Panel 3

The Role of the State in the Economy: Centralisation or Subsidiarity?

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The topic of the panel, the topic of the summit – the role of the state – and this panel the role of subsidiarity is extremely timely, obviously, both for Europe and the United States. Both the European Union and the United States are in a state of crisis right now. The crisis has different features in our two zones, and analysing it – contrasting the features of the US fiscal system and role of the state and the counterpart in the European Union – is, I think, extremely helpful. In the United States we are facing a chronic budget crisis and an undersupply of public goods. Europe is facing a crisis of a starkly divided Europe and the inadequacy, in some ways, of the European-level institutions to address that sharp division.

So let me turn first to the United States and offer some brief thoughts. The United States right now is in a crisis of the state. In my view a crisis of chronic undersupply of public goods – infrastructure, education, healthcare, help for the poor, help and financing even for diplomatic and international development initiatives – and that undersupply of public goods is creating a certain kind of rot in the US economy and society right now. We are not supplying the public goods to narrow income inequalities, to help the poor escape from the cycle of poverty, to ensure an adequate level of healthcare, education, family care or day care for young children that the normal high-income society would produce. The United States has become more unequal in income and wealth than at any time in US history. The redistribution of income from the super-rich to the working class poor is very limited right now, and there are extremely stark ideological divides and differences of opinion about what to do.

I would put it this way: the United States is essentially the lowest tax revenue country within the high-income world, within the OECD high-income countries, when you measure tax revenues as a share of gross domestic product. The United States, including federal, state and local government revenues, is now collecting about 31/32 percent of GDP in revenues, even significantly less this year because of the business cycle. And that is far below the European average of 40 percent of GDP, and, of course, far, far below the levels of northern Europe, which reach nearly 50 percent of GDP or even higher in some countries. The United States is chronically, from a social, ideological, political-organisational point of view, an anti-tax society – the whole country was born in an anti-tax rebellion – and US federal tax paid as a share of national income has been fairly constant, about 18 percent of GDP over nearly half a century. State and local taxation has risen gradually and very modestly to perhaps 10 or 12 percent of GDP, leading to this overall level of roughly 30 percent of GDP in tax take.

We cannot run our society at this level but the public does not really know it, unfortunately. Our federal taxes are completely eaten up by the military budget, Medicare and Medicaid in health, Social Security, and interest payments on the debt. All the rest of government at the federal level, whether it is infrastructure, education, energy, agriculture, diplomacy, international assistance – that is all on borrowed money now because we don't raise enough revenues actually to run our government. Yet politically the Republican Party is essentially 100 percent organised around further tax cuts. The Democrats are more or less organised around holding things where they are, and almost no one is telling the truth to the American people that you cannot run a modern society at 30 percent of GDP in total revenues. That is the American crisis. In terms of the division of those revenues, the federal government is collecting, as I said, about 18 percent of GDP and the state and local governments about 12 percent of GDP in revenues. So they are divided roughly two-thirds at the federal level and one-third at the state and local level. I think, from a division point of view, that is probably OK. I'd even like to see a bit

more at the federal level, because the states themselves are engaged in a race to the bottom right now, where they are each trying to cut their taxes to try to attract business from their next-door neighbours. That kind of race to the bottom is, of course, a classic prisoner's dilemma where each of our state-level government decision-makers is operating in a game that is leading to a loss of revenues for all of the states and inadequacy of public goods provision that is being exacerbated by that race to the bottom.

Now the US system from a subsidiarity point of view has the fairly desirable feature that first there is lots of mobility within the country and there is a fair amount of redistribution of income through the federal tax system – partly it is direct taxation at the federal level that is directly redistributed to state and local governments in programs like Medicaid, part of it is the play of automatic stabilisers, where when one part of our country has an economic decline its tax burden goes down automatically while the receipts of federal moneys go up in unemployment compensation and so forth. So we have a fairly good internal redistribution system both through migration and the fiscal system, but the crisis is that the overall level of public revenues is chronically too low and the American society, in my view, is sinking as a result of this. We are simply losing the bottom half of the population, which is not getting the healthcare, the skills, the infrastructure and the environmental safety it needs. And the whole world is paying a price when the United States is unwilling to invest in sustainable energy and climate change, in global poverty reduction and so on.

