Summary

The European Economic Advisory Group was established in 2001 and produced its first report on the European economy in 2002. This report is thus the sixth one of the group. Like that of last year, the report consists of two parts: one dealing with short-term macroeconomic issues and the other with longer-term ones.

The first part of the report contains three chapters.

- *Chapter 1* provides a macroeconomic outlook and discusses fiscal and monetary policy options for the euro area. The forecast is one of a mild slowdown in the world economy and a slower – but continued – recovery in the European economy. The need for further fiscal consolidation in the EU countries and for a restructuring of government expenditures in favour of government investment, R&D and education is stressed. A special section analyses how well the common monetary policy has fitted individual countries. The upshot is that there are considerable stabilisation policy costs which have not fallen over time.
- *Chapter 2* analyses macroeconomic adjustment within the euro area. The focus is on the adjustment problems in Ireland (which has had a booming economy) and Italy (which has instead been exposed to strong contractionary shocks). The analysis stresses how adjustment processes may be much more complex than was believed earlier. One reason is asset price dynamics. Another is that supply-side adjustment mechanisms, such as labour migration, may also have demand effects. A key conclusion is that deregulations that enhance productivity growth may be a key adjustment mechanism in the medium term for a country – like Italy – that needs to improve its competitiveness.
- *Chapter 3* examines how well the ten member states that entered the EU in 2004 have been doing. It is a follow-up of earlier extensive analyses in our 2004 report. The finding is that the growth performance of the EU-10 has been very good in general. The chapter warns about the dangers of keeping those countries that have entered the ERM II outside the monetary union and proposes a rebate with respect to the inflation criterion for joining the euro for fast-growing countries that are catching up with the old EU countries. The chapter also assesses the current economic situation of Bulgaria and Romania, who acceded to the EU on 1 January this year.

Much of the European policy debate is about what economic model Europe should opt for. The issue is often cast as a choice between a market-liberal, Anglo-Saxon model, providing economic efficiency at the cost of low social protection, and a social European model, delivering equity but at a high cost in terms of efficiency. Chapters 4 to 6 provide in-depth analyses of various aspects of this choice.

- *Chapter 4* looks in detail at the macroeconomic performance of Denmark, Finland and Sweden. Finland and Sweden have achieved high output growth but less satisfactory employment growth. Denmark has been less successful in terms of output growth, but labour market performance has been impressive. The question is whether the Scandinavian economic model represents a role model for the rest of Europe that is able to combine economic efficiency with social justice. The conclusion is that the Scandinavian experiences show that an improvement of macroeconomic performance in European countries requires market-liberal reforms, but that already limited reforms can produce significant results, still leaving in place a system very different from the Anglo-Saxon ones.
- *Chapter 5* analyses corporate taxation within the EU and asks whether the new EU states expose the old ones to unfair tax competition. Various policy approaches are discussed. The chapter recommends an increase in VAT and a reduction in labour income taxes as a way of "simulating" an efficient destination-based tax on corporate profits.
- *Chapter 6* provides an in-depth analysis of the phenomenon of economic nationalism, as practiced by many governments in the EU, for example in the form of opposition to cross-border mergers, promotion of national champions and bailing out of

domestic firms. Even though such measures usually are very inefficient ways of achieving national objectives, they still have been employed. The chapter finds public ownership – both full and partial – of firms to be a key factor behind harmful nationalistic interventions in the economy. The best way to deal with economic nationalism would be to severely restrict the degree of public ownership. Coordinated deregulation across the EU may also be a necessary prerequisite for countries to deregulate sufficiently.

Chapter 1: Macroeconomic outlook and policy

With a growth rate of 5.1 percent for world GDP, the world economy expanded almost as fast in 2006 as in 2004, the year of the highest growth since 1973. Especially the integration of fast growing, emerging economies like China, India, Russia and Eastern Europe into the world trading system has brought this about. High profits, booming asset markets and low long-term interest rates were also important contributing factors. The oil price increases during the first part of 2006 restrained growth only marginally.

The world economy has just surpassed its peak and will decelerate somewhat during the next few months. Most likely, the slowdown will be temporary and modest: we expect a world economic growth of slightly below 5 percent both this and next year.

In 2006, economic dynamism shifted from the US towards Europe. After approximately three years of high growth, the *US* economy started to cool down markedly last year. A key factor is falling residential construction. Partly due to the real depreciation of the dollar, US economic growth will begin to speed up again from the second half of 2007. After growth of 3.4 percent last year, GDP will grow by 2.5 percent in 2007 and 2.8 percent in 2008. The current account deficit will shrink slowly, after having increased to 6.6 percent of GDP last year.

