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POLICY

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RRP: $9.95 NZ$10.95 • **Vol. 25 No. 2** • Winter 2009

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9 781031 663488

DOES EUROPE STILL MATTER?

Europe's economic weakness is a problem for Australia, writes **Oliver Marc Hartwich**

Talking about Australia's economic prospects, we often tend to look outwards. After all, Australia is a relatively small, open economy and, therefore, conditions abroad matter greatly to the domestic economy. This is particularly true for a country with a strong resources sector.

Over the last few years, Australians have focused primarily on China. Reading the business sections of Australian newspapers, you get the impression that the rest of the world hardly matters as long as Australia continues to benefit from China's rise. Whether the United States will manage to sort out its financial system or Europe can deal with its troubled economies seems not nearly as important as the question of whether China will continue to import Australian commodities. Consequently, not much attention is being paid to European affairs in Australia. All eyes are on Beijing, not on Paris, Brussels, Berlin, or Bratislava.

In a sense, Australia's fascination with China is completely understandable. With the exception perhaps of the invention of the internet, nothing in the past two decades has changed the global economy as much as the rise of China. After Deng Xiaoping's famous endorsement of the market economy in 1992, the country's transition from a relatively closed economy to an economic heavyweight has happened at a remarkable speed. China not only became the world's largest exporter but also one of the largest importers of commodities. It now accounts for roughly a quarter of global metal consumption.

Few countries have benefited from the spectacular rise of China as much as Australia, for obvious reasons. First, Australia is geographically well placed for trade with China. Second, Australia can offer many of the commodities that China demands. Last year, Australian copper ore exports to China increased by 48 percent while iron ore exports almost doubled at 99.7 percent.[1] Third, Australia benefits from having a large number of Chinese speakers in its workforce, further facilitating trade.

China has become one of Australia's largest export markets, second only to Japan. Whereas only a decade ago Australian exports to China were below A$5 billion, by 2008 Australia's exports to China had climbed to A$32.5 billion. Given this development, it is unsurprising that Australia's economic focus has shifted from its traditional trading partners to China and, to a lesser degree, other Asian countries.

However, such a perspective is slightly misleading. While in both relative and absolute terms China has undoubtedly become much more important to Australia, traditional export markets such as the United States and Europe should not be neglected, either. Though 14.9 percent of

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Endnotes for this essay can be found at www.policymagazine.com.

Australian merchandise exports went to China in 2007–08, the European Union still accounted for 10.6 percent, according to Department of Foreign Affairs and Trade (DFAT) figures.[2] In terms of total trade (exports and imports), Europe had a share of 15.8 percent of Australian trade, which was still higher than China's 15.1 percent.[3]

The current economic crisis has hit Europe particularly hard and will have implications for Australia. While Australia's hopes of getting through the global recession are largely pinned on China managing to avoid a major economic downturn, Alan Kohler recently warned in *Business Spectator* that 'the unfolding disaster in Europe offsets the signs of a government-sponsored recovery in China.'[4]

Whether Kohler is right with his pessimist prediction, there should be no doubt that what happens in Europe will have repercussions in Australia. For this reason alone, it is worth paying close attention to European affairs at least as much as to China.

Where is the European Union heading? How are Europe's economies dealing with the repercussions of the financial crisis? And where will the continent be when the crisis is over? These are the questions that should be asked in Australia because the state of Europe still matters to our economy.

Between Lisbon Strategy and Lisbon Treaty: The state of the Union

If everything had gone according to the European Union's plans, then of course there would be no need for concern. After all, the European Council had agreed at a summit in the Portuguese capital in 2000 that within a decade, the European Union should become 'the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment.' While it is hard to argue that the Europeans were lacking ambition, the so-called Lisbon Strategy soon turned out to be a toothless tiger.

When the former Dutch Prime Minister Wim Kok was commissioned to deliver an interim report on achieving the Lisbon targets, his assessment was downbeat. '[T]he overall picture is very mixed and much needs to be done in order to prevent Lisbon from becoming a synonym for missed objectives and failed promises,' the group led by Kok wrote in their report.[5] But even this grim statement was on the euphemistic side. Far from turning the European Union into a region at eye-level with the United States in terms of employment rates, labour productivity, and research spending, the Europeans had fallen even further behind the Americans. In fact, the results from Kok's interim report were so disappointing that the European Union refrained from setting itself further targets for the coming years. After all, the Union could miss the targets again. This begs the question what is more embarrassing: failing to reach targets or cowardly not setting any targets at all?

