring in less than what governments spend. France and Germany, for example, has not had a fiscal surplus since the 1970s, Greece expected a budget deficit of about 10 percent of GDP in 2011 and Hungary, Serbia, Ukraine, and many others have been struggling to contain budgetary imbalances.

This will have to change. The reform of pensions and disability allowances will have to be the highest priority now, with costs of long term health care soon becoming a pressing problem. Europe already spends twice as much on social security as Japan and the United States. There are some countries in Europe that are showing how to address these problems. Some such as Sweden are well-known; others like Iceland could be studied more (Iwulska, 2011). European societies will also have to modernize social welfare systems so that the disincentives to work are minimized. Denmark, Germany, and Ireland may inspire others how this can be done. But what needs to be done is not hard to see: Europeans will have to work for more years.

## From distinct to distinguished

In 2007 *An East Asian Renaissance*, a report by the World Bank, introduced the notion of the “middle income trap.” (Gill and others 2007). It was about why countries seem to easily grow from low per capita income levels to middle income, but find it difficult to become and remain high income economies. Later research identified about two dozen countries that have grown from middle-income to high income since 1987. Some had discovered oil, like Oman and Trinidad and Tobago. But this can hardly be a development model for others to emulate, because it is a matter more of providence than policy. Some like Hong Kong SAR (China), Singapore, and the Republic of Korea had translated peace into prosperity through export-led strategies that involved working and saving a lot and sometimes postponing political liberties for later. They had to be aggressive, like tigers, looking out only for themselves.

But of the countries that have grown quickly from middle income to high income, half—Croatia, Cyprus, Czech Republic, Estonia, Greece, Hungary, Latvia, Malta, Poland, Portugal, the Slovak Republic, and Slovenia—are in Europe. If you can be a part of the formidable European convergence machine, you do not need to be extraordinarily fortunate to become prosperous nor—like the East Asian Tigers—do you have to be ferocious. You just have to be disciplined.

The inability of this convergence machine to continue to deliver rapid growth and improved quality of life in the advanced economies of Western Europe has been recognized for some time. Europe's policymakers have put together protocols and commitments to encourage innovation and dynamism. Policies that were a core component of Europe's post-war growth model—or those that evolved from it—are not giving European economies enough flexibility to take advantage of new technologies that have led to high productivity growth in Asia and North America during the last 15 years. It is not that European product market regulation and employment protection became more stringent over time, they just became more costly.

The Western European model that so effectively enabled catch up has created “afterglow” institutions that are hindering growth in a different era—an era of greater competition abroad and big demographic shifts at home. These institutions now need updating. In the states aspiring to become part of the machine, notably the candidates, potential candidates, and the Eastern Neighborhood, the afterglow structures will probably not preclude the benefits that come from greater economic union. In the new member states too, these institutions may not yet prevent productivity gains if their ties with advanced Europe become stronger and sophisticated. In the western economies, the structures must quickly be made more flexible. Convergence to a rigid core may soon become unappealing.

The European Union has a growth strategy, *Europe 2020*, which recognizes this imperative. Not all of the 45 countries covered by this report are in the European Union, but most share the aspirations of *Europe 2020*: economic development that is smart, sustainable, and inclusive. Europe's way of life—and its growth ambitions—put a premium on combining economic dynamism with environmental sustainability and social cohesion.

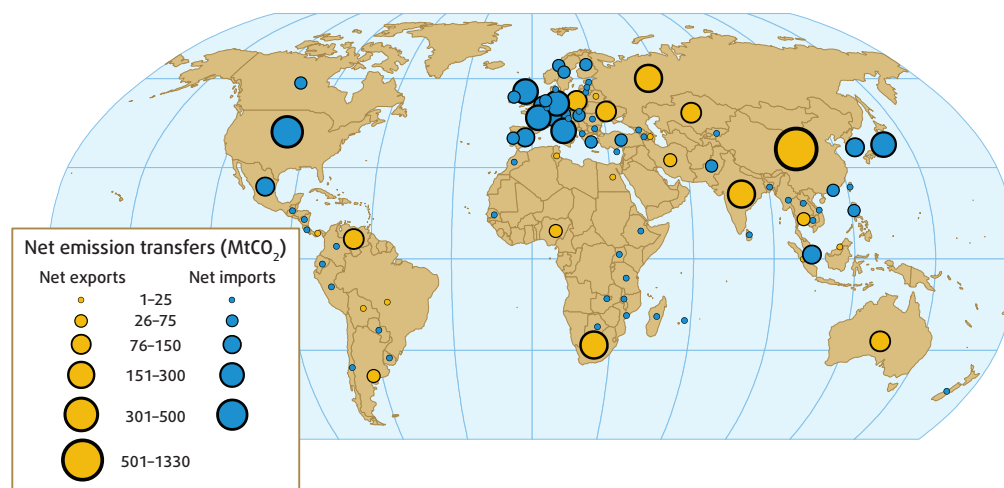
Europe's economic model is already more environment-friendly than most. It has made production cleaner than any other part of the world except Japan, and will become the lowest per capita emitter of carbon dioxide by 2020. But it is still the largest importer of emissions (embedded in imported products—figure 20), polluting not as much through production as by proxy. Europeans

will need to do more on the consumption side to be considered truly green. It is testament to European ideals that Europe is willing to pay the most to avert global warming while it is likely to be damaged least. There is reason to believe that Europe's economic model can become greener without unduly sacrificing growth: Germany, France, and Sweden may already be showing the way (see spotlight two).

