What Went Wrong with Western Europe? An Essay on the Causes of Its Economic Decline and on Possible Remedies

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Abstract This paper deals with the causes of the economic crisis of Western Europe (WE) by taking a very long run and classical approach to the slow build up of structural imbalances. It maintains that the growth beyond acceptable levels of the state sectors and labour costs and the fact that the BRIC have learned how to produce industrial goods are among the main causes. The collapse of communism, the market oriented policies of China and a very high degree of forward shifting of taxation onto wages in WE have also played an important role. The long run growth of government expenditures and taxation and their effects on wages, employment, investment and economic growth are analyzed. The crisis has also a cyclical component linked to successive waves of tax increases and to high real interest rates. Only a drastic rethinking of the role and functions of the state sectors can bring back prosperity and freedom in WE.

1 Introduction

In the period 2008–12 Western Europe (WE) recorded an unprecedented and unusually long slowdown in economic activity, while Brazil, Russia, India and China (BRIC) and other developing countries continued to grow at high rates. For instance in 2013 real GDP in Brazil was 23.4 % above its level in 2007, while in Italy it was 8.4 % below. The crisis in WE has a cyclical component aggravated by successive waves of tax increases which were implemented in order to keep government budgets within the 3 % limit imposed by the Monetary Union (MU) and, especially in Southern Europe, to keep the countries in the Euro area. In addition the risk of abandoning MU led to very high real interest rates in some member countries. However, the main causes of the crisis of WE are first that in the last decades labour costs have grown too much, except in Germany, and that the overall

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investment environment is not as favourable as it used to be. Second the BRIC countries have finally learned how to produce industrial goods which before only the West could produce and their macroeconomic policies have become more reasonable than in the first decades of the post World War II period. The end of communism in several developing countries and the fact that since the 1980s China's economic policies have become much more market oriented also played an important role. This "awakening" of many countries occurred while in WE the size of governments and taxation grew beyond acceptable levels, thus contributing significantly to the excessive increase in labour costs and to the worsening of the investment environment. WE wages are today more than 10 times higher than in China and more than 5 times higher than in Brazil. These enormous differences undermine the industrial sectors of WE, where labour markets are much more rigid than in the US. The financial crisis, which started in the US in 2007 and the crisis of the Euro are often also listed as causes. However, they are merely aggravating factors.[1] To guarantee a return to acceptable rates of economic growth, drastic measures would have to be taken to correct the accumulated structural imbalances. Excluding autarky, which would damage the whole world and which completely contradicts the economic principles which the West has stood for since the end of World War II, the only possible strategy consists in reducing significantly the cost of labour, in making WE a much more hospitable place for investment, in reducing in a drastic way the role and functions of the State and allowing thereby a massive reallocation of resources towards sectors in which WE has a high comparative advantage. This is admittedly extremely difficult to do, because of the many powerful vested interests which are against it.

2 The Growth of Government Expenditures and Real GDP in Western Europe Since the 1950s

Table 1 shows from 1952 to 2012 the individual growth rates of 17 countries, 8 industrial and 9 developing ones, and the average growth rates for 3 groups of countries: WE, BRIC and 5 smaller developing ones. The data show that in the 2008–12 period the recession in WE was very severe, especially if one compares it with economic growth elsewhere, and that the slowdown has been steady since the 1950s, especially in Italy, Germany and France, although their high growth rate in 1952–1959 is distorted by post-war reconstruction. In the period 2008–12 real GDP per capita fell in WE by 0.68 % per year on average, much more than real GDP.

Table 2 shows General Government Total Expenditures from 1870 to 2012 for 6 EU countries, the US and Japan. In 1870 in the 5 WE countries for which the data is available Government Expenditure (GE) was between 9.1 % of GDP in the Netherlands and 13.7 % in Italy, the simple average being 11 %. For the 5 countries

[1] There is no record in history of a great economic crisis not accompanied also by a financial crisis.

