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Does the European Union Emulate the Positive Features of the East Asian Model?

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In recent years, criticism of the European economic model has grown stronger. In comparison with both the American and the East Asian models, it has been perceived as inferior in terms of economic efficiency as reflected in both overall economic growth rates and productivity. For instance, Alberto Alesina and Francesco Giavazzi (2006, 4–5) complained that EU GDP per capita fell from 80 percent of the US level in the late 1980s to 70 percent of the US level in 2006. The South Korean GDP per capita in purchasing power parity, by contrast, rose from 12 percent of the US level in the mid-1960s to 50 percent at present.

The European Union has gradually accepted this critique and tried to improve its economic model. The main policy statement was adopted by the European Council in March 2000 in Lisbon, formulating "a strategic goal for the next decade." The Lisbon Agenda acknowledges the challenge in dramatic words (European Council 2000):

> The European Union is confronted with a quantum shift resulting from globalization and the challenges of a new knowledge-driven economy. These changes are affecting every aspect of people's lives and require a radical transformation of the European economy. The Union must shape these changes in a manner consistent with its values and concepts of society and also with a view to the forthcoming enlargement.

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The Lisbon Agenda detailed these strategic goals, aiming at "an average economic growth rate of around 3%." The European Council asked the European Commission and the member states to carry out a large number of reforms to accomplish the strategic goals.

The question today is whether this is actually happening and, if so, how. Critics of the EU model tend to look either at the United States (notably, Alesina and Giavazzi 2006) or East Asia. The purpose of this chapter is to scrutinize EU performance and adjustment in light of the East Asian model. The first section establishes what the East Asian model actually amounts to and how it compares with the EU model. The second section summarizes the main idea of the discussion of the East Asian model after the Asian financial crisis in 1997–98. The third section considers how the EU model could be altered so that it would be able to adopt the desirable features of the East Asian model. The fourth section offers conclusions.

Characteristics of the East Asian Model in Comparison with the EU Model

The East Asian "miracle" started out as the single Japanese miracle after World War II, but Japanese growth faded around 1990. The next impressive growth story was the four East Asian Tigers—Hong Kong, Taiwan, Singapore, and South Korea—which took off in the early 1960s. Later on, the East Asian high-growth group broadened, and I shall discuss the six most developed East Asian countries: South Korea, Hong Kong, Singapore, Taiwan, Malaysia, and Thailand. All these countries have reached such a high GDP per capita that they are no longer developing countries, and they all represent the East Asian model as discussed below. As the East Asians were creeping closer to the EU countries in GDP per capita, the East Asian model was taken more seriously, although so far only Hong Kong has overtaken the EU average GDP per capita in purchasing power parities. In its original study, *The East Asian Miracle*, the World Bank (1993) also included Indonesia and the Philippines among eight "high-performing Asian economies," but they remain far poorer and are therefore of little relevance for a comparison with Europe. China has produced high economic growth since the start of its reform in 1978, but it, as well as Indo-China, is even poorer. The European Union of comparison in this paper is the European Union of 15 countries from 1995 to 2004.

The World Bank singled out the East Asian economies because they had achieved rapid, sustained economic growth of 5.5 percent a year between 1960 and 1990. What distinguished these economies from other developing economies was their high investment rates and sizable and rising endowments of human capital due to universal primary and secondary education (World Bank 1993, 8). These factors were assessed to account for

Table 9.1 GDP in East Asia and EU-15

Country	GDP growth, 1996–2005 (percent)	GDP per capita, PPP, 2005 (dollars)
East Asia		
Hong Kong	3.9	33,479
Korea	4.5	20,590
Malaysia	4.8	11,201
Singapore	5.2	28,368
Taiwan	4.5	27,721
Thailand	2.8	8,368
Average	4.3	21,621
EU-15		
Austria	2.2	33,896
Belgium	2.1	32,524
Denmark	2.1	34,367
Finland	3.6	31,367
France	2.2	30,104
Germany	1.3	30,253
Greece	3.9	22,691
Ireland	7.5	38,075
Italy	1.3	28,396
Luxembourg	4.6	68,681
Netherlands	2.6	34,359
Portugal	2.4	19,707
Spain	3.7	27,284
Sweden	2.8	31,691
United Kingdom	2.8	32,265
Average	3.0	33,044

PPP = purchasing power parity

Sources: World Bank, *World Development Indicators* database, 2007; International Monetary Fund, *World Economic Outlook* database, September 2006.

roughly two-thirds of the growth in these countries, while the remainder was attributable to improved productivity.

Over time, East Asian growth rates have slowed down somewhat. The (unweighted) average annual growth rate in the decade 1996–2005 was 4.3 percent in the six East Asian countries, compared with 3 percent in the EU-15. (If the growth rate of the EU-15 were weighted it would decline about 1 percentage point to 2 percent a year because of the underperformance of three big EU economies.) The difference is not all that impressive, as the average GDP per capita in purchasing power parities in East Asia was $21,621, compared with $33,044 in the EU-15 in 2005 (table 9.1).

It can largely be explained merely by a laggard effect of economically more backward countries growing faster when they pursue the same economic policies as already richer countries. However, East Asian dynamism in this period was reduced by the devastating 1997–98 financial crisis. The difference in growth is not conspicuous but still significant.

How has East Asia been able to achieve the high growth rates and rates of investment in both physical and human capital, and what can other countries learn from this experience? This was the question asked by the World Bank (1993), which has become the standard source describing the principal elements of the "East Asian model."