On the European side, at least my view looking from outside in, is that the overall levels of taxation – averaging about 40 percent of GDP and going up to about 50 percent of GDP – are far better than the United States. I don't think Europe is overtaxed, despite the usual assumption. I think the United States is undertaxed, and I hope Europe preserves its tax base. Europe's problem, it seems to me, if you compare it to the US system, is that Europe collects all its taxes at national, state and local levels and very little at the European-wide level through the assessments to the European Union. So if you take the EU or the euro area as the analogy to the US federal level, then the EU has a budget of about 1 percent of the gross product of the EU, I understand, and that means in effect there is no significant collection at the European-wide space. And I think Europe pays a price for this, quite predictably. When the euro was established, something I strongly supported then and continue to support now and believe in, I published a paper at the time that said Europe is obviously not an optimum currency area, even though it is interconnected economically. Migration levels are rather modest and fiscal policy is national, not European-wide. There are not automatic stabilisers European-wide; there are not cross-country transfers European-wide; there is no mechanism for bank bailouts European-wide. And of course Europe is living through that drama right now. It does not really have an effective response today to Portugal, Greece, Ireland – Spain to some extent, although I am more optimistic about Spain.

When a part of Europe, especially the southern tier or Ireland, gets into a deep crisis, this is borne entirely – I think it is fair to say – at the national level. The most Europe has done is to give some fairly short-term loans. But there is no fiscal remedy, and migration, which of course should be a part of the solution, exists but is rather moderate. So my take on the European side, simply put, is that the overall level of taxation is much smarter than in the United States because Europe can run a civilised economy, one that has social security, one that makes transfers to the poor, one that ensures coverage of healthcare, one that ensures better quality of public education and more access to higher education, one that actually delivers more social mobility in Europe than in the United States these days according to all of the OECD findings. So don't slash taxes for the US liberal model. We don't provide the public goods we need to hold our society together. But do find a way, in my opinion, to bolster the role of the fiscal system at the European-wide level so that there can be more automatic stabilisers, more cross-country transfers and more ways to resolve these sharp crises that arise when the poorer and more vulnerable regions of Europe fall into crisis, even as the heart of the European economy, especially Germany and northern Europe, are doing quite well. It's kind of a convergence argument in a way.

I'd like to see the United States be more like Europe, especially more like northern Europe, and I'd like to see Europe be a bit more like the United States of Europe – the famous idea – in terms of acting like a somewhat more unified fiscal space to go along with the unified monetary area and the unified single market. I am a huge fan of what Europe has accomplished. I think it is the best model of regional integration in modern history and for the world. And I think it needs to continue to be in the forefront and adding that part at the European-wide level in my

opinion would bolster the great results that Europe has achieved in its modern history. So continue to be a role model for us in the United States. Eventually we will learn something about being civil even to our poor people, and we will learn that taxes are not the bane of civilisation but the key to it. And I hope that together then the North Atlantic can be a dynamic role model for the rest of the world economy rather than two regions holding on for dear life as we watch China and India and others soar.

Panel

John Peet of *The Economist* chaired the third panel and started by drawing two conclusions from the conference thus far: (1) the size of the state is probably too large but because of demographic pressure it will not be possible to shrink it very much, perhaps only to 40–45 percent of GDP; and (2) Europe has a very low productivity growth which underscores the importance of making our public and our services sectors more productive.

The first panel speaker was **Norbert Reithofer,** CEO of the BMW Group, who stressed the role of governments in ensuring that "we have the freest possible markets with few trade barriers and world-wide fair competition on a level playing field". Promoting new technologies, such as e-mobility, is an important joint task of government and business.

In the opinion of **Dennis M. Nally,** Chairmann of PWC International in New York, "we all have an interest in making sure that free-market capitalism works properly". Despite the different models, we all share one core assumption: "the private sector and not the state must be the primary engine for economic expansion". Many issues, like trade, currency, financial crime and the climate, can only be dealt with at the international level. These issues should be addressed not only by governments but also by businesses: "business has to maintain a more central role in sustaining the market system and improving its performance in society as well".