Table 1 Real GDP/GNP growth by country and groups of countries, 1952–2012

	1952–69	1970–89	1990–99	2000–07	2008–12
Germany	6.1	2.5	2.3	1.4	0.8
France	5.1	3.1	1.9	2.0	0.3
Italy	5.9	2.8	1.5	1.4	−1.4
Spain	6.0[a]	3.2	2.8	3.6	−0.8
Netherlands	5.2	2.5	3.1	2.1	−0.1
UK	2.7	2.2	2.2	2.7	−0.3
US	3.5	3.0	3.1	2.5	1.0
Japan	8.8	5.5	1.5	1.7	−0.3
Brazil	6.6[b]	5.8	1.7	3.4	3.1
Russia	–	–	0.7[c]	7.1	1.8
India	3.6[d]	4.2	5.6	7.1	6.5
China	–	9.2[e]	9.9	8.1	10.7
Colombia	4.8	4.6	2.8	4.2	3.5
Philippines	5.5	4.0	2.7	3.4	4.9
Thailand	6.3	7.1	4.9	4.9	3.0
Turkey	5.6	4.8	3.7	5.0	2.7
Vietnam	–	–	7.1	7.4	5.9
Western Europe[f]	5.2	2.9	2.3	2.2	−0.2
BRIC	–	–	4.5[g]	6.4	5.6
Other developing[f]	5.6[h]	5.1[h]	4.2	5.0	4.0

Yearly averages; *Source* IMF, IFS, various issues and www.economywatch.com
[a]1955–69
[b]1950–69
[c]1996–2007
[d]1960–69
[e]1980–89
[f]Simple average
[g]Russia included only starting in 1996
[h]Excluding Vietnam

plus Spain the simple average increased to 13.6 % in 1913, 21.9 % in 1920, 30.3 % in 1960 and 48.9 % in 2012. During these 142 years real GDP grew by a factor of about 20 but GE grew a lot more. Only between 1960 and 2012 the ratio increased by a remarkable 18.6 percentage points.

In 1870 all 6 Western European countries had a public administration, a parliament, a judicial system, a police force and an army. Except for France they also had kings or emperors the costs of whose courts fell largely on the government budget. Two countries, Germany and France, were even at war with each other.[2] In 1960 social security and a public health systems were already in place in most of

[2]In 1937 also Italy and Japan were at war, yet in that year the ratio was 31.1 and 25.4 % respectively.

Table 2 General government total expenditures as percent of GDP in industrial countries

	Around	Around						
	1870	1913	1920	1937	1960	1980	2007	2012
Germany	10.0	14.8	25.0	34.1	32.4	49.5	43.5	45.5
France	12.6	17.0	27.6	29.0	34.6	46.0	52.6	56.6
Italy	13.7	17.1	30.1	31.1	30.1	42.1	47.6	50.7
Spain	–	11.0	8.3	18.4	18.8	30.5	39.2	46.7
Netherlands	9.1	9.0	13.5	19.0	33.7	54.0	45.3	50.1
UK	9.4	12.7	26.6	30.0	32.2	42.7	40.2	43.5
US	7.3	7.5	12.1	19.7	27.0	34.0	36.7	40.3
Japan	8.8	8.3	14.8	25.4	7.5	32.1	33.3	41.3
Average for WE[a]	11.0	13.6	21.9	26.9	30.3	44.1	44.7	48.9

Sources Ministry of Economics, MEF (2011), Rome, www.rgs.mef.gov.it and www.economywatch.com, www.ecb.europa.eu
[a]Simple average

the 6 countries. It follows that the comparison between GE today and in 1960 is probably more relevant. An important question is then if there are solid theoretical reasons to believe that the observed enormous growth of this ratio from 1960 to 2012 had very negative effects on employment, economic growth, the well-being of citizens and individual freedom.

Table 3 shows the same ratio from the 1990s to 2012 for the same 9 developing countries of Table 1. In 2007 the average ratio was 27.8 %, with the highest recorded in Brazil (38.4 %) and the lowest in China (18.9 %). In 2012 the average ratio was 29.6 %, only moderately higher than in 2007. Thus by 2012 the ratio reached in developing countries the level recorded in WE in 1960.