East Asia is quite a varied region with respect to history, culture, and economy. Public policy in East Asian countries has also been far from homogeneous, but some key elements have been more or less common.[1] In comparison with the EU model, East Asia has some common features, some advantages, and some drawbacks. We start with the common positive features: sound macroeconomic policy, economic freedom, and export orientation.

- *Conservative macroeconomic policy*. All of the East Asian countries have long adhered to "sound fundamentals"—maintaining low budget deficits, inflation, and low current account deficits—which has created a stable business environment and encouraged high saving and investment rates. Over the last five years, inflation in the region averaged 2.3 percent, and current accounts and government budgets were in surplus at 9 and 0.4 percent of GDP, respectively (table 9.2). These good monetary and fiscal policies distinguish East Asian countries from other developing countries and even many developed countries. The advantages of "getting the basics right" remain unchallenged even while many other recipes for growth have gone out of fashion.

Since the adoption in 1993 of the Maastricht criteria on fiscal and monetary policy, the European Union has also pursued quite a conservative macroeconomic policy. The average budget deficit from 2000 to 2005 was a tiny 0.8 percent of GDP, and inflation has lingered around 2.2 percent, even better than East Asia's (table 9.2). There are two main explanations of the higher inflation in East Asia. First, the East Asians have kept their exchange rates low by buying up large international currency reserves, while the European Union has focused on combating inflation, which has been facilitated by the European Central Bank. Second, the Balassa-Samuelson effect leads to higher inflation in countries that are growing richer, because their low domestic price level is catching up with that of wealthier countries. The European Union does not appear to have much to learn from the East Asians in macroeconomics.

1. The summary below draws on World Bank (1993) and Stiglitz and Yusuf (2001).

Table 9.2 Stabilization indicators in East Asia and EU-15

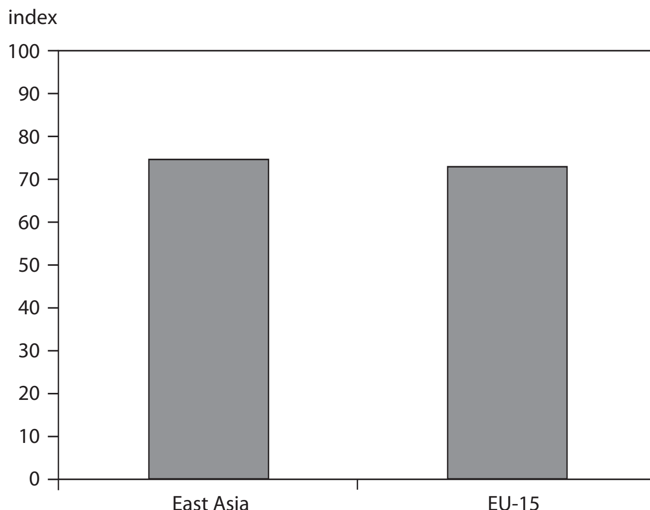
Country	**Budget deficit, 2000–2005** (percent of GDP)	**CPI growth rate, 2005** (percent)	**Current account balance, 2001–05** (percent of GDP)
East Asia			
Hong Kong	–2.2	0.9	9.0
Korea	1.9	2.7	2.2
Malaysia	n.a.	3.0	11.4
Singapore	5.7	0.5	20.9
Taiwan	–3.9	2.3	7.0
Thailand	–1.4	4.5	3.7
Average	0.4	2.3	9.0
EU-15			
Austria	–1.2	2.3	–0.1
Belgium	0.2	2.8	3.6
Denmark	1.5	1.8	2.8
Finland	3.8	0.9	7.6
France	–2.9	1.7	0.2
Germany	–2.7	2.0	2.3
Greece	–5.4	3.5	–7.2
Ireland	1.2	2.4	–1.0
Italy	–2.9	2.0	–0.9
Luxembourg	1.8	2.5	9.3
Netherlands	–0.9	1.7	5.1
Portugal	–4.7	2.3	–8.0
Spain	–0.1	3.4	–4.7
Sweden	1.6	0.5	5.9
United Kingdom	–1.5	2.8	–1.8
Average	–0.8	2.2	0.9

CPI = consumer price index
n.a. = not available

Sources: World Bank, *World Development Indicators* database, 2007; International Monetary Fund, *World Economic Outlook* database, September 2006; UN Economic Commission for Europe database, 2007.

- *Economic freedom*. Overall economic freedom has not been much of an argument, because economic freedom in East Asia and the EU-15 is almost identical and among the highest in the world, although East Asia is slightly ahead of the EU-15 (figure 9.1). Prices and trade are free.
- *Export orientation*. Export promotion is considered to have been the "engine of growth" in East Asia. These states provided strong incentives for successful exporters via subsidies and favorable credit terms.

Figure 9.1 Economic freedom in East Asia and EU-15, 2007



Note: Economic freedom is graded using a scale from 0 to 100, where 100 represents the maximum freedom.

Source: Heritage Foundation and the Wall Street Journal, 2007 Index of Economic Freedom.

