THE FUTURE OF EUROPE

Alberto Alesina and Francesco Giavazzi, 2006, MIT Press, Cambridge, USA, pp. 186

Review*

In this provocative book, Alberto Alesina and Francesco Giavazzi compare the economic systems of Europe and the United States, arguing that if Europe does not start implementing some "pro-American" reforms, its relative economic and political power will start to diminish. The most important lesson Europe has to learn from the United States is that people respond to incentives and that markets are in most cases the best alternative. The book is divided into an introduction and fourteen chapters.

In the introduction, authors predict that without pro-market reforms, Europe's relative economic strength will decline, although Europe will maintain a high standard of living. They list three reasons why this poses a problem. First, lack of economic power will lead to declining political power. Second, individuals' happiness depends not on their income as much as on its relation to the income of others. Third, relative decline can lead to a "culture of stagnation", which in turn can lead to absolute economic decline.

In Chapter 1 Alesina and Giavazzi compare the different social models of the United States and Europe. Americans and Europeans have different values and beliefs. First, Americans believe that the poor are responsible for their poverty and should help themselves out of their poverty. In contrast, Europeans believe that the poor are trapped in poverty so the state should intervene to help them. Also, Europeans value equality much more than Americans. In addition, Americans see society as mostly mobile while Europeans see it as mostly immobile. Finally, European societies are ethnically and linguistically more homogenous. These cultural differences lead to different economic models, with Europe having large governments and a lot of government intervention to "improve" the way markets work. The United States, on the other hand, has a much more market-friendly economic system.

Chapter 2 elaborates different approaches to handling ethnic diversity in Europe and in the United States. European countries are more ethnically and religiously homogenous than the United States, and endeavour to preserve this homogeneity. This is due to the fear that immigrants are taking away the jobs of the locals. In addition, it is believed that

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solidarity does not travel well across different ethnic and linguistic groups. Thus, it is feared that immigrants will reduce support for the welfare state. But with an aging European population, stopping immigration is not a solution. Diversity has good and bad sides. It is not a coincidence that the two most diverse US cities – Los Angeles and New York, are also centers of business and culture. Instead of restricting immigration, Europe should implement US work permit schemes to balance immigrants with needs of labour market.

Chapter 3 points out that Europeans value leisure much more than Americans. They have lower employment rates, work fewer weeks in a year and fewer hours in the week. But this was not always so. Following the devastation of Europe during World War II, Europeans worked hard to rebuild their societies and in that time, Europe's GDP per capita was converging with that of the US. It started to change in the 1970s, when Europeans started working less and less.

Even though authors are very critical of European labour markets, they do not wish to leave workers entirely to the mercy of the whip of the market. In Chapter 4 they outline their preferred labour market model, which should have low firing cost, as in the US. However, they argue for more substantial unemployment benefits, as distinct from the US model, providing that the unemployed are actively searching for a job and are willing to go through retraining programs. Their position is much closer to the flex-security labour market model of Denmark than the less generous and more laissez-faire US model. Also is suggested an interesting method of financing unemployment benefits through a dismissal tax. Easy firing might lead to moral hazard problems, and this tax is meant to ensure that firms will fire only when it is in their long-term interest, while also providing funds for unemployment benefits.

In the last few decades, Europe started to lose ground to the United States. One of the reasons is in the character of technological progress, which is the topic of Chapters 5 and 6. In the early stages, when Europe was far behind the US, it could generate catch-up growth through imitation. But once Europe got very near the technological frontier of the US, it could no longer use imitation, but had to rely on innovation. And the failure of Europe in recent decades is a failure of innovation. In order to have innovations, it is vital to have excellent universities (Chapter 5) and a business environment with lots of "creative destruction" (Chapter 6). In Chapter 5, the authors argue that the reason Europe has inferior tertiary education is not lack of funds but lack of incentives. Equal pay and job security for teaching staff eliminates incentives for improvement. Also, European universities have weaker links with the business world, making research at European universities less conducive to economic growth. The European Union is aware that its universities are no match for top American universities, and this problem is addressed in Lisbon Agenda. But the authors argue that the EU's educational policies are going to fail because they are based on pumping more money into the educational system without changing the incentives system. In Chapter 6 they provide three reasons for lack of creative destruction – regulations that create rents for incumbents, government subsidies to incumbents and weak anti-trust authorities. Without reforms, Europe will continue to be technologically behind the US and will not be able to match US growth rates.

