Europe: Still a Laggard Economy

BY NORMAN BARRY

There have been increasing signs of optimism from European economy watchers. After some years in the doldrums, with slow growth and rising unemployment, things appear to be looking up: labor markets are more efficient; growth was good for 2006; and the euro is doing well against the dollar after years of weakness following its inception in 1999.

However, as I shall show, these promising signs must not be misunderstood as indications of permanent improvement, for the conditions that caused Europe's decline—rigid and inflexible markets, too-high public spending, and excessive taxation—are still there. The long-term survival of the European "social model," with its massive welfare spending, will ensure that the continent will lag behind America, much to the chagrin of the chauvinistic French. The increasing hold that the policies of European Union (EU) institutions have on the member states will guarantee that the familiar anti-market strategy will be pursued. Indeed, one method for opening up Europe's markets—the admission of former communist regimes of Eastern Europe that have pioneered low taxation and deregulation—will be weakened as they are compelled to adopt the standard inefficient European practices. The EU has never valued competition either in product markets or the markets for regulation and taxation. The most disappointing case of all is the United Kingdom: for a long period it was the least "European" of the member states and something of a free-market beacon for the continent. But under the allegedly nonsocialistic New Labor, the country has drifted toward the European "social model" while doggedly remaining outside the euro currency area.

To maintain my argument that signs of a European economic recovery are premature, I shall look at the major economies, Germany, France, Italy, and the United Kingdom, in some detail since they set the standards for the continent as a whole and illustrate its many weaknesses and few strengths. They also dominate the institutions of the EU, which are endeavoring to set common continental economic standards.

Germany. This is the most interesting and instructive country, for in its postwar history it has revealed both the strengths and lamentable weaknesses of European economies. It is still the world's third-biggest economy, after the United States and Japan, but seems to have lost the secret of that success. Germany's economic greatness came in the immediate postwar period when it adopted the *Sozialemarktwirtschaft* (Social Market Economy) under Finance Minister, and later Chancellor, Ludwig Erhard. It tried to combine the requisite free-market efficiency with a measure of state welfare. Thus it accepted Bismarck's welfare state but vowed it would not introduce a Scandinavian version. Welfare measures should be *marktkonform*, designed so as not to disturb the efficiency features of the free market.

But the "philosophy" of the Social Market Economy extended beyond the welfare imperative into the organization of the capitalist economy itself. Postwar Germany did not have a shareholders' economy. It included other "stakeholders," that is, non-owners who were considered to be equally important, such as trade unions and banks. Thus the two-board system of company manage-

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ment included a supervisory board with heavy union representation. Also, investment was funded not only by share issues but by bank lending. This gave the banks inordinate influence on company policy and shielded the managers from shareholder pressure; it eventually brought a loss of competitiveness to German industry. Not surprisingly, the Social Market system became popular across all political parties, including the former Marxist Social Democratic Party (SPD).

Over time the behavior of successive governments brought about the very thing the founders of the Social Market Economy did not want: a Scandinavian welfare state. Unfunded pensions were extended, as were unemployment benefits, so that it became irrational to work at all. State-funded education was generous enough to encourage students to stay at school past 30. The elimination of shareholder pressure from business protected incompetent managers—takeovers were rare and foreign acquisitions almost unheard of. A combination of all these factors led to the decline of the German economy, exacerbated by the costs of reunification, which involved the partial extension of the welfare benefits to the former communist East.

Angela Merkel

Not surprisingly, the German economy found it difficult to cope with globalization, especially with competition from the Far East. It has remained a manufacturing economy, but its rigid labor market was easily outperformed by the newly marketized China. The once-powerhouse of Europe became the weakest-growing EU economy between 1994 and 2003. When unemployment hit 5 million, over 10 percent of the workforce, even the Social Democrats realized something had to be done. Under Gerhard Schroeder they introduced mild reforms of the labor market, but they met with intense trade-union opposition. Hopes rose with the election in 2005 of the Christian Democrat Angela Merkel, who had a more radical market-oriented program. But she has been hampered by the fact that she was compelled to form a coalition with the SPD, which has representatives in the top economic positions in government.

Not All Bad

But things are not all bad for Germany, and there has been some improvement in recent years. Economic growth has resumed, albeit falteringly, and the flow of capital to more hospitable countries has been stemmed though not stopped. Many employers' organizations are now saying that Germany is a good place to invest. While still a manufacturing economy, the proportion has fallen from almost 27 percent in 1992 to 22 percent in 2002. Much of the improvement has come about not from government's relaxation of the labor laws but rather from voluntary agreements between employers and unions. Economic reality has dented the woolly optimism of the politicians.

There is still a long way to go before Germany restores its economic greatness. Politicians could make a start by reading up on the conditions that led to Erhard's success and remembering that he was never happy with the inclusion of the word "social" in his model. And before Germans get too optimistic about their recent recovery, they should remember they face a hefty value-added-tax (a kind of European consumption tax) rise of 3 percent fairly soon—another confrontation with the reality of big government.