In *Japan*, a reduction in private consumption was not fully compensated by stronger investment and export performances in 2006 and led to a slower pace of recovery than in 2005. Private consumption will pick up again in 2007, mainly due to increased firm profits and a tightening of the labour market. On the other hand, the slowdown in the world economy will initially reduce export growth and investment. Also, reinforced fiscal consolidation efforts will result in a negative growth contribution from public spending. Overall, GDP will grow at 2.0 percent this year and 2.2 percent in 2008. In July 2006, the Bank of Japan made its first interest rate move since September 2001 and thereby signalled its intention to normalise monetary policy. Moderate inflation will allow the bank to continue its course of gradually making monetary policy less expansionary.

The *Chinese* economy continues to grow very dynamically at rates around 10 percent per year. The objective of the government to decrease income disparity between rural and urban areas and the strong rise in retail trade sales suggest that the increases in private consumption will be able to compensate for the somewhat lower export growth. So far, there are no signs that the Chinese economy is overheating. Inflation rates will continue to stay between 1 and 2 percent. During the past year, there was only a small appreciation of the renminbi, by slightly more than 3 percent, against the US dollar. Therefore, foreign exchange reserves continued to increase further, making China the country with the largest foreign exchange reserves in the world.

Developments in Europe

The economic recovery in the EU continued to gather pace last year. With a rate of 2.9 percent in 2006, the EU recorded the highest GDP growth since 2000. Growth was somewhat weaker in the second half of the year. Aggregate output in the EU is expected to grow by 2.2 percent in 2007 and 2.5 percent in 2008. The growth gap between Europe and Japan, on the one hand, and the US, on the other, will almost disappear this year, basically because growth in the US will decelerate significantly.

The recovery in the European economy in 2006 was largely driven by domestic demand. Private consumption increased notably almost everywhere. Improved labour market conditions and higher wages were the main causes. Another important factor behind demand growth last year was private investment. However, the somewhat weaker outlook for the world economy had some negative effects on the propensity to invest during the second half of last year. Therefore, we expect investment in the EU to grow at a somewhat more moderate pace of approximately 4 percent in this and the next year.

Not only investment, but also foreign demand in the EU developed somewhat weaker in the second than in the first half of 2006. This development will continue during the first part of 2007 with the consequence that net exports will contribute negatively to GDP growth this year. In 2008, the stronger world economy will reverse this.

Higher employment growth during especially the first half of 2006 caused the unemployment rate in the EU to fall to 7.9 percent in 2006. Over the coming two years, the labour market situation will improve further, albeit at a considerably slower pace.

As the output gap closed, upholding the wage moderation that has characterised many European countries in the past few years became more difficult in 2006. Nevertheless, an average nominal wage increase in the euro area of 1.9 percent last year was still moderate.

Despite further increases in the oil price in the first half of last year, no significant inflation pressure arose. Consumer prices rose by 2.2 percent in 2006. With inflation rates of 2.2 and 1.9 percent in 2007 and 2008, price increases in the EU will also remain moderate. The higher inflation in 2007 than in 2008 can be explained by the German VAT increase, which will contribute 1/4 percentage points to inflation in the EU this year.

Fiscal policy

Business cycle developments have supplied the tailwind for fiscal consolidation in many European countries. Nevertheless, the overall fiscal deficit of the EU states as a share of GDP fell by only 0.3 percentage points last year and a further reduction of only 0.4 percentage points is forecasted for this year, bringing it down to 1.6 percent of GDP. Whereas last year the entire deficit reduction was due to the working of automatic stabilisers, that is increased tax revenues and lower social security spending caused by improved income and labour market conditions, this year two thirds of the reduction reflects structural improvements.

Given the future budget pressures from demographic developments, the current reductions in budget deficits are clearly insufficient. The still relaxed attitude of politicians towards the long-run fiscal situation in Europe continues to be worrying. Indeed, the cyclical improvement in fiscal positions in many countries that is now occurring is potentially dangerous, because it may create the illusion that fiscal problems have been overcome and that the revised stability pact is working. There is a large risk that past experiences of insufficient tightening of fiscal policy in upswings are repeated, which will have grave consequences in the next downturn. We recommend that the current cyclical upswing be used for larger fiscal consolidation than is now occurring.

To further economic growth in the long run, governments should reallocate spending to those areas that foster growth, like infrastructure, R&D investment and education. The ten-year Lisbon Strategy – initiated in 2000 –focuses on research and education. With only three years to go until 2010, Europe still is far off its 3 percent of GDP target for R&D spending. With only around 1.9 percent of GDP, R&D spending stood at virtually the same level in 2005 as in 2000. Also education expenditures in the euro area have basically stagnated since 1999. Although the EU countries should not follow any uniform growth strategy, it is clear that at present levels of R&D spending even the more developed part of the EU will not be able to reach the aspired international technology frontiers.

Monetary policy

Since December 2005 the ECB has increased its main refinancing rate in six steps by 1.5 percentage points to a level of 3.5 percent at the end of last year. This, together with an appreciation of around 10 percent of the euro against the dollar, implied more restrictive monetary conditions in the euro area last year. A likely continuing appreciation of the euro, a steady decline in inflation and increasing real interest rates will make overall monetary conditions in the euro area in 2007 even less accommodative than last year.

