The European growth model

When this report was being finalized in late 2011, Europe was in crisis. The nations of Europe that had given up the most prized symbol of sovereignty—their currency—in exchange for the euro had the most troubled economies in the world. The countries that had ostensibly integrated the most were the ones deepest in trouble—surely a sign of a deeply flawed growth model.

But if Aristotle were writing about the good life today, he could still consider Europe. Europeans live long and largely healthy lives. They work less than workers in other prosperous societies. European incomes are not as high as American incomes, but most European countries have high-income economies. They have built these economies with democratic and representative societies, sacrificing neither civil liberties nor basic needs. And along the way, they have looked after the unfortunate among them and helped poorer nations in the neighborhood.

During the “Golden Age of European Growth,” the early 1950s to the mid-1970s, Western European incomes converged toward those in the United States. From the mid-1970s to the early 1990s, the incomes of more than 100 million people in the poorer southern periphery—Greece, southern Italy, Portugal, and Spain—rapidly converged on those of advanced Europe. After the fall of the Berlin Wall, the European Union absorbed another 100 million people in Central and Eastern Europe. Incomes in these countries have converged quickly. As another 100 million people in the Balkan states and Turkey wait to enter the world’s most powerful association of nations, they are already benefiting from the aspirations and institutions that helped almost half a billion people achieve the highest standard of living in the world.

What makes the European economic model unique?
Have changes in Europe and the rest of the world made a new economic model necessary?
Which parts of the European model should be preserved, and which should be changed?
One could say without exaggeration that Europe had invented a “convergence machine,” taking in poor countries and helping them become high-income economies. In other parts of the world, middle-income countries had to be extraordinarily fortunate—finding oil, for example—or unusually ferocious, such as the East Asian Tigers, to become wealthy. In Europe, they did not need to be either.

European societies are not only among the wealthiest in the world but also among the most equal. Europeans benefit from near-universal access to social services, including universal health care and free primary, secondary, and in many countries, tertiary education. They are protected by an elaborate system of social insurance. Due to smaller wage differentials, higher and more progressive taxes, and more generous social transfers, income distribution in Europe is more equal than in the United States, Japan, and most emerging market economies. At the same time, Europe has become greener over the past two decades and—except for Japan—is more energy-efficient than other high-income countries.

Perhaps most important, after two continental wars in the first half of the twentieth century, Europe has found peace through economic and political integration. This unique achievement is at the heart of Europe’s remarkable economic success after 1945 and the peaceful transformation of the countries in Central and Eastern Europe after the fall of the Berlin Wall. As economist Paul Krugman notes, “The Europeans have shown us that peace and unity can be brought to a region with a history of violence, and in the process they have created perhaps the most decent societies in human history, combining democracy and human rights with a level of individual economic security that America comes nowhere close to matching” (Krugman 2011).

The citizens of Europe appear to appreciate these achievements. According to the Eurobarometer, a survey of EU citizens conducted twice a year, most Europeans are optimistic about the future. Other surveys find that Europeans lead not only long and healthy lives, but also happy ones (Veenhoven 2011).

All this was keenly appreciated before the latest crisis. Europe’s economic and social conditions in 2011 provide a stark contrast to its achievements over the past six decades. Since 2009, Europeans have had to accept cuts in incomes and social spending, sparking angry protests in some countries. Markets fret over high sovereign debt, and question the inconsistencies between a shared currency and widening differentials in fiscal discipline and entrepreneurial abilities among the members of the eurozone. Even more seriously, they question the ability of the worst-affected countries to grow their way out of the crisis.

These concerns are not new. In 2002, the Lisbon Agenda had recognized Europe’s disadvantage in innovation and productivity growth relative to the United States and Asia. The global economic and financial crisis of 2008–09 left scars in Europe, especially in its periphery, and strained European institutions. The European Commission has repeatedly pointed to long-standing competitiveness issues across the region. European leaders today face the hard task of selling tough adjustment to a reticent population, reassuring markets
and addressing deep-rooted competitiveness issues. There is little consensus on how to do this. But there is growing consensus that unless Europe learns to grow again, the European way of life and Europe’s place in the world are under threat.

Recent developments can also be seen as a challenge to the integration at the center of Europe’s unique success. An increase in North African refugees after the Arab Spring prompted calls by French and Italian leaders to restrict the free movement of people between countries that are members of the Schengen Agreement. The fear of competition from workers from new member states in Eastern Europe is widespread even in countries facing acute shortages of qualified labor, such as Germany. High rates of youth unemployment in several European countries and persistent pockets of social exclusion stand in contrast with the ideals of European solidarity. Even as Europe’s new members in the east have rapidly caught up with their western neighbors, Europe’s southern economies have started to fall behind, prompting concerns that Europe’s latest enlargement may have been at the expense of the weaker among the EU’s older members. Coordinated action by banks and supervisors during 2008–09 avoided rapid deleveraging by parent banks that had expanded into Eastern Europe. However, the same outcome is not guaranteed if national supervisors focus on shoring up the domestic capital base of their banks at the expense of faster deleveraging abroad.

Not surprisingly, support for further enlargement in the European Union is declining, though it runs higher among new members. 1 Citizens of the EU’s neighboring countries, too, have started to doubt the EU’s attractiveness. Support for EU membership is falling in Turkey. 2 Ukraine has reverted to a foreign policy that tries to balance commitment to integration with Europe and reintegration with the Russian Federation. In Serbia, polls indicate only a thin majority in favor of EU membership. The model of European integration and solidarity may not be coming apart at the seams, but it is fraying at the edges.

Europeans have become less confident that their development model can sustain improvements in living standards, and neighboring countries are cautious about joining an aging and ailing club. Although many people in the world admire Europe, some suspect the continent’s best days are past. After the achievements of the last six decades, Europe’s economy has lost some of its lustre.

**What makes Europe unique**

Although the end of European complacency is good, a loss of confidence in the European model may be dangerous. In a rush to rejuvenate growth, the positive attributes of the European development model may be abandoned along with the negative. By identifying the European growth model’s strengths and weaknesses, this report aims to reduce the risk of policymakers inadvertently discarding the best parts of Europe’s economic approach.

It is fair to ask if it is possible to rigorously identify a growth model except in narrow technical terms defining the interaction of technology, capital, and labor.
This report takes a more practical approach by analyzing the six activities that are the principal components of an economic model: enterprise, labor, trade, finance, innovation, and government. This approach is motivated by a broad concept of economic and social advancement (box 1.1).

It is also fair to ask whether it is appropriate to assume a “European model.” There are differences in how Ireland and Italy regulate enterprise and labor, or how Germany and Greece balance fiscal and social policies. There are differences in what Spain and Sweden export, and how they regulate trade in services. There are differences in how Poland and Portugal regulate their banks, and not just because one shares a common currency while the other has its own. There are differences in how Finland and France provide essential government services, and each approach has merits. Because of these differences, various subgroups of countries within Europe are analyzed and contrasted in subsequent chapters of this report. This chapter emphasizes what is common across different parts of Europe; the next six chapters identify what is different and why.

But these differences in specifics do not rule out common principles that together constitute a unique approach to economic growth and social progress. This common approach consists of policies and institutions that govern trade and finance, enterprise and innovation, and labor and government. Together they define an economic and social model that is uniquely European. This report is premised on the belief that all parts of Europe—EU member states, candidates and potential candidates, and nations in the EU eastern partnership countries—share the aspirations that motivate a common European model, sometimes summarized as “the social market economy” (box 1.2). This report identifies features of this model that should be preserved and those that must be changed, analyzes how change can occur, and presents examples from Europe and around the world that illustrate how countries have successfully made some of these changes.

Box 1.1: Europe’s economic model and its standard of living

Jones and Klenow (2010) propose a broad notion of the standard of living that captures not just the level of national income, but also its distribution, how much of it is available for consumption, how much leisure people need to trade to achieve their level of consumption, and how long they can be expected to live. Calibrating such a broad, consumption-based concept of welfare to existing data reveals that many European countries approach levels of welfare in the United States, despite considerably lower levels of national income. By contrast, the performance of emerging markets in Asia and Latin America looks less impressive than in Europe, because growth there has often been associated with a declining share for consumption and rising income inequality.

The basic idea of Jones and Klenow can be related to the practical approach taken in this report to analyze Europe’s economic and social model. The activities of enterprises, their innovation and entrepreneurship, the trade links between them, and their access to finance and skills determine the productivity of an economy and its aggregate income level. The organization of labor determines how long people have to work to afford a particular level of consumption and whether such work is available for all. The activities of government determine how much income is redistributed, what skills are formed in the education system, and the access to and cost of health care and social insurance that impact what risks people take and how long they can expect to live.

Jones and Klenow note that their measure of economic welfare does not capture possible tradeoffs between present and future generations. It captures only the expected welfare of consumers today and does not address environmental sustainability. Intertemporally optimal or “golden” growth paths have been analyzed by Phelps (1961), among others. Europeans today have to find ways to safeguard the high level of economic welfare achieved over the last six decades while ensuring that future generations do not have fewer opportunities.
CHAPTER 1

The principal components of the European growth model

The organization of Europe’s main economic activities demonstrates what is unique about the European development model.

- **Trade.** Richer and poorer economies are more integrated than in any other part of the world, resulting in quicker convergence in living standards than in incomes, which in turn is quicker than convergence in institutional quality.

