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Europe after the Crisis: *Dirigisme* vs Liberalism

Abstract

The socio-economic model of continental Europe seems to win over the Anglo-Saxon one during the current crisis (at least according to the British «The Economist»).

But one should also wonder if and to what extent figures show that this would-be victory is really taking place. Is this a completely unexpected result? Is it in line with economic literature or a new discovery in economics?

The Policy Brief analyses the functioning of these two competing models during the crisis and highlights their advantages and shortcomings to cope with the post-crisis era. A mid-way solution between them would represent a successful response but only if it could be included in the framework of the European Union. The EU seems the ideal and inevitable place to find a compromise but the sensitiveness of the future competences and powers to be handed over to the EU and the growing differences in the political space of the enlarged Europe are challenging this view.

Is it possible to find a "second best" solution not necessarily including the entire EU but – at least in the short-medium run – a part of it?

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The world is in the midst of a severe economic crisis whose effects are still not totally clear. Its social and political impact (i.e. changes in labour markets, ruling classes, etc.) is beginning to be felt, thus reflecting the lag that usually exists between changes in output and changes in employment (and political preferences).

Despite this lag, a large debate on the possible winning economic model in Europe after the crisis has been already prompted.

To put it simply, two models have been confronting each other in Europe so far: the liberal Anglo-Saxon model and the social market economy of continental Europe. One could argue that this draws an over-simplified picture out of which a much more complex situation exists. Indeed, significant differences can be detected inside these two alternative models and each encompasses – at least partially – many peculiar features of the other. For instance in continental Europe, the State-centred French economic model (the so-called *dirigisme*) cannot be fully matched with the German corporatist system and includes many elements of the typical Anglo-Saxon model (if anything for the French participation in the European Single Market). In addition, the relatively small North European countries have tried to follow an alternative path which puts together a large welfare state and free-market reforms.

Notwithstanding these differences, the identification of two competing models (Anglo-Saxon and continental) can be read as a good approximation of the reality, especially for the biggest European economies. This simplification can be extremely useful not only to evaluate the best economic model to cope with the current economic crisis but also to check its ability to be the preferred option for European countries (and the European Union as a whole) in the post-crisis era.

British *laissez-faire*? No, thanks

Despite the positive heritage of Thatcherism in Great Britain in the last decades, continental Europe has opted for a social market economy based on a "big-size" State. On the one hand, this implies higher taxes, heavy regulation of product and labour markets but, on the other, also a generous social safety-net.

This continental approach has always been criticised by "orthodox" liberals who have warned that a minor emphasis on free-market will lead – sooner or later – to less productivity of the economic system, less competitiveness in international markets and, ultimately, less economic growth and employment. Besides, the expensive welfare state may give rise to a debt-fuelled economy hampering the future development of a country and posing problems of inter-generational equity. In few words, the sclerotic continental economy appeared to be overregulated and too dependent on State interventions. This was the prevalent opinion on the continental model until a US-generated financial crisis turned itself into a full-blown global crisis which hit Europe last year with severe economic and social consequences unevenly spread across its countries.

The unparalleled intensity reached by the crisis is challenging this view and putting into question the success of models of economic development we have been experiencing so far.

In an increasingly uncertain context verging on real panic, some people have also raised doubts about liberalism itself and its future sustainability (for instance in environmental terms). As a result, the crisis risks to engulf not only the international economy but also the liberal approach itself, which is showing unexpected drawbacks in a truly globalised economy. But this criticism seems to be too extreme. Rather, the crisis is bringing back to the surface recurring, if not old, questions on the liberal economic system: the presence of the State in the economy; market failures; proactive use of fiscal policies; participation in international economic governance; the environmental sustainability of capitalism, etc[1].

These questions are not particularly original as they have been characterizing the capitalist system since its origins, but the depth and size of the current crisis are placing new emphasis on the best model – in the framework of a liberal approach – a European State should opt for. In particular, the uneven social impact of the crisis in Europe is stressing the limits and drawbacks of the Anglo-Saxon model while shedding light on the benefits of the continental one.

