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Anders Åslund

How Can the EU Emulate the Positive Features of the East Asian Model?

Warsaw, February 2007

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Abstract

The spectacular, sustained economic growth experienced in several East Asian countries leads to the question what Europe can learn from the East Asian economic model. Three advantages of the East Asian model stand out: small social transfers, low taxation and free labor markets. The superiority of such policies is now widely accepted, and the question is how they can be emulated by Europe. Traditionally, the EU has taken a top-down approach to decision making and policy implementation, which is characteristic of the Lisbon Agenda, which has not made much progress. However, after the powers of the European Commission have been weakened in the last few years competition between national governments has spurred swift tax cuts and faster deregulation of labor markets. Bottom-up reforms arising from competition should be more readily accepted in the EU.

Introduction

During the last three-four decades, the East Asian model has emerged as seemingly superior to the West European model through persistently higher economic growth rates and broad social development.[c] For a long time, the high East Asian growth rates were perceived as merely a matter of catching-up from a low base. As the East Asians were creeping closer to the EU countries in GDP per capita, the East Asian model was taken more seriously, but so far only Hong Kong has just about overtaken the EU average GDP per capita in purchasing power parities.

The “East Asian miracle” started out as the single Japanese miracle after World War II, but the Japanese growth faded around 1990, and it is a separate story. The next impressive growth story was the four East Asian “tigers,” Hong Kong, Taiwan, Singapore, and South Korea, which took off in the early 1960s. Later on, the East Asian high-growth group broadened, and we shall discuss the six most developed East Asian countries: South Korea, Hong Kong, Singapore, Taiwan, Malaysia, and Thailand. All these countries have reached such a GDP per capita that they are no longer developing countries, and they all represent the East Asia model as discussed below. In its original study *The East Asian Miracle,* the World Bank (1993) also included Indonesia and the Philippines among eight “high-performing Asian economies,” but they remain far poorer and are less relevant for a comparison with Europe. China has produced high economic growth since its reform start in 1978, but it, as well as Indo-China, remains very poor. China and Indo-China are also systemically peculiar as only partially reformed communist economies. Besides, China is so big that statistically it would drown all the other countries. The EU of comparison is the EU of 15 countries from 1995 until 2004, as these countries define the EU model.

The first section establishes what the East Asian model actually amounts to and how it compares with the EU model. In the second section, we summarize main idea of the discussion of the East Asian model after the Asian financial crisis in 1997/98. The third section considers how the EU model could be altered so that it would be able to adopt the desirable features of the East Asian model.

[c] Julija Remeikaite has provided me with valuable research assistance.

1. Characteristics of the East Asian Model

The reason that made the World Bank single out the East Asian economies was that they had maintained rapid, sustained economic growth of 5.5 percent a year between 1960 and 1990. The World Bank (1993, p. 8) emphasized that what distinguished these economies from other developing economies was their high investment rates, including unusually high rates of private investment, and high and rising endowments of human capital due to universal primary and secondary education. These factors were assessed to account for roughly two-thirds of the growth in these countries, while the remainder was attributable to improved productivity.

Over time, East Asian growth rates have slowed down somewhat. The (unweighted) average annual growth rate in the decade 1996-2005 was 4.3 percent in the six East Asian countries to compare with 3.0 percent in the EU-15. If the growth rate of the EU-15 were weighted it would decline about one percentage unit to 2 percent a year. The difference might not appear impressive, especially as the average GDP per capita in purchasing power parities in East Asia was $21,600 to compare with $33,000 in the EU-15 in 2005 (see Table 1). However, the East Asian numbers in this period were reduced by the t devastating effects of the 1997-1998 East Asian currency and financial crises. The difference is not conspicuous but still significant. It can hardly be explained merely by a laggard effect of economically more backward countries growing faster, if they pursue the same economic policies as already richer countries.

Table 1. GDP in East Asia and EU-15

	GDP, % growth, 1996-2005	GDP per capita, PPP, 2005
East Asia		
Hong Kong	3.9	33 479
Korea	4.5	20 590
Malaysia	4.8	11 201
Singapore	5.2	28 368
Taiwan	4.5	27 721
Thailand	2.8	8 368
Average	**4.3**	**21 621**
EU-15		
Austria	2.2	33 896
Belgium	2.1	32 524

	GDP, % growth, 1996-2005	GDP per capita, PPP, 2005
Denmark	2.1	34 367
Finland	3.6	31 367
France	2.2	30 104
Germany	1.3	30 253
Greece	3.9	22 691
Ireland	7.5	38 075
Italy	1.3	28 396
Luxembourg	4.6	68 681
Netherlands	2.6	34 359
Portugal	2.4	19 707
Spain	3.7	27 284
Sweden	2.8	31 691
United Kingdom	2.8	32 265
Average	**3.0**	**33 044**

Source: World Bank World Development Indicators database (2007); IMF World Economic Outlook database, September 2006

How has East Asia been able to achieve the high growth rates and rates of investment in both physical and human capital and what can other countries learn from this experience? This is the key question asked by the World Bank (1993), which has become the standard source describing the key elements of the "East Asian model." East Asia is quite a varied region with regard to history, culture, and economy. Public policy in East Asian countries has also been far from homogenous, but some key elements have been more or less common.[d]

- *Conservative macroeconomic policy.* All countries have long adhered to "sound fundamentals" - maintaining low budget deficits, inflation, and low current account deficits – which has created a stable business environment and encouraged high savings and investment rates. Over the last five years, inflation in the region averaged 2.3 percent and current account and government budget were in surplus of 9.0 percent and 0.4 percent of GDP, respectively (see Table 2). These sound monetary and fiscal policies distinguish East Asian countries from other developing countries and even many developed countries. The advantages of "getting the basics right" remain unchallenged even while many other recipes for growth have gone out of fashion.