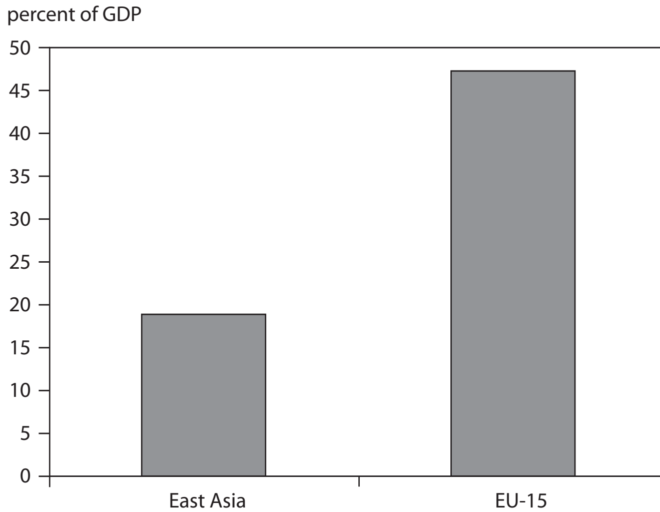
> They also maintained competitive exchange rates, which contributed to domestic companies' export success. Because their domestic markets are small, export markets have been crucial for achieving efficient production scales. By maintaining open markets and by exposing domestic industries to foreign technology and foreign competition, the East Asian countries have been able to achieve a rapid rate of technological progress, which was critical for their economic growth. South Korea and Taiwan were not particularly open in the 1960s because of substantial protective tariffs and import substitution policies, but their openness has evolved.

Europe has an old and proud tradition of free trade and open markets, as the origin of such policies. One of the greatest achievements of the European Union is the single market. In this regard, East Asia has essentially followed Europe's successful lead, but it is still lagging behind in terms of freedom of trade.

East Asian advantages are noticeable in primarily four regards: smaller social transfers, lower taxes, freer labor markets, and stronger education.

- *Small social transfers and public expenditures.* Low public expenditures on social transfers are hallmarks of the East Asian economies. Here,

Figure 9.2 Public expenditures in East Asia and EU-15, 2005



Sources: European Commission, Eurostat database; International Monetary Fund, *World Economic Outlook* database, September 2006; International Monetary Fund, *Government Finance Statistics Yearbook 2005*.

the difference between East Asia and Europe is huge. In 2005 total public expenditures in East Asia amounted to about 19 percent of GDP compared with 47 percent of GDP in the EU-15 (figure 9.2). Most of the additional public expenditures in Europe are devoted to social transfers. The difference in policy on social transfers stands out as one of the most important quantitative and qualitative contrasts between the two models.

- *Low taxes*. A natural consequence of the limited public expenditures in East Asia is that taxes can also be kept relatively low. By all measures, East Asian taxes are far lower than in Europe, whether considering personal income taxes, corporate profit taxes, or consumption taxes. These low taxes should contribute to higher growth rates in East Asia.
- *Freer labor markets*. According to the original World Bank (1993, 266) study, "in East Asia, more than elsewhere, governments resisted the temptation to intervene in the labor market." Since wages flexibly adjusted to the demand for labor, East Asian economies have been able to adjust to changing economic conditions more quickly and less painfully, maintaining high employment levels. In 2005, when the whole world was booming, the average unemployment rate was 4.7 percent in East Asia, which appears a reasonable approximation of full employment,

Table 9.3 Labor markets in East Asia and EU-15

Country	Unemployment, 2005 (percent of labor force)	Rigidity of Employment Index, 2007[b]
East Asia		
Hong Kong	5.7	0
Korea	3.7	37
Malaysia	4.0[a]	10
Singapore	3.1	0
Taiwan	4.1	49
Thailand	2.0[a]	18
Average	4.7	19
EU-15		
Austria	5.2	37
Belgium	8.4	20
Denmark	4.8	10
Finland	8.4	48
France	9.5	56
Germany	9.5	44
Greece	9.8	55
Ireland	4.3	17
Italy	7.7	38
Luxembourg	4.5	62
Netherlands	4.8	42
Portugal	7.6	48
Spain	9.2	56
Sweden	7.8	39
United Kingdom	4.7	7
Average	7.1	39

a. 2004 data.
b. Based on World Bank *Doing Business* database, 2006.

Sources: World Bank, *World Development Indicators* database, 2007; International Monetary Fund, *World Economic Outlook* database, September 2006; UN Economic Commission for Europe database, 2007; World Bank *Doing Business* database, 2006.

compared with 7.1 percent in the EU-15 (table 9.3).[2] In this regard, East Asia went against dominant global tendencies, because overall richer countries tend to regulate their labor markets less than poor countries (Botero et al. 2004). Moreover, this discrepancy is considerable. European labor markets are about twice as rigid, or overregulated, as in East Asia, according to the World Bank's 2006 *Doing Business* database.

2. The figure is comparatively low because we used an unweighted average, considering that most big European countries have more unemployment than the small countries.

- *Strong education.* A persistent and common feature of all the East Asian countries has been a strong societal tendency to invest heavily in both public and private education. In recent Programme for International Student Assessment (PISA 2006) comparisons of education by the Organization for Economic Cooperation and Development in various developed countries, the East Asian countries regularly cram the top of the tables with the qualitatively best education. It is a great challenge for Europe to catch up with them, though Finland has already succeeded in beating most of them. Clearly, the disparity among EU countries is great, and this is and will remain a sphere of national policy among them.

Naturally, the East Asian countries also have some drawbacks. It would be rather surprising if they were ahead of the wealthier EU countries in all regards. Three aspects stand out: substantial state intervention, excessive tolerance of corruption, and mild authoritarianism.