Social cohesion is the cornerstone of Europe's economic model, but this aspiration must be realized in ways consistent with sound economic principles. It can be, because Europe has three priceless assets: the European Union's Single Market, a momentum for regional integration, and the global influence that comes from being the generator of one third of the world's annual output. Inclusive development will be a natural outcome of measures to deepen the single market, expand the scope of regional economic integration, and preserve Europe's global influence (see chapter 8).

### Figure 20: Greening production but not consumption

(net CO<sub>2</sub> emission transfers [territorial minus consumption emissions], 2008)



Note: MtCO<sub>2</sub> = million tons of carbon dioxide.

Source: See spotlight two.

This will require adjustments in all of the European economic model's six components. The rules to guide policymakers—adapted from Phelps (1966)—might look something like the following:

- *Extend the benefits of freer trade to those outside the European Union.* Enlargement has made Europe stronger, and economic integration should be continued toward the east. The single market can be made deeper and wider at the same time.

- *Borrow from abroad only for investment.* In Europe, where foreign finance has been used for private investment, it has fueled growth and convergence. But relying on foreign capital to finance consumption makes economies everywhere more vulnerable than dynamic.
- *Provide enterprises with the freedom to start up, grow, and shut down.* Efficient regulation of enterprise trusts but verifies, makes compliance easy but punishes violation, and assesses risks and concentrates resources where risks are highest.
- *Use public money to catalyze private innovation, not substitute for it.* Effective innovation policy sets the table for innovators to thrive by supporting inventions, mobilizing finance, and bringing the power of choice and the resources of business into Europe's universities.
- *Design labor laws to treat insiders and outsiders more equally.* Regulations should not favor either those with jobs or those without. Seeing labor as a fixed lump to be divided among workers leads to poor rules for regulating work.
- *Consider government debt mainly as a way to finance public investment.* With high debt levels and modest growth prospects, public finance should be premised on the expectation that future generations will not be much wealthier than today's. Social protection, social services, and public administration should be financed with taxes and contributions, not sovereign debt.

European economies do not have to become North American or East Asian to keep to these rules. But Europe might learn a few lessons from them. From North Americans, Europe could learn that economic liberty and social security have to be balanced with care: nations that sacrifice too much economic freedom for social security can end up with neither, impairing both enterprise and government. To get this balance wrong could mean giving up Europe's way of life and its place in the world. From the Japanese, the Koreans, and Chinese, Europe might learn that while the gifts of prosperity and longevity arrive together, they have to be unbundled: being wealthier means that Europeans do not have to work as hard as before, but living longer means having to work more years, not fewer. To do otherwise unjustly burdens future generations, and violates growth's golden rule.

Europeans can of course learn the easiest and most from each other. The countries in Europe that have instituted policies manifesting both cultural maturity and economic discipline have shown how a distinct growth model can be made distinguished.



## Notes

- 1 Among the economists were Maurice Allais, Tjalling Koopmans, Christian von Weizsäcker, Joan Robinson, John von Neumann, Robert Solow, and Trevor Swan.
- 2 The report covers 45 countries: the 27 member states of the European Union, 4 countries in the European Free Trade Association (Iceland, Liechtenstein, Norway, and Switzerland), 8 candidate and potential candidate countries (Albania, Bosnia and Herzegovina, Croatia, Kosovo, the former Yugoslav Republic of Macedonia, Montenegro, Serbia, and Turkey), and 6 eastern partnership countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine).

## Spotlight Zero

### 30 questions, 30 answers

#### Questions

#### Answers

#### Chapter 1: The European growth model

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|---|--|
| What makes the European economic model unique?  | ➤ The principal components of Europe's growth model—trade, finance, enterprise, innovation, labor, and government—are organized in unique ways.  |
| Have changes in Europe and the rest of the world made a new economic model necessary? | ➤ Sluggish productivity growth, a declining workforce, and growing fiscal imbalances have revealed weaknesses of the European economic model, and the entry of a billion Asian workers into the global market is adding to the stress.     |
| Which parts of the European model should be preserved, and which changed?             | ➤ Many changes are needed in how governments and labor markets are organized. Fewer changes are needed to foster innovation, productivity growth, and job creation by enterprises, and fewer still to improve finance and trade in Europe. |

