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### Europe

Alberto Alesina\*

Per capita income in Continental Western Europe (in short, Europe) was catching up with the United States from the end of the Second World War until the mid-1980s; from 1950 to about 1975, we speak of a European miracle. Then, something changed. The United States re-emerged from the difficult decades of the 1970s with a renewed political energy that led to deregulation, increased competition, reduction of marginal tax rates, and restructuring of corporations, which later facilitated the immediate adoption of the innovations from the information revolution. Europe, instead, seemed “stuck:” incapable of gathering sufficient energy to reform itself. This was especially the case for the largest countries: Germany, France, Italy, and Spain.

#### What Happened?

Let’s start with the basics. One of the most remarkable facts about Europeans is that they work much less than Americans. Europeans worked more than Americans in the 1950s and 1960s, when they were lowering their heads in the war reconstruction efforts, first, and then during a period of boom. But then Europeans began to work fewer and fewer hours per capita. While in the early 1970s hours worked per person were about the same in Europe and in the United States, today the French, German, and Italians work about 1400 hours per person per year versus about 1800 hours per person in the

United States.

There are three reasons why work hours per person are lower in Europe: 1) fewer people are in the labor force (early retirements, lower worker participation, delayed entry into the labor force, all in various combinations depending on the country); 2) more vacation time for those who do work; 3) lower hours in a “normal” work week. In different proportions for different countries, all three factors matter. For instance, in Italy the first factor, lower participation, is the driving force. In France and Germany, all three factors explain about a third each of the difference with the United States.

Europeans are working less and less for three reasons: first, increasing marginal tax rates (especially from the 1960s to the 1980s); second, a preference for leisure; and, third, labor regulation and union-imposed standards for work time, including retirement regulations. Social multipliers compounds these effects: if a family member or friend has more time off, your own benefit from leisure increases, creating more social demand for leisure. When it becomes the social norm, because of regulations requiring six weeks of vacation, or retirement at age 60 because the law imposes it, then it is difficult to change people’s minds about what is “fair.”

Working less and maintaining reasonable growth rates is possible if your productivity increases at a healthy pace. In fact, this has been the case for several decades in Europe in the 1950s, 1960s, and later through the 1980s. So, Europeans managed to keep up with the United States by working less but being more and more productive. But in the 1990s, European productivity growth fell below that of the

United States. Europe was slower to capture the benefits of the technological revolution in information technology (IT). Part of the reason was lack of competition in the product and, especially, the service markets. The slow pace of deregulation in these sectors created disincentives to innovation and investment.<sup>1</sup> An early deregulation in the 1980s, restructuring of companies, and a new generation of aggressive and powerful CEOs in the United States created the fertile ground on which the IT revolution could generate an exceptional period of rapid growth. In Europe, instead, incumbent firms continued with the old practice of government protection from competition and government hidden subsidies.

The second major rigidity in Europe is, of course, in the labor market. Firing costs interfere with firms’ decisions, making them cautious about hiring. Rather than removing these impediments (and introducing well thought out unemployment insurance schemes), several countries, especially France, seem unable to reform. Europeans remain enamored of “job security” which often means “security” for those insiders who have a job and no work for those who are not “in.” Progress in this direction, achieved in Denmark and Sweden, both of which have vastly reduced firing costs, has been immediately followed by a significant reduction in unemployment.

In summary, you can work less and less and not fall behind if you are more and more productive when you work. But several countries in Europe may have pushed this too far, and their policies are not sufficiently productivity enhancing. Perhaps Europeans have more or less consciously “chosen” to grow less than

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the United States and to fall behind economically and, as a consequence, politically, but this does not seem to be the official rhetoric emanating from European capitals.

