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Europe's Growth Challenge

by **Anders Åslund and Simeon Djankov**

Oxford University Press, 2017.

Considering the fact that Europe's economic growth has been sluggish for decades, the consensus that "something must be done", and two prominent academic economists being involved in nitty-gritty details of day-to-day reform business in transition economies, readers' expectations of this book cannot be exaggerated. The clearly specified aim of the book "to propose a reform agenda suggesting what European policymakers should do to secure a higher long-term [economic] growth" (p. 1) only raises expectations. For the authors, it is evident that Europe as a whole has ended up in a low growth trap and that it needs to break out of it. There is no need to convince growth economists of such an insight, but many European policymakers doubt this. They have other priorities which do not necessarily contradict the preferences of the constituency. After all, growth in Europe reached almost 2 percent in 2016, and similar growth rates can be expected in 2017 – not too bad, many Europeans think, after the recession. With the Greek default avoided for the time being, sovereign debt of other EU members issue calmed down, the euro and the monetary union not being annihilated, the attention shifted to Syrians and other immigrants, both those at the borders and those already within them, or dealing with Ukraine and its eastern neighbour, or dealing with Brexit. Economic growth is hardly a priority for Europe. Even in its strategic documents, like "Europe 2020", it is stipulated that growth should be smart, ecologically sustainable, and inclusive, but no targets were set for economic or productivity growth.

So, the first concern related to the book is whom exactly are the authors addressing, proposing an agenda for increasing Europe's growth rate by one percentage point, i.e. increasing the existing growth rate by one-third, as if this is the top priority of Europe's political agenda, since Europe is hardly interested in increasing growth rate and productivity. The concerns of European political elite are something else. Authors quote Jean-Claude Juncker as saying (back in 2007): "We all know what to do, but we don't know how to get re-elected once we have done it" (p. 3). This paradigmatic self-serving figure of European politics, who should be the first to implement the proposed reform agenda, is obviously hardly interested in it. In this sense, much better job was done by Alberto Alesina and Francesco Giavazzi (2006), focusing on the same topic, trying to persuade Europe's elite, not necessary only the political elite, that Europe is facing "reform or decline". In other words, Europe's welfare is not sustainable in the modern globalised and fast changing world. International

competition, not only on the product market, is stiffer by the day and new competitors emerge. Europe needs an academic wake-up call. Nonetheless, the authors' approach is based on the implicit assumption that Europe has already awoken, that it has already even sipped its morning coffee, and that is ready to kick off reforms.

The second concern regarding the book is related to the approach to the issue of Europe's growth. What is promising in this approach is that the authors focused only on long-term economic growth, rather than on GDP volatilities within business cycles and that the solutions for the growth crisis are not considered within demand management, which is so popular. As the authors point out – macroeconomic stimulus is not the cure. Accordingly, for them the solution is on the supply side, i.e. “the key to long-term growth lies in structural transformation and the opening of markets to facilitate competition to boost efficiency and welfare” (p. 7). The problem is that this conclusion is not founded in the insights of modern growth theory, nor based on the analysis of what are the causes of Europe's modest growth.

Although the authors pointed out, referring to Phillipe Aghion and Peter Howitt (2009), that “theory of endogenous growth holds that investments in human capital, innovation and institutions contribute significantly to economic growth” (p. 21), that is not entirely correct. The endogenous growth theory is about explaining the technology progress, i.e. innovations, that affect the steady-state growth rate, not about what are all the factors of economic growth. It is conventional wisdom among growth economists that investments in human capital and institutions are important, but endogenous growth theory focuses on innovations. Furthermore, recent contributions to growth theory (Daron Acemoglu, Aghion, and Fabrizio Zilibotti 2006), within the conceptual framework of endogenous growth theory, demonstrated that institutional set-up suitable for one level of economic development, i.e. distance from the technological frontier, is not necessarily suitable for other levels of economic development, the main reason being that the dominant engine of growth depends on the distance from the technological frontier: for economies far from the technological frontier, accumulation of production factors is crucial for growth; for economies close to the technological frontier, it is innovations, i.e. technological progress that is crucial for growth. The institutions suitable for one engine of growth are not suitable for the other. That is basically the middle-income convergence trap¹.