- **Finance.** Europe is the only region where private capital in all its forms—foreign direct investment (FDI), nonfinancial and financial FDI, and portfolio funds—flows downhill from richer to poorer countries and from low-growth to high-growth economies.

- **Enterprise.** Private enterprise is accountable to shareholders for profit, but it is also held more responsible for the social and environmental consequences of its actions than in other parts of the world.

- **Innovation.** Research and development (R&D) and tertiary education, recognized around the globe for their economic spillovers, are viewed in Europe as primarily the responsibility of the state.

- **Labor.** Workers in Europe enjoy the most effective protection against abuse by employers and the most generous wage, job security, and nonwage benefits—such as unemployment insurance, paid leave, and pensions—of any workers in the world.

- **Government.** National governments are more redistributive, and supranational coordination in Europe is the world’s most advanced.

**Box 1.2: Europe’s postwar consensus: the social market economy**

The idea of the social market economy is simple: combine the efficiency of markets with social fairness, and combine economic freedom with basic social security. The conceptual fathers of the social market economy, such as Walter Eucken (1940) and Alfred Müller-Armack (1947), were liberals in the European sense of the term. They emphasized the role of free markets in allocating resources and of private property and contract rights in organizing economic activity. Their positions ran counter to the pervasive skepticism of markets and private property in Europe during the Great Depression (Phelps 2007). But they also emphasized the need for government activism to safeguard markets through competition policy and to deal with externalities through regulatory interventions. Private businesses were expected to be responsible for the consequences of their activities—a kind of generalized “polluters pay” principle.

For Eucken, government intervention to achieve social objectives would be limited to progressive taxation, basic social security, and unemployment insurance. Müller-Armack saw a need for structural interventions to achieve distributional objectives in addition to measures to safeguard market competition. He explicitly referred to the reconciliatory role of the social market economy. Indeed, the need for social consensus after the ravages of the war and in the face of the communist alternative developing in Eastern Europe led to government interventions beyond those originally foreseen by the fathers of the social market economy. In the German labor market, centralized wage bargaining was introduced and large companies adopted codetermination in management. Across Europe, the 1950s saw a rapid increase in social insurance and transfers. Generous pay-as-you-go pension systems were put in place, benefiting from favorable postwar demographics and reflecting the need to provide for a generation that often had lost private savings and assets as a result of war and economic turbulence.

For Europeans, to make the market acceptable, the “animal spirits” of capitalism needed to be tamed. The idea of the social market economy was the basis for policy mainly in Austria and Germany, and its corporatist application extended across Scandinavia and the Benelux states. France chose a more interventionist model with the nationalization of strategic industries such as mining, transport, and finance as well as large manufacturing companies such as Renault. Common to all continental economies was the emphasis on a social consensus between capital and labor. This was often organized by a state that supported high savings and investment rates, which in turn led to the easy adoption of frontier technologies from the United States and resulted in quick income convergence (DeLong 1997; Eichengreen 1996; see spotlight one in this report).
One can—and should—ask whether these achievements are sustainable in today’s world, or whether some countries have applied some of these principles poorly. Before answering that question, though, it is useful to note that the European growth model has resulted in a deeper integration and quicker convergence between advanced and developing economies than in any other part of the world. European enterprises balance corporate mandates and social responsibility, and governments mobilize taxpayers to aid innovation. Despite considerable economic uncertainty, European workers still benefit from a high level of security, and no societies achieve better egalitarian outcomes in market economies.

Trade and Finance: deeper integration and quicker convergence

European economies are more integrated than any others in the world. Trade flows relative to gross domestic product (GDP) are much higher in European countries, especially in the new EU member states (EU12), than in other parts of the world (figure 1.1). Among the 27 EU member states (EU27), trade openness is higher than in any other region, including East Asia. In the EU candidates and EU eastern partnership countries, openness is higher than in most other emerging market regions, though it is somewhat lower than in East Asia.

The large share of trade in total GDP results from low barriers to the goods trade in the single market and falling trade barriers for both goods and services in the region, as well as the relatively small size of economies in the region, similar to the developments in East Asia. But the integration of richer and poorer countries facilitates a frenetic flow of goods and makes “Factory Europe” different from the much-heralded “Factory Asia.” Europe’s most developed economies have been outsourcing more and more sophisticated tasks to their eastern neighbors, benefiting both sides in the process. The success in unifying national markets into a single European market has made Europe ambitious enough to consider many services as tradable within the region. But the Single Market for Services can be made a more efficient, potent source of growth in Europe (Monti 2010).
Capital flows in Europe have been the largest—as a share of economic output—in the history of humankind. Labor mobility, while low, is picking up. This economic integration has resulted in quicker convergence in incomes than in other parts of the world (figure 1.2). Outside Europe and East Asia, there is no relation between GDP per capita in 1970 and its growth rate between 1970 and 2009. European countries that were poorer in 1970 experienced higher growth than countries with higher GDP per capita in 1970. East Asia is the other region in the world where convergence in incomes has been observed, but the link between initial income per capita and subsequent growth is much less robust.

Capital flows are fundamental to income convergence in Europe. In Europe, capital flows “downhill,” as predicted in economic theory (Lucas 1990). Outside Europe, capital flows “uphill”—from poorer countries such as China to richer ones like the United States—a puzzling but well-established pattern (Prasad, Rajan, and Subramanian 2007). Outside Europe, many forms of capital go to low-growth countries (figure 1.3). In other words, among many emerging markets outside Europe, high growth in incomes only happens when current account surpluses grow. This “allocation puzzle” is not a problem in Europe. In Europe, consistent with the fundamental tenets of economic theory, capital flows to high-growth countries, principally those in Central, Eastern, and Southeastern Europe. This pattern is most noticeable in the European Union and those aspiring to join it. The EU eastern partnership countries (Belarus, Moldova, Ukraine, and others) look similar to other emerging markets.

In sum, European integration has led to both a higher share of trade in output and to much larger financial flows from richer to poorer countries. Quicker convergence in living standards is the unsurprising outcome. This does not imply that living standards everywhere in Europe have converged. Some

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**Figure 1.2: Convergence in incomes was faster in Europe than elsewhere**

(GDP per capita levels in 1970 and growth from 1970 to 2009)

Source: World Bank staff calculations, based on Penn World Table 7.0 (Heston, Summers, and Aten 2011).
regions, such as Italy’s Mezzogiorno, have persistently lagged. Europe’s Cohesion Funds are designed to help lagging regions catch up. This has not worked well everywhere, partly because national policies have differed with respect to using these funds. Where the focus has been on integrating leading and lagging regions through connective infrastructure, such as in Ireland, regional convergence has resulted. Where instead, funds have been spent on spreading out economic activity and bringing jobs to people in lagging regions through spatially targeted interventions, success has been rare (World Bank 2009). Convergence in Europe appears to have come from market-based integration, not from nonmarket mechanisms driven by solidarity.

European integration has not, however, led to a similarly rapid convergence in the quality of institutions. There is considerable variance in institutional quality across Europe (figure 1.4). A larger “pancake” in figure 1.4 indicates better quality. The size of the pancake in the EU candidate countries or the EU eastern partnership countries is comparable with that in Latin America and smaller than in East Asia.

Figure 1.3: In much of Europe, capital flows to high-growth countries (capital inflows (current account deficits) and per capita GDP growth, 1997–2008)

Figure 1.4: Institutional quality varies a lot within Europe (indicators of property rights and contract enforcement, 2008–09)
International macroeconomics texts argue that the risks investors face in poorer countries depress risk-adjusted returns and discourage investment, preventing convergence. These risks may result from the lower quality of poor countries’ institutions (Acemoglu, Johnson, and Robinson 2001). The risks seem not to prevent convergence in Europe because EU membership—actual or prospective—may be an assurance of future institutional improvements. So far, this reassurance has worked to Europe’s advantage.

The European debt crisis of 2011 is a reminder, however, that investors can lose confidence when the promise of institutional improvements is not kept. Countries in Europe do not need to be ferocious to converge. But the more institutionally integrated a European economy becomes, the less it can afford not to converge. Indeed, for the economies of the eurozone that share a common currency and hence are more tightly integrated than others, economic convergence is as much a prerequisite as it is a perk.

**Enterprise and Innovation: more responsible competition**

The social market economy model adopted in Europe after World War II relies upon business recognizing its social responsibilities. The extent to which this has happened varies across Europe. The business action component of the Responsible Competitiveness Index 2007 captures the efficacy of corporate bonds, the ethical behavior of firms, the wage equality of workers doing similar work, the strength of audit and accounting standards, the extent of staff training, and the occupational fatalities in regions around the world (figure 1.5).

The highest-ranked countries are all European: Sweden, Denmark, Finland, Norway, Iceland, Switzerland, the United Kingdom, the Netherlands, Ireland, and Germany are all ranked higher than the United States, Japan, and most other countries in the world. The average of Europe’s advanced economies (EU15) is above that of Japan and East Asia. To the extent that the ranking reflects the preferences of investors and consumers, corporate responsibility is good for business in Europe. However, not all European countries are equal: Eastern and Southern Europe rank below East Asia and on a par with Latin America.