Instead, the European Union resorted to what it does best, namely posturing about what it would like to achieve rather than mention the paucity of its accomplishments. Speeches by the President of the European Commission José Manuel Durão Barroso are full of statements such as 'the EU is not content to simply lead by example: we are actively challenging the global community to share our ambition,'[6] but concrete action hardly ever follows such rhetorical grandstanding.

For example, when the European Commission recently held an EU Employment Summit in Prague, it came up with a list of 10 suggestions (e.g. 'Maintain as many people as possible in jobs' and 'Identify job opportunities and skills requirements') so abstract and meaningless that the only employment that followed from the summit was for the ministerial bureaucracy to translate this empty statement into 23 different languages and prepare further meetings on the issue in Madrid, Stockholm and Prague.[7] Although EU politicians must be aware that employment policy is almost exclusively done at the national level, this did not deter them from showing a commitment to job creation.

Jobs have also been created for lawyers. The think tank *Open Europe* recently estimated that the *acquis communautaire*, the body of EU law, has reached 170,000 pages in total.[8] While paying lip-service to deregulation and reducing red tape, European law has kept on expanding.

The failure of the Lisbon Strategy is symptomatic for the state of the European Union and its institutions. What began as a small group of countries coordinating some of their policies, has over 50 years since the signing of the Treaty of Rome in 1957 grown into a complex organisation with ambitions to play a role in nearly every policy area. However, its institutional capacities have not grown nearly as fast as its ambitions.

It is telling that for each of the past 14 years (!), the European Court of Auditors has refused to sign off on the EU budget on grounds that significant amounts of money were being misspent. Needless to say, in EU-speak even the fourteenth consecutive rebuke of its budget could be turned into something positive. The EU Executive's Vice President Siim Kallas, who is responsible for administration and anti-fraud, seemed delighted with the result: 'The European Commission welcomes the auditors' constructive analysis and will continue efforts to improve its financial management to address the weaknesses identified.' Who would bet against 2009 being year 15 without signed-off accounts?

The European Union's democratic deficit is legendary. It is often joked that no country as undemocratic as the Union itself would be allowed to join it. Decisions in the Union are driven by the executive. For instance, the European Commission has the monopoly of initiative in introducing legislation in the European Parliament. The parliamentarians, on the other hand, cannot draft legislation themselves. Although the European Parliament has gained some competencies over time, it still does not work like an ordinary Parliament. And despite having MEPs from 27 countries representing not fewer than 204 political parties, Parliament seldom works as a place of debate, especially not when it comes to the question of closer European integration.

Whereas polls regularly show public opinion to be divided or even hostile to transferring more power from the national level to the European Union, the European political class is almost unanimously in favour of further integration. To make matters worse, there is very little public interest in the proceedings of the European Parliament, something that Czech president Vaclav Klaus pointed out in an address to Parliament. He warned that '[s]ince there is no European *demos*—and no European nation—this defect cannot be solved by strengthening the role of the European Parliament either,' at which point many MEPs walked out of the chamber. Apparently, the parliamentarians were not used to listening to dissenting points of view. It must have been a completely new experience for them.

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The European Union's strange attitude to democracy was further exemplified in its attempts to introduce a Constitution for Europe. In 2001, the European Council initiated the constitutional drafting process by calling for 'more democracy, transparency and efficiency in the European Union' (Laeken Declaration). This sounded too good to be true—and it was. How democratic this new Constitution was going to make the European Union became obvious when two countries, France and the Netherlands, rejected the Constitution in referenda. This should have been the end of the Constitution because it could not come into force unless ratified by all member states. But Europe's governments simply agreed to change the name from Constitution to Lisbon Treaty, amended a few marginal provisions, and went ahead as if it had never been defeated. Even former French president Valéry Giscard d'Estaing, who was president of the convention that drafted the original Constitution, admitted that the Lisbon Treaty and the Constitution were virtually the same.[9]

The change of name allowed the European Union to ignore the Dutch and French votes, but when the Lisbon Treaty also failed to win a referendum in Ireland, the European Union was temporarily in crisis again. The solution it found was very EU-like: instead of giving up on the Constitution project, the Irish were to be asked to vote a second time. It is a strategy that has worked in the past: when Denmark did not vote for the Maastricht Treaty in 1992, it too had to vote again to produce the result that the Union demanded from the Danes. Given this bizarre procedure, how likely is it that Europe's voters would believe the promises of greater democracy and transparency?