Not only were monetary conditions in the euro area at the end of last year as restrictive as they have ever been. Also an estimated reaction function of the ECB (a forward-looking Taylor rule) indicates that the actual interest rate is somewhat above target at the moment. Therefore, further increases in the ECB interest rate would not be in line with the bank's past behaviour. For this reason, we have assumed that the ECB will opt for an interest-rate pause, leaving the main refinancing rate at 3.5 percent during 2007 and 2008. But, given the current pronouncements of the bank, additional interest rate rises are possible, although only higher inflation than earlier expected or stronger macroeconomic developments would justify such a policy. On the other hand, if there were to be stronger fiscal consolidation efforts, this could create room for lower interest rates.

The cost for member countries of the common monetary policy is often discussed. It implies almost by definition that not all member countries are pleased with the course being followed. We provide *stress indicators,* whose evolution over time provides information on the adequacy of the single monetary policy for each of the EMU member countries. Stress in a particular member country is defined as the difference between the actual short-term interest rate and the interest rate that would prevail if that country was able to follow an "optimal" monetary policy. We argue that the actual reaction function of the ECB would be a good description of "optimal" monetary policy at the country level provided that the interest rate could react to country-specific deviations of inflation from the ECB target and country-specific output gaps. Asymmetries in inflation and cyclical output developments across countries will generate differences between the actual interest rate and the interest rate that would be set if the reaction function of the ECB were applied on the national level.

There is no clear trend in absolute stress levels over time, suggesting that there has not been a steady increase in the degree of business cycle synchronisation over the past eight years. This speaks against the argument that the monetary union would automatically reduce differences in cyclical developments among the member countries. But this does not mean that stress levels are constant over time. In particular during 2003 and in the summer of 2005, stress levels were particularly high in the euro area.

From the perspective of an individual country, Ireland in particular is noteworthy. This country shows the highest levels of overall stress, and optimal interest rates would have been considerably higher. On the other hand, the low inflation in Germany would have motivated lower interest rates there if the country had been able to set its own interest rate.

From a European perspective, it appears that policy weights attached by the ECB to developments in the large countries, and in particular to Germany, are lower than would be suggested by their economic size. On the other hand, developments in small member countries appear to have received more than proportional weights in the monetary policy decisions of the ECB.

Chapter 2: Macroeconomic adjustment in the euro area – the cases of Ireland and Italy

A key issue in the debate about monetary union has concerned how individual economies adjust to country-specific shocks. This chapter takes a closer look at the experiences during the first years with the euro. The analysis focuses on Ireland and Italy. Ireland provides a case study of excessive monetary stimulus. Italy, in contrast, is an example of recessionary shocks from a fall in external demand and adverse productivity developments.

The adjustment problem arises from the presence of nominal and real rigidities that hamper efficient movements in relative prices. If prices and wages were sufficiently flexible, a positive demand shock in one country and a negative one in another would lead to a relative price change: The real exchange rate of the former country vis-à-vis the latter would appreciate, so as to keep employment and output at their natural rates in both countries. With frictions, the short-run responses are instead inefficient output and employment changes as well as misalignment of relative prices.

The adjustment problem stems from the fact that equilibrating movements of prices and the real exchange rate occur only sluggishly over time. This delayed response often causes additional macroeconomic stress, because inflation persistence leads to excessive real appreciation and overshooting of equilibrium relative prices. Moreover, adjustment does not work symmetrically: Real depreciation in response to a negative shock is typically much slower than real appreciation in the case of a positive shock, and often fails to materialise with the necessary intensity for many years.

This asymmetry implies a general lesson for the countries in the eurozone: the inherent dynamics of adjustment creates a bias towards "competitiveness problems". These are persistent when a country is hit by a negative shock. In economies exposed to expansionary shocks, such problems are likely to appear at the end of booms, as excessive real appreciation may cause a hard landing.

Ireland

In Ireland, labour costs have increased very rapidly in the context of the expansionary monetary and fiscal policy mix of the first years of the euro. So far, because of the Irish specialisation in sectors where demand is highly elastic to growth at the global level, the dynamics of world GDP has prevented a deterioration in export performance. But the strong appreciation of the real exchange rate makes the country vulnerable to changes in the global outlook, creating substantial macroeconomic risk.

Ireland provides an example of how asset prices, especially housing prices, may play a much larger role in the dynamics of adjustment in a monetary union than was understood earlier. Through their impact on housing prices, expansionary monetary conditions can fuel sustained construction booms, which outlast the initial demand shock, and contribute to a cumulative process or real appreciation. In the Irish case, the growth in the housing stock is to some extent a by-product of the convergence process, as the capital–labour ratio approaches the long-run equilibrium level. But the pace and intensity of housing investment have arguably been amplified by monetary stimulus. The strong expansion in the construction sector and the high market valuation of real estate clearly point to the risk of a significant reversal, which could amplify the contractionary effects of real appreciation once a downturn starts.