Greater regulation makes European producers cleaner and greener than American producers, though Japanese producers are even greener and Eastern
Europe lags behind the rest of Europe. European leaders embrace green growth as a driver of Europe’s future development model. According to the most recent data from the United Nations Framework Convention on Climate Change, European countries have made the largest reductions in greenhouse gas emissions (figure 1.6). For the former centrally planned economies, large reductions reflect their inefficient starting points. But Finland, Norway, Sweden, and Germany have achieved emission reductions as a result of investments in renewables and in energy-saving technologies, often spurred by strict emission controls or regulatory and tax measures designed to boost investment in alternative energy. Sweden is a leader in the use of biogas and Denmark in wind, while Germany and Spain have pioneered the use of subsidies to encourage renewable sources of energy. Spotlight two discusses the steps needed to make the European growth model even greener.

Figure 1.6: Emerging European countries are the best performers in emission reduction
(change in greenhouse gas emissions from the base year to 2009, percent)

Figure 1.7: The business climate varies substantially across Europe
(principal component analysis index of Doing Business ratings, 2011)
While addressing social and environmental objectives, Europe’s approach to business regulation may make its enterprises uncompetitive. As described in greater detail in chapters 4 and 5, Europe’s leading economies have struggled to close the productivity gap with the United States, and enterprises in Southern Europe particularly seem to suffer from excessive and cumbersome regulation. A composite index of the quality of the investment climate, based on the Doing Business indicators developed by the World Bank Group, shows that Europe lags the United States and Japan (figure 1.7). This has motivated calls for ambitious regulatory reform, such as in the EU’s Lisbon Agenda of 2002.

Another concern is that Europe lags the United States in innovation – and this explains the persistent productivity gap – as Europe’s leading economies no longer benefit from the technological catch-up that drove growth during the first three postwar decades (Aghion and Howitt 2006). Europe’s approach to innovation assigns a bigger role to government for promoting scientific research and tertiary education. Worries about Europe’s innovation shortfall have led to Europe-wide targets for R&D spending. This approach does not seem to be working (figure 1.8). The bulk of the world’s R&D takes place in the United States, Western Europe, and northeast Asia, but Europe is falling behind—due to the smaller role of the private sector in R&D spending. EU15 governments spend the same share of GDP on R&D as Japan and the United States, but European enterprises spend only about a third of what their U.S. and Japanese counterparts spend. The result is the same when the new member states are compared with emerging East Asia.

Likewise, governments in Europe bear almost all of the expense of university education (figure 1.9). Universities in many European countries are free, though the United Kingdom and several German states recently introduced or raised tuition fees. Universities are predominantly public in Europe, in contrast with the leading universities in the United States and, increasingly, Asia. Lower private financing of tertiary education in Europe may hinder the flow of new ideas from academics to business and contribute to lower private sector R&D investment. Much of the rest of the world (Brazil, India, and Russia, for example) has largely followed the European model of state-dominated university education, but...
fast-growing East Asia is moving toward the U.S. blend of private and state universities.

Europe must consider whether greater regulation and government participation in R&D will help or hurt enterprise and innovation, and widen or shrink the productivity gaps between the United States and the EU15, and between East Asia and the EU12.

**Labor and Government: greater security and equality**

Work conditions in Europe are better than in other parts of the world. Europeans work fewer hours a week, fewer weeks a year, and fewer years during their lifetime than workers in other regions.

Roxburgh and Mischke (2011) estimate that the annual hours worked per capita in the EU15 is 733, about a month less than in the United States. The fewer work
weeks a year account for half of this difference. The remaining half is due to
the lower incidence of women working part-time (around 20 percent); a lower
participation rate among 55–64-year-olds as a result of early retirement (15
percent); higher unemployment in Europe (6 percent); and other factors (around
10 percent). In a broader regional comparison, the EU15 stands out for low
participation rates among 55–64-year-olds (both male and female) and a low
number of hours worked during the year (figure 1.10). The EU12 has particularly
low participation rates in the 55–64-year-old age bracket, but longer annual
average working hours. This pattern is repeated in the EU candidate countries,
which also suffer from higher unemployment among youth.

Economists believe that people prefer leisure to work if they can afford it.
Europeans can afford time off to spend with their families, pursue hobbies,
exercise, or simply rest, and most Europeans welcome this. But for some, less
than full participation in the labor market may be involuntary. Young people and
ethnic minorities such as the Roma are often excluded from the labor market,
even when they are prepared to work. It is worrisome that several European
economies, particularly those in the east and south, feature large informal
Large shadow economies mirror inefficiencies in labor markets—for example, due to high marginal tax rates or rigidities due to labor regulations. The Organisation for Economic Co-operation and Development (OECD) calculates an employment protection legislation index that includes three dimensions: the protection of individuals against unjustified dismissal, the burden of requirements to justify collective dismissal, and regulations on temporary employment, which is less secure than permanent employment (OECD 1999 and 2004, and Venn 2009). Turkey ranked the highest for employee protection in 2008, while workers in the United States were least protected. Non-EU industrial countries, including Japan, generally have weaker employment protections than EU countries (figure 1.11). Within Europe, there is significant variation in employment protection. In Continental Europe and the south, employment protection legislation is more restrictive than in the north and the east. Although labor market reforms across Europe have narrowed differences in employment protection over the past decade, regional differences are still large and contribute to greater labor market segmentation in the south and the east.

Europeans worry that measures to increase labor force participation will lead to a class of working poor. In fact, according to the OECD, the incidence of low pay in many European countries is much lower than in the United States—the EU15 average is around 15 percent compared with 25 percent in the United States (Japan is closer to the EU15). By the same token, wage incomes in the European Union are considerably more equal than those in the United States (figure 1.12). The ratio of earnings in the ninth to the first decile is less than 2.5 in Scandinavia and below 3.5 in much of Continental Europe, but almost 5 in the United States. The greater flexibility of labor markets is not necessarily inconsistent with maintaining greater wage equality, as the Scandinavian countries show. An assessment of what others can learn from this experience is given in chapters 6 and 7.

Europeans not only enjoy relatively high levels of employment protection, they also benefit from generous health services and support in their old age. Social spending on pensions, health, and education is relatively high in Europe (figure 1.13). In most European countries, pension and health systems are managed by government and financed through mandatory payroll contributions or general

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**Figure 1.13: Social spending is higher in Europe**

(government expenditures on education, health, and social protection, 2005–09)

Note: Social spending is a sum of education (707), health (709), and social protection (710) expenditures, as classified in the IMF GFS. Source: IMF GFS, and IMF WEO.
taxes. The rise in pension spending explains the bulk of the increase in the size of governments in Europe, with health-related spending accounting for the remainder.

Several European countries are implementing pension reforms, including increasing the retirement age, reducing early retirement benefits, and reducing replacement rates. In many cases the EU’s new members and Eastern European neighbors spearheaded these reforms as they faced the challenge of rapid aging with far lower average incomes and productivity. Nonetheless, replacement rates in Europe tend to be considerably more generous than in other high-income countries, most notably Canada, Japan, and the United States. The comparison with Japan is particularly instructive because Japan is the one high-income country that shares Europe’s predicament of a labor force that is rapidly declining in size. In most European countries, pension reform remains unfinished business.

The large role of government in providing basic public services and the generosity of the social security system comes with a higher tax burden. Corporate tax rates decreased over the past two decades, leading to more uniform effective rates in Europe and among all developed countries. Personal income tax rates still vary from other parts of the world and even within Europe, especially when the new EU member states are included. Europe’s high payroll taxes and marginal income taxes lead to the largest difference in the world between gross and net wages. One implication of this gap is that the post-tax distribution of earnings is more equal in Europe (figure 1.14). Another implication is that work incentives are weaker.

As a share of their GDP, European countries do not have higher expenditures for health or education than other high-income countries. The role of the government in providing and financing these services, however, tends to be greater in Europe. On average, governments finance three-quarters of all health

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**Figure 1.14: Redistribution through the tax and transfer system is more pronounced in Europe**

(Gini indices, 2000s)

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a. For Australia and New Zealand, the latest available data are from 1994 and 1997, respectively.
b. Japan’s data are from 1993.
Note: “EU cand.” refers to EU candidate countries and “E. prtn.” refers to EU eastern partnership countries.
Source: WDI, and OECD Income Distribution and Poverty Database.
spending in the EU27, but only 60 percent in high-income countries, and as little as 45 percent in the United States. Japan also has a high share of government expenditures in total health spending (81 percent). In education spending, Europe stands apart from the rest of the world. Governments in Europe finance more than four-fifths of total education spending, compared with up to three-quarters in a few and half in most OECD countries. In most European countries, primary, secondary, and tertiary education is free, which explains the much larger government role in financing education.

Given the substantial role of government in providing services and social security, government accountability is pivotal. But there is a delicate balance between the accountability desired by most European societies and the moral hazard from the aspirations of a common European project. Europe is a unique experiment in shifting from national to international redistribution and to a deeper political integration than anywhere else in the world.

While it is difficult to discern a clear set of characteristics shared by every European country, a consistent pattern distinguishes Europe’s development model. Even if there were no such thing as a common European growth model, Europe would face common challenges that set it apart. There are variations in the severity of these challenges among European countries, but they are small relative to the differences with the Americas and Asia. It is these common challenges that motivate a study on restoring the lustre of the European growth model.

The need for change

External and internal developments are putting pressures on Europe—as exhibited in stalling productivity, shrinking workforces, and widening fiscal imbalances. But the remedies lie in three interrelated challenges: making the most of modern services, both financial and nonfinancial; closing productivity gaps, such as the one between the EU15 and the United States, and the growing divergence in productivity growth between Southern Europe and the rest; and dealing with an increasingly serious demographic drag, caused by a combination of aging and shrinking populations in many parts of Europe, including its emerging markets.