Table 3 General government total expenditures as percent of GDP in developing countries

	1990	2007	2012
Brazil	38.9 (1996)	38.4	40.0
Russia	32.8 (2000)	33.1	36.6
India	20.1	26.5	27.5
China	21.0	18.9	24.8
Colombia	17.5	28.0	28.2
Philippines	20.3 (1994)	19.0	18.8
Thailand	17.3 (1995)	21.3	24.1
Turkey	42.7 (2002)	33.3	36.1
Vietnam	20.3 (1998)	30.6	30.5
Simple average	25.9	27.8	29.6

Source www.economywatch.com, www.ecb.europa.eu. The numbers in parenthesis are the years for which sufficiently reliable data became available

3 The Effects According to Classical Economic Theory of an Increase in Government Expenditures on the Cost of Labour

From 2000 to 2011 real wages grew by a moderate 5 % in the developed world, while they grew by 15.1 % in Latin America and the Caribbean, 17.8 % in Africa, 94.9 % in Asia and 171.3 % in Eastern Europe and Central Asia.[3] Thus in the last 12 years there was a certain wage moderation in the West and a significant degree of catching up of wages elsewhere. However, the wage gap remains huge. Today real wages in WE are at least 5 times higher than in Brazil and 10 times higher than in China. Table 4 compares absolute wages in a number of countries.

A crucial issue in this paper is how the huge increase in GE and taxes in WE influenced the cost of labour and international competitiveness. The components of the cost of labour are three: the after tax wage, taxes and social security contributions and the productivity of labour. A crucial link between taxes and the cost of labour is the degree of shifting forward of taxation onto wages, which can in principle be anything between zero and 100 %. In lectures of economics it is in general maintained that for Adam Smith and David Ricardo the after tax wage cannot fall below the subsistence wage, since workers cannot otherwise live and reproduce themselves. Hence the degree of forward shifting is supposed to be 100 %. However, upon a closer analysis of classical economic theory, the subsistence wage is a long run concept influenced also by cultural determinants (Tullio 1989). Smith for instance argued that:

> "The labouring poor will not now be contented with the same food, clothing and lodging which satisfied them in former times" (Smith 1776, 1976, p. 96) and that necessities include "not only the commodities which are indispensably necessary for the support of life, but whatever the custom of the country renders it indecent for creditable people, even of the lowest order, to be without" (Smith 1776, p. 870). And according to Ricardo the subsistence wage "varies at different times in the same country and very materially differs in different countries" (Ricardo 1817, 1976, p. 54–55).

Thus for both authors the positive effect of taxes on labour and necessities on wages "does not in fact stand or fall with the subsistence assumption" (Hollander 1979, p. 387). The above considerations are very important to understand why in WE the increase in taxes did not lead to a proportionate reduction in the after tax wage and why the growth of government has increased labour costs. Another crucial question is what value workers and labour unions attribute to GE. The less they value them, the higher is the degree of shifting forward of taxation. In classical economic theory all GE was wasted on wars or on lavish expenditures of the ruling class. This is clearly not the case in WE, where in the early post war period the size of government may have been below the social optimum and as a result the marginal benefit of public expenditures may have been above their marginal cost. However, in many Western European countries, sometime in the early post war

[3] International Labor Office, Geneva.

Table 4 Nominal salaries in US dollars, 2010, international comparisons

Brazil	5.41	France	21.06
Portugal	7.16	UK	21.16
Argentina	8.68	US	23.32
Greece	13.01	Netherlands	23.49
Spain	14.53	Germany	25.05
Japan	18.32	Switzerland	34.29
Italy	18.96	Denmark	34.78

Source International Labour Office, Geneva

period, the marginal cost started exceeding the marginal benefit and the difference between them grew further with the size of government. Thus sometime after 1950 the degree of shifting forward of taxation onto wages must have increased significantly in all countries and probably approached 100 % in some, along the lines predicted by Smith and Ricardo, despite the fact that wages were well above the level of subsistence. It is therefore not a coincidence that the rates of economic growth started tapering off in WE. The degree of forward shifting is positively influenced not only by the level of GE, but also by the inefficiencies of government, waste, corruption and the usefulness of public goods offered, such as perceived by workers. Smith for instance compared the acceptance of taxes by the population in a small Republic like Hamburg with the reluctance to pay them in a large country:

> This tax is generally supposed to be paid with great fidelity. In a small republick, where the people have entire confidence in their magistrates, are convinced of the necessity of the tax for the support of the state, and believe that it will be faithfully applied to that purpose, such conscientious and voluntary payment may sometimes be expected. It is not peculiar to the people of Hamburgh (Smith 1776, p. 850).