The Irish case also raises the issue of whether adjustment channels can work in "perverse" ways and move demand in the same direction as the shock. This point has been emphasised early on by the so-called Walters critique of the fixed exchange rates in the ERM. In response to a demand boom, adjustment requires an increase in the price level, although the process is usually delayed by nominal rigidities. This means that, in the short run, expectations of higher inflation – and thus a fall in the real interest rate – can further stimulate aggregate demand. As suggested by the Irish experience, similar considerations may apply to the adjustment via labour migration. Immigration of workers can contain labour shortages in booms, reducing the pressure on wages and prices. Yet, new migrants also increase aggregate expenditures and in particular the demand for new housing.

Italy

In contrast to Ireland, Italy is suffering from sustained contractionary shocks. There has been a fall in external demand – associated with increased competition from emerging market economies in the "traditional" sectors dominating the Italian economy – which appears to have deepened after 2002. An adjustment to these contractionary shocks would require real depreciation. This has not happened. Despite a severe slowdown of growth, real labour costs have continued to increase faster than in other eurozone countries. This, in combination with *negative* productivity growth, has caused a large increase in Italy's relative unit costs. The competitiveness problem has been exacerbated by the strengthening euro.

The crisis has opened a deep divide between sectors that are exposed to external competition and sheltered sectors, which have a much lesser incentive to increase efficiency and lower costs. The problem is that inefficiency and lack of competitive pricing in the latter sectors translate into high costs of producing and innovating for all firms in the economy.

Demand policies are of limited use in the present circumstances. Fiscal policy faces a well-known policy trade-off. A contractionary policy would help gain competitiveness through disinflation but would exacerbate output and employment costs in the short run. The Italian government is currently implementing a small *internal devaluation* through measures that reduce the effective payroll tax rate on non-financial firms (excluding public utilities) by approximately 3 percentage points. This is a step in the right direction, but it is clearly insufficient to address the competitiveness crisis in Italy.

Other measures are likely to be more consequential. In particular, the government could speed up deregulation policies, reducing monopoly power in the sectors of the economy least exposed to international competition. An increase in efficiency and more competitive pricing in these sectors would clearly have large, beneficial effects on the sectors exposed to international competition. The recent experiences in the Italian economy point to the need for reversing the adverse productivity developments, not only to promote long-term growth but also to address the short-run macroeconomic adjustment problems. The experiences from the Scandinavian economies, which are discussed in Chapter 4, show that deregulation policies can be quite effective in generating productivity growth already in the medium term. A general lesson seems to be that policies that work on the productivity margin may be much more important also for short-run adjustment than was realised earlier.

Chapter 3: The new EU members

In the last three years, EU membership has grown by twelve new countries. In May 2004, ten countries joined and in January 2007 two more countries, Bulgaria and Romania, became members.

The foreign trade performance of the countries that joined the EU in 2004 indicates increased integration with the EU15 countries. Spurring of economic growth has been a second benefit of EU membership, with only Malta and Lithuania as possible exceptions to the pattern. Labour market performance has not, however, been as favourable to the 2004 entrants, as unemployment has fallen only in the Baltic countries, Poland, Slovenia and the Slovak Republic.

Membership in the monetary union

Joining the euro is a longer-term objective for the 2004 entrants. Only Slovenia has so far achieved this goal, having entered the monetary union on 1 January 2007. Membership in the monetary union requires fulfilment of several criteria of macroeconomic stability. These include price and exchange rate stability, low fiscal deficits and government debt, and a low long-term interest rate.

Cyprus, Estonia, Latvia, Lithuania, Malta and the Slovak Republic are currently in the ERM II, and these countries are evidently slated to adopt the euro relatively soon. Apart from inflation, the Baltic countries and the Slovak Republic fulfil the criteria for entry into the monetary union, although the latter country is a border-line case in terms of fiscal deficits. Cyprus and Malta have some problems with the fiscal criteria, and inflation in Malta is fluctuating and thus potentially problematic. Last year, Lithuania's application for membership in the monetary union was turned down and Estonia was advised not to apply. In both cases, too high inflation (around four percent) was the reason for refusal of membership.

The other 2004 entrants do not yet have definite plans to enter the ERM II. Hence their membership in the monetary union will be at least several years in the future. Especially Hungary (with a deficit of around ten percent of GDP in 2006) but also Poland have difficulties with the fiscal criteria. As regards long-term interest rates, there are significant variations among the 2004 entrants: Hungary clearly fails and Poland is a border-line case.