Unexploited potential in modern services

In developed economies, about three-quarters of national income is generated in the services sector. Europe’s internal trade in services is the largest worldwide at around US$4 trillion. And yet the Single Market for Services remains fragmented. The most integrated in Europe is the market for financial services, and this has brought ample benefits (chapter 3). But even here, coordination among national regulators to oversee the activities of financial institutions operating across national borders may have been exposed as deficient during the recent crisis. The uncoordinated deleveraging of bank balance sheets in Europe’s emerging markets as a result of capital calls by national regulators could impose significant collateral damage on host countries’ economies. This would exacerbate downward economic pressures across
CHAPTER 1

To avoid costly disintegration, further regulatory integration is called for.

In other services, regulatory barriers prevent the benefits of trade and integration from being fully realized (chapter 2). Digital services, such as Internet sales and IT support, are far less developed in Europe. For example, the United States accounts for around 80 percent of global e-book sales, but Europe for only 10 percent, mostly in the United Kingdom. The online music storage and sharing service Spotify is available in only 7 European countries, and iTunes is accessible in only 15 states. National regulations make it difficult for companies to operate Europe-wide, preventing efficiency and cost gains from being realized. After years of negotiations, Europe still does not have a single European patent, which increases the cost to innovators. Telecom services, biotechnologies, and pharmaceuticals are nationally regulated, leading to significant price divergence across Europe and reduced incentives for business to invest in R&D. In professional services, the mutual recognition of qualifications remains incomplete, while contract law and professional liability and insurance requirements differ and create risks for cross-border sales, particularly by small and medium enterprises.

The regulatory barriers hampering the development of services trade across Europe are economically significant. Some estimates put the gains from strengthening the Single Market for Services at 4 percent of the EU’s aggregate GDP (Monti 2010). About 70 percent of the productivity gap with the United States in the “old” members of the European Union is in the productivity of services (Roxburgh and others 2010). Lower productivity growth in distribution (retail, wholesale, transport, and logistics) accounts for a large share of Europe’s divergence in productivity from the United States and Japan since the mid-1990s (Jorgenson and Timmer 2011). Europe lags the United States in highly innovative industries such as biotech, the Internet, and medical services (chapter 5). Europe

Note: The chart shows productivity levels in the core EU15 rather than the wider EU27. The EU’s new members (EU12) have been converging to the United States but are too small to fundamentally affect the picture for Europe as a whole. Note also the declining gap with Japan even during the recent decades, when Japan grew slowly. Once demographic “drag” is subtracted, labor productivity growth in Japan compares well with Europe and is on a par with the United States between 1995 and 2005. Source: World Bank staff calculations, based on the OECD Productivity Database.

Figure 1.15: Europe’s productivity leaders are lagging behind the United States

(EU15 labor productivity, indexed to the United States and Japan)
has gotten less out of the information technology revolution and risks missing out on biotech, the next important wave of business opportunities in the “New Economy.”

**Widening productivity gaps**

Growth in labor productivity in Europe’s advanced economies has fallen behind that in the United States (figure 1.15). This growing gap with the world’s technology leader is in sharp contrast with the rapid convergence in labor productivity Europe experienced in the five decades after World War II. It prompted several European policy initiatives, starting with the Lisbon

![Figure 1.16: Southern Europe lags the EU15 North, and Eastern Europe is catching up to it](image)

(EU15 South labor productivity, indexed to EU15 North and EU12)

![Figure 1.17: Europe’s population could shrink by a third over the next 40 years](image)

(population projections, 2010–50)

Note: “EU15 S.” refers to countries in EU15 South, which are also included in the EU15 aggregates. “EU cand.” refers to EU candidate countries and “E. prtn.” refers to EU eastern partnership countries. Source: World Bank staff calculations, based on U.S. Census Bureau International Data Base.
Agenda of 2002 and reinforced in Europe’s 2020 Agenda of 2010, all aimed at strengthening Europe’s competitiveness and productivity performance, while ensuring that economic growth in Europe remains socially inclusive and environmentally sustainable. The results of these efforts have been modest. Subsequent chapters in this report analyze what needs to be done.

The growing gap with the United States is not the only productivity gap Europe needs to worry about. Within Europe, labor productivity growth until the mid-1990s tended to be faster in the relatively poorer countries. But over the past decade, the pattern has become more complex. While the new member states of the European Union in Central and Eastern Europe have grown fast and made good progress in closing the large initial productivity gap with the EU15, among the “old” members of the EU, productivity has diverged since the end of the 1990s (figure 1.16). In particular, productivity growth in Europe’s southern economies—Greece, Italy, Portugal, and Spain—has been slower than in Europe’s north. These trends worsened in the five years leading up to the economic and financial crisis of 2007–08. But incomes have not matched labor productivity. The result has been a sharp divergence in unit labor costs within the eurozone and a corresponding increase in internal imbalances among its member states.

**Growing “Demographic Drag”**

Over the next 50 years, with current policies, Europe’s labor force will decline by 50 million, with the largest part of the decrease happening between 2020 and 2040. The numbers are quite daunting, because there will be changes at both ends of the population pyramid. Due to low fertility rates, the labor force will decline by around 15 percent in the EU15 and by more than 30 percent in the EU12 and the EU eastern partnership countries, but it is likely to increase by 15 percent in the potential candidate countries. At the same time, the share of

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**Figure 1.18: European governments are the biggest in the world, and often heavily indebted**


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Note: “EU cand.” refers to EU candidate countries and “E. prtn.” refers to EU eastern partnership countries.

Source: IMF WEO, European Commission’s annual macro-economic database (AMECO), and Abbas and others 2011.
European ages 65 and older is projected to increase from less than 20 percent today to around 30 percent by 2050 (figure 1.17).

This contrasts markedly with predicted developments in the United States, India, and emerging markets in Latin America and North Africa. Although China and Japan also face a declining labor force, there are vast opportunities in China for productivity gains from capital deepening and from the structural transformation of the economy. Japan is most comparable with Europe in its demographic patterns, but it has managed the fiscal implications of aging more prudently and has sustained higher rates of productivity growth than Europe. Europe will need to boost labor force participation and adjust its institutions to cope with the need for greater immigration if it is to achieve sustainable GDP growth (chapter 6).

Demographic changes are straining Europe’s welfare systems. European countries have larger governments than countries in other regions, regardless of per capita income level (figure 1.18). The differential is about 10 percent of GDP, and the main reason is that European governments spend more on social security, mostly on pensions (chapter 7). This is not because European societies are already much older than others at similar income levels. Rather, Europe has more pensioners because workers retire earlier. Europe’s social spending is large, though the continent is still relatively young. As Europeans live longer and populations age, this will need to change.

The burden of implicit pension liabilities has been recognized for some time. Until recently, however, the large size of Europe’s governments and the increasing levels of public debt did not attract much attention. This has changed in the wake of the crisis, as European governments struggle to convince investors that they can and will redeem their debts. The need for fiscal adjustments and debt reduction is now widely acknowledged. How to do this in a socially balanced way is perhaps the key challenge facing European policymakers over the coming decade. How to sequence and coordinate the adjustment in the context of large internal imbalances within Europe and the looming risk of a renewed recession is a key challenge over the coming months.16

An underdeveloped services market, a persistent gap to the world’s productivity frontier, an aging society, and the immediate need for fiscal adjustment—together these conditions make economic growth the greatest imperative for Europe. The issue is not just higher material output. Intergenerational equity, sustainability, and global relevance are also at issue. Only a growing Europe will be able to maintain its attractive blend of ever-better living standards, individual rights and social security, and regional solidarity.

**Mending the model**

It is understandable that given half a century of success, many Europeans are inclined to preserve and defend their economic model rather than change and adapt. But it is clear that changes are necessary. Changes are needed for the European single market to deepen, for Europe to become an even bigger economic union, and for Europe to retain or regain its global economic leadership.
The rest of this chapter introduces the key policy debates that frame the case for changing the various components of the growth model. The policy debates concern all of Europe, but the implications are often quite different across countries. Some parts of the model will require less adjustment than others. The structure of this report reflects these differences. A few salient points:

- The structure of this report mirrors its main messages. Trade and finance come first: they are the parts of the economic model that are the strongest and—except for the single market for some services—require the least change. Enterprise and innovation come second: they work well in some parts of Europe and poorly in others. Some countries need to change their policies just a little, others a lot. Labor and government come next: they require the most change in many countries.

- The organization of the chapters also reflects their geographic focus. The debates about enlargement are best informed by discussing the experience of emerging Europe—the new member states of the European Union, the EU candidate countries in the Balkans, and the EU eastern partnership countries. The discussions of trade and finance emphasize the economic relations between emerging Europe and the advanced EU15 economies. The debates about European competitiveness are centered on the European Union, with growing concerns about the competitiveness of enterprise in the southern states and weaknesses in the innovation fundamentals of the European Union. The discussion of enterprise and innovation is focused on the 31 countries in the European Union and European Free Trade Association. The debates about labor and government span all 45 countries in Europe: the European Free Trade Association, the European Union, the EU candidate states, and the EU eastern partnership countries.