Since the adoption of the Maastricht criteria, the EU has also pursued quite a conservative macroeconomic policy. The average budget deficit from 2000 to 2005 was

[d] The summary below draws on World Bank (1993) and Stiglitz and Yusuf (2001).

tiny – 0.8 percent of GDP, and inflation has lingered around 2.2 percent, even better than East Asia's (see Table 2). The explanation of the lower inflation in the EU is that the East Asians have maintained undervalued exchange rates by buying up large international currency reserves, while the EU has focused on combating inflation, which has been facilitated by the common European Central Bank. The EU does not appear to have much to learn from the East Asians with regard to macroeconomic policies.

Table 2. Stabilization Indicators in East Asia and EU-15

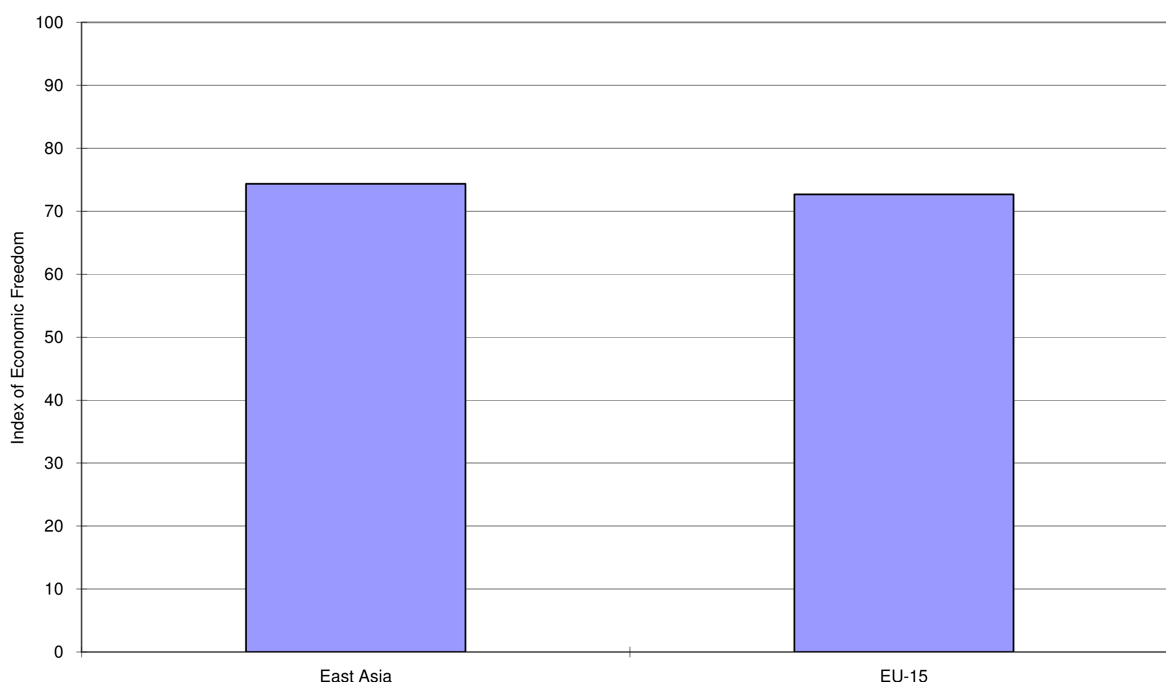
	Budget deficit, % of GDP, 2000-2005	**CPI, % growth rate, 2005**	**Current account balance, % of GDP, 2001-2005**
East Asia			
Hong Kong	-2.2	0.9	9.0
Korea	1.9	2.7	2.2
Malaysia	-	3	11.4
Singapore	5.7	0.5	20.9
Taiwan	-3.9	2.3	7.0
Thailand	-1.4	4.5	3.7
Average	**0.4**	**2.3**	**9.0**
EU-15			
Austria	-1.2	2.3	-0.1
Belgium	0.2	2.8	3.6
Denmark	1.5	1.8	2.8
Finland	3.8	0.9	7.6
France	-2.9	1.7	0.2
Germany	-2.7	2	2.3
Greece	-5.4	3.5	-7.2
Ireland	1.2	2.4	-1.0
Italy	-2.9	2	-0.9
Luxembourg	1.8	2.5	9.3
Netherlands	-0.9	1.7	5.1
Portugal	-4.7	2.3	-8.0
Spain	-0.1	3.4	-4.7
Sweden	1.6	0.5	5.9
United Kingdom	-1.5	2.8	-1.8
Average	**-0.8**	**2.2**	**0.9**

Source: World Bank World Development Indicators database (2007);
IMF World Economic Outlook database, September 2006;
UN Economic Commission for Europe database (2007)

- *Economic freedom.* Overall economic freedom has actually not been much of an argument, and curiously economic freedom in East Asia and the EU-15 is almost

identical and among the highest in the world, with East Asia slightly ahead of the EU-15 (see Chart 1). Prices and trade have been free.