Evidence about the degree of forward shifting of taxation in WE can be obtained by estimating wage equations which include taxes as independent variables. The degree of forward shifting has been found to be high and significant (Knoester and van der Windt 1987; Gordon 1971) and it is generally higher for taxes on wages, followed by indirect or sales taxes, with social security contributions coming last.[4] The degree of forward shifting is also in general found to be higher in WE than in the US. An additional channel through which the growth of government influences positively the cost of labour is the competition for labour between the private and the public sector:

> … the fund raised by the tax is employed by the government in maintaining labourers, unproductive indeed, but still labourers. If the price of labour were not to raise when wages are taxed, there would be a great increase in the competition for labour, because the owners of capital … would have the same funds for employing labour, whilst the government who received the tax would have an additional fund for the same purpose. Government and people thus become competitors and the consequence of their competition is a rise in the price of labour (Ricardo 1976, p. 144).

[4]Social security contributions have a smaller effect because workers associate them with specific benefits.

4 Taxes on Wages are Taxes on Profits: Their Effects on Capital Accumulation, Foreign Direct Investment, Private Employment and Economic Growth According to Classical Economic Theory

For the classical economists taxes on wages are taxes on profits, because the after tax wage cannot fall below the level of subsistence. Ricardo argued that the burden of the tax on wages falls on stockholders (profits):

> "Taxes on wages will raise wages and therefore will diminish the rate of the profit of stock (capital) …. A tax on wages is wholly a tax on profits; a tax on necessaries is partly a tax on profits and partly a tax on rich consumers." (Ricardo 1976, p. 140) and elsewhere he states: "Taxes are not necessarily taxes on capital because they are laid on capital" (Ricardo 1976, p. 95).

In an integrated world in which capital is mobile the after tax profit rate tends to be equalized across countries in the very long run because of the movement of capital and labour between countries. The world today is very open and globalized, probably more than the British Empire was in the 18th and 19th centuries. Since the after tax profit rates are now so much lower in WE than in developing countries investment in the production of industrial goods and of internationally tradable services increases in developing countries and falls in developed ones, other things being equal, until the adjustment of after tax profits will be completed. In Ricardo's words:

> "Notwithstanding the immense expenditure of the English government during the last 20 years, there can be little doubt that the increased production on the part of the people has more than compensated for it …. Still, however, it is certain that, but for taxation, this increase of capital would have been much greater. There are no taxes which have not a tendency to lessen the power to accumulate" (Ricardo 1976, p. 95). According to Ricardo, in open economies taxes on wages also affect capital accumulation negatively via the loss in competitiveness which they cause: " … it may be objected against such a tax[5] … that raising wages and lowering profits is a discouragement to accumulation, and acts in the same way as the natural poverty of the soil … that by raising the prices of raw produce the prices of all commodities into which the raw produce enters would be raised, and that therefore we should not meet the foreign manufacturer on equal terms in the general market" (Ricardo 1976, p. 865).

Some WE governments complain that firms close factories at home and open them elsewhere.[6] However, governments have no right to interfere with the profit-maximizing behaviour of firms, which is one of the fundamental building-blocks of the wealth of nations. Smith and Ricardo also analyzed the effect of higher wage costs (product wage) on the demand for labour by firms and on employment. Smith held that:

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[5]Ricardo refers here to a tax on "raw produce" by which he means a tax on raw materials, food or necessities.

[6]For instance Fiat, which recently bought Chrysler in the US, is rightly threatening to close more factories in Italy.