- This report tries to provide answers to the questions that are most pertinent for policymakers. The number of questions in each chapter increases as the report progresses from the strong points of the European economic model to its weaker aspects. But the debates addressed in chapters 2–7 span questions related to three of Europe’s biggest assets: the single market, the consensus for economic enlargement, and Europe’s global economic importance. Highlighting the priorities, chapter 8 notes countries in and outside Europe whose performance can be used as a benchmark by others.

**Trade: taking advantage of enlargement**

There are many who question whether enlarging the European Union to the east has benefited Europe’s “old” member states, especially the ones in the south; there is not much debate about whether the new members have benefited—they clearly have. A corollary of this concern is skepticism about the benefits to current members of the European Union from further enlargement to include the western Balkans, Turkey, and Europe’s eastern neighbors, especially Belarus, Moldova, and Ukraine.

The fears about trade integration with the east are centered on the relocation of production facilities to benefit from a qualified but cheaper labor force. The argument is often made that this leads to a loss of jobs in the west—that competition has harmed economies in “old” Europe. This report documents
the spread of industrial networks as a result of EU enlargement and shows how the EU’s old members have indeed been increasingly offshoring activities to the newer ones. This has helped companies in Western Europe—in Austria, Germany, and others—become or stay competitive. Western Europe’s most successful economies have increasingly relied on suppliers in the east. And the new member states have been given increasingly sophisticated tasks in the process, which has turned them into global exporters in their own right.

The same phenomena can be observed with a lag in the western Balkans and Turkey, where trade in industrial intermediates is catalyzing changes in the structure of exports. The conclusion of deep and comprehensive free trade agreements with the eastern neighbors would likely bring many of the benefits that the customs union, concluded in 1995 between the European Union and Turkey, has brought to Europe’s second most populous country.

But while enlargement has been a success for most, Europe’s southern economies have missed out on the benefits of deepening integration. FDI that used to go southward has increasingly headed east. Neither has the south substantially increased its trade linkages with the new member states or the accession countries, with the notable exception of Greek and Italian banks expanding into the western Balkans. Enterprises in Greece, Italy, Portugal, and—to less extent—Spain tend to be too small to internationalize. The family business model needs updating as the European family grows ever bigger.

If trade in manufacturing has been a motor of European integration, trade in services is less developed and more regulated in Europe, even inside the European Union. Services trade has grown significantly, as has the sophistication of services exports of both old and new EU member states. But services trade in the European Union is estimated to be only about half what it could be if the Single Market for Services were fully developed. Moreover, services trade in non-EU members is less impressive and remains primarily for traditional services, pointing to sizable gains from further liberalization of trade in services with non-EU members. Tapping this potential requires strengthening the capacity of EU candidate countries to adhere to European regulations in areas such as intellectual property rights and financial services. It will also require the European Union to accept the greater labor mobility required for trade in traditional services such as construction, transportation, and tourism.

Europe’s global trade relations are characterized by the increasing proliferation of bilateral trade deals, custom-made for the particular sensitivities involved. For Europe, agriculture remains a policy area dominated more by politics than economics. The weakest part of Europe’s approach to trade is the high protection afforded by the Common Agricultural Policy, which distorts farming decisions and—unlike the rest of the components of the European economic model—helps neither poorer farmers nor poorer countries. (See chapter 2 for an argument that Europe would do well to reconsider its agricultural trade policies toward the economies of the EU eastern partnership, where many people are still farmers.)

Trade is one of Europe’s strong points. European integration is a unique political and economic achievement, and enlargement represents opportunities for both
old and new member states of the European Union. Making fuller use of these opportunities requires strengthening as well as extending the single market.

**Finance: managing quick capital flows**

Banks and financiers are not popular these days. There are questions about whether financial integration in Europe has gone too far. This report argues that financial integration has been at the core of one of Europe’s biggest achievements—the rapid convergence of incomes and living standards across the continent. These flows should not be slowed; Europe should just get better at managing them.

Critics of financial integration in Europe point to the risk that excessive debt levels may slow down growth in the future, because new credit is not available while banks reduce exposure to repair their balance sheets. Easy finance may have obscured structural weaknesses of economies and enterprises and led to a misallocation and waste of capital at the cost of European taxpayers, who now have to bail out the banks. And critics point to the shortcomings of Europe’s financial and regulatory architecture, with financial institutions that operate freely across borders while remaining under the supervision of national authorities.

The criticism points to areas that need fixing. But this report argues that on the whole, finance has been a boon to Europe despite some excesses. In supporting this conclusion, the report distinguishes between the emerging markets in Eastern Europe and the countries that joined the European Union during the 1970s and 1980s—the erstwhile “cohesion countries”—Ireland, Greece, Portugal, and Spain. The private sector credit boom in emerging Europe has not created a debt overhang. Corporate and household balance sheets are not excessively leveraged, and credit has gone to stronger companies and wealthier households. By and large, finance has helped real convergence in Eastern Europe. Going forward, while commercial banks struggle with a large share of nonperforming loans, and credit growth may be subdued for some time, exchange rate flexibility in countries such as the Czech Republic or Poland and the political will to carry through an internal devaluation in places like the three Baltic states should mitigate the risks of a credit-less recovery.\(^{17}\) By contrast, debt levels in the cohesion countries are near or above the thresholds of sustainability and growth-friendliness. The debt overhang compounds the challenge of restoring competitiveness and growth, without which in turn debt sustainability is questionable. External borrowing in Europe’s south has typically gone hand in hand with a decline in domestic private savings. Except Ireland, where productivity growth was high throughout the boom, finance in the cohesion countries has not promoted real convergence but instead has fueled the convergence of nominal incomes. Europe’s underlying productivity gap between north and south, more than its financial system, needs fixing.

A peculiar feature of financial integration in Europe (both within the European Union and in some EU eastern partnership countries, such as Ukraine) is the predominance of financial FDI, most obviously manifest as foreign banks in emerging Europe. This has made financial flows more durable during the crisis, with rollover rates close to 100 percent compared with 60–65 percent during the East Asia crisis of 1997–98. This success was in part achieved thanks to
spontaneous coordination among home and host regulators, banks themselves, and international financial institutions under the so-called “Vienna Initiative.” As the sovereign debt crisis in Europe has put renewed pressure on European banks, however, Europe needs to consider moving beyond coordination toward building a Europe-wide regulatory architecture that provides enforcement powers to supranational institutions such as the European Banking Authority. Managing quick capital flows successfully is likely to require national regulators to transfer some authority to the European level.

At the national level, countercyclical fiscal policy and macroprudential financial sector regulations would have helped economies in emerging Europe get the best out of western finance. A lesson of the crisis is the need for European policymakers to act more forcefully to cool excessive domestic demand. There is a moral in the coincidence of the success of financial integration and an improved investment climate: where domestic competition was weak, finance flowed into real estate and retail lending in the absence of a sufficient supply of creditworthy corporate borrowers. Financial integration can catalyze real economic integration when the right structural policies are in place—but it cannot substitute for them. In the meantime, the macroprudential architecture in Europe has also been strengthened in the course of the crisis, with the creation of the European Systemic Risk Board. Whether this is sufficient to prevent future excesses can be debated. Market signals in the course of 2011 were clear: yields came down for sovereigns in countries like Ireland and Latvia where macroeconomic policies have sharply unwound the excesses of the past; they did not where measures remained halfhearted or where political commitment to stay the course of adjustment was in doubt.

The comparison of south and east provides lessons in how financial integration can foster convergence when managed well, and how it can destabilize all of Europe when the capital flows into unproductive activities. But this report concludes that closer financial integration between wealthier and less advanced economies in Europe is unique, and a strength of the European economic model.

**Enterprise: making structures better suited for an enlarged Europe**

Advocates of free, unregulated markets point to Europe’s modest growth performance over the past two decades, compared with those of the United States and East Asia, as an example of the stifling effects of excessive regulation. While the attempted regulatory harmonization in the 120,000 pages of the *Acquis Communautaire* is an admirable ambition, Europe is not considered an easy place to do business. Unless this changes, it is argued, Europe’s growth prospects look dim.

In reality, there is considerable variation in the extent of government regulation of private enterprise across Europe. Regulation remains pervasive despite a decade-long process of gradual liberalization in the south and some Continental European countries, but is now lighter in the north and in some new EU members in the east. This report examines how these differences lead to differences in the health of Europe’s economies, taking a microeconomic
approach to the assessment of enterprise performance. In particular, it examines how enterprises have done in achieving three objectives: adding value, creating jobs, and increasing exports.

European enterprises do not do worse than their competitors in the United States and East Asia in these three dimensions. There are, however, big differences across Europe that result from how countries regulate enterprise. In the European Union, the north exceeds the performance of the United States in all three dimensions, Continental Europe does well in exports but less so in value added and employment growth, and the south has added jobs, but not value and exports. Productivity growth within the EU15 has begun to diverge in recent years. By contrast with the south, the EU’s eastern members and neighbors have done well in increasing productivity and exports, but less in creating jobs.

The differences in the business environment and the performance of enterprises are linked. Cumbersome regulations, high tax rates, compliance costs, and weaknesses in contract enforcement keep enterprises small in the south. Smaller firms often stay below the radar screen of inspectors or benefit from simplified requirements. Staying small often means staying nimble and limiting risks. But smaller firms are also less attractive for foreign investors and face significant risks themselves in trading and investing internationally. And smaller firms can ill afford the wages demanded by a highly educated workforce. These are all reasons why the south has experienced slower productivity and export growth than other regions in Europe, and they explain how fast job creation has coexisted with significant youth unemployment, often of university graduates.