#### Chapter 2: Trade

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|---|---|
| Is "Factory Europe" as dynamic as "Factory Asia"?                                 | ➤ Factory Asia is growing faster, but goods trade in Europe is more sophisticated.  |
| Is the Single Market for Services underachieving compared with the United States? | ➤ The single market is working quite well for traditional services such as travel and transport, but it is underperforming in modern services such as insurance, information technology, and other business services.         |
| Is the Common Agricultural Policy compromising Europe's global leadership?        | ➤ The European Union's agricultural policies hobble the extension of the single market to its neighbors, and Europe is missing an opportunity to improve the lives of 75 million people in the eastern partnership countries. |

#### Chapter 3: Finance

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|--|--|
| Why is finance in emerging Europe different from other regions?  | ➤ The prospect of membership in the European Union exerts a powerful policy and institutional pull, making Europe unique and strengthening the link between foreign savings and economic growth.           |
| How did some European economies benefit more from international financial flows than others?                         | ➤ European economies that managed to "boom-proof" public finances and "crisis-proof" private financing without resorting to the costly self-insurance seen in Asia benefited from foreign financial flows. |
| Is there evidence of a "debt overhang" in emerging Europe that reduces growth and justifies government intervention? | ➤ In emerging Europe, treasuries, enterprises, and households do not face a debt overhang, but in the eurozone's periphery this problem is acute, posing a danger for banks everywhere.                    |

#### Chapter 4: Enterprise

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|---|--|
| What does Europe expect from its enterprises?         | ➤ Workers expect enterprises in Europe to create jobs, shareholders to generate value added, and governments to bring in sizable export earnings.  |
| How have European firms done in an enlarged Europe?   | ➤ In most parts of Europe, firms have taken advantage of greater regional integration to decentralize production, attract foreign investment, and expand the markets for their products.               |
| Why did some parts of Europe do better than others?   | ➤ In Western and Eastern Europe, industrial structures were better suited for a single market; Southern European enterprises have been slower to offshore activities and to attract foreign investors. |
| Which government policies help enterprises do better? | ➤ In advanced European economies, many governments have to streamline regulations to make doing business easier; in emerging Europe, most have to improve infrastructure and credit as well.           |



## Chapter 5: Innovation

How much does Europe's innovation deficit matter?	>	Europe's innovation deficit matters most for the EU15, and so it also matters for the economies of emerging Europe because they are closely integrated.
Why does Europe do less R&D than the United States, Japan, and the Republic of Korea?	>	European enterprises do less R&D than their American firms because they tend to be in sectors that are not as innovation-oriented.
What are the special attributes of a successful European innovation system?	>	The most innovative European economies such as Switzerland spend a lot on R&D, but also share key attributes with the United States—tight business-university links, good management skills, and top universities.
What should European governments do to increase innovation?	>	Measures to fully integrate the single market for services will provide the scale, more privately funded universities will supply the skills, and regulations that foster competition will create the incentives for European enterprises to innovate.

## Chapter 6: Labor

Is there a European work model?	>	European economies generally have more stringent employment protection and more generous social benefits than their peers in North America and East Asia.
Given demographic changes, how can Europe achieve a stable and more productive workforce?	>	Increased participation can help stem the decline of the workforce, but more competition for jobs, greater mobility within Europe, and measures to attract global talent will still be necessary.
Are employment and social protection practices inhibiting labor participation and efficiency?	>	Employment protection gives too much power to those with jobs while banishing others to the fringes of the labor market, and generous social benefits weaken the incentives to work.
Is Europe taking full advantage of the benefits associated with internal labor mobility?	>	Migration among and within countries in Europe is still low, and even intra-EU migration falls short of the European Union's aspiration of a fully integrated labor market.
How can Europe become a global magnet for talent?	>	Europe needs an approach to global talent with policies that link immigration to labor markets, and a business climate that rewards skills and entrepreneurship.

## Chapter 7: Government

Are governments in Europe bigger than elsewhere?	>	Governments in Europe spend about 10 percent of GDP more than their peers, and this is almost entirely because they spend more on social protection.
Is big government a drag on growth in Europe?	>	Controlling for other differences, European economies with government spending greater than 40 percent of GDP have had much lower growth rates during the last 15 years.
If big government impedes growth, how do countries such as Sweden do so well?	>	Countries like Sweden have big governments, but they deliver high-quality social services, make it easy for citizens and enterprises to comply with taxes and regulations, and have high levels of social trust.
How can governments be made more efficient?	>	Countries where government works have made their bureaucracies leaner, fiscal institutions more reliable, public services competitive, tax administration effective, and citizens more empowered.
Should fiscal consolidation be a top policy priority in Europe?	>	To respond to market pressures and aging populations, almost every country in Europe must make big fiscal adjustments to reduce public debt to precrisis levels.

## Chapter 8: Golden growth

How can Europe make the single market more efficient?	>	Greater labor mobility and more uniform national regulations for modern business services are making the single market more efficient.
How can Europe maintain the momentum for regional economic integration?	>	Sustaining economic integration requires making the single market efficient, crisis-proofing financial flows, and facilitating production networks through improved public services in emerging Europe.
What is needed to maintain Europe's global leadership?	>	To remain a global economic leader, Europe has to sustain regional integration, reduce public debt, reform social security, revamp employment protection laws, and institute policies to attract talent from around the world.