The British «The Economist» fuelled the debate on the best European economic model with an unexpected – and partial – *mea culpa* which touched upon the very core principles of the newspaper since its foundation in 1843: *laissez-faire* capitalism and decreasing role of the State in the economy. In particular, the newspaper stressed the fact that a «new European pecking order has emerged, with statist France on top, corporatist Germany in the middle and poor old liberal Britain floored»[2].

[1] These issues are extensively analysed in the volume *Liberalism in Crisis? The European Economic Governance in the Age of Turbulence*, in C. SECCHI - A. VILLAFRANCA (eds.), to be published by Edward Elgar in July 2009.

[2] See *Europe's new pecking order*, in «The Economist», May 9-15, 2009.

Indeed, data show that all the big European countries (with slight differences) have experienced a severe economic downturn in the last quarter of 2008 leading to a modest 0.9% of GDP growth for the EU as a whole on annual basis. Things will be even worse for the EU's GDP (-4.0%) next year. Clearly, no good news can be predicted for the three biggest European economies in 2009: -3.0% of GDP in France, -5.4% in Germany, -3.8% in the UK. In addition, the severe economic downturn will be inevitably mirrored by a dramatic rise in job losses. The average unemployment rate for the three countries is expected to increase by 8.8% in 2009 and 10.2% in 2010, with minor differences among them.

Nonetheless, the social impact of this downturn in 2009 (near-stagnation being the best forecast for 2010) and the reasons behind it are considerably different in the three countries just because of the adopted economic model.

In the UK, GDP reduction will be determined – to large extent – by a significant fall in domestic demand (-3.6%). Therefore, the limits of a small safety-net leading to a sharp decrease of private consumptions in times of crisis (-3.4% in 2009 and -1.5% in 2010) are crystal clear. In this context, it comes as no surprise that public consumptions will sharply rise in the next two years (3.6% and 2.9%, respectively, in 2009 and 2010) as part of the huge fiscal stimulus measures announced by the UK government. These measures are estimated to account for a quarter of the forecast increase in public deficit ratio (from 7.2% in 2009 to the impressive 13% in 2010). Obviously, this needs to be read as the attempt of the British government to counterbalance its modest welfare state (and the ensuing income squeeze for its citizens during the crisis) with new measures of public spending. This will also lead to an unprecedented increase in the UK debt ratio from 66% in 2008 to about 79% by 2010.

The situation is rather different in continental Europe. In this case, a strong welfare state already exists and automatic stabilisers – including unemployment benefits (such as redundancy funds, mobility allowances, solidarity contracts, etc.) – are working at full speed, even if mechanisms, amounts and timing differ for each country. As a result, the trend of private consumptions is not expected to be negative in France (+0.2% in 2009 and +0.3% in 2010), while a modest reduction is foreseen in Germany (-0.5% in 2009 and -0.7% in 2010). This implies a minor need for increased public consumption and fiscal stimulus (if compared with the UK) with lower pressures on public accounts. The French budget deficit is projected to rise to 6.5% in 2009 and to 7% in 2010, while Germany will reach 4% and 6%, respectively, in the next two years. These figures are definitely above the limits of the Stability and Growth Pact (SGP) but they look low if compared with the skyrocketed British data.

The differences between Germany and France stem from the main source of the GDP fall: foreign balance (60%) for the export-oriented Germany and stockbuilding (40%) for France (the foreign balance contributing for 33%) in 2009[3].

Therefore, the continental model seems to prevail in the wake of a crisis as it can rely on existing safety-nets that make the burden less painful for citizens.

On the political side, one could easily predict that people will clearly perceive the potential superiority (and advantages) of this model and tend to favour and vote for parties supporting it. As a result, the policy recommendation for the UK would not be simply to increase the size of the State by spending more but to improve the quality of the State intervention by spending better through constant and efficient investments (as the French health system demonstrates).

But in doing so, we are not certainly making a new discovery in economics. It has always been clear that the Anglo-Saxon model wins in times of growth but it makes the social impact of the crisis harder. Conversely, the continental model hampers growth potentials but makes the crisis less painful and its exit smoother.