The authors' description of the Europe's economic growth path, with 30 “glorious years” (Chapter 1) featuring 4.5 percent average annual growth rate from 1945 to 1975, perfectly fits in accumulation of production factors stage of economic growth, starting with the reconstruction of devastated industrial capacities and infrastructure. That was the phase of catching-up and convergence of GDP *per capita* with the US – something labelled as “Europe's golden growth” (Indermit S. Gill and Martin Raiser 2012). But the slowing down of growth after 1975 is a symptom that the engine of growth ran out of steam. It is technological progress that is now the dominant engine of growth and Europe was not prepared to switch from the old engine to the new. Hence, the way out for Europe's vigorous economic growth is pro-

¹ Although middle-income convergence trap has multiples meaning (Fernando Gabriel Im and David Rosenblatt 2013), this interpretation of it is conventional within the framework of endogenous growth theory, focusing on incentives for research and development as the source of innovation.

ducing innovations much more and much deeper than up to now. This is the only way that Europe can achieve a higher yet sustainable growth rate and become/remain competitive with the US and emerging Asian economies. Nonetheless, none of that is mentioned in the book that focuses on Europe's economic growth. Pity.

This convergence trap conceptual framework can be used for the evaluation of the recommendations provided in the book. The first one is limiting the fiscal role of the state (Chapter 2). The bottom line is that public expenditures share in the GDP should be between 35 and 42 percent, much lower than the 47 percent of GDP in 2015. It is suggested that public expenditures below 35 percent of GDP appear to be undesirable in developed democracies and anything below 42 percent of GDP is "likely to be optimal for economic growth in a developed economy" (p. 44). A story about Europe's public expenditure is told before the recommendation is given, mentioning Wagner's law, waves of nationalisations, the Beveridge Report and the swinging back of the pendulum in the 1980s. Even major academic contributions on effects of public expenditures to economic growth and their findings, starting with seminal paper by Robert J. Barro (1991), have been reviewed, with the major conclusion that "government consumption, subsidies and government investments have a sizable, negative and statistically significant effect on growth" (p. 34). It has also been clarified, following Bernhart Heitger (2001), that government expenditures on core public goods have a positive impact on growth, but this positive impact tends to decline or even reverse "if government further increases expenditures in such a way that it ultimately produces private good" (p. 34). Point well taken, but it is the structure of public expenditures rather than their size. It can be argued that the increase of the size of public expenditures inevitably decreases the share of expenditures for public goods, but the relation is definitely not straightforward nor linear.

Taking all this into account, it is not evident that the suggested band of public expenditures is optimal for Europe's economic growth, let alone how it will boost innovations. The good thing is that an optimum band is suggested (however specified), meaning that exact optimal level should differ from one European country to the next. Apparently, taking into account the existing public expenditure structure, lowering public expenditures would do no harm, but a boost in economic growth, especially innovation-based growth, should not be expected. This is especially the case since, as pointed out by the authors, nine EU members have already reached targeted public expenditures and their growth rates have not skyrocketed.

A collateral effect of decreasing public expenditures would be a decrease in the tax burden (for a given level of public debt), a ground for reforming taxes with the aim of supporting entrepreneurship and growth (Chapter 3). The consideration of taxes focuses on corporate profit tax, with its rate inevitably dropping on account of globalisation and the international mobility of capital, personal income taxes with progressive rates, for a long time considered "an ideal instrument for social engineering" (p. 51), payroll taxes that limit official work, noting that the bulk of payroll tax revenues goes to pensions, and value-added tax that generates most of the budgetary revenues in European countries. The prospects for tax harmonization are evaluated with pessimistic outcome, and the ill fate of financial transaction tax, i.e. "Tobin tax" is used to support such pessimism. Nonetheless, three main suggestions of the au-

thors follow: (i) taxes should be few in number, low and relatively flat; (ii) personal income taxes and payroll taxes need to be maximally trimmed, to encourage participation in the labour force; (iii) as marginal income taxes are too high, Europe suffers from high tax wedges on labour, which should be removed to increase labour supply and working hours. One way or the other, revenue-neutral tax reform with such features is very complicated endeavour, especially within the framework not favourable for harmonisation and without clear political motivation. Anders Åslund and Simeon Djankov mention none of this.