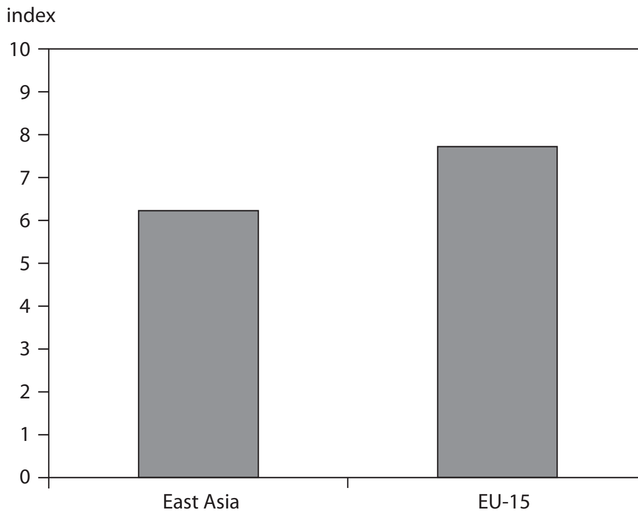
- *Substantial state intervention.* Very centralized economic decision-making power characterized some East Asian economies, especially South Korea and Taiwan, while Hong Kong and Thailand were non-interventionist. State interventions took many forms:

  > Targeting and subsidizing credit to selected industries, keeping deposit rates low and maintaining ceilings on borrowing rates to increase profits and retained earnings, protecting domestic import substitutes, subsidizing declining industries, establishing and financially supporting government banks, making public investments in applied research, establishing firm- and industry-specific export targets, developing export marketing institutions, and sharing information widely between public and private sectors. (World Bank 1993, 5)

The governments of South Korea and Taiwan supported especially their heavy industry and high-tech sectors. They not only promoted research and development through direct and indirect subsidies but also allocated credit to preferred sectors, projects, and firms (Amsden 1989). Whether industrial policy was a major source of growth in these economies was a major dispute until the East Asian crisis. Today, a broad consensus in the economic growth literature sees state intervention as a negative influence (Barro and Sala-i-Martin 2004). Extensive industrial policy is now seen as a drawback in the East Asian model, which strangely has not cost all too much, presumably because these economies were catching up with the West, so it was relatively easy to divine which industries to support. The European Union has had less state intervention.

- *Tolerance of corruption.* Corruption ranges widely in the region. As measured by the Transparency International Corruption Perceptions Index, Singapore consistently ranks as one of the most transparent countries in the world, but most of the others are somewhat more cor-

Figure 9.3 Corruption in East Asia and EU-15, 2006



Note: The figure shows Transparency International's Corruption Perceptions Index (from 0 = "highly corrupt" to 10 = "highly clean").

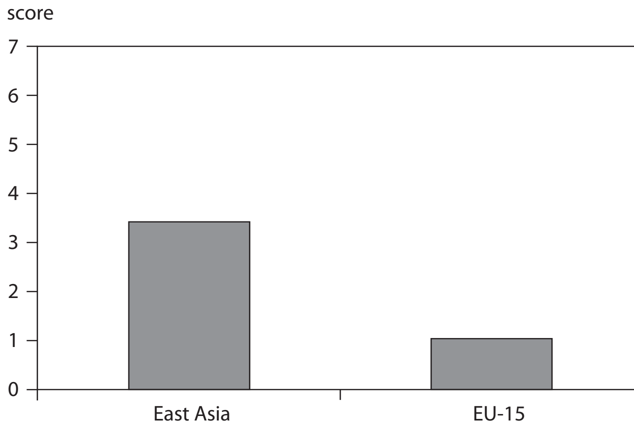
Source: Transparency International (2006).

rupt than the EU countries, making the group average somewhat more corrupt than the European Union (figure 9.3; Transparency International 2006). The special relationship between government and business in East Asia that was once celebrated as one of the causes of high growth was denounced as "crony capitalism" during the East Asian financial crisis and blamed for the severity of the economic downturn. Multicountry regression analysis suggests that corruption is bad for economic growth, so the higher corruption appears a negative factor (Mauro 1995).

- *Mild authoritarianism.* Another part of the "Asian development model" is a forceful bureaucracy able to achieve the developmental goals of the state. This "strong state" in the East Asian context frequently means an authoritarian, centralized state. According to the report recently released by Freedom House (2006; see figure 9.4), the region saw little change over the last year, with the majority of the countries remaining only partially free. Thailand was even downgraded from "partly free" to "not free" in 2006.

Evidently, the East Asian model is no panacea in comparison with the EU model, but it has an impressive record of higher economic growth. In several respects, the two models are more or less equal, namely in conser-

Figure 9.4 Political freedom in East Asia and EU-15, 2006



Note: The figure shows Freedom House Political Rights and Civil Liberties average score (from 1 = "free" to 7 = "unfree").

Source: Freedom House (2006).

vative macroeconomic policies, great economic freedom, and free trade. In at least three important regards, the East Asian model appears to have advantages over the EU model: smaller social transfers, lower taxes, and freer labor markets, and possibly in education as well. But East Asia also has some rather unattractive features: substantial state intervention, somewhat high corruption, and mild authoritarianism.

Controversy over the East Asian Model

After the World Bank labeled East Asia an economic miracle in 1993, a lively debate erupted. Initially, the discussion focused on an assessment of the actual quantitative effects of its different features. A natural follow-up was an interpretive debate on possible ideological conclusions.