One should also note that the systemic nature of the current crisis is contributing to emphasize the positive aspects of the continental model. Notwithstanding the uneven social impact, the presence of a symmetric external shock (as the crisis is hitting all the European countries) allowed the Council to ease the Maastricht criteria with no relevant complaint by member States. But in case of an asymmetric shock (hitting a State or group of States) governments would be required to get a special exemption from the EU (also under the revised SGP) to overshoot the 3% deficit criterion (and, in any case, respecting precise and narrow limits)[4]. This would inevitably reduce the available options of a single government and, ultimately, limit the benefits of the continental model since automatic stabilisers would not be allowed to work fully and no transfer from European funds could be foreseen.

In sum, the debate over the best model of economic development is anything but new. Also today's crisis is stressing benefits and

[3] Calculations by the authors on data provided by the *Economic forecasts - Spring 2009*, European Commission, Directorate-General for Economic and Financial Affairs, March 2009.

[4] In 2005 the Council has redefined the exception foreseen in TEC, art. 104, par. 2a: any (temporary) excess over the reference value which results from a period of negative growth rate (thus no longer a recession of at least 2 per cent, or 0.75 per cent), or even from the accumulated loss of output during a protracted period of very low growth relative to potential growth, should be considered as exceptional, and therefore not sanctioned. See C. ALTOMONTE *et al.*, *EU Fiscal Policy in the Age of Turbulence: will the Lisbon Strategy Survive It?*, in C. SECCHI - A. VILLAFRANCA (eds.), cit., p. 134.

drawbacks in line with the economic literature. Therefore, the issue to be tackled is not the validity of the Anglo-Saxon model and its potential substitution with the continental one but the ability to limit its overindulgence in some fields (i.e. financial markets) and rigidities in others (i.e. welfare state and income distribution) by introducing some features of the other model, and *viceversa*.

The State is obviously the actor which is supposed to draw the line between the two competing models and take economic and political decisions accordingly. But «The Economist» fails to consider another powerful tool in the hands of the States: the European Union.

Adding Europe to the argument

In a recent article[5], Mario Monti entered the debate over the two European economic models by pointing out that the crisis can be seen as an unrepeatable occasion for the EU. Each European government may keep its preferred model but its shortcomings could be toned down by searching a mid-point between the two competing models through a new European Pact.

In this regard, there is room for a negotiation in Europe because the supporters of each model have requests to present to the others which can be inscribed in the inevitable (and, in many respects, ideal) EU framework. Indeed, countries adopting an Anglo-Saxon approach are keen to reconsider some features of their economic model in light of its drawbacks in the wake of the crisis. But they also complain about a growing resistance of continental Europe to "free-market oriented" rules (especially on state aids and completion of the Single Market).

Similarly, time would be ripe for the latter to adopt some features of the Anglo-Saxon model. Continental Europe can overcome its traditional social resistance to changes by trading the huge public spending in times of crisis (including automatic stabilisers and fiscal stimulus plans) with structural reforms which people usually tend to reject. But it has also some complaints to present: the unavailability of countries supporting the Anglo-Saxon model to further increase the coordination of fiscal policies. This puts heavy constraints on the continental model since crises (and the inevitable collapse in tax revenues) reduce its ability to mitigate the downturn (especially in case of asymmetric external shocks).

In other words, the Anglo-Saxon countries fear the return of the spectre of economic nationalism, while the others highlight the constraints of a limited economic coordination leading to a lose-lose situation aggravated by competitiveness on fiscal policies and government bonds. According to some calculations[6], the huge wave of government bonds at world level to repay the increased national debts may range from 15 to 33 trillion dollars (depending on the future developments of the crisis). It is obviously an impressive amount (about 1/3 of world GDP) that would inevitably imply competitiveness on interests rates, problems in redeeming bonds at maturity (not only in small countries) and future inflation. Clearly, this situation is a big issue for the entire world economy but its consequences (especially in terms of competition) may be even worse for the European Union and, particularly, for the Eurozone. The limited scope of common measures in the Eurozone to face this challenge is striking and potentially very dangerous for the stability of the Euro.