## The Role of the EU

Has the European Union been able to increase competition and move the continent to market-friendly growth-enhancing reforms? The record is mixed. On the one hand, some progress has been achieved in the area of trade, government subsidies, and goods markets. But, on the other hand, Europe remains full of impediments to free market competition across national boundaries, especially in the service sectors and when it comes to mergers and acquisition.<sup>2</sup>

Rather than concentrating on this critical point of a common and truly continental free market, EU institutions have vested much energy in areas that are better left to national governments. An excessive tendency to “coordinate” and “plan” in Brussels has led to inconclusive rhetoric and displaced efforts.<sup>3</sup> One prime example of this is the glorified “Lisbon process” that sets detailed targets on socioeconomic variables, identical for all countries in Europe, and all to be reached within a certain time period. For example, the Lisbon targets specify how many children of different age groups should be in public childcare facilities in 2010 in all European Union countries, what the women’s participation rate should be in the labor force, and so on. Another example is the “obsession” with the coordination of fiscal policy imbedded in the details of the Growth and Stability Pact.<sup>4</sup> The need for tight coordination of fiscal policy in a monetary union has been vastly over-emphasized. Part of the problem is that certain countries historically incapable of keeping the fiscal house in order (like Italy and Greece) needed to be “constrained” with some external commitments, but lately even France and Germany have violated these budget rules.

Why did EU institutions make this mistake, namely focusing on excessive coordination? There are two reasons: one is, in part, a typical European tendency

to “plan,” and a favorable view of government dictated policies for achieving a multitude of social goals. The second is the resistance of national governments to truly open their markets, a resistance that has created obstacles to those European leaders who indeed understood the benefits of competition. In European capitals, often one hears a grand pro-European rhetoric, but as soon as non-domestic (but European) firms try to acquire domestic ones, the European rhetoric is immediately forgotten and nationalistic protection resurfaces.

## And the Euro?

Overall, the first six years of the Euro have confirmed the pros and cons that economists had identified regarding the construction of an average monetary union.<sup>5</sup> The Euro has eliminated the possibility of competitive devaluations that, in the end, cause inflation and has vastly reduced the risk premise of government debt of highly indebted countries, such as Italy. It also has facilitated financial market integration and possibly inter-regional trade and may have increased cross-national price competition.

On the other hand, it has imposed the same monetary policy on all country members. As it turns out, the economic cycles of countries in “Euro land” have been less correlated than one might have predicted; therefore, the common monetary policy does not indeed fit all countries at all times. The European Central Bank has been repeatedly accused of checking European growth and compared negatively to the pro-growth policies of the Federal Reserve Bank of Alan Greenspan. However, these criticisms of the European Central Bank are almost totally misplaced. First, this institution is often a convenient scapegoat for governments that do not have the will or courage to implement reforms. Second, these criticisms come from the misplaced view that the European sluggish growth problem is demand driven and that monetary policy could have helped in this regard.

Above and beyond the economic arguments in favor or against a monetary union in Europe, an additional

more “political argument” was put forward in favor of the Euro: the common currency, by shutting down competitive devaluations as a temporary “drug” for a national economy, would have facilitated the adoption of structural reforms in the labor, goods, and service markets. Thus far it has not quite worked, certainly not everywhere and with the necessary speed. Labor and goods market reforms, with the exception of a few northern countries, have been very slow to materialize and encounter great political opposition of two types. One is that of “insiders” who fear losing their privileges. Think of incumbent protected firms, unionized workers with job security, service providers sheltered by international competition, banks protected by foreign acquisitions, and so on. The second stems from the general European public, which by and large is “ideologically” averse to free market thinking. In fact, Europe, especially France, seems to be embracing more and more protectionist policies when it comes to foreign competition; and the Anglo-American pro-market approach is viewed more and more suspiciously. These tendencies are ingrained in European culture and reflect the history of ideas of this continent.<sup>6</sup>

Europeans talk about a “European model,” something that Germans refer to as a “social market economy,” and they contrast it to the Anglo-American free market model. Unfortunately, much of this thinking about a “European model” is fuzzy and ends up facilitating political compromises with privileged insiders. Europe does not have to adopt the American model; it certainly can have something distinct from it, say a system of efficient competitive markets coupled with extensive but efficient redistributive programs and social protection. Northern European countries are moving in this direction, but the major European countries are far from it. In these countries, the combination of regulation, protectionism, high tax rates, and redistributive programs end up creating unnecessary distortion and often directing flows of resources not to the truly needy but to politically powerful categories. Measure of effectiveness of welfare states in moving in the desired

direction for income flows from rich to poor vary dramatically across European countries; northern European countries do relatively well, Mediterranean countries are the worst. Lack of swift reforms in many European countries does not depend only on the inability of their leaders. Europeans themselves remain very suspicious of market liberalization. An interesting case in this respect is Germany. This country has received recently the “political shock” due to the assimilation of former East Germans. Evidence shows that their Communist experience has accustomed them to extensive government intervention and, as a result, they have moved the preference of the average German in this direction.<sup>7</sup> Europe faces great challenges in the near future. The need for reforms is clear; the political will is lacking.