"If direct taxes upon the wages of labour have not always occasioned a proportionable rise in those wages, it is because they have generally occasioned a considerable fall in the demand for labour" (Smith 1776, p. 865) and Ricardo distinguished between a direct effect of a higher product wage on the demand for labour from an indirect effect via lower capital accumulation: "Taxes, then, generally as far as they impair the real capital of the country, diminish the demand for labour and therefore it is probable, but not a necessary nor a peculiar consequence of the tax on wages, that though wages would rise, they would not rise by a sum precisely equal to the tax" (Ricardo 1976, p. 145).

Reliable estimates of the elasticity of the private demand for labour with respect to the real wage show that in the long run it is very high in WE, between 0.8 and 1. However, the speed of adjustment of the labor market is generally quite low, up to 4 years, and as a result the short run elasticity is much smaller (Sommariva and Tullio 1987). To sum up, high GE and taxation reduce employment because labour demand depends negatively on real wages and because of their negative effect on capital accumulation. There is strong empirical evidence that already in the period 1955–85, when the ratio of GE to GDP was below its current levels, its growth was reducing the rate of economic growth in industrial countries (Tullio 1987). For the deindustrialization and the economic decay of a country caused by high levels of taxation Smith uses the interesting expression of "declension of industry":

… the declension of industry, the decrease in employment for the poor, the diminution of the annual produce of the land and labour of the country, have generally been the effects of such taxes (Smith 1776, p. 865).

Table 5 shows net Foreign Direct Investment (FDI) to developing countries in billions of US dollars. It sheds some light on the movement of physical capital from developed to developing countries. Net FDI grew from 167.00 billion in 2002–04 (55.7 billion per year) to 440.62 billion in 2008–12 (110.2 billion per year). These are very large numbers indeed. It is particularly worth noting that FDI to developing countries was not at all affected by the crisis of 2008–12.

Table 6 shows data on net FDI as percent of GDP from 1980 to 2012 for the same countries of Tables 1, 2, and 3 with the exclusion of Germany, the UK, Spain and Russia. The first two have attracted FDI from abroad much more than other EU countries because in these countries the business environment is much friendlier

Table 5 Net foreign direct investment to developing countries by major areas, 2002–2012, in billions of US dollars

	To developing Asia	To Latina America[a]	To Europe[b]	Total[c]
2002–04	64.50	47.40	19.00	167.00
2005–07	138.27	61.70	58.67	340.87
2008–12[d]	202.18	102.58	37.26	440.62

Source IMF, World Economic Outlook, October 2013
[a]Includes Caribbean Islands
[b]To developing Central and Eastern Europe
[c]Includes also net FDI to Africa
[d]Notice that this period includes 4 years while the previous ones only 3

Table 6 Net foreign direct investment as percent of GDP, 1980–2012

	1980–89	1990–99	2000–07	2008–12
France	−0.28	−1.18	−2.56	−2.00
Italy	−0.08	−0.37	−0.53	−1.22
Netherlands	−1.79	−2.25	−2.79	−3.68
US	0.33	−0.11	−0.13	−0.82
Japan	−0.64	−0.57	−0.79	−1.66
Brazil	0.60	0.25	0.22	2.06
India	–	0.40[a]	0.64	1.26
China	0.40[b]	3.35	2.60	2.20
Colombia	1.18	1.86	2.94	2.16
Philippines	0.58	1.55	1.09	0.60
Thailand	0.93	2.30	3.48	0.48
Turkey	0.39[c]	0.36	1.14	1.82
Vietnam	–	7.26[d]	4.50	7.00
3 countries of WE[e]	−0.70	−1.27	−1.96	−2.30
3 BRIC (e)	–	1.33	1.15	1.84
8 developing countries[e]	–	2.17	2.08	2.20
6 d.c. excl. Ph. and Th.	–	2.25	2.01	2.75

Source IFS and OECD, various publications; a *minus sign* indicates a net outflow of capital
[a]1991–99
[b]1982–89
[c]1987–89
[d]1996–99
[e]Simple average

than elsewhere in WE and the share of GE to GDP is significantly lower. Spain and Russia are special cases and have been kept out for this reason.