In sum, the reciprocal complaints and requests could be matched in a European Pact searching for a mid-way solution between the two competing models and including viable way-outs to the fiscal competition and overabundant issue of government bonds. As a result, European governments could take advantage of the positive conditions (in terms of negotiation) created by the crisis and pave the way to a further step of the European integration process.

This would certainly be a desirable outcome. A sort of "first best solution" in line with the traditional integration

[5] See M. MONTI, *Un patto (vero) per l'Europa*, in «Corriere della Sera», May 10, 2009.

[6] See K. ROGOFF - C. REINHART, *The Aftermath of Financial Crises*, NBER Working Paper n. 14656, January 2009.

process of the EU. But notwithstanding these external positive conditions, one could arguably note that it is realistically difficult to reach a compromise in today's enlarged Europe for at least two negative internal conditions: number of member countries and type of competencies to be given to the European level.

In order to play a relevant role in the post-crisis international arena, the EU is requested to take decisive steps not only towards a stricter coordination in the economic field (including finance, fiscal policy, welfare state), but also towards a stronger external representation (involving foreign and defence policies, energy and environmental policies, etc.). Evidently, a new European Pact should also include agreements on these fields.

This approach has the advantage of being non-ideological and driven by concrete needs. Unfortunately, it would touch a raw nerve with many European countries because it would impact on the very existence of the States as independent entities and would push for a "quasi-federal" system.

In addition, the last enlargement of the EU has enormously widened the differences in the political space of the European Union and has made much more difficult to find a mid-way solution in the negotiation process. In a nutshell, the "bargaining set" (the cluster of policy solutions that represent Paretian improvements for everybody) seems to be almost empty in the enlarged Europe.

A clear example of these difficulties is represented by the Lisbon Treaty. The negotiation process took almost 10 years (including the unfortunate European Constitution). When hopefully Ireland ratifies the Treaty, it will be born old for it is was not drafted to face new challenges (such as the current crisis).

All in all, a "second best solution" should be found to overcome the limits of these negative internal conditions (broad political space and sensitivities of the new competences). Therefore, the practicability of another path should be taken into consideration: a multi-speed Europe better exploiting the opportunities of the enhanced cooperation foreseen by the Treaties[7]. This option is not intended to be discriminatory since each country would be free to decide whether and when to join the "smaller clubs". But it would allow the other countries – especially those with relevant common interests (i.e. the Eurozone for the fiscal and financial coordination) – to find a compromise by reducing the political space of the bargaining. Besides, this option would be successful only if it started a process leading to the participation of all the member countries in the medium run. By following this approach, the traditional European integration process (first sign a Treaty and then use the competences) would be turned upside down. Three new steps of the EU integration process should be followed. First, start an informal cooperation in a "small club" (including a better understanding of the implications for a multi-level decision-making context) by sharing new competencies on specific issues. Second, highlight the positive pay-offs of the new cooperation and involve other member States through a "one-by-one-approach". Third, include the new competences and powers – whose benefits have been already tested by many States – in a revised Treaty.

Should these steps be taken fully, probably ten years would not be required to sign a new Treaty.

And the winner is…

It is very unlikely that a one-fit-all model will emerge as a final solution for all the European countries in the post-crisis era. Both the Anglo-Saxon and the continental model show advantages in different periods. The latter is expected to better deliver in times of crisis, while the other tends to prevail in times of growth.

This article suggests that the winner of the context between the two competing model is a mid-way approach. It allows each country to keep its preferred model but, at the same time, aims at improving it through a bargaining taking place in the ideal and inevitable context of the European Union. Therefore, this non-ideological approach would lead to a new European

[7] See Articles 10, 280 (A to I) in the Treaty of Lisbon emending the Treaty on European Union and the Treaty establishing the European Community.

Pact allowing for a further step in the European integration process.

Unfortunately, the broad political space of the enlarged Europe and the sensitiveness of the new competences to be handed over to the EU risk to make this approach unrealistic. A second best solution may be offered by a non-discriminatory multi-speed Europe in which States will decide whether and when to strengthen their cooperation.

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