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<sup>1</sup> A. Alesina, S. Ardagna, G. Nicoletti, and F. Schiantarelli, “Regulation and Investment,” NBER Working Paper No. 9560, March 2003, published in the *Journal of the European Economic Association*, June 2005, pp. 791–825.

<sup>2</sup> See A. Alesina, I. Angeloni, and L.

Schucknecht, “What Does the European Union Do?” NBER Working Paper No. 8647, December 2001, published in *Public Choice*, June 2005, pp. 275–319; A. Alesina and R. Wacziarg, “Is Europe Going Too Far?” NBER Working Paper No. 6883, January 1999, published in *Carnegie Rochester Conference Volume, supplement of Journal of Monetary Economics*, December 1999, pp. 1–42.

<sup>3</sup> A. Alesina and R. Perotti, “The European Union: A Politically Incorrect View,” NBER Working Paper No. 10342, March 2004, published in *Journal of Economic Perspectives*, Winter 2004, pp. 26–48.

<sup>4</sup> A. Alesina, I. Angeloni, and F. Etro, “International Unions,” published in *American Economic Review*, June 2005, pp. 602–15.

<sup>5</sup> A. Alesina and R. Barro, “Currency Unions,” NBER Working Paper No. 7927, September 2000, published in *Quarterly Journal of Economics*, May 2002, pp. 409–30; A. Alesina, R. Barro, and S. Tenreyro, “Optimal Currency Areas,” NBER Working Paper No. 9072, July 2002, published in *NBER Macroeconomic Annual*, 2002.

<sup>6</sup> A. Alesina and M. Angeletos, “Fairness and Distribution: U.S. versus Europe,” NBER Working Paper No. 9502, February 2003, published in *American Economic Review*, September 2005, pp. 913–35; A. Alesina, R. Di Tella, and R. McCulloch, “Inequality and Happiness: Are Europeans and Americans Different?” NBER Working Paper No. 8198, April 2001, published in *Journal of Public Economics*, May 2004, pp. 837–931; A. Alesina, E. Glaeser, and B. Sacerdote, “Why Doesn’t the U.S. Have a European-Style Welfare System?” NBER Working Paper No. 8524, October 2001, published in *Brookings Paper on Economic Activity*, Fall 2001, pp. 178–287; A. Alesina, S. Danninger, and M. Rostagno, “Redistribution through Public Employment: The Case of Italy,” NBER Working Paper No. 7387, October 1999, published in *IMF Staff Papers*, December 2001, pp. 447–73.

<sup>7</sup> A. Alesina and N. Fuchs-Schuendeln, “Good Bye Lenin (or not?) — The Effect of Communism on People’s Preferences,” NBER Working Paper No. 11700, October 2005.

## Consumer Demand for Health Insurance

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Since the early 1990s, prominent proposals for health insurance reform have focused on increasing consumer choice and competition among integrated health plans. Under “managed competition” models, consumers choose from a menu

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of health plans on the basis of price and quality. Proponents of these market-oriented plans argue that, in such a system, consumers will sort themselves into lower cost, higher quality plans; this pressure by consumers will provide strong incentives to health plans and their affiliated providers to control costs and increase quality in order to compete for enrollment. The Clinton administration’s Health Security Act and the “premium support” proposals for reforming Medicare are variants of the managed competition approach.

Although a “managed competition” model has yet to be adopted as national policy, many large employers organize their health benefits programs according to the same basic principles. Research on the behavior of employees and retirees in these employer programs provides a useful laboratory for the role of price and quality in consumer health insurance decisions.

One distinct problem for market-oriented solutions to health insurance is that, when consumers are offered a choice of