Paul Krugman (1994) claimed that growth in East Asia was not sustainable because it was based primarily on factor accumulation—eventually subject to diminishing returns rather than productivity growth; it was not caused by a superior economic system but by great savings. Krugman argued that total factor productivity made a negligible contribution to growth in much of industrializing East Asia. It was "mainly a matter of perspiration rather than inspiration—of growing harder not smarter" (Krugman 1997, 27).

Several econometric papers responded to Krugman's assertions (notably, Collins, Bosworth, and Rodrik 1996; Iwata, Khan, and Murao 2003;

Ito and Krueger 1995; Ito and Rose 2004). Iwata, Khan, and Murao (2003) provided a late and convincing econometric analysis in which they found that Hong Kong, South Korea, Singapore, and Taiwan, the original Asian Tigers, had very similar total factor productivity growth of 3.4 to 3.9 percent over the long period of 1960–95, and total factor productivity accounted for no less than 44 to 47 percent of the output growth of each country during that period. Capital accumulation, by contrast, contributed only 25 to 28 percent of their output growth. Besides, something in their economic model apparently made East Asians save and invest more, not least in their human capital.

When the East Asian model dawned on the world as a miracle, the former Soviet Bloc was undergoing its transition. Leftwingers and rightwingers picked and chose what they liked in the East Asian model and singled out their ideological preferences as the cause of success. Leftwingers particularly liked the state intervention and its soft dirigisme, allowing the state to pick industrial "winners," but the role suggested for the state was rather limited. Although a certain acceptance of state ownership was suggested, nobody advocated increased state ownership (Amsden, Kochanowicz, and Taylor 1994; Aoki, Kim, and Okuno-Fujiwara 1996; Stiglitz 1996). Some even advocated more tolerance of corruption (Amsden, Kochanowicz, and Taylor 1994).

Jeffrey Sachs (1996) assumed the opposite rightwing point of view. He stated that the role of the state was exaggerated and particularly its positive impact. Looking at East-Central Europe, he argued: "Perhaps the greatest economic challenge in the medium term will be to reduce the scope and ambition of the social welfare state, both to ease chronic fiscal pressures, and to reduce the distortions caused by very high levels of labor taxation" (p. 55). Other authors (e.g., Kokko 2002) praised the trade liberalization of the East Asian countries, while singling out the selective large-scale export promotion and failed attempts to "pick winners" as particularly unsuccessful policies. The rightwing view of the East Asian experience was that its three big lessons were to keep social transfers small, taxes low and reasonably flat, and labor markets free, while excessive state intervention, especially to the benefit of the very large companies, remained a serious problem, breeding corruption and hampering economic growth.

The East Asian financial crisis of 1997–98 challenged the positive international opinion about the East Asian miracle and tested the many hypotheses of its causes.[3] A sense spread that something was profoundly wrong with this model. Two major conclusions emerged.

First, to peg exchange rates at unrealistic levels was obviously unfortunate, but this mistake had little to do with the model as such (Stiglitz and

3. See Adams and Ichimura (1998), ADB (1999), Henke and Boxill (2000), and Jomo (2001).

Yusuf 2001, 8–10). The East Asian countries adjusted their exchange rate policies, formally adopting more or less floating exchange rates, but they moderated their exchange rates downward by purchasing vast international currency reserves. The change of exchange rate policy did not have any ideological consequences.

Second, the benefits of industrial policy with directed credits and subsidies were seriously challenged. This ran against the arguments of, particularly, Alice Amsden (1989; Amsden, Kochanowicz, and Taylor 1994), who had cherished South Korea's state interventions. More broadly, the opaque governance system of both state and big corporations was questioned. The right saw "crony capitalism," the corrupt intertwining of large business and government, as the main problem (Krueger 2002). In this regard, the right won a major victory.

A large number of other arguments were raised, but they were soon forgotten, because the crisis was much less profound than first appeared to be the case, with Indonesia being a partial exception. By and large, the East Asian governments have become slightly more orthodox capitalists and their capitalisms slightly less crony. Their fiscal policies have become even more conservative. Leftwingers focused on what they considered premature financial liberalization, which had been advocated by the IMF (Stiglitz 2002), but the East Asian economies have become even more open after the crisis and their financial depth has evolved. Both the left and the right criticized the IMF for excessive intervention after the crisis erupted.

Robert Barro (2001) concluded that a sharp reduction of economic growth had occurred, especially in the five countries directly hit (Indonesia, Malaysia, the Philippines, South Korea, and Thailand). In particular, their investment rates were reduced. Still, in his broader analysis he found no evidence that the financial crisis had effects on growth that persisted beyond a five-year period. At present, the East Asian model looks even more attractive than before the crisis, although growth rates have faded somewhat as the development gap to the West has shrunk (Gill and Kharas 2006). The leftwing case for the success of the East Asian model, most strongly made by Alice Amsden (1989) for South Korea, is quite difficult to maintain today.

Thus, the ideological strife over the East Asian model now appears to point in the direction of a more unregulated market model, although that may change.

Adaptation and Reform of the European Union

Europe has undergone a great ideological change. Today, it is difficult to recall the ideas of far-reaching social engineering and egalitarianism that were so common in the 1970s, when marginal taxes of 90 percent were still

common. The belief in the capacity of the state is still far greater than in other parts of the world, but the understanding of the benefits of a freer economy and larger private sector is great and seems to penetrate ever more people and countries.

A comparison with either America or East Asia suggests that the European Union's most immediate need is to emulate three fundamental advantages of both models: smaller social transfers, lower and flatter taxes, and freer labor markets. To improve the education system is a much more complex reform that requires more elaboration. The reasons for undertaking such changes are well known and widely accepted. All three aims were incorporated into the Lisbon Agenda (European Council 2000).