Chart 1. Economic Freedom in East Asia and EU-15



Source: Heritage Foundation and the Wall Street Journal *2007 Index Of Economic*

- *Export orientation.* Export orientation is generally considered to have been the "engine of growth" in East Asia. The state provided strong incentives for successful exporters via subsidies and favorable credit terms. It also maintained competitive exchange rates, which contributed to domestic companies' export success. Because domestic markets are relatively small in the majority of the countries, export markets have been crucial to achieving efficient production scales. By maintaining open markets and by exposing domestic industries to foreign technology and foreign competition, these countries have been able to achieve rapid rate of technological progress, which was critical for their economic growth. Disagreement over the subject of efficacy of exports in generating high growth rates centers on the question of causality. Some countries, such as South Korea and Taiwan were not particularly open in 1960s and maintained significant protective tariffs and import substitution policies. High degree of openness in these countries evolved only gradually, accompanying rather than preceding the process of economic growth. Over time, freer trade has won out.

Europe has an old and proud tradition of free trade and open markets. One of the greatest achievements of the European Union is the single market. In this regard, East Asia has essentially followed Europe's successful lead. East Asia is still lagging behind in terms of freedom of trade but not much.

Table 3. Tax Burden in East Asia and EU-15

	Public Expenditure, % of GDP, 2003-2005	***Doing Business* total tax payable by businesses, % of gross profit, 2005**
East Asia		
Hong Kong	22	14
Korea	-	30
Malaysia	21	12
Singapore	15	20
Taiwan	-	-
Thailand	17	29
Average	**19**	**21**
EU-15		
Austria	50	51
Belgium	50	45
Denmark	53	63
Finland	50	43
France	54	52
Germany	47	50
Greece	47	48
Ireland	34	45
Italy	48	-
Luxembourg	43	45
Netherlands	45	48
Portugal	48	53
Spain	38	60
Sweden	56	53
United Kingdom	45	53
Average	**47**	**51**

Source: Eurostat; IMF World Economic Outlook database, September 2006;
IMF *Government Finance Statistics Yearbook 2005*;
World Bank *Doing Business* database 2006

- *Small social transfers.* Low public expenditures on social transfers are hallmarks of East Asian economies. In this sphere, the difference between East Asia and Europe is huge. In 2005, total public expenditures in East Asia amounted to some 19 percent of GDP to compare with 47 percent of GDP in the EU-15 (see Table 3). Almost all the additional

public expenditures in Europe are devoted to social transfers. The difference in policy on social transfers stands out as one of the most important qualitative contrasts between the two models.

- *Low Taxes*. A natural consequence of the limited costs of social security in East Asian is that taxes can also be kept relatively low. By all measures, East Asian taxes are far lower than in Europe, whether considering personal income taxes, corporate profit taxes or consumption taxes. One of the easiest and most relevant measures is corporate profit taxes. According to the World Bank study *Doing Business*, the average corporate profit tax as a share of gross profits of businesses is 21 percent in East Asia to compare with 51 percent in the EU-15, that is, about two and a half times higher (see Table 3).[e] The lower taxes should contribute to higher growth rates than the European welfare state model.

- *Free labor markets.* The conventional view holds that little state intervention in labor markets has significantly contributed to high growth rates in East Asia. According to the World Bank study, "in East Asia, more than elsewhere, governments resisted the temptation to intervene in the labor market" (1993, p. 266). Since wages flexibly adjusted to the demand for labor, East Asian economies have been able to adjust to changing economic conditions more quickly and less painfully, maintaining high employment levels. In 2005, when the whole world was booming, the average unemployment rate was 4.7 percent in East Asia, which appears a reasonable approximation of full employment, to compare with 7.1 percent in the EU-15 (see Table 4).[f] Moreover, the difference in the rigidity of the labor markets is great with the European labor markets being about twice as rigid, or over-regulated, as the East Asian markets.

- *Strong education.* A persistent and common feature of all the East Asian countries has been a strong tendency to invest in both public and private education. In recent PISA comparisons of education by the OECD in various developed countries, the East Asian countries regularly cram the top of the tables with the qualitatively best education. It is a great challenge for Europe to catch up with them, though Finland has already succeeded

[e] Admittedly, the real tax rates are difficult to compare because the tax bases and deductions are defined differently even within Europe, leading to disparate measurements. The overall point, however, that the profit taxes are far higher in Europe is indisputable.
[f] The figure is comparatively low because we used an unweighted average, considering that most big European countries have more unemployment than the small countries.

in beating most of them. Clearly, the disparity among EU countries is great, and this is and will remain a sphere of national policy among the EU countries.