By contrast, enterprises in the north and in Europe’s continental economies have faced fewer obstacles in growing bigger. They have internationalized and have been able to attract and retain skilled labor. They have done so although regulations and taxes in Northern and Continental Europe remain more burdensome than in other high-income OECD countries. But compliance costs have been reduced, and predictability and evenhanded enforcement have helped firms adjust. The recent success of enterprises in countries such as Finland, Germany, and Sweden indicates that the European economic and social model is not incompatible with competitive enterprise.

In the east, deregulation and simplified tax systems have helped attract FDI from Estonia to Georgia. Good infrastructure, as in the Czech Republic, and a large domestic market, such as in Poland, have also helped. By internationalizing and becoming part of Austrian, German, and Swedish multinational production chains, Eastern European enterprises have benefited from enlargement and have been rewarded with gains in productivity and world record export performance.

Innovation: improving the structures that bring ideas to market

Researchers who are worried that European enterprises are becoming less competitive relative to North American and East Asian firms point to Europe’s
weaker innovation fundamentals: competition, universities, and R&D funding. Policymakers in Europe have been focused on innovation for several years as reflected, for instance, in the Lisbon Strategy of 2002. This set a target for Europe to reach a level of R&D spending of at least 3 percent of GDP. Today, Europe as a whole remains quite distant from this objective and also lags the United States, the world’s innovation leader, in a number of aspects related to innovation. This report assesses what the main components of a European “innovation ecosystem” might be.

A composite indicator developed by the European Union covers public and private R&D investments, the quality of universities, linkages between research and business, access to finance, protection of intellectual property rights, and access to a large market. The measure highlights the innovation gap between Europe and the United States. Among Europe’s major competitors (the United States, Japan, Brazil, Russia, India, and China), only Russia is falling behind in relative terms. The United States and Japan score better than the European Union and are widening the gap.

Close up, the picture looks different. Switzerland, Sweden, Denmark, Finland, and Germany perform close to U.S. levels, but much of Southern and Eastern Europe lags well behind. The poor performance of some advanced European countries such as Italy, Spain, and—to less extent—France in various dimensions of innovation is of particular concern. Poorer economies can often grow fast even without much innovation by adopting frontier technologies. Europe’s own history up to the mid-1970s, and East Asia’s “flying geese” pattern of structural change and technological advance, are examples of catch-up growth. But closer to the technological frontier, institutions have to change to promote innovation. Studies suggest that competition, the quality of tertiary education, and the availability of venture capital finance are the main ingredients of success at the frontier (for example, Aghion and Howitt 2006). Europe as a whole lags the United States in these dimensions, and Europe’s low-innovation economies lag behind its leaders in every one of them.

One sign of Europe’s innovation gap is that it has too few young, leading innovators—firms that have grown quickly to become large. Young firms form the majority of leading innovators in the United States, and a substantial share of R&D in leading sectors. Europe does not specialize in R&D-intensive sectors such as aerospace, biotech, information technology, health care, pharmaceuticals, and telecommunications. Even in countries with strong national innovation systems such as Germany or Sweden, there are few young, fast-growing companies, and innovation-based sectors are poorly represented. Europe, like Japan, carries out the bulk of its R&D in traditional, old firms. While this works for some—such as the well-known “export champions” like ABB, Erikson, BMW, Mercedes Benz, BASF, or Siemens—Europe has few companies that match the dynamism of Apple, Amazon, Google, Facebook, or Microsoft. This report links this back to the fragmentation in the single market for digital services, which makes it more difficult for young innovators in Europe to grow to global scale.

Europe did not get the same productivity kick as the United States out of the wave of improvements in information communications and technology over the
last decade and a half. It will have to harness the power of the single market to do better when the next technological revolution comes along.

**Labor: getting more from work**

Europeans sometimes fear that Europe is running out of work. But it is workers that Europe is running out of. Addressing this misconception may be one of the most important tasks for European policymakers.

Labor markets have long been recognized as one of Europe’s weaker points. Persistent unemployment during the 1980s and 1990s was perhaps the most widely discussed aspect of what some called “Eurosclerosis”—the inability of Europe’s postwar institutions to adjust to a changing global economy (Giersch 1985). Motivated in part by the view that work in Europe was a pie of fixed size, policymakers made it easier for Europeans to retire earlier and to work fewer hours. Workers in Europe have responded to these incentives, not least because they enjoy social security. The generosity of social welfare and the high degree of protection afforded to workers in Europe are a distinguishing characteristic of the European economic and social model, setting the continent apart from other high-income economies.

This report assesses the costs of this generosity, highlighting inconsistencies in the way work and welfare are organized in Europe. As part of financing generous social benefits, the burden of payroll taxes has grown while the workforce that pays these taxes has declined. The laws make workers, once hired, feel secure. The same laws make employers think twice before hiring. High taxes and burdensome employment protection rules discourage job creation with the consequence that some Europeans—often the young—remain excluded from the labor market. Europe’s policies regulating work can be linked to the inefficiencies in the labor market, which in turn contribute to a loss of competitiveness and reduced ability of enterprises to innovate.

The strains in Europe’s insider-outsider labor market have grown since economists first pointed out its inefficiencies in the 1980s. Youth unemployment rates of 40 percent such as in Spain are hardly compatible with the objective of social inclusion. At the same time, many Europeans fear that with globalization and European enlargement, their jobs are competed away through outsourcing and immigration. When the amount of work available is seen as a fixed pie, the inclination is to limit the number of eaters. The tension between insiders and outsiders has correspondingly grown.

It need not be like this. Compared with the 1970s and 1980s, Europe has become better at creating jobs. Excluding some from the labor market is an anachronism in a continent facing a rapid decline in its labor force over the coming decades. If current patterns persist, Europe will have 30 million fewer young workers (ages 19–39) by 2060. Europe’s youth have to be brought into the economic mainstream. And even then, shortages of skilled labor remain likely.

Encouragingly, a growing number of European countries have been changing their labor market policies. It will be reassuring for many Europeans that labor markets in Denmark and Germany have succeeded in combining high levels of income security for workers with stronger incentives to look for new growth.
opportunities, and with measures to lower the payroll tax and thus encourage employers to create jobs. It should also be reassuring that governments in Northern Europe have been successful in matching younger workers and jobs, though such policies are difficult to get right and can be expensive.

Some parts of Europe are poised to do a lot better than others when it emerges from the current economic turbulence. These differences in prospects have consequences for workers. Europe’s single market is premised on the aspiration that labor can move freely in response to economic opportunities. In reality, Europeans move little both inside countries and across national borders. High regional unemployment rates motivate costly regional development policies that attempt to bring jobs to people, rather than encourage people to move to where the jobs are. Low levels of mobility are associated with high unemployment.

Language barriers, family ties, and attachment to local culture make Europeans reluctant to move, yet these are not unique to Europe. Younger, educated, and ambitious Europeans would benefit from stronger signals from the labor market, better-functioning housing markets, and more easily portable health and social protection benefits. In Europe’s economic powerhouses like Germany, enterprises are often short of skilled labor. In Spain and Italy, many university graduates are struggling to enter the labor market. Europe as a whole will benefit from higher labor mobility. Indeed, for countries that share a single currency, labor mobility may be the most important missing ingredient—one that could help make the eurozone an “optimum currency area.”

Europe will also have to learn to compete for global talent. Europe offers much in the way of cultural richness and economic opportunity, yet talent from around the world is more likely to go to the United States because of better universities, more-accommodating labor markets, and institutions that are more welcoming (The Economist 2009). Europe has much to change in its approach to immigration.

**Government: making a representative state more efficient**

Seen from Asia or America, Europe is a region with big government. For many, big government is associated with bloated bureaucracies, high taxes, and wasteful government spending. Little wonder, it is said, that European economies have trouble growing. The recent financial turbulence in Europe, prompted by concerns over large public debts and persistent fiscal deficits, has added weight to the arguments of those skeptical of large government.

This report asks whether large governments are indeed harmful for growth. In Europe, this seems to be the case; countries with larger governments grow more slowly. And in Europe, governments are larger. This is primarily because of higher spending on social protection—most important, public pension systems. Population aging lies behind growing social security spending in all high-income and many middle-income countries, but the impact is highly variable.

Rethinking the design and size of social security systems in Europe can draw on existing good practice, such as in Iceland or Japan, to deal with the
demographic drag on economic growth. Many countries in Europe have already started to increase the retirement age and tighten eligibility criteria for public pensions. Others have introduced mandatory “second pillars,” which accumulate contributions in individual pension accounts, to encourage domestic savings and reduce the burden on public pay-as-you-go systems. Sweden and Switzerland are often seen as models in this regard, but as the experience of several Eastern European countries during the past three years demonstrates, sustaining these reforms can be politically difficult. Whatever route is chosen, those countries in Europe that have not done so yet must find ways to restrain spending on social security or risk growing fiscal challenges.

There are economies in Europe with large governments that do well. Sweden, for instance, hardly fits the stereotype of a rigid, bureaucratized Leviathan, though government spending in 2010 was more than half of GDP. One reason that Scandinavian countries with large governments do so well is that public services are of high quality. This report considers their reforms to draw lessons for the rest of Europe and the world. But one asset that Northern European countries have that may be tough to replicate is a higher degree of social trust. Where the rule of law is weak and social trust is low, large government is likely to be harmful. So Southern Europe might have done better to keep government small, since it is difficult to make it efficient without the preconditions for compliance with taxes and regulations, high levels of work participation, and frugal use of social welfare. This is a lesson that emerging market economies in Europe with large public sectors, such as Ukraine’s, should learn.