The assumption is that lower public transfers give people greater incentives to save for their own social security, and lower taxes increase their ability to do so. Lower taxes also offer people better incentives to invest in their human capital through education. A deregulation of labor markets will improve the allocation of labor and reduce unemployment, and thus reduce the need for social transfers to the unemployed. A broad consensus has evolved among economists that these steps are necessary for Europe's future.

The question today is no longer how the EU model needs to adjust, but how it can most easily adjust to these three requirements. How can the economically vital become politically possible? Two competing approaches exist, top-down or bottom-up change.

The traditional EU approach has been top-down. From the outset, the European Union aimed at a greater centralization of political power. The essence of the Treaty of Rome is that the EU members get together and decide unanimously what the Union as a whole should do about ever more issues. Such a top-down approach of decision making was characteristic of the 1950s, which favored extensive state intervention, with industrial policy and mild central planning. All joint EU decisions, including the *acquis communautaire*, belong to this category. Not only the old EU model of economic policy but also the old EU model of decision making appears to have failed because they offered the wrong incentives. Rather than facilitating necessary reforms, they impeded them.

The sources of inspiration of the European Union's centralized mode of operation were many. The fundamental EU idea—no more war!—suggested that all governments should get together and agree. Another inspiration were the ideas of central planning and social engineering so prevalent after World War II, which have been conserved in the EU structures. The soft version of central planning is international harmonization and standardization. A third influence was that the European Commission was formed on the French administration with its Napoleonic centralization. Even when the European Union has advocated deregulation of various markets, it has done so in a centralized rather than a decentralized or competitive manner.

Strangely, this top-down mode of action has long been taken for granted. The Lisbon Agenda is also a child of this model. The European top politicians gathered and decided plan targets for what Europe should do. Alesina and Giavazzi (2006) accuse the Sapir report (2003) of the same flaw, although it argues for a much freer market economy in Europe.

Today, not only the content of common EU policy but also its mechanisms are now under serious scrutiny. For years, disappointment has developed with the EU top-down approach. A major cause was the apparent failure of the Lisbon Agenda. Although the European Union had solemnly declared clear quantitative targets, little action was taken to reach these goals (Gros 2007). The *acquis communautaire* functions as a conserving force: One rule after the other is added to the *acquis*, but it is exceedingly difficult to eliminate obsolete rules. As a result, the European Union is petrified and overregulated. To contemporary Europeans, the centralized EU model is seen as the way things are done in Europe. Naturally, the tremendous economic progress after World War II reinforces the European sense of having seen the light through the formation of the European Union.

Two recent events have exposed the EU mode of operation and its decision-making mechanism to new challenges. One was the referendums on the European Constitutional Treaty in the summer of 2005, in which France and the Netherlands rejected the Treaty. Even if the focal issues were not the centralized EU model, the popular rejections of the EU treaty undermined it. Another challenge was the sizable enlargement of the European Union in 2004, opening the Union to many nations with poorer populations and more liberal economic policies. At the same time, the gradual reinforcement of the internal market and global economic integration expose the EU countries to increasing competition. As a consequence, national governments felt compelled to accept responsibility for their economic policy and not only blame Brussels.

In fact, the EU model marks a sharp disruption of European precedence. Traditionally, Europe has been a disorderly and decentralized place, where each country has gone its own way, as economic historians emphasize (Rosenberg and Birdzell 1986, Landes 1998). One of the clearest illustrations of the old European model has been put forward by David Landes in his discussion of "European exceptionalism" from the Middle Ages. Landes argues that the strength of Europe lay in fragmentation:

> Fragmentation gave rise to competition, and competition favored good care of good subjects. Treat them badly, and they might go elsewhere. (p. 36)

> Ironically, then, Europe's great good fortune lay in the fall of Rome and the weakness and division that ensued. (p. 37)

> The economic expansion of medieval Europe was thus promoted by a succession of organizational innovations and adaptations, most of them initiated from below

> and diffused by example. The rulers, even local seigneurs, scrambled to keep pace, to show themselves hospitable, to make labor available, to attract enterprise and the revenues it generated. (p. 44)

This traditional European approach of competitive evolution has come to the fore after the failure of the constitutional referendums and the recent enlargements. The most obvious example is the tax competition that is spreading from the East.

It started in 1994 in Estonia with a 26 percent flat personal income tax (now 22 percent), and ever lower flat income taxes have proliferated (in chronological order) to Lithuania, Latvia, Russia, Ukraine, Slovakia, Georgia, Romania, and Kyrgyzstan (table 9.4). In spite of predictions to the contrary, flat personal income taxes are continuing to spread (Keen, Kim, and Varsano 2006); at present, Bulgaria and Poland are seriously considering the introduction of flat personal income taxes. The overall effect has been considerable. The average highest personal income tax has fallen among ten new EU members in Eastern and Central Europe by 7.8 percentage points from 37.0 percent in 1998 to 29.2 percent in 2006. This has also had effects on the old 15 EU members, whose maximum marginal income tax has decreased meanwhile by 3.1 percentage points from 48.9 to 45.8 percent. Needless to say, liberal migration rules in Europe will further sharpen tax competition.