Table 4. Labor Markets in East Asia and EU-15

	Unemployment, % of labor force, 2005	***Doing Business*** **Rigidity of Employment Index, 2006**
East Asia		
Hong Kong	5.7	0
Korea	3.7	34
Malaysia	4[g]	10
Singapore	3.1	0
Taiwan	4.1	56
Thailand	2e	18
Average	**4.7**	**20**
EU-15		
Austria	5.2	37
Belgium	8.4	20
Denmark	4.8	17
Finland	8.4	48
France	9.5	56
Germany	9.5	44
Greece	9.8	58
Ireland	4.3	33
Italy	7.7	54
Luxembourg	4.5	-
Netherlands	4.8	42
Portugal	7.6	51
Spain	9.2	63
Sweden	7.8	43
United Kingdom	4.7	14
Average	**7.1**	**41**

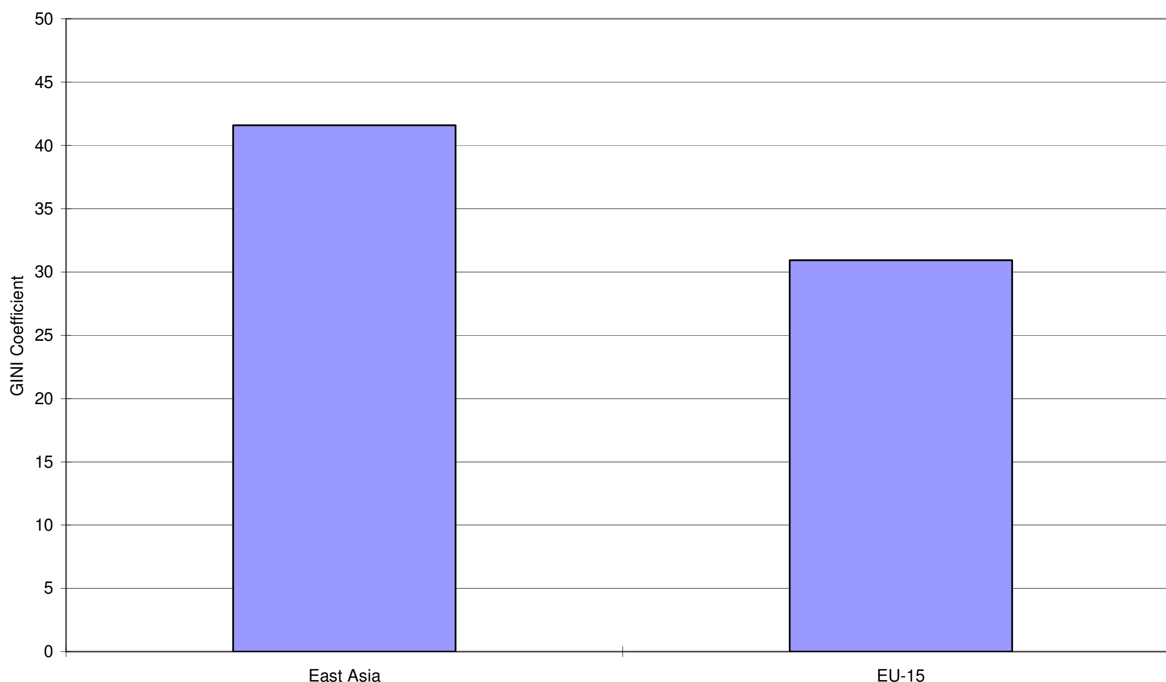
Source: World Bank World Development Indicators database (2007);
IMF World Economic Outlook database, September 2006;
UN Economic Commission for Europe database (2007);
World Bank *Doing Business* database 2006

- *Income inequality*. The World Bank labeled East Asia as "rapid growth with equity." Despite low social transfers, East Asian countries have *moderate income inequality*. High GDP growth rates have led to development of large middle class, and absolute poverty rates have declined sharply. As measured in Gini coefficients, East Asia is significantly

e. 2004 data.

less egalitarian than Western Europe, but it slightly less so than the United States, which had Gini index of 44 in 2005 (see Chart 2).

Chart 2. Inequality in East Asia and EU-15: Gini Coefficients (Latest available data)



Source: World Bank *World Development Indicators* database (2007)

- *Substantial state intervention.* A very centralized economic decision making power also characterizes many East Asian economies. Among the countries under consideration, the most highly interventionist state strategies were followed by South Korea and Taiwan, while Hong Kong and Thailand were mostly non-interventionist. As the World Bank report summarizes, policy intervention took many forms:

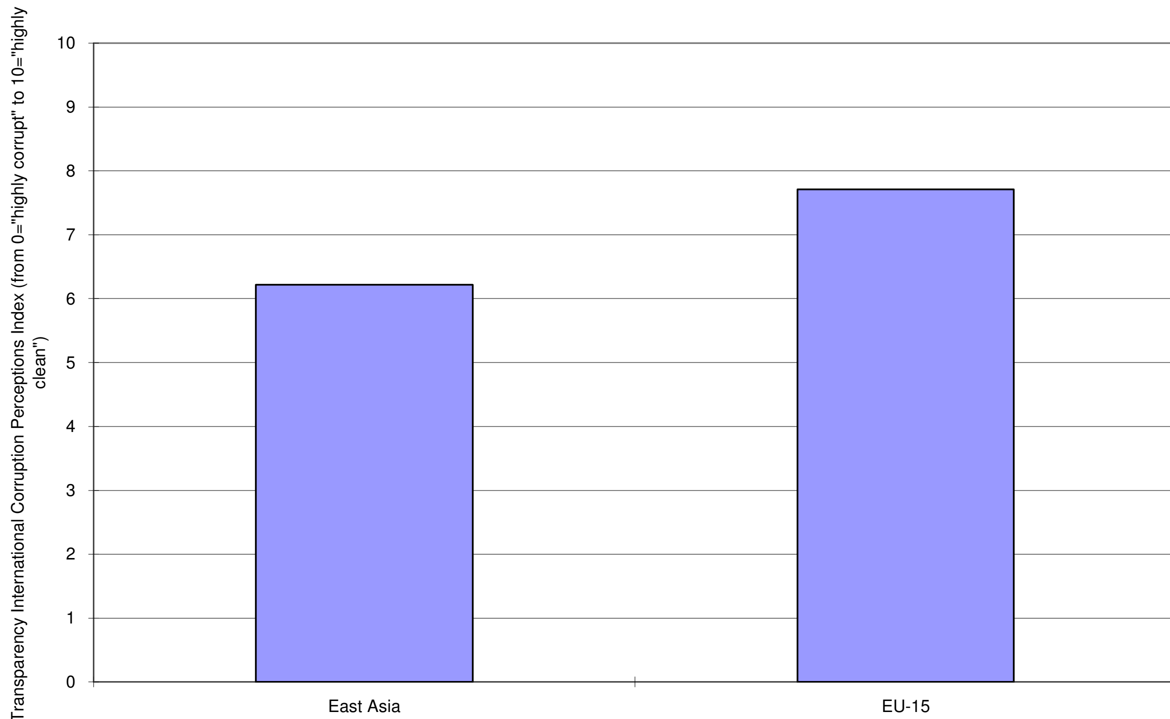
> Targeting and subsidizing credit to selected industries, keeping deposit rates low and maintaining ceilings on borrowing rates to increase profits and retained earnings, protecting domestic import substitutes, subsidizing declining industries, establishing and financially supporting government banks,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

The governments of South Korea and Taiwan actively supported the development of specific sectors, especially heavy industry and high-tech sectors. Their industrial policy involved active promotion of research and development through direct and indirect subsidies, and the less justifiable policies that allocated credit to preferred sectors, projects, and firms. Whether industrial policy was a major source of growth in these economies remains in question.

The EU hardly needs to learn anything from East Asia with regard to state intervention. If anything this has been a negative feature in the standard East Asian model which strangely has not cost all too much in terms of economic growth. A broad consensus in the economic growth literature now sees state intervention as a negative influence (Barro and Sala-i-Martin 2004).

- *Tolerance toward corruption.* Corruption varies greatly in the region. As measured by the Transparency International corruption perceptions index, Singapore persistently ranks as one of the most transparent countries in the world, but most of the others are somewhat more corrupt than the EU countries, making the group somewhat more corrupt than the EU-15 (see Chart 3; Transparency International, 2006). The special government and business relations in East Asia that have been celebrated once as one of the causes of high growth have been denounced as "crony capitalism" after the crisis and blamed for the severity of economic downturn that struck these counties. Multi-country regression analysis has firmly established that corruption is bad for economic growth (Mauro, 1995).

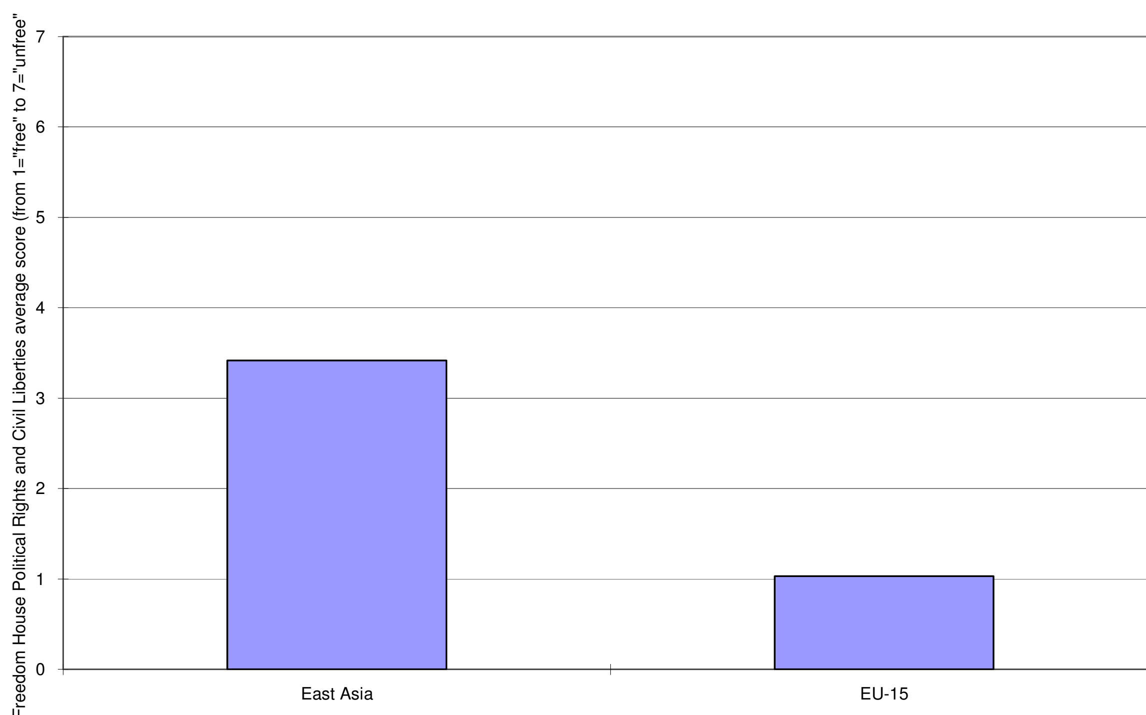
Chart 3. Corruption in East Asia and EU-15