Strict application of the inflation criterion as a way to postpone entry into the monetary union is creating a potentially vulnerable situation for the Baltic states, Cyprus, Malta, and the Slovak Republic. Requiring both exchange rate stability and low inflation is, in general, problematic because it sets two simultaneous targets for monetary policy. Moreover, the double requirement is particularly problematic for countries that are experiencing rapid growth which raises inflation through the Balassa-Samuelson effect. This effect implies high inflation when high productivity growth in the tradables sector causes high wage increases that spill over to the non-tradables sector and result in substantial price rises there. Given that these countries are growing well, are integrating with the EU and fulfil, or are not far from fulfilling, the EMU criteria apart from inflation, they should be admitted quickly to the eurozone. As the formulation of the inflation criterion in the Maastricht Treaty did not take the entry of fast-growing, catching-up countries into account, we propose that a *Balassa-Samuelson rebate* of up to one percentage point should be added to the inflation criterion when applied to the new member states. Alternatively, one could move from using the inflation in the three EU countries with the lowest inflation to using aggregate euro area inflation as the norm of comparison. With either formulation, both Lithuania and Estonia would have been close to passing the test in 2006.

The Eastern European 2004 entrants all have substantial current account deficits. These are countered to varying degrees by foreign direct investment, which mainly originates from the euro area, Denmark and Sweden. More generally, these countries have significant net foreign liabilities, but the net liabilities take mostly the form of equity liabilities. This reduces short-term vulnerability. Various indicators also show that the 2004 entrants are rapidly improving their financial systems. Stock markets are growing in significance and banking systems are improving in terms of efficiency and risk management. Nevertheless, past experiences in a number of emerging economies with exchange rate pegs have provided vivid illustrations of the risk of capital flow reversals, when a period of overheating and credit expansion associated with large capital inflows has been followed by capital outflows and financial stress. This provides a strong argument for making the ERM II period as short as possible for the new EU member states.

Bulgaria and Romania

The two most recent EU entrants, Bulgaria and Romania, are the poorest EU countries, with living standards of around 60 percent of the average of the eight Central and Eastern European countries. However, Bulgaria and Romania have been growing well in recent years, though Romanian growth has exhibited substantial fluctuations. Inflation is a major concern for both countries. The two countries have high unemployment and low employment rates, although Bulgarian unemployment has been falling rapidly. With respect to public sector balances, Bulgaria and Romania are doing reasonably well. Both countries are, however, running significant current account deficits. In terms of financial development indicators, the financial sector in Bulgaria appears to be roughly on a par with those of the 2004 entrants. For Romania the values of these indicators are much lower, which suggests that the financial sector in that country is lagging behind those of the other new member countries.

EU membership is likely to bring significant benefits to Bulgaria and Romania in the coming years, though these countries must continue to reform their economies. Overall, the medium-term prospects for Bulgaria are likely to remain favourable, but a boom in domestic credit and a high level of private external debt could lead to a vulnerable situation, as Bulgaria has a currency board arrangement. The medium-term prospects for Romania appear fairly good. Fast credit growth, however, has led to some concerns about potential financial-sector and macroeconomic vulnerability. There are also signs of deteriorating competitiveness due to an appreciation of the currency, strong wage growth and unsatisfactory productivity developments. These concerns imply clear downside risks to the basic medium-term scenario for Romania.

Chapter 4: Scandinavia today: An economic miracle?

In much of the recent European policy discussion, there has been talk of a Scandinavian "economic miracle". The Scandinavian model has been hailed as a role model for others to follow, as it has been perceived to deliver high growth, high employment and macroeconomic stability, at the same time as a generous welfare state provides a high level of social protection.

The chapter assesses macroeconomic developments in Denmark, Finland and Sweden. The perception of the Scandinavian economies in other European countries is often based on insufficient knowledge and too rosy. But it is clear that Scandinavian macroeconomic performance has recently been better than in many eurozone countries, especially the large ones.

Output growth

In terms of output growth, Finland and Sweden have been doing much better than most of the euro area over the last decade. Denmark in contrast has not. But the picture needs to be qualified. Part of the high growth in Finland and Sweden has represented a recovery from unusually deep demand-induced recessions in the first half of the 1990s. Productivity growth has, however, continued at high rates also in recent years, which is in stark contrast to developments in the major euro area countries. Hence, structural factors must also have been at work. High productivity growth seems linked to a larger focus on ICT investment than in most other countries and to larger contributions from both ICT-producing and ICT-using sectors. A well-educated work force – which because of capital-skill complementarity may have made investment into ICT particularly profitable – and high R&D spending are also likely to have been of great importance.

High productivity growth in Finland and Sweden has been associated with relative price declines for exports, implying large terms of trade losses. If output growth is corrected for this, real income developments in Finland and Sweden appear more normal as compared to Continental European countries, and Denmark is more on a par with the two other Scandinavian countries we examine. The implication is that a substantial fraction of the high output growth in Finland and Sweden has benefited consumers elsewhere.

There is considerable support for the hypothesis that extensive deregulation in product and service markets has been important for productivity growth in the Scandinavian countries. The current level of regulation is lower than in most euro area countries, although not quite as low as in Anglo-Saxon countries. The change in the amount of regulation over the last two decades has not been larger than in the euro area, but deregulation steps were earlier and are therefore likely to have contributed more to productivity growth in the past decade.