Considering that capital is more mobile than labor, we would expect tax competition to have even greater impact on corporate profit taxes, and that is indeed the case, as is evident from table 9.5. From 1995 to 2007, the average corporate tax fell by no less than 12.9 percentage points in the 10 new EU members and almost as much as 9 percentage points in the 15 old EU members. At the same time the dispersion of corporate profit taxes has declined sharply. No single European country has as high a corporate profit tax as the United States (40 percent). All EU countries, save Finland and Sweden, which had the lowest tax already, have reduced their corporate profit taxes since 1995. This tendency toward lower taxes is no global phenomenon but a European exception (KPMG 2007).

The most fundamental question about Europe's future might be whether tax competition will be allowed or not. If it will, the overall tax pressure is likely to fall toward the lowest level, that is, from currently about half of GDP to barely one-third of GDP, the level in Romania and Lithuania (EBRD 2007). The champions of tax competition are most of the new members, the United Kingdom, Ireland, and Luxembourg. As part of its radical market reforms, Ireland reduced its profit tax to 12.5 percent, and Estonia has abolished profit tax on reinvestments as undesirable. The main opponents have been Germany and France. In 2006 German Minister of Finance Peer Steinbrück lashed out against Austria because of its decision to cut corporate tax rates from 34 to 25 percent: "In the case of Austria we are dealing not with a moderate position but a rather ambitious

Table 9.4 Personal income tax (percent)

Country	1998	2000	2006	Tax rate
EU-15				
Austria	50.0	50.0	50.0	p
Belgium	55.0	55.0	50.0	p
Denmark[a]	58.0	59.0	59.0	p
Finlanda	n.a.	n.a.	50.9	p
France	n.a.	n.a.	40.0	p
Germany	53.0	53.0	42.0	p
Greece	45.0	42.5	40.0	p
Ireland	46.0	42.0	42.0	p
Italy	46.0	45.5	39.0	p
Luxembourg	46.0	46.0	38.9	p
Netherlands	60.0	52.0	52.0	p
Portugal	40.0	40.0	42.0	p
Spain	48.0	39.6	45.0	p
Sweden[a]	n.a.	n.a.	56.6	p
United Kingdom	40.0	40.0	40.0	p
EU-15 average	48.9	47.1	45.8	
10 new EU members[b]				
Bulgaria	40.0	38.0	24.0	p
Czech Republic	40.0	32.0	32.0	p
Estonia	26.0	26.0	23.0	f (since 1994)
Hungary	42.0	40.0	36.0	p
Latvia	25.0	25.0	25.0	f (since 1995)
Lithuania	33.0	33.0	27.0	f (since 1995)
Poland	40.0	40.0	40.0	p
Romania	45.0	40.0	16.0	f (since 2005)
Slovakia	42.0	42.0	19.0	f (since 2004)
Slovenia	n.a.	42.0	50.0	p
10 new EU members average	37.0	35.8	29.2	
Overall average	43.8	41.9	39.2	

f = flat, p = progressive
n.a. = not available

a. State taxes plus municipality taxes.
b. Excluding Malta and Cyprus.

Note: Table shows top statutory rate (highest marginal).

Sources: European Commission (2007); World Bank, *World Development Indicators* online database (accessed on November 5, 2007).

and aggressive attempt to get companies to come to Austria" (Parker 2006). However, before his demise, even German Chancellor Gerhard Schröder, the other great enemy of "tax dumping," made a failed attempt to reduce the German federal profit tax by 6 percentage points. France's

Table 9.5 Corporate tax, statutory rate (percent)

Country	1995	2000	2007
EU-15			
Austria	34.0	34.0	25.0
Belgium	40.2	40.2	34.0
Denmark	34.0	32.0	28.0
Finland	25.0	29.0	26.0
France	36.7	36.7	33.3
Germany	59.0	51.6	38.4
Greece	35.0	40.0	25.0
Ireland	38.0	24.0	12.5
Italy	53.2	41.3	37.3
Luxembourg	40.3	37.5	29.6
Netherlands	35.0	35.0	25.5
Portugal	39.6	37.4	25.0
Spain	35.0	35.0	32.5
Sweden	28.0	28.0	28.0
United Kingdom	33.0	30.0	30.0
EU-15 average	37.7	35.4	28.7
10 new EU members[a]			
Bulgaria	30.0	20.0	10.0
Czech Republic	41.0	31.0	24.0
Estonia	26.0	35.0	22.0
Hungary	18.0	18.0	16.0
Latvia	25.0	25.0	15.0
Lithuania	29.0	24.0	15.0
Poland	36.0	30.0	19.0
Romania	38.0	25.0	16.0
Slovakia	40.0	29.0	19.0
Slovenia	25.0	25.0	23.0
10 new EU members average	30.8	26.2	17.9
Overall average	35.0	31.7	24.4

a. Excluding Malta and Cyprus.

Sources: KPMG (2007); World Bank, *World Development Indicators* online database (accessed on October 26, 2007); World Bank and PricewaterhouseCoopers (2006); EBRD (1995, 2001).

President Jacques Chirac, another great critic of "fiscal dumping," proposed to slash France's profit tax from 33 to 20 percent soon before his departure.[4] As tables 9.5 and 9.6 indicate, tax competition is thriving, and it is not likely to be contained.