Source: Transparency International (2006)

- *Mild authoritarianism.* Another part of the "Asian development model" is a strong bureaucracy able to achieve the developmental goals of the state. This "strong state" in the East Asian context frequently means an authoritarian, centralized state. According to the report recently released by the Freedom House (2007; see Chart 4), the region saw little change over the last year with majority of the countries remaining partially free. Thailand was even downgraded from "partly free" to "not free" in the last year.

Chart 4. Political Freedom in East Asia and EU-15



Source: Freedom House (2006)

Evidently, the East Asian model is no panacea in comparison with the EU model, but it has a strong record of higher economic growth, based on higher investment in physical and human capital as well as productivity growth. In several regards, the two models are very similar, namely they both pursue conservative macroeconomic policies, maintain great economic freedom, and free trade. In three important regards, the East Asian model appears to have clear advantages over the EU model: smaller social transfers, lower taxes, and freer labor markets. As a consequence, income differentials are somewhat greater in East Asia, which has also some rather unattractive features: substantial state intervention, somewhat high corruption, and mild authoritarianism.

2. Discussion of the East Asian Model

The East Asian model has provoked an extensive debate. Partly, it has been concerned with how large the quantitative effects have been of its different features. This debate has then been followed by an ideological, interpretive debate on what conclusions to draw.

In 1994, Paul Krugman (1994) initiated an animated debate about the East Asian model, claiming that growth in the region was not sustainable because it was primarily based on factor accumulation – eventually subject to diminishing returns, rather than productivity growth. The East Asian "miracle" was not caused by a superior economic system but only great savings. Krugman argued that total factor productivity made a negligible contribution to growth in much of industrializing East Asia. His interpretation appeared prophetic as it was presented before the financial crises of 1997-98, which indicated that East Asia had over-invested. According to Krugman (1997, p. 27), the Asian growth was "mainly a matter of perspiration rather than inspiration – of growing harder not smarter."

Several econometric papers were written in response to Krugman's assertions (notably, Collins et al., 1996; Iwata et al., 2003; Ito and Krueger, 1995; Ito and Rose, 2004). Iwata, Khan and Murao (2003) provided a late and convincing econometric analysis. They found that Hong Kong, South Korea, Singapore, and Taiwan, the original Asian tigers, had very similar total factor productivity growth of 3.4-3.9 percent over the long period 1960-95, and total factor productivity accounted for no less than 44-47 percent of the output growth of each country during that period. Capital accumulation, by contrast, contributed only 25-28 percent of their output growth. Besides, something in their economic model apparently made East Asians save and invest more, which appears a good thing in itself. East Asia's great investment in human capital is even more obviously positive.

The East Asian model dawned upon the world as a miracle when the former Soviet Bloc was undergoing its transition. Leftwingers and rightwingers picked and chose what they liked in the East Asian model and emphasized that they were the cause of the success, and they naturally chose opposing elements in line with their ideological preferences. What leftwingers particularly liked about the East Asian model was the state intervention. Its soft form of dirigisme appeared to work. A dominant idea was that the state could and should try to pick industrial "winners," but the roles suggested for the state were rather limited. Although a certain tolerance

for state ownership was suggested, nobody really advocated more state ownership (Amsden et al., 1994; Aoki et al., 1996; Stiglitz, 1996). Some even went so far as to advocate tolerance of corruption (Amsden et al., 1994).

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

The East Asian currency and financial crises of 1997-98 radically transformed the international opinion about the East Asian experiences.[h] It tested the many hypotheses of the ground for the East Asian miracle. A sense spread that something was profoundly wrong with this model. The view brought to fore by Krugman (1994), that growth was increasingly driven by increasing factor inputs rather than increased total factor productivity, was reinforced. Two major conclusions were drawn.

First, an obvious shortfall was pegged exchange rates at unrealistic levels, which had little to do with the model as such (Stiglitz and Yusuf, 2001, pp. 8-10). The East Asian countries adjusted their exchange rate policies. Formally, they have more or less floating exchange rates, but, in effect, they manipulate their exchange rates downwards by purchasing huge international reserves. Their fiscal policies became even more conservative. Leftwingers focused on what they considered premature financial liberalization, which had been advocated by the IMF (Stiglitz 2002). Both the left and the right criticized the IMF for excessive intervention after the crisis had erupted. The change of exchange rate policy did not have any real ideological consequences.

Second, the benefits of industrial policy with directed credits and subsidies were seriously challenged. This ran against the arguments of particularly Alice Amsden (1989; Amsden et al., 1994), who had cherished South Korea's state interventions. More broadly, the opaque governance system of both state and big corporations was questioned. The right saw

[h] See Adams and Ichimura (1998); ADB (1999); Henke and Boxill (2000) and Jomo (2001).