Labour market developments

Employment rates (employment relative to working-age population) in Denmark and Sweden are among the highest in the OECD area and somewhat lower in Finland (higher than in most euro area countries but lower than in Anglo-Saxon countries). The largest contributions to higher overall employment than in the eurozone come from higher employment of females and elderly. Denmark has also been successful in achieving high youth employment.

To understand the employment-generating capacity of the Scandinavian model, one needs to see how different parts of the system interact. High and progressive taxation discourages work in general, but also finances generous childcare and makes it profitable to split household income between two breadwinners. Together with separate taxation and the absence of dependent spouse deductions, this has promoted high female employment. A fairly high degree of coordination of wage bargaining may also have helped restrain wages despite high unionisation, high taxes and generous unemployment benefits.

Although the reductions in unemployment relative to the peak years in the early 1990s have been substantial in all three Scandinavian countries, only part of the earlier unemployment rises have been recovered. Denmark has been particularly successful in reducing unemployment and raising employment. In much of the European policy debate, this has been attributed to the Danish *flexicurity* model, which combines low employment protection, providing high flexibility, with generous unemployment benefits, providing high social protection. Emulating Danish flexicurity has come to be a standard prescription for the Continental European countries. Unfortunately, the success of this particular policy mix is largely a myth. There is not much serious research suggesting that low employment protection is a main cause of low unemployment, but there is plenty of research suggesting that generous unemployment insurance contributes to high unemployment. What has occurred in Denmark are significant *reductions* in the generosity of unemployment benefits and *increases* in the requirements on the unemployed. In contrast, there has not been much change in employment protection: it remains more or less the same as in the late 1970s and the 1980s when unemployment was very high.

The Scandinavian model is less successful in generating many hours worked than in generating high employment rates. Total hours worked (at least as reported) are higher than in most euro area countries but significantly lower than in non-European OECD countries like the US. In Sweden, this reflects to a large extent high sickness absence, which rose when unemployment fell in the late 1990s. This suggests that there may be a substantial amount of concealed unemployment in other social insurance systems. Indeed, benefit dependency rates are high in the Scandinavian countries and have not come down much from the mid-1990s.

Policy lessons

Does the Scandinavian model represent a viable alternative to the Anglo-Saxon model? It is true that high employment and high output growth have been achieved with much higher social protection than in the Anglo-Saxon countries. A well-educated work force is likely to have been an important contributing factor. But it is also true that recent improvements in macroeconomic performance in the Scandinavian countries have been associated with limited – but yet clear – steps in a market-liberal (Anglo-Saxon) direction. This is obvious in terms of product market deregulations in all three Scandinavian countries. Denmark is an example of how limited reductions in benefit generosity can help reduce structural unemployment very significantly. Sweden up till 2006 provides a contrast: the earlier absence of labour market reforms was associated with more or less unchanged structural unemployment. This may explain why Sweden under a new liberal-conservative government has now embarked on a path of labour market reforms not too different from the earlier Danish ones.

What are the policy lessons for other European countries? It is certainly *not* that macroeconomic performance can be improved without market-liberal reforms. On the contrary, other Continental EU countries would be well advised to reduce their product market regulations to the Scandinavian level and beyond. They would also be well-advised to strengthen work incentives by reducing unemployment benefit replacement rates and increasing the requirements on the non-employed. The Scandinavian experiences offer two main insights here.

- The first is that measured labour market reform can produce substantial employment gains, while at the same time leaving in place a system very

different from the Anglo-Saxon one. Such reform may be required to reduce unemployment once it has risen, even if low unemployment could formerly be sustained with more generous welfare provisions.
- The second insight is that reforms should be broad, that is encompass all social insurance systems, to reduce the risk that reduced benefit generosity in one insurance system only results in an overflow of benefit recipients to other systems.

The Scandinavian experiences also illustrate the "benefits" of having a deep crisis. Denmark, Finland and Sweden all underwent grave fiscal crises in the 1980s or early 1990s. These crises helped form a consensus on the need for sustained fiscal discipline, which has been conducive to fiscal consolidation and pension reform. An important characteristic of the "Scandinavian miracle" may simply be that sharp crises – conflicting with generally held perceptions of the superiority of the own model – offer a more fertile soil for policy change than a creeping crisis (as in France and Germany) or a continuous crisis (as in Italy). The most important policy changes may not necessarily be radical reforms of institutions but rather curbing the excesses that tend to accumulate over time in any system. The Scandinavian experiences highlight the importance of building a consensus on such measured reform.

Chapter 5: Tax competition

Tax competition seems to be taking place in the EU, as member states compete with each other for mobile capital and profit. In particular, corporation tax rates have fallen significantly in the last decade. There is evidence that this has been partly fuelled by more aggressive competition from the EU10, which have substantially lower rates than the EU15.