The weakness of anti-trust authorities is the theme of Chapter 7; it prevents market competition and creates rents for incumbents. Authors argue that there might be a change in the European policies. Industrial policies are in the domain of Brussels, and the European Union has several advantages over member states with respect to reforming Europe's market competition policies. First, the Commission's decisions do not require government approval. Second, it is more difficult for incumbent companies to bribe the EU Commissioner than a local politician. Finally, Brussels has taken a Big Bang approach, stopping member states from helping its failed giants.

In Chapter 8, the authors argue that Anglo-Saxon common law system is better in enforcing contracts than the formal-procedural continental law. Enforceability of law is critical for trust in contracts; without it contracts are meaningless. The common law system gives more discretionary power to judges, while in the civil law judges just follow procedures and forms. The end result is that cases brought to the court are much more quickly resolved in Anglo-Saxon countries than in continental Europe.

In Chapter 9 authors argue that the first-past-the-post electoral system produces lawmakers in Anglo-Saxon countries that respond to crisis quicker. For instance, it took the US half a year to respond to Enron, while it took two years for Italian parliamentarians to respond to the Parmalat crisis. They also argue against the European practice where companies' supervisory boards are filled with union representatives; which makes it less likely to fire employees.

The next three chapters are devoted to the European Union. In chapter 10 authors argue that the real opposition in the EU is not between federalists (economic union) and intergovernmentalists (political union) but between pro-market and *dirigisme* groups. The European Union was created with the idea of a common market, but so far it applies only to goods and not services. Chapter 11 gives a critical overview of the Lisbon Agenda, a ten year plan authors claim looks like something that came out of Stalin's cookbook. It sees plan as a solution to every problem. Another potential downside of the Agenda is that it could impose the same standards on a diversified set of countries – the UK could gain more social protection, while Scandinavian countries could lose some. Finally, the Lisbon Agenda is often viewed as a failure and this could lead to setbacks in areas where the EU is doing a good job. In Chapter 12 authors defend the euro, claiming that the problem is not the currency itself but the lack of reforms necessary to make it work better.

Chapter 13 addresses problems of balancing budgets. Both the US and many European countries have issues in keeping their budgets balanced. But the US has fewer problems with lowering taxes and government spending than European countries. This is important because OECD experience points out that in order to balance the budget reducing government spending is better for growth than increasing taxes. Spending is best cut on public employment and transfer programs. In addition, a reduction in government spending is less likely to lead to a recession, even in the short run, than an increase in taxes.

In the last chapter the authors summarize their conclusions. The problems of Europe are that its economic system is based on the protection of insiders who are trying to maintain their rents. In addition, government is always seen as a solution rather than a problem. If Europe is to maintain its economic and political power, it needs to start liberalizing its products, services and labour markets, allow selected immigration (mimicking the US green-card system) and reduce the size of its governments. In one sentence, it needs to create a system which will create incentives for Europeans to work hard and be innovative.

Alesina and Giavazzi fall into the category of moderate pro-market economists. They believe that markets are the best way of organizing most activities, though not all. They acknowledge that health care is not one of those. Still, they cannot be labelled as laissez-faire economists. Gosta Esping-Andersen in *Three Worlds of Welfare Capitalism* has outlined three economic models – liberal, conservative and social-democratic. Their argument is primarily against the conservative model of social economy, which is dominant on the European Continent. And although the authors do not try to hide that their affiliation is with the liberal model of Anglo-Saxon countries, they rarely argue against the Scandinavian social-democratic model. In fact, in some cases they prefer it to the liberal model, e.g. higher unemployment benefits conditional on retraining and active job search.

Their economic logic is powerful enough to convince readers that Europe will suffer relative economic decline. The biggest problem of this book is their reasoning why Europeans should care. The authors admit that Europe will maintain a high standard of living, but that relative decline matters because Europe's political influence will dwindle. In addition, happiness is going to go down because it is relative in nature – people constantly compare themselves with others. Finally, relative decline can create a culture of stagnation, which can lead to absolute decline. The problems with these reasons are the following. First, increasing political power is not a very standard goal of economic policy. In fact, some small countries, like Switzerland, have managed to sustain their political power on a global level as an impartial mediator precisely they are not involved in political power struggle. Second, it is true that people base their happiness on how they fare in comparison with others. But I will not compare myself with someone in Somalia but with someone in my own society. Therefore, inequality matters for happiness, but not so much inequality between but within countries. And it is Europeans that are more concerned about within country inequality than Americans. Thus, the only good reason why Europeans should worry about their relative economic decline is the threat of absolute decline, which comes with culture of stagnation. But Alesina and Giavazzi just mention this as a possibility without even describing the characteristics of the culture of stagnation. And this is a big flaw of this book. In short, this work does a good job of convincing reader that without reform Europe will go through relative economic decline, but it does not do such a good job in convincing the reader that will be altogether disastrous.

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