The simple averages for the 3 groups of countries are reported at the bottom of Table 6. For the 3 WE countries considered net FDI grew steadily over time and in 2008–12 there was no interruption of the trend. Among the developing countries considered the stars are Vietnam, China, Brazil and Colombia, while in the years 2008–12 Thailand and the Philippines suffered from domestic problems, political instability in the first and guerrilla warfare in the second. The numbers reported may seem small, but 2.1 % for Brazil and 2.2 % for China are huge numbers, especially if one considers that they are period averages and that the figures on capital inflows by foreign residents are net of outflows by domestic residents. Overall the data reported in these tables fully confirm Smith and Ricardo's predictions on the direction of international capital flows under the circumstances described.

The channels through which high GE and high taxes affect economic growth discussed so far are by no means exhaustive. Laws on firing workers are too rigid in many WE countries, and it takes too much time and too much money to obtain new licences and to comply with many bureaucratic encumbrances. The laws and regulations are often too complicated and contradictory and the fines in the case of

even small errors are often absurdly high. In some countries, certainly in Italy, the officers of the tax police are often under-qualified and/or corrupt. In several WE countries there are very powerful vested interests operating against the public interest and governments listen more to them than to the public interest. In some countries, again certainly in Italy, crony capitalism has become too widespread. Welfare programs tend to have pernicious side effects on the economy and on individuals. People never spend someone else's money as carefully as they spend their own and as a result inefficiency, waste, abuse, theft, and corruption are inevitable. Furthermore these problems tend to be self-perpetuating because they destroy work incentives. Finally these hindrances reduce individual independence and dignity because bureaucrats, who are placed in positions of tremendous power, exercise a great influence over the lives of welfare recipients (von Hayek 1944; Friedman 1980). The progressive growth of welfare programs and of GE in WE has tended over time to shift economic policy towards an atmosphere of central planning and control. It is a sad irony of destiny that all this is happening after many communist regimes collapsed in the early 1990's. Be that as it may, all the factors mentioned in this paragraph further reduce after-tax profits, capital accumulation and economic growth. They also increase the incentives to invest abroad and even to move abroad.

5 Tensions in the Euro Area and Important Differences in EU Countries

The previous sections suggest that the variables on which the WE governments should concentrate if they want to bring WE out of the present crisis are four: the ratio of GE to GDP, wage costs, the reallocation of resources towards competitive sectors and the productivity of labour at the national and the firm's level. On all these fronts there is a very sharp contrast between what has been done in the last 20 years or so by Germany and by Southern Europe. In Germany wages have been very successfully kept under control and firms and labour unions have actively collaborated to increase productivity at the level of the firm. In addition Germany has successfully further specialized in those sectors and markets in which it has a considerable comparative advantage, like high quality capital goods and luxury cars. The main actors in Germany have understood very well, and well in advance with respect to other EU members, the big challenges posed by the awakening of the developing countries and by the exchange rate constraint of the Euro. This asymmetric behaviour has led to problems and tensions within the MU. However, it is wrong to consider the tensions within the Euro as an important cause of the crisis in WE. Since the real causes are much deeper, the decline of WE would continue even if the tensions within MU were to disappear overnight, although there is no doubt that, especially in the last years, the severe exchange rate and the fiscal constraints of the MU have made the management of the business cycle by member governments more difficult. It follows that Germany is not immune to the economic

decline discussed in this paper, although it is in a more favourable position than Southern Europe and France. Also the UK is in a more favourable position because it has a more flexible labour market, a less invasive government, more market oriented economic policies, a flexible exchange rate, an independent monetary policy, a high degree of competitiveness in some sectors like banking, a language which is spoken worldwide and the Commonwealth. In Italy virtually nothing has been done in the last two decades on the 4 fronts discussed in this paper. Yet Italy has an immense potential. It has a huge number of citizens with high levels of inventiveness and initiative. It has sectors with a very high comparative advantage, like luxury goods (cars, furniture, fashion), top quality agricultural products (wine, oil, cheese), cuisine, as well as cultural tourism and hospitality in superb listed historical buildings. In the last 20 years Italian governments have devoted their efforts mainly in suffocating the "animal spirits" of the Italians. This criticism fully holds also for all Italian governments which have followed Mr. Berlusconi in 2011. To satisfy the Maastricht criteria they have all dramatically increased taxes in the midst of a severe recession and hardly cut GE.