Surprisingly, corporation tax revenues have held up remarkably well, though there are two different forces at work here. First, aggregate tax revenues have remained high, probably due to higher rates of profit, than in the past. But second, there is evidence that countries that are able to maintain a relatively low tax rate are attractive locations for both capital and profit; hence these countries can generate substantial revenues partly at the expense of other countries. Flows of both capital and profits appear to be highly sensitive to differences in tax rates among countries.

However, continued downward pressure on tax rates must ultimately also depress aggregate revenues. This process of competition raises four questions:

- Does it matter?
- Is it fair?
- Should there be a coordinated response?
- How should individual governments react?

The setting of corporation taxes

Broadly, economic theory suggests that an individual country tends to lose out by taxing the return to capital located in that country. The reason is that, because capital is mobile, its owners will shift their capital to jurisdictions where they earn the best post-tax rate of return. As a result, any taxes levied on capital located in an individual country tend to increase the required pre-tax rate of return there, leaving the post-tax rate of return largely unaffected. This occurs through a process of shifting capital elsewhere, which results in a lower level of economic activity and hence lower overall income for the residents of that country. In addition, the effective burden of the tax is in any case passed on to domestic residents; the owners of the capital do not bear the burden since they continue to receive the same post-tax rate of return.

That suggests that individual countries should not tax the income on capital located within their jurisdictions. This statement has to be qualified, however, insofar as capital needs public infrastructure in order to operate efficiently. Indeed, it is efficient from a single country's perspective to impose a tax on mobile capital equal to the marginal congestion cost (or reduction in the user quality of the infrastructure) that this capital incurs. Thus a capital income tax that has the character of a user fee for the public infrastructure is likely to survive a process of intense tax competition.

In practice, though, governments typically try to tax capital at higher rates than this implies. One reason may be an apparent aim of equity as well as efficiency. A tax on capital income may give the appearance of taxing owners of capital, even if economic theory suggests that the tax does not make them any worse off. Further, EU governments raise two to three percent of GDP from corporation taxes; in practice they are reluctant to forgo such a stream of income.

Since EU member states retain the right to set their own tax rates, it is hard to describe the setting of low tax rates as unfair, even if this causes flows of capital or profit from other countries. This may seem unfair, as the new EU member states with the lowest tax rates are also recipients of grants from the rest of the EU. However, low taxes and grants can be seen as serving the same end: they both attract capital and ultimately reduce the dispersion in standards of living across the EU. So, if one accepts the idea of EU grants to these countries, one should also accept that they impose lower corporation taxes than the old EU states.

A coordinated response within the EU may slow the rate of decline of corporation tax rates but would not end competition. One important reason is simply that there are many countries outside the EU who would not be part of an agreed structure. In any case, coordination would have to encompass the definition of the tax base as well as the tax rate; this would be extremely complex.

The advantage of destination-based taxation

So is there any useful policy available to individual governments? One possible route is to consider *where* the return to capital is taxed. The bulk of taxes on corporate profit are levied on a *source basis* – where the economic activity (for example, production or the head office of multinationals) is located. Such taxes tend to drive that economic activity away, and hence lead to tax competition.

There are two alternatives. A *residence-based tax* could in principle be introduced on the worldwide income either at the level of the head office of a multinational corporation or on its ultimate shareholders. But the former would not solve the problem of tax competition, since head offices themselves are also mobile. The latter is simply not practical; it would require a shareholder individual to be taxed on his share of the retained profit of a non-resident company that may have no economic activity in the shareholder's country. Since the income is not remitted to, and hence not observed by, the shareholder's home country, a tax on it would be impossible to enforce. A capital gains tax based on the valuation of assets held abroad would generate problems of valuation, and also possibly problems of liquidity if introduced on an annual basis.

A more radical idea is a *destination-based tax,* levied where consumers buy goods and services. If such a tax could be introduced, it would avoid distorting the location of economic productive activity since that would be irrelevant for ultimate tax liabilities. Instead, only the location in which a good or service was purchased would affect tax liabilities. Such a tax would also make intra-company financing and trading irrelevant for tax purposes; only the sale to a final consumer would affect the ultimate tax liability. This would make it much harder for multinational corporations to shift profits between countries. If individual consumers were relatively immobile, competition would be largely avoided.

In fact, introducing a destination-based tax is not as difficult as it might seem, since such a tax almost exists already. VAT is a destination-based tax on value added, and value added is equal to the sum of economic profit and labour income. It would be possible to levy a destination-based tax only on economic profit by increasing the rate of VAT, and making an offsetting reduction in taxes on labour income. Such a tax would be in the interest of an individual country to introduce on its own, since it would tend to attract activity from countries with source-based taxes. And if all countries used such a tax, then tax competition for capital and profit would be largely eliminated.

Chapter 6: Economic nationalism

The Treaty of Rome and subsequent EU treaties insist on the principle that national governments should not discriminate against residents of other member states. Economists claim that such a principle buttresses efficiency; it is inefficient, for example, to favour a national firm in public procurement if a foreign firm can supply the same good at a lower cost.