"crony capitalism," the corrupt intertwining of large business and government, as the main problem (Krueger 2002). In this regard, the right won a major victory.

A large number of other arguments were raised that were soon forgotten, because soon the crisis turned out to have been much less profound as first appeared to be the case, with Indonesia being a partial exception. These countries' economic models changed little, though their capitalisms became slightly less crony. Robert Barro (2001) concluded that a sharp reduction of economic growth had occurred, especially in the five countries directly hit (Indonesia, Malaysia, South Korea, the Philippines, and Thailand). In particular, their investment rates were reduced. Still, in his broader analysis he found no evidence that financial crises had effects on growth that persisted beyond a five-year period. At present, the East Asian model looks almost as attractive as before the crisis, although growth rates have faded somewhat. It has become significantly more capitalist (Gill and Kharas, 2006). The leftwing case for the success of the East Asian model most strongly made by Alice Amsden (1989) for South Korea is quite difficult to maintain today.

3. Adaptation and Reform of the EU

Today, it appears evident what the EU should do. It needs to emulate the three fundamental advantages of the East Asian model:

1. lower social transfers,
2. lower taxes, and
3. freer labor markets.

The assumption is that lower public transfers offer people greater incentives to save for their own social security, and lower taxes increase their possibilities to do so. Lower taxes also offer people better incentives to invest in their human capital through education. A deregulation of labor markets will improve the allocation of labor and reduce unemployment, and thus reduce the need for social transfers to the unemployed. A broad consensus has evolved among economists that these steps are necessary for Europe's future. The question today is how the EU model can most easily adjust to these three requirements, that is, how the economically vital can come politically possible.

In principle, two competing approaches exist, top-down or bottom-up change. Traditionally, Europe has been a disorderly and decentralized place, where each country has gone its own way. The European Union changed that from its very outset. The essence of the Treaty of Rome is that the EU members get together and decide unanimously what the Union as a whole should do. That is, the Rome Treaty introduced a top-down approach that was previously alien to Europe as a region. All joint EU decisions, including the whole *acquis communautaire* and the Lisbon Agenda, belong to this category. Strangely, this top-down mode of action has been taken for granted for long. The sources of inspiration were many. The fundamental EU idea – no more war! – suggested that all countries should get together and agree. Another inspiration was of course the ideas of central planning and social engineering so prevalent after World War II. The soft version of central planning is international harmonization and standardization. Even when the EU has advocated deregulation of various markets it has done so in a centralized fashion rather than in a competitive manner.

The EU mode of operation and its decision-making mechanism are now under scrutiny, especially after the referendums on the European Constitutional Treaty in the summer of 2005 in France and the Netherlands rejected the Treaty. Another reason for disappointment with the EU top-down approach is that the Lisbon Agenda seems just about dead. Although the EU had solemnly declared clear quantitative targets, little action was taken to reach these goals (Gros 2007). A third concern is that the *acquis communautaire* functions as a conserving force. One rule after the other is added to the *acquis,* but it appears close to impossible to deduct anything from it. As a result, the EU is becoming petrified and overregulated. Finally, time and again, leaders of European countries complain about "tax dumping" and "wage dumping," appealing to common EU policy to stop more liberal countries to pursue competitive policies. The old EU model appears to have failed in practice, and it offers the wrong incentives. Rather than facilitating necessary reforms, it impedes them.

To contemporary Europeans, the centralized EU model is seen as the way things are done in Europe. Naturally, the tremendous economic progress after World War II reinforces the European sense of having seen the light through the formation of the EU. Although this is true in general, it does not mean that the current EU model is perfect, as is evident from its inability to adopt the mentioned desirable reforms.

Economic historians with a longer perspective present a very different European model (Rosenberg and Birdzell, 1986; Landes, 1998). One of the clearest points of view has been put forward by David Landes in his discussion of "European Exceptionalism" from the middle ages. Landes argues that the strength of Europe lay in fragmentation:

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

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

- The economic expansion of medieval Europe was thus promoted by a succession of organizational innovations and adaptations, most of them initiated from below and diffused by example. The rulers, even local seigneurs, scrambled to keep pace, to show themselves hospitable, to make labor available, to attract enterprise and the revenues it generated (p. 44).

In fact, it appears as if this traditional European approach of competitive evolution, which has been the hallmark of Europe throughout the centuries, has come to the fore after the failure of the constitutional referendums. The most obvious example is the tax competition that is spreading from the East. It started in 1994 in Estonia with a 26 percent flat personal income tax (now 24 percent), and ever lower flat income taxes have proliferated to Lithuania (33 percent in 1994, now 30 percent to be reduced to 24 percent in 2008), Latvia (25 percent since 1997), Russia (13 percent since 2001), Ukraine (13 percent in 2004), Slovakia (19 percent in 2004), Georgia (12 percent in 2005), Romania (16 percent in 2005), and Kyrgyzstan (10 percent in 2006). In spite of predictions to the contrary, the flat personal income taxes are continuing to spread (Keen et al., 2006). Needless to say, liberal migration rules within Europe will further sharpen tax competition.