4. Vanessa Houlder, "Europe's Tax Rivalry Keeps Multinationals on the Move," *Financial Times*, January 19, 2007, 11.

Table 9.6 General government expenditure
(percent of GDP)

Country	1995	2000	2005
EU-15			
Austria	56.0	51.4	49.9
Belgium	51.9	49.1	49.9
Denmark	59.6	54.2	53.1
Finland	61.6	48.3	50.5
France	54.4	51.6	53.7
Germany	54.8	45.1	46.9
Greece	45.5	46.7	43.2
Ireland	41.1	31.5	34.2
Italy	52.5	46.2	48.3
Luxembourg	39.7	37.6	41.8
Netherlands	56.4	44.2	45.2
Portugal	42.8	43.1	47.7
Spain	44.4	39.1	38.5
Sweden	67.1	57.1	56.6
United Kingdom	44.9	39.8	44.5
EU-15 average	51.5	45.7	46.9
10 new EU members[a]			
Bulgaria	41.3	39.7	37.5
Czech Republic	40.5	41.8	43.6
Estonia	39.4	36.5	33.2
Hungary	52.6	46.5	50.0
Latvia	37.5	36.7	35.5
Lithuania	34.7	32.5	32.5
Poland	50.1	41.1	43.3
Romania	34.7	35.3	31.0
Slovakia	54.1	63.1	38.0
Slovenia	41.6	47.4	46.0
10 new EU members average	42.7	42.1	39.1
Overall average	48.0	44.2	43.8

a. Excluding Malta and Cyprus.

Sources: European Commission, Eurostat (accessed on November 30, 2007); European Bank for Reconstruction and Development online database (accessed on November 30, 2007).

The reduced taxes have been accompanied by improved fiscal discipline and lower public expenditures (table 9.6). In this regard, the 15 old EU members starred, cutting their average public expenditures by almost 6 percentage points from 1995 to 2000, which occurred as a preparation for the introduction of the euro. The sharpest cuts were undertaken by Finland, Sweden, and Ireland, which cut their public expenditures im-

pressively by 13, 10, and 10 percentage points, respectively. The new EU member states did not have such high public expenditures to begin with, so their cuts have been more moderate. Even if the old EU members have seen their expenditures rise slightly during the long boom, the trend toward lower public expenditures is likely to recur with leaner times and more tax competition.

Although less striking, another characteristic of Europe today is competitive deregulation of goods, services, and labor markets. Some of this deregulation is inspired by the European Commission, but most of it is not. Examples are the very gradual deregulation of the labor markets that most EU countries are now pursuing (Lenain 2007). The big breakthrough was Margaret Thatcher's acrimonious deregulation in the 1980s, which was later emulated by Ireland, contributing to that country's great economic success. Even if European deregulation is tardy and piecemeal, it is steady.

Conclusions: Competition Revives Subsidiarity

The hype about the East Asian miracle has abated, but its specific advantages have also become more evident, namely low social transfers, low and relatively flat taxes, and free labor markets, leading to high investment in both physical and human capital and high economic growth. Hardly anybody praises its minor remaining crony features—state intervention, more corruption, and less democracy—as benefits after the Asian financial crisis of 1997–98. Europe has learned these most obvious lessons. A broad consensus, as reflected in the Lisbon Agenda, agrees that the European Union needs to emulate these three features of the East Asian model not to be left behind in near stagnation and ultimate decline.

The question today is not whether the European Union needs to adopt the three liberal features of the Asian model but how to do so most easily. The main idea of this chapter is that the centralized mode of resolving problems in the European Union, which has accomplished a great deal in the last half century, has run its course. What Europe needs today is not top-down decisions but a greater acceptance of bottom-up reforms of taxation, social transfers, and deregulation, based on its traditional comparative advantage, competition among the European countries and regions. In particular, tax competition should be welcomed and facilitated. The same is true of regulatory competition, notably labor market deregulation, which will be greatly facilitated by freer movement of labor.

We may attempt a concrete prediction of the outcome of these changes already under way. First, since enterprises are easily relocating from one country to another, we may expect corporate profit taxes to rapidly fall to 15 to 20 percent. Considering that labor is much less mobile, a higher taxation of labor may still be feasible. Yet, given the new trend of flat personal income taxes in the range of 16 to 25 percent in several new EU

members, personal taxation might go through a radical reduction because of the example and moral imperative rather than factor mobility. A natural consequence would be that the total burden of taxation declines from about half of GDP to one-third of GDP, which appears a reasonable level (Tanzi and Schuknecht 2000).

With the anticipated greater labor mobility in the European Union, the need for Europeanization and harmonization of pension rules and payroll taxation is becoming ever greater, which would probably have to be done in the old top-down fashion. Evidently, because of fiscal constraints, systems of social transfers have to adjust, which is likely to be done incrementally at a national level. Ever since Britain's deregulation of its labor market in the 1980s, similar reforms have spread piecemeal through Europe. After they have proved both their economic and social efficacy, they are likely to proliferate further.

In theory, the European Union has long cherished the principle of subsidiarity. In reality, however, the rhetoric has suggested that everything needs to be done top-down by the European Commission. The referendums of the summer of 2005 were a rude surprise to the EU establishment. Their productive outcome might be that subsidiarity has become reality, and that the European Union's excessively hierarchical mode of functioning has become supplemented with a healthy element of horizontal competition between countries and regions. The perceived power of the European Commission in Brussels has been rolled back to what it formally is and what it was supposed to be.

If the trends suggested here were to hold, the European Union might have found a good formula for future economic development. The liberal features of *acquis communautaire*—the free movement of goods, services, capital, and labor—provide Europe with a level playing field. Globalization and enlargement reinforce the competition. Then, ceteris paribus, Europe will be prone to move in a more free-market direction than East Asia or the United States.

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