Whether or not large government is bad for growth and fiscal austerity is seen as harming the short-term prospects of growth in Europe, for countries with large public debts fiscal consolidation is a necessity. Neither higher taxes nor productivity increases are likely to keep the public finances of these countries afloat at current spending levels. High-quality fiscal consolidation strategies to reach sustainable paths for public debt are analyzed in chapter 7. There is ample room in Europe to cut spending without affecting social outcomes. Nonetheless, the political challenge of maintaining primary surpluses for several years is daunting. Some countries have room to adjust more gradually than others. And given the close economic links between European countries, those with fiscal space could perhaps use it.

**Restoring Europe’s lustre**

In November 2008, as the consequences of the financial collapse gripped markets and policymakers worldwide, a senior U.S. government official remarked: “You never want to let a serious crisis go to waste.” It is not clear whether the United States has used the crisis well. But three years later, the epicenter of economic turbulence lay not there but in Europe. The attention was focused on restoring the confidence of markets in European governments. But behind the market nervousness were doubts about the sustainability of Europe’s economic and social model. The European sovereign debt crisis could be seen as an opportunity to address these concerns quickly.
This report was written with more deliberate adjustments in mind. That will indeed be the course of reform in the many countries that have responsibly applied the principles of the European growth model. But the countries that have strayed furthest from them will be forced to adjust abruptly. It should be a warning to the others. There have been changes in the world that necessitate a reexamination of the basic economic model. Since 2005, the contribution of developing countries to global growth has been greater than that of advanced economies, even though their share in global GDP is half that of the developed world. All advanced economies should reflect upon these shifts.

This report is such a reflection for 45 countries in Europe. An unprecedented combination of enterprise, labor, trade, finance, innovation, and government attributes makes the European growth model unique. The close economic ties between richer and poorer countries; the balance between profit and public interest in enterprise; the social contract that protects the poor, elderly, and unemployed; and the representativeness of government at continental, national, and local levels are unique and admirable. Europeans cherish these features and much of the world admires and tries to emulate them. This report concludes that the European economic model needs to be adjusted, not abandoned.

The changes that have made it necessary for Europe to craft a new economic model are demographic, entrepreneurial, and fiscal. Europe’s working population is expected to decline by about 15 percent by 2050, while that of the United States will grow by more than 25 percent. Asia’s productivity and competitiveness will allow its enterprises to outstrip all but the most innovative ones in the United States. It will especially pressure Europe, where productivity growth has been slowing since the mid-1990s and the service economy has been held back by fragmented regulation. The growing costs of social security and slowing economic productivity will squeeze Europe from two sides in the coming decade. The pressures may rise quickly. Debt burdens that seemed manageable at the borrowing costs of 2008 may be unbearable in the market conditions of 2012. Europe needs to change.

The order of chapters in this report reflects the changes required in ascending order. Europe’s strong points are in trade and finance. In the areas of enterprise and innovation, Europe has countries that do well in the world. But many European countries are struggling to generate and support entrepreneurial high achievers and innovators. The biggest need for change is in the areas of labor and government. Labor policies must be reoriented toward greater labor mobility, incentives to work, and more competitiveness and job creation in sectors where Europe lags behind. Almost everywhere, European governments are too big and inefficient in delivering services. They will have to become smaller or more efficient, whichever is quicker. Their weaknesses and strengths are summarized in table 1.1.

The necessary changes will not be easy, but many European countries have already made progress, and others can learn from their experiences. Other parts of the world are dealing, or have dealt with, similar pressures, and Europe may learn from them too. Using more than 16 pairs of benchmarking briefs prepared for this report, chapter 8 provides accounts of successful experiences.
## Table 1.1: Strengths and shortcomings of Europe’s growth model

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<tr>
<th>Strengths</th>
<th>Shortcomings</th>
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<tr>
<td><strong>Trade</strong></td>
<td>Single Market for Services remains incomplete.</td>
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<tr>
<td>Highest share of trade in GDP of all regions in the world.</td>
<td>Common Agricultural Policy reduces the benefits of trade integration for Europe’s eastern neighbors.</td>
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<tr>
<td>Lowest barriers to trade in goods.</td>
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<tr>
<td>Growing size and sophistication of production networks connecting emerging and advanced Europe.</td>
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<tr>
<td>High degree of trade integration in traditional services.</td>
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<td>Fastest convergence in incomes and living standards in the world.</td>
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<tr>
<td><strong>Finance</strong></td>
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<tr>
<td>Capital flows downhill from countries with high incomes and low growth rates to countries with low incomes and high growth rates.</td>
<td>Boom-time excesses point to the need to ensure crisis-proof financial integration and strengthen supranational regulation.</td>
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<tr>
<td>Financial foreign direct investment has brought western know-how and finance to emerging Europe.</td>
<td>Cheap finance made Southern and Eastern Europe complacent about external imbalances.</td>
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<td>Dependence on western banks to date has mitigated the effect of the crisis on emerging Europe.</td>
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<tr>
<td><strong>Enterprise</strong></td>
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</tr>
<tr>
<td>Business bears more responsibility for social and environmental consequences of its activities than in any other part of the world.</td>
<td>Countries with more onerous business regulations have lagged in productivity growth and exports.</td>
</tr>
<tr>
<td>European enterprises have—by and large—generated employment, productivity, and exports.</td>
<td>Growing gap in economic competitiveness between the southern states and the rest is a source of instability in the eurozone.</td>
</tr>
<tr>
<td>Variations in business regulation across Europe do not confirm a “race to the bottom.”</td>
<td>European production has become greener but not its consumption.</td>
</tr>
<tr>
<td><strong>Innovation</strong></td>
<td></td>
</tr>
<tr>
<td>Some European countries figure among the top global innovators and exporters.</td>
<td>Europe’s private R&amp;D spending is much less than in U.S. and Asia’s developed economies.</td>
</tr>
<tr>
<td>Established tradition of strong public support to universities and R&amp;D institutes.</td>
<td>Linkages between research institutes and business are weak because of overdependence on public funding.</td>
</tr>
<tr>
<td>Europe has a proud tradition of innovation in engineering, pharmaceuticals, and clean energy that could be harnessed for future innovation.</td>
<td>Europe is not specialized in fast-growing high-technology sectors such as ICT and biotech.</td>
</tr>
<tr>
<td><strong>Labor</strong></td>
<td></td>
</tr>
<tr>
<td>Greater post-tax earnings equality.</td>
<td>Labor participation rates below those in U.S. and East Asian advanced economies.</td>
</tr>
<tr>
<td>Strong income protection and unemployment insurance systems.</td>
<td>Rapid aging will result in workforce falling by a sixth over the next 50 years.</td>
</tr>
<tr>
<td>Good aggregate job creation performance over past decade.</td>
<td>Generous eligibility raises concerns over the sustainability of social security.</td>
</tr>
<tr>
<td><strong>Government</strong></td>
<td>Large informal sectors in some European countries and high youth unemployment point to problems of labor market exclusion.</td>
</tr>
<tr>
<td>Most representative and decentralized of all regions.</td>
<td>Low labor mobility despite formally free movement of labor within Europe.</td>
</tr>
<tr>
<td>Broad coverage of public services and social security.</td>
<td>Unfriendly immigration policies may keep global talent away.</td>
</tr>
<tr>
<td>Low post-tax income inequality.</td>
<td></td>
</tr>
<tr>
<td>Government size is 10 percent of GDP greater than in other parts of the world, and public spending to GDP has risen by about 5 percentage points during the crisis.</td>
<td></td>
</tr>
<tr>
<td>Pension burdens are high for a relatively young (but quickly aging) region.</td>
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<tr>
<td>Generosity of social welfare programs weakens incentives to work.</td>
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<tr>
<td>High marginal tax rates promote evasion and make Europe less attractive for enterprises and skilled workers.</td>
<td></td>
</tr>
<tr>
<td>Variation in quality of public services unrelated to government spending.</td>
<td></td>
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<tr>
<td>Unsustainable public debt in some countries, fiscal imbalances in many.</td>
<td></td>
</tr>
</tbody>
</table>
To sustain its success in the twenty-first century, Europe will need to draw on the strength of its integrating institutions, especially the Single Market for Services. It will need to stimulate greater competition to push laggard enterprises to catch up with Europe’s best, and to free Europe’s high achievers to innovate and grow. It will need to reorganize work and government to deal with the imperatives of regional integration and global competition, while maintaining domestic cohesion. This will require greater flexibility and mobility of labor, efficient management of capital mobility, and a new balance between economic freedom and social security.