France. This is not a country that we look to for a free-market past to inspire its present and future. It is true that in the Fourth Republic the economy modernized itself, largely because no government was in power long enough to do lasting damage. De Gaulle's Fifth Republic was tied up with the Algerian problem and foreign affairs in general to either extend or foul up its basically market economy. The trouble really started with the election of François Mitterrand in 1982 and his extreme socialist program of nationalization and redistribution. Some sort of order was restored with the election of Jacques Chirac in 2000, but France remains a *dirigiste* (directed) country, whoever is in power. Today the government is still involved in banking, energy, automobiles, transport, and telecommunications. Unemployment was at 9.1 percent last July, down from 10 percent,

but it is still a big problem, and public debt is at 6 percent of GDP, way above the mandated EU limit of 3 percent. The country is weighed down by a welfare state and a minimum wage of almost $10 per hour.

There have been some measures to address unemployment, especially among the young. These include some minor tax cuts and a serious attempt to break the rigidity of French labor laws with the "First Employment Contract" (known as CPE), which would have allowed employers with more than 20 workers to dismiss them at will for the first two years of the contract. Adequate safeguards were built in to help the "victims," but the proposed law still met with tremendous opposition from the left and the unions, no doubt fearing that something worse would follow. As a result, Prime Minister Dominique Villepin felt compelled to abandon it. That was bad news for free marketeers in France; for such a mild measure to meet with such opposition, and for the government to cave in so abjectly, indicated that France remains a socialist country even under a conservative administration.

Some other minor measures have been introduced to tackle unemployment but nothing substantive or structural. French productivity has been badly affected by the law limiting work to 35 hours per week. It was introduced allegedly to create jobs. One can almost hear the great French laissez-faire economist Frédéric Bastiat say: "Why not make it 10 hours per week. Think how many jobs that would create!"

The European Disease

France is afflicted by the European disease more than any other country. This is the illusion that wealth can be created by laws, that poverty can be solved by administrative decree, and that happiness and prosperity are a function of goodwill rather than reward for effort. Although there once was a radical free-market tradition in France, this is now but a distant memory. Formal Marxism might be dead, but it still casts a long shadow. Trade unions may be weak in the private sector, but they are still powerful in the government sector and capable of great economic damage. One might ask: how does France survive at all? Well, despite the *dirigiste* government the French workforce is educated and highly productive, and growth is picking up. But both taxation and government spending are far too high for long-term economic success. There is a big public deficit, but the idea persists that it can be dealt with by high taxes and not reduced spending.

If the government won't do anything about this nightmare, the people will. Thousands are already flocking to hated England and are taking up well-paid jobs in the equally hated City of London.

Perhaps the saddest thing about France is the lack of any serious debate about the free market. There was once a politician, Alain Madelin, who understood it. He ran for president and served in Chirac's government, but he has been mute in recent years.

Italy. It is always a pleasure to visit this country, and even to write about it. That legendary Italian cynicism about politics is a welcome dampener on the euphoria of the Europhiles. A prominent Italian conservative said to me last April of Silvio Berlusconi, the former conservative prime minister: "He may be a crook but he is at least he is our crook." But Italians can be a little pleased at the moment. They will record a growth rate of 6 percent for 2006, the best in years. They have a socialist government but carry on making money. They are impossible to regulate and difficult to tax.

I am sure they won't get too carried away by their current success, for trouble is just around the corner. As the Italian finance minister Tommaso Padoa-Schioppa recently said: "A recovery must last for years not just six months." And will it last? Probably not. Retail sales have recently dipped; public debt is still above the recommended EU figure; and business confidence has recently taken a knock. Moreover, there is a serious long-term problem: the emigration of its skilled workers. Graduate emigration quadrupled relative to total emigrants in the

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1990s. Economic conditions must be pretty bad for qualified people to want to leave such a wonderful country, and they will probably get worse in the future. The current growth rate is unlikely to be sustained next year, and Italians are facing serious tax rises. Like other European countries, Italy is trying to solve a government debt problem by raising taxes rather than by cutting spending.

The United Kingdom. It is always a puzzle to talk about Britain in the context of Europe since it is never clear that it wants to be in the EU anyway. The conservatives are definitely Euroskeptic, and some would leave the EU. The tragedy is that the country is moving in a European social-democratic direction without being proper Europeans. Some Europhiles regard the country as an outpost of hated American free-market capitalism.

How then is Britain moving in a European direction? Answer: one man—the current chancellor of the exchequer and soon-to-be prime minister Gordon Brown. Okay, he doesn't believe in old-fashioned nationalization, but he does believe in tax and spend just like the Europhiles. Since his tenure began, government spending has reached 45 percent of GDP, up from 37 percent, and taxes have gone up on 63 occasions. And still government debt is about $39 billion and threatening to go even higher—largely to pay for the 800,000 new civil servants he has hired. Brown writes articles of a Euroskeptic persuasion for the *Wall Street Journal* and takes his vacations in the United States. But that does not make him seriously pro-capitalist. Under Brown the United Kingdom has whittled away the Thatcher legacy.

The Delusions of Europe

A glance at the four major economies of Europe shows that the continent is far from recovery. It is still social democratic in its outlook. Its current moderate success conceals deep problems brought about by the earlier adoption of discredited economic policies, and its only hope is to reverse the trend and follow the strategies of its new member states. I am thinking primarily of the Baltic states: Latvia, Lithuania, and Estonia. They now have flat taxes of something over 20 percent, completely privatized economies, and almost no agricultural subsidies. Therein lies the future, not in old Europe. And I have not mentioned the looming pension problem that threatens to engulf Germany, France, and Italy. Neither have I mentioned the two successful economies of old Europe, Spain and Ireland, both of which have pursued market policies. No wonder the Europhiles rarely mention them.