One European institution that has in the past contributed much to open markets is the European Court of Justice. In its landmark *Cassis-de-Dijon* decision of 1979, it had strengthened the principle of free trade within the European member states against interventions of national governments. But if the court's most recent decision is anything to go by, there are doubts that it will continue this free trade line. It upheld Germany's antiquated laws that only allow pharmacists to own pharmacies, in effect banning international pharmacy chains. While the court stated that this law was a restriction on freedom of establishment and the free movement of capital under EU law, such restrictions could be justified on public health grounds, to be determined by the member states. Never mind that pharmacy chains operate in many countries around the world without detrimental health effects.

If such flimsy, fabricated public health arguments are enough to strike down the most fundamental rules of the common market, then the protection of trade within the Union may be hollowed out by national governments. From here to protectionism lies a slippery slope, and this completely undermines the rhetoric of open, competitive markets in Europe.

> The European project has reached a point at which it stifles the development of its member states.

For all these reasons, the European Union, as it presents itself today, is a monstrous, undemocratic and increasingly sclerotic structure. EU politicians and officials may still indulge in visions of creating the world's most prosperous region, but this cannot deflect from the fact that the European project has reached a point at which it stifles the development of its member states.

German agony, British decline, Eastern Europe on the abyss

For the future development of Europe we cannot expect too many positive impulses from the European Union, if any at all. Unfortunately, politics at the national level of Europe's countries does not give much reason to be cheerful, either. While it is true that the global financial crisis had its origins in the United States, it has mercilessly revealed the weaknesses of many European economies. We shall briefly look at Europe's two largest economies, Germany and Britain, here but let's not forget that the situation in France, Spain, Ireland or Italy is not much better.

Germany

Germany has Europe's largest economy, but the former engine of European growth has been stuttering for many years. Charles Dumas of Lombard Street Research recently calculated that Germany's GDP has hardly grown since 2000. 'Already we have real GDP levels that are up only about 3pc from 2000 in Germany ... —i.e. growth has been only a little over ¼pc a year—making this a lost decade for much of continental Europe on a worse scale than Japan in the 1990s,' he said.[10]

Some economists believe that Germany's problem is that it has focused too much on exports while neglecting demand in its domestic market. It is a perspective often heard from Keynesian economists who conclude that the lack of domestic demand in the German economy can only be cured by the state. However, the real problem lies elsewhere.

Despite some limited economic reforms under the centre-left Schröder government, Germany's economic policy has been in virtual standstill for more than a decade, not least because of a so-called Grand Coalition in which the coalition partners cancelled each other out. All of Germany's problems are well known, well documented, and well researched: its ageing population; its financially unsustainable commitments to public health and pensions; its overly complex and burdensome tax system. Besides, taxes and duties still account for more than half of Germany's GDP.

It is thus little wonder that German consumers do not spend much. Considering all taxes and duties, even people on moderate incomes have marginal tax rates well over 50 percent. Given these high taxes, it is also understandable that Germans enjoy among the longest holidays in the world: if working more than necessary is not worth much, then taking time off work becomes a much more attractive option.

Faced with severe structural problems in many areas, Germany's growth outlook is grim. In the first quarter of 2009, the economy contracted by 3.8 percent. The country's leading economic research institutes forecast unemployment approaching 5 million people within the next two years, and the budget is showing record deficits. Whether any of these problems will be tackled also depends on the forthcoming general elections in September. Holger Schmieding, an economist at Merrill Lynch/Bank of America, warns that 'if the centre-right again fails to win a majority this September, German economic policy would likely shift further to the left, with higher taxes, more minimum wages and probably some reversal of earlier labour market and welfare reforms.' But even if Germany gets a centre-right government for the first time since 1998, it is not clear whether Chancellor Angela Merkel will find the courage to implement an agenda of unpopular, yet necessary, reforms.

Britain

If the outlook for Germany is not rosy, the prospects for Britain may be even worse. For many years the British saw themselves as a model for the rest of Europe. While the economies on the continent were struggling, Britain celebrated 'Cool Britannia' and its 'post-modern economy' based on financial services and 'the creative economy.' At the same time, Britain's Labour government embarked on a spending spree that put much pressure on the UK budget.

The global financial crisis has revealed that much of this British model had been built on sand. House prices, one of the pillars of UK growth, have fallen off a cliff; the banking system is in shambles and had to be part-nationalised; unemployment is projected to reach 3 million by next year.

Meanwhile, the UK's public finances have dramatically deteriorated. Chancellor Alistair Darling forecast annual deficits of more than £170 billion for the next couple of years, but even this could be too optimistic. Standard & Poor's was the first ratings agency to warn Britain that it could soon lose its AAA ranking.