The problems of the banking sector in Britain were described by **Lord Oakeshott of Seagrove Bay,** Liberal Democrat Member of the House of Lords. Making banks safe is vital for the future of the British and European economies. The banking system in Britain is so large "that it dwarfs the rest of the economy. To compete with New York, Frankfurt and Zurich, Britain unfortunately ended up with a 'light touch regulation' of the banking sector". Britain now has a very distorted economy with a huge financial and a small manufacturing sector. It is the job of the state to curb the power of the banks.

Rolf Alter, Director for Public Governance and Territorial Development of the OECD, asked whether we have taken advantage of the crisis to re-establish the balance between government and markets. We need to look not only at government size but also at its quality, which is a matter of how government interacts with citizens and with business. Europe also needs to look beyond its borders, especially at the dramatic developments in North Africa and the Middle East. In terms of government quality, the OECD with its 34 member countries strives to be a 'club of good policy practices'.

The last panel commentator, former German MP **Friedrich Merz,** stressed that our problems need to be solved at the European level. The EU Internal Market has been a great success, with the EMU as the next logical step. The promise of a stable currency has been kept, but the promise of a political union is still outstanding, and it is precisely the current crisis that is showing is the 'lack of political integration in Europe'. There are consequences of this deficiency. (1) ESM will only buy time, in which a 'restructuring mechanism' for states in the EU must be devised. (2) Competitiveness must be improved, but within a Europe with a stronger political union.

In the discussion, Mr. Peet asked about the acceptance of a 'transfer union' in Germany. Friedrich Merz replied that Germany has benefitted from EU developments in the past twenty years. Since much of Germany's wealth depends on the euro, it is obliged to help the troubled countries. This requires a sort of transfer union in Europe, which must be properly constructed. Hans-Werner Sinn replied that it is a 'false assessment' to say that Germany gained most from the euro. The euro has helped Europe in general including Germany, but under the euro capital flowed out of the country into the European periphery, "while Germany had the lowest net investment share in GDP among all OECD countries". This retarded growth in Germany led to mass unemployment and to a real economic depression. The domestic economy stagnated, which necessitated the Schroeder reforms. It is 'a big mistake' to interpret the export surpluses as a gain for Germany. In response, Mr. Merz pointed to

the strong growth in Germany in 2010 after unit labour costs had been reduced. Germany is still one of the countries that is "benefitting from the European development economically and politically the most". What is important is to make the EU more competitive as a whole, not just individual countries. For Europe, the question is one of global competitiveness, and Germany is only one part. Mr. Reithofer added that "to be a strong global player, you need a strong home market" and for his company Europe is the home market because of the single market reforms. Having the euro also helped his company to master the crisis. Rolf Alter stressed that taking a national approach is no longer adequate. We cannot "pursue policies at the level of nation states when the markets are so heavily integrated". Since the most integrated markets are financial markets, the response to them is hardly to be found at the national level. Elmar Brok pointed out that Europeans cooperating with the Americans would be able to set standards in the financial world; the nation state is too small for this. The EU can only survive if all member states see it as a win-win situation, which means that the weaker states must be helped under the condition that they put their houses in order.

Anatole Kaletsky observed that there is an unnecessary confusion between two financial crises. There is a sovereign debt crisis in Greece due to incompetent and even dishonest management of the government. In Ireland and Spain, however, it is not a sovereign debt crisis but is all about the banking sector. The problem is that we have a single market in European banking but a national system of regulation and guarantees for these banks. "We need a euro-wide system of recapitalising, guaranteeing and regulating the banks". Friedrich Merz agreed and added that the critical point is what competencies should be transferred to the European level and which ones should be left at the national level. A strong European Commission should make this clear. Social security and health care should remain national competencies, but others such as banking regulations or capital requirements cannot be left at the national level. The preventive control of deficits and debt is needed at the European level as a way to avoid crises. Lord Oakeshott made the observation that Ireland was a state that was controlled by its banks. Banking regulations at a European level are not realistic until the British banking system is reformed. Rainer Brüderle stressed that a common market requires common rules. On the other hand, we have very strong competition in the financial markets between New York, London and the continental financial centres. London has its own ideas, especially with regard to the financial transaction tax. "We have nearly overcome the financial crisis, but we have no new rules". At the G20 meeting in Korea, for example, there were very few common ideas. "And I do not think we will have enormous progress in the coming years. That is the risk for the next crisis. Without a minimum of common rules we will have another crisis".