All this is hard work. But the policymakers who address these imperatives will create a growing Europe. It will be a Europe that keeps its way of life and its place in the world, that radiates hope and again becomes an inspiration for others. It will be a Europe that has restored its lustre.
### Chapter 1: Annexes

#### Annex 1.1: List of countries and regions

<table>
<thead>
<tr>
<th><strong>EU15</strong></th>
<th><strong>EU candidate states</strong></th>
<th><strong>Latin America (LAC)</strong></th>
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</thead>
<tbody>
<tr>
<td>Austria</td>
<td>ALB</td>
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</tr>
<tr>
<td>Belgium</td>
<td>BIH</td>
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<tr>
<td>Denmark</td>
<td>HRV</td>
<td>Chile</td>
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<tr>
<td>Finland</td>
<td>KSV</td>
<td>Colombia</td>
</tr>
<tr>
<td>France</td>
<td>MKD</td>
<td>Mexico</td>
</tr>
<tr>
<td>Germany</td>
<td>MNE</td>
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<tr>
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<td>SRB</td>
<td>Uruguay</td>
</tr>
<tr>
<td>Ireland</td>
<td>TUR</td>
<td>Venezuela, RB</td>
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<tr>
<td>Luxembourg</td>
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<tr>
<td>Netherlands</td>
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<tr>
<td>Portugal</td>
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<tr>
<td>Spain</td>
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<tr>
<td>Sweden</td>
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<tr>
<td>United Kingdom</td>
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<table>
<thead>
<tr>
<th><strong>EU15 southern states</strong></th>
<th><strong>Eastern partnership states</strong></th>
<th><strong>North America and Oceania</strong></th>
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</thead>
<tbody>
<tr>
<td>Greece</td>
<td>ARM</td>
<td>Australia</td>
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<tr>
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<td>Aze</td>
<td>Canada</td>
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<tr>
<td>Portugal</td>
<td>BLR</td>
<td>New Zealand</td>
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<tr>
<td>Spain</td>
<td>GEO</td>
<td>United States</td>
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<tr>
<td>Sweden</td>
<td>MDA</td>
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<tr>
<td>United Kingdom</td>
<td>UKR</td>
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<thead>
<tr>
<th><strong>EU12</strong></th>
<th><strong>European Free Trade Association</strong></th>
<th><strong>Africa</strong></th>
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</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>BGR</td>
<td>Algeria</td>
</tr>
<tr>
<td>Cyprus</td>
<td>CYP</td>
<td>Egypt, Arab Rep.</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>CZE</td>
<td>Morocco</td>
</tr>
<tr>
<td>Estonia</td>
<td>EST</td>
<td>South Africa</td>
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<tr>
<td>Hungary</td>
<td>HUN</td>
<td>Tunisia</td>
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<tr>
<td>Latvia</td>
<td>LVA</td>
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<tr>
<td>Lithuania</td>
<td>LTU</td>
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<tr>
<td>Malta</td>
<td>MLT</td>
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<tr>
<td>Poland</td>
<td>POL</td>
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<tr>
<td>Romania</td>
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<tr>
<td>Slovak Republic</td>
<td>SVK</td>
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<tr>
<td>Slovenia</td>
<td>SVN</td>
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<thead>
<tr>
<th><strong>East Asia</strong></th>
<th><strong>European Free Trade Association</strong></th>
<th><strong>Africa</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>CHN</td>
<td>Algeria</td>
</tr>
<tr>
<td>Indonesia</td>
<td>IDN</td>
<td>Egypt, Arab Rep.</td>
</tr>
<tr>
<td>Japan</td>
<td>JPN</td>
<td>Morocco</td>
</tr>
<tr>
<td>Korea, Rep.</td>
<td>KOR</td>
<td>South Africa</td>
</tr>
<tr>
<td>Malaysia</td>
<td>MYS</td>
<td>Tunisia</td>
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<tr>
<td>Philippines</td>
<td>PHL</td>
<td></td>
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<tr>
<td>Singapore</td>
<td>SGP</td>
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<tr>
<td>Taiwan, China</td>
<td>TWN</td>
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<tr>
<td>Thailand</td>
<td>THA</td>
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<tr>
<td>Vietnam</td>
<td>VNM</td>
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<table>
<thead>
<tr>
<th><strong>Other</strong></th>
<th><strong>European Free Trade Association</strong></th>
<th><strong>Africa</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>IND</td>
<td>Algeria</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>RUS</td>
<td>Egypt, Arab Rep.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>European Free Trade Association</strong></th>
<th><strong>Africa</strong></th>
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</thead>
<tbody>
<tr>
<td>Iceland</td>
<td>ISL</td>
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<tr>
<td>Liechtenstein</td>
<td>LIE</td>
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<td>Norway</td>
<td>NOR</td>
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<tr>
<td>Switzerland</td>
<td>CHE</td>
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<tr>
<td>Armenia</td>
<td>ARM</td>
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<tr>
<td>Azerbaijan</td>
<td>AZE</td>
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<tr>
<td>Belarus</td>
<td>BLR</td>
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<td>Georgia</td>
<td>GEO</td>
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<td>Moldova</td>
<td>MDA</td>
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<tr>
<td>Ukraine</td>
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<td>Armenia</td>
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<td>MDA</td>
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<tr>
<td>Ukraine</td>
<td>UKR</td>
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</tbody>
</table>
Notes

1. In 2004, around 50 percent of EU15 citizens supported the accession of additional members to the European Union. In 2008, 47 percent of citizens in the EU27 supported the accession of additional members, but support in all new member states except Latvia was above 60 percent, whereas the four biggest EU15 countries all had support levels of about 40 percent or less.

2. According to Eurobarometer, it has fallen from 66 percent in 2004 to just 52 percent in 2008.

3. Specifically, this report distinguishes between the EU15 (often called the “old member states”) and the EU12 (the new members) and within these groups between subgroups of “Northern,” “Continental” or “Central,” and “Southern” European countries. Among the EU’s neighbors, the report distinguishes countries that are advanced economies (the European Free Trade Association members: Iceland, Liechtenstein, Norway, and Switzerland) and those that are emerging markets. The report also distinguishes between candidates for future membership in the European Union (Turkey and the western Balkans) and countries that are part of the EU eastern partnership (Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine).

4. See annex 1.1 for a list of country abbreviations.

5. By far the largest capital flows, a substantial share of which in official transfers, occurred between East and West Germany. But this is a special case of integration and convergence within one nation with little relevance for regional integration experiences, perhaps except for the Democratic People’s Republic of Korea and the Republic of Korea.

6. The lack of convergence globally is not what economists would expect. Neoclassical models of economic growth predict income convergence across countries. In Solow (1956), the long-run growth rates of per capita income are purely driven by technical progress, while the level of per capita income is determined by the “steady state” savings rate. Allowing for differences in savings rates across countries, one obtains the less demanding prediction of conditional convergence, which holds across a large range of countries (for example, see Mankiw, Romer, and Weil 1992). Europe has seen unconditional convergence.

7. Europe uniquely has also experienced faster convergence in consumption than in income. This to some extent reflects nonsustainable borrowing for consumption purposes, predicated on the assumption of almost “automatic” income convergence in Europe. As the experience in Europe’s southern countries demonstrates, such an assumption is risky. Europe’s institutions make it easier for poorer economies to catch up. But persistent high income levels must be earned in Europe as elsewhere.

8. Note that in this chart, Azerbaijan is excluded from the trend line for Europe because as an oil producer it runs huge current account surpluses. Poorer developing countries are excluded from the “rest of the world” trend line because official flows play a much greater role and the determinants of these flows are quite different.

9. This puzzle was first formally noted by Gourinchas and Jeanne (2007).

10. EBRD (2009) reached a similar conclusion.

11. Gordon (2004) estimates that around one-third of the gap in incomes per capita between the EU15 and the United States may be due to voluntary reductions in labor supply in Europe. The remainder reflects regulations that reduce labor supply and should be seen as a welfare loss. In Europe, this claim is considered debatable.

12. They also mirror low tax morale and low confidence in public institutions (World Bank 2011). While labor market regulations and payroll tax rates do matter, general institutional weaknesses are likely to be at least as important in perpetuating informality.

13. Most European countries also provide more protection against unemployment than other OECD countries. Of the 15 OECD countries with replacement rates during the first year of unemployment above the average (66 percent), 14 are EU member states. The United Kingdom, Ireland, and Greece stand out for low replacement rates.

14. The incidence of low pay is defined by the OECD as the share of full-time workers earning less than two-thirds of median earnings. Low pay is thus a relative rather than absolute concept and closely related to measures of the dispersion of earnings.

15. Other analyses suggest that instead of a European model, there are several regional models within Europe. Roxburgh and Mischke (2011) identify a northern model, which includes Ireland, the Nordic nations, and the United Kingdom; a continental model, including Austria, the Benelux states, France, and Germany; and a southern model, including Greece, Italy, Portugal, and Spain. Atkinson, Piketty, and Saez (2011) distinguish an English-speaking group of countries in the evolution of income distribution from Continental Europe.

16. Although public debt levels are high in most European countries, the sustainable level of public debt differs significantly between countries like Germany that is running current account surpluses and countries like Greece with a large current account deficit. von Weizsacker (2011) argues that for countries like Germany, the optimal public debt level has increased as demographic changes have led to a downward shift in the natural rate of interest. In a “closed economy” setting with public debt held domestically, this implies a higher sustainable public debt level. Japan falls into the same category.

17. Darvas (2011) examines recoveries following banking crises and shows that in countries with flexible exchange rates, postcrisis growth was higher, even when credit was subdued, than in countries facing the need to adjust with fixed exchange rates.

18. This argument assumes that the skills provided by Spanish and Italian universities are the skills required by German employers. Increasing labor mobility in Europe also requires improved recognition of professional qualifications and arguably greater attention to quality in Europe’s education systems.

REFERENCES