Unfortunately, neither British party seems to have any idea how to move the country out of its quagmire. The British state accounts for half the country's economic output, yet neither party has the courage to make the necessary cuts to public spending to put Britain's finances back on a more sustainable footing. Britain faces an uncertain future with the threat of sovereign default looking no longer like a remote possibility.

Eastern Europe

Both Britain and Germany show how the Western European economies have been affected by the financial crisis. The situation is probably even worse in parts of Eastern Europe. On the difficult path of transition from communism, many Eastern European economies have become heavily indebted. This alone would be problematic enough during a credit crunch, but to make matters worse the debt has often been taken out in foreign currency. For example, it is estimated that in Poland some 60 percent of mortgages are denominated in Swiss Francs.[11]

According to some estimates, Eastern Europe has borrowed a total of US$1.7 trillion abroad; the repayments for this year equal up to a third of the region's GDP. It is therefore possible that some Eastern economies will soon find themselves unable to fulfil their commitments. Such defaults would not only be a problem for Eastern Europe but also for the lending countries. Austria is one such lender whose banks are heavily engaged in the Eastern European economy to a tune of about 70 percent of Austria's GDP. It does not take much to imagine what a default would do to Austria's banking system.

As if all of this was not bad enough, the problems in Europe cannot be contained to just a single country. Thanks to the common currency, the Euro, difficulties in one country affect other Euro nations. Although the Maastricht Treaty, which established the monetary union, explicitly rules out bail-outs for member states, in practice it will almost be impossible for European governments to refuse emergency measures. Whether they make economic sense is a different question, but then again the Euro has always been a political project. Finance ministries of hitherto relatively stable economies such as Germany or France are anxiously watching developments in Eurozone members with weaker public finances such as Ireland, Greece and Italy.

Policy options for Australia

No matter from which angle one looks at the state of Europe, the picture is not pretty. Europe's national economies are battling severe problems. In most Western European economies, the state sector has become too big and the high taxes needed to feed it are sucking the lifeblood out of the economy. Eastern European economies are faced with incredible amounts of foreign-denominated debt that they are struggling to serve. All of this is happening within a European Union that is losing its original commitment to promoting intra-European trade while stifling development through a combination of political centralisation and bureaucratisation.

In the past, Europe's political class has not shown the leadership needed to turn things around. In Italy, Prime Minister Berlusconi did not use his mandate (and his influence over the media) to consolidate the country's finances. In France, President Sarkozy did not live up to the expectation that he would become the French equivalent of a Margaret Thatcher. In Germany, Chancellor Merkel shied away from her original reformist agenda after her pro-market campaign nearly cost her party the last general election.

If Europe's problems do not get solved, the European brain drain will continue. This is bad for Europe, but potentially good for countries such as Australia.

Things look unlikely to turn around in a meaningful way. In all likelihood, we can expect a further deterioration of Europe's public finances, a substantial increase in unemployment across the continent, and weak economic growth for years to come. Europe's ageing population will further slow economic dynamism.

All of this would not matter to us here if Europe were not one of Australia's biggest trading partners. But since it is, Australians should ask themselves how to react to the seemingly inevitable European decline.

Since Australia cannot directly influence developments in Europe, all it can do is prepare for the consequences of a prolonged period of economic weakness in Europe. On the one hand, this will mean that Europe's importance as a trading partner will decrease further. Australia is well advised to pay even more attention to what is happening in other regions, particularly in Asia.

But Australia could also benefit from Europe's problems, albeit indirectly. It is likely that economic circumstances in Europe will deteriorate further. In particular, many European countries may have to increase taxes to balance their budgets. In such a situation, Europe could become a much more burdensome place to do business and an even more frustrating location for ambitious individuals and entrepreneurs. Faced with marginal tax rates beyond the 60 percent or even 70 percent mark and confronted with regulatory burdens beyond the imagination of most Australians, there could be a substantial number of well-qualified, mobile people looking for attractive, alternative places to live and work outside Europe.

Looking at recent emigration levels from European countries, we can see that this exodus from Europe has already begun. Between 1997 and 2006, nearly 2 million Britons left their country, and that was at a time when the British economy was still growing.[12] The same picture in Germany: More than 160,000 people left the country in 2007, many of whom were highly qualified.[13] A survey compiled for the Economics Ministry revealed that a large proportion of German migrants named high taxes and a complicated bureaucracy as important factors contributing to their decision—and this was before the economic crisis.

If Europe's problems do not get solved, the European brain drain will continue. This is bad for Europe, but potentially good for countries such as Australia. There will be thousands of well-qualified British entrepreneurs, German engineers, and Polish doctors. Is Australia ready to recognise this as an opportunity?