6 A 10-year Plan of Reductions in Government Expenditures; Keynes Versus the Proponents of Austerity and Concluding Comments

Keynes predicted a negative effect of reduced GE or increased taxes on aggregate demand. In the short run and within a "normal context" the Keynesian negative effect clearly dominates over any positive one caused by a lower budget deficit, a lower debt and lower interest rates. By a "normal context" the author means here a situation in which long run market expectations about future growth and employment are not changed by the fiscal restrictions implemented. However, in the current circumstances a drastic and credible 10 year-program of reductions in GE aiming at bringing the ratio of GE to GDP back to its 1960 level will change instantly and significantly the long run expectations about future growth and about the business and investment environment in such a way that its effects are likely to be very positive even in the short run. Long run expectations of foreign residents are also crucial for the final outcome of the 10-year plan proposed, because they have a strong influence on FDI and capital inflows. Thus in the short run both Keynes and the proponents of austerity can be right, the effect of the reduction of the GE to GDP ratio depending on the magnitude and the credibility of the 10-year plan, on the type of fiscal measures taken and on the planned changes in the role and functions of the State. The signature of a "letters of intent" with the IMF, the EU and the ECB would bind future governments and make the 10-year plan more credible. The sharp reduction in GE and in the role and functions of the State proposed in this paper will likely contribute *per se* to an increased efficiency of government because it is easier to manage something which is small than something which is big. Countries like

Italy could and should implement such a plan on its own initiative, without waiting for the pressure of the EU and Germany to mount to unacceptable levels.

WE governments and EU institutions focus their attention principally on government deficits and debts, which have not been addressed in this paper, simply because they are not as important for long term growth as are the ratio of GE to GDP, the distortions caused by high taxes and the overall business climate. If the main message of this paper is correct, the whole of WE is on the wrong track. Economic policy in WE has been devised and implemented without sufficient understanding of economic theory. The 3 % Maasterricht criteria for the deficit to GDP ratio and the 60 % limit for the debt to GDP ratio, which are both so crucial for Euro members, do not make much economic sense and have brought the whole of WE on a completely wrong track. The government debt is over 200 % of GDP in Japan and the deficit of the US government was 11.6 % in 2009, 9.3 % in 2010 and 7.9 % in 2011, yet in terms of financial stability and prospects of growth the US and Japan are today better off than WE.

One interesting question is why the crisis in WE broke out only in 2008 and not before, given that the structural imbalances discussed in this paper have been present for a long time. There are two reasons for this delay. First the introduction of the Euro in 1999 exerted initially a positive effect on the economies of the EU[7] and second, as a result of the US slowdown in 2001, the technology crash and the September 11 attacks, the FED's monetary policy was very expansionary until 2006. The world was flooded with US dollars and world economic activity was kept high. These factors retarded the outbreak of the crisis in WE.

The gains from international trade and the specialization of countries in the production of goods and services in which they have a high comparative advantage can be enormous, as demonstrated in the 19th century by David Ricardo. The introduction of the Euro in 1999 and the very large increase in international trade among developing countries in the last decades played a very positive role. A similar large gain could come in the next decades from increased trade between the northern shores of the Mediterranean and Black seas and their Southern and Eastern shores. These potentially huge gains would accrue also to the Russian Federation and to the Northern EU countries. For these gains from trade to become a reality the EU, the Russian Federation and the US should strengthen their collaboration to establish a durable peace and stable and moderate governments in North Africa and the Middle East. They also should increase their efforts to eliminate religious sectarism and terrorism in the area and to help moderate governments in North Africa and in the Middle East to eradicate poverty. It is also necessary to invest a lot more in achieving a durable peace between Israel and Palestina. Poverty in the above mentioned areas of the world and constant tensions between Israel and Palestina are two major sources of Islamic terrorism. On these two accounts the foreign policy of the West has completely failed with possible dangerous and unpredictable long run consequences for the whole world.

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[7]See for instance in Table 1 the average growth rate of Spain in the period 2000–2007.

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