Tax competition is naturally even more evident for corporate profit taxes, as capital is more mobile than labor. They have fallen from levels of 30-50 percent in East-Central Europe to currently 15-19 percent in most of East-Central Europe. In the last years, Europe stands out as the part of the continent where overall taxation has declined.

Another feature characteristic of Europe today is competitive deregulation of goods, service, and labor markets. Some of this deregulation is inspired by the European Commission, but most of it is not. Examples are the very gradual deregulation of the labor markets that almost most EU countries now are pursuing (Lenain, 2007). The big breakthrough was Margaret Thatcher's acrimonious deregulation in the 1980s, which was later emulated by Ireland,

contributing to that country's great economic success. Even if European deregulation is tardy and piecemeal, it is steady.

As competitive tax cuts and deregulations have already got the upper hand in Europe, the policy issue is primarily to let it happen. The most fundamental question about Europe's future might be whether tax competition will be allowed or not. If tax competition will be allowed, the overall tax pressure is likely to fall toward the lowest level, that is, from currently about half of GDP to barely one third of GDP, the level in Romania and Lithuania (EBRD, 2006). At present, tax competition is allowed, but it is highly controversial. Especially, German and French politicians have called for it being curtailed, while its champions are most of the new members, the United Kingdom, Ireland, and Luxemburg. In 2006, German Minister of Finance Peer Steinbrück lashed out against Austria because its decision to cut corporate tax rates from 34 percent to 25 percent: "In the case of Austria we are dealing not with a moderate position but a rather ambitious and aggressive attempt to get companies to come to Austria" (Parker, 2006).

When did competition become bad? Sensibly, as part of its radical market reforms, Ireland reduced its profit tax to 12.5 percent, and Estonia has abolished it altogether as undesirable. The most intense tax competition is taking place within Switzerland, where most of the tax is determined by the cantons. Now, the European Commission wants to limit this tax competition that is even outside of its jurisdiction because the European Commission deems it "unfair," which presumably is Eurocratese for competitive (Simonian, 2007). But European tax competition is strong and on the rise with the integration brought about by the single market. A sign of how far European tax competition has gone is that even France's President Jacques Chirac, one of the greatest complainers about "fiscal dumping," has proposed to slash France's profit tax from 33 percent to 20 percent (Houlder, 2007). Before his demise even German Chancellor Gerhard Schröder, the other great enemy of "tax dumping" made a failed attempt to reduce the German federal profit tax by 6 percentage units. The EU needs to adjust to the most liberal model. No other decision is likely to be as important for the nature of the EU as whether tax competition remains permitted.

4. Conclusions: Competition Revives Subsidiarity

The hype about the East Asian miracle has abated, as not only its advantages but also drawbacks have become evident. But a consequence is that the prime advantages of the East

Asian model have become all the more obvious, namely low social transfers, low and relatively flat taxes, and free labor markets, leading to high investment in both physical and human capital and high economic growth. Hardly anybody praises its minor remaining crony features as benefits after the Asian financial crisis of 1997/98, notably state intervention, more corruption and less democracy. A broad consensus, as reflected in the Lisbon Agenda, agrees that the EU needs to emulate these three features of the East Asian model not to be left behind in near stagnation and ultimate decline.

The question today is not if the EU needs to adopt these three liberal features of the Asian model, but how to do so most easily. The main idea of this paper is that the centralized mode of resolving problems within the EU, which has accomplished a great deal, has reached its limits. What Europe needs today is not primarily greater ability to make rational top-down decisions but a greater acceptance of bottom-up reforms of taxation, social transfers, and deregulation, based on Europe's traditional comparative advantage, competition among the European countries and regions. This means that tax competition should be welcomed and facilitated. The same is true of regulatory competition, notably labor market deregulation, which will be greatly facilitated by freer movement of labor.

We may attempt a concrete prediction as these changes are already under way. Since enterprises are easily relocating from one country to another, we could expect corporate profit taxes to rapidly fall toward the interval 10-20 percent of net profits. Labor is much less mobile, and a higher taxation of labor would be feasible. However, given the new trend to adopt flat income taxes in the range of 16-25 percent in several new EU members, personal taxation might go through a radical reduction because of example and moral imperative rather than factor mobility. A natural consequence would be that the total burden of taxation declines from about half of GDP to one third of GDP, which appears a reasonable level (Tanzi and Schuknecht 2000). With anticipated greater labor mobility within the EU, the need for Europeanization and harmonization of pension rules and payroll taxation is becoming ever greater, which would probably have to be done in the old top-down fashion. Evidently, because of fiscal constraints, the systems of social transfers have to adjust, which is likely to be done incrementally at a national level. Ever since Britain's deregulation of its labor market in the 1980s, similar reforms have spread piecemeal through Europe. After they have proved both their economic and social efficacy, they are likely to proliferate further.

The European Union has long cherished the principle of subsidiarity in theory. In reality, however, the rhetoric has suggested that everything needs to be done top-down by the European Commission. The referendums of the summer of 2005 provided the EU establishment

a rude surprise. The productive outcome might be that subsidiarity becomes reality, and that the excessively hierarchical mode of functioning of the European Union becomes supplemented with a healthy element of horizontal competition between countries and regions.

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