Yet, we have observed in recent years a number of incidents where individual countries have pursued nationalistic economic policies in a discretionary and selective way despite their pledge. Governments have intervened in financial markets so as to block or modify cross-border mergers involving prominent domestic firms. Attempts to subsidise national champions or to recapitalise and bail out national losers are still common. Such interventions may take several forms: influencing the location of firms, influencing control, political intervention to obtain contracts, state aid, state ownership, influencing technological standards to mention some examples.

The consequences of economic nationalism

Economic nationalism typically benefits private interest groups, often at the expense of consumers. Politicians can derive substantial private rents from nationalistic policies. These rents may be obtained in several ways:

- Buying the support of a political clientele in order to be re-elected.
- Investing in symbolic, visible projects in order to enhance one's own prestige.
- Distributing favours within networks of friends ("crony capitalism").
- The revolving door (securing comfortable fallback positions in large firms for politicians).
- Undercover finance of political parties in exchange for favours.

But economic nationalism may also benefit national residents as a whole, at the expense of foreign residents. The main underlying mechanism is the *transfer effect,* by which national residents benefit from the monopoly rents earned abroad by national firms, while not suffering as consumers. As a result, voters in each country may actually support policies that increase these rents, while aggregate decision-making at a higher level (say the EU) would take into account the welfare of foreign consumers and try to block these policies.

The costs imposed by economic nationalism have several dimensions. The most salient ones are associated with direct control/ownership of commercial firms and/or state aid to these firms. One can cite:

- *Lack of market discipline and poor corporate governance.* A firm that receives state aid has little interest in cutting costs and improving product quality, as losses are expected to be offset by the government. The firm's managers will have little incentive to rationalise production, to recruit workers adequately, to resist pressure for wage increases, and to innovate.
- *Productive inefficiency at the firm level.* Locational, technology and product choices are influenced by political considerations rather than economic efficiency.
- *Distortions in competition.* Government-supported firms can better stand losses as they expect to be bailed out by taxpayers. These firms are given a "deep pocket" from which to claim resources, which allows them a lower cost of capital and thus the possibility to undercut their rivals even though these rivals may be more efficient. Government-supported firms may also have better access to public infrastructure (airport slots, mail delivery etc.) and an edge in procurement contests.
- *Coordination failures.* The potential benefits of nationalism for a country are offset by the nationalistic policies of competing countries, while its costs in terms of distortions usually remain.

Despite the recent surge in economic nationalism, it is not clear how much of an actual bearing it has on the economy. Powerful counter forces exist. European Single Market rules make many nationalistic interventions illegal or subject to the approval of the European Commission. Business interests lobby actively against policies that meddle with their own managerial decisions. Cross-border merger activity is gathering pace in Europe. 2005 and 2006 witnessed several large value mergers or acquisitions. Economic nationalism may claim some victories in the short term but most likely will be defeated in the long term. This is because of the pressure from Brussels, because of the discipline imposed by international capital markets, and because of the fact that countries may fear retaliation if they shut their borders to cross-border mergers.

Policies to fight economic nationalism

The Commission and the wider public must keep an open eye on the dangers of economic nationalism. The tools of European competition policy are limited because of the different regulatory and ownership structures in different countries. European competition policy can control state aid and may be effective in checking support to national champions, but still cannot overcome regulatory barriers or limit the activities of state-owned firms except under the competition statutes. We propose the following:

1. Regulatory asymmetries should be overcome by harmonisation of regulation, coordination of regulators and the establishment of European regulators. In energy markets, for example, the unbundling of transmission (high-tension grid) and transport (pipelines) should be considered because they are a natural monopoly and the control of these bottlenecks by vertically integrated firms has high exclusionary potential. Interconnection capacity across boundaries

should be managed at the European level since firms and national regulators may not have the right incentives to provide interconnection capacity across countries. In general, a European system of regulators may be a commitment device to avoid opportunism and resist political pressure. A step in the right direction is the recent move to limit the leeway of central banks and national regulators to block foreign takeovers in the banking sector.

2. A debate should be opened about introducing a European rule that would severely restrict indefinite public ownership of corporations – even if it is only partial. Publicly owned firms distort the market for corporate control with severe adverse effects on industry restructuring as a consequence. Public ownership also introduces severe conflicts of interest for governments. Our proposal to radically restrict public ownership in competitive environments would go a long way toward eliminating the incentives for harmful nationalistic intervention. Most of the remaining public ownership today is a remnant of the past that has persisted for no good economic reason.
3. Entry barriers in different EU countries should be lifted simultaneously to avoid the strategic gaming and positioning of large firms and countries that follows from asymmetries in the deregulation process. A country that liberalises earlier than others puts the consumer first, but may give away opportunities for its firms to consolidate their positions and later expand in the deregulated markets in other countries. Coordinated deregulation across the EU may therefore be a necessary prerequisite for countries to deregulate sufficiently.