There is no doubt that Europe is aging rapidly. The authors point out that, as a share of the active population (aged 16-64), the European population aged 65 or more is projected to increase from 28 percent in 2016 to 53 percent in 2060, hence the need for reforming pensions (Chapter 4). The share of pension payments in GDP in Europe is already rather high (9.2 percent of GDP) and an aging population will render this unsustainable, hence the need for pension reform is unquestionable. However, the problem is who will champion it, since very long-term thinking is needed. Two moves have already been made, though only in their first steps: tightening of early retirement schemes and raising the retirement age. This will decrease the number of pensioners, but the link between the number of the pensioners and the size of the outflow, i.e. amount of pensions paid out, is not linear. A comprehensive pension reform is what is needed, the authors suggest, since most of the pensions in Europe are paid out by the first pillar: a public pay-as-you-go pension scheme. This is actually the reason for high burden on salaries, due to either payroll tax or compulsory contributions (they produce the same incentives for employers), responsible for a part of high tax wedge and decreasing labour supply, generating lower fiscal revenues earmarked for paying out pensions, among other things. It is recommended that the comprehensive pension reform in Europe should be based on decreasing in the scale and importance of the first pillar (providing only a minimum pension), on one side, and strengthening the second (compulsory funded pension insurance with private funds) and third pillar (voluntary funded pension insurance with private funds), on the other. The shift would effectively be from a pay-as-you-go system to a funded pension insurance system. The public expenditures would be crowded-out by savings, which at least in principal can be invested in physical and human capital. The problem is that successful operations of the second (where they exist at all) and third pillar pension funds require a good legal framework and fine regulation, which do not exist at the moment. The greater the opportunity to invest in diverse assets, the lower the risk and the greater the likelihood of good returns. The problem is that many countries have substantial limitations to these investments. In the extreme case, in Spain, for example, there is a legal obligation for the pension fund to invest only in domestic government bonds. Instead of funding business endeavours, household savings are used to fund fiscal deficit, i.e. public expenditures.

The pension reform in the Netherlands is selected as success story as size of the funded pension funds is 160 percent of the GDP, nearly double of the US and four times the average of the OECD countries. For the authors, the Netherlands is a beacon of pension reform; it is a model that other European countries should follow. The problem is that political economy of the pension reform is very complicated and

it is specific for each individual country (John Myles and Paul Pierson 2001). The success of the Dutch pension reform is not the consequence of some specific knowledge available to the decision makers in that country, but rather of its specific demographics, the intertemporal preferences of the population and the specific political economy. These things are specific for each European country. If the Netherlands is recommended as an example to follow, it is the first best solution, but it is not available for many of the European countries precisely because of the mentioned specific political economy.

The single product market is considered one of the success stories of the EU, for good reason. Nonetheless, the success has been achieved only in the case of goods, not in the case of services. Although services account for more than 70 percent of economic activity in the EU, their share in intra-EU trade is only 28 percent. Therefore, it is understandable that Åslund and Djankov recommend opening up services and digital trade (Chapter 5). The main problem with the services is that there are substantial barriers to trade embodied in national legislations that effectively trim down competition. The example of a Swedish construction firm that wants to build in Germany vividly demonstrates these barriers, as such an endeavour proves to be an impossible mission. Again, it is important to emphasize that the example is about a firm from Sweden, who's quality of housing construction is ranked highest in the EU according to the European Construction Association, not a firm from the usual suspects, Romania or Bulgaria. Furthermore, the authors point out that various professions (notaries, real estate agents, etc.) are heavily regulated, concluding that "it is not safety that drives the regulators, but rather an aspiration to keep competition at bay" (p. 84). And this aspiration comes from the political economy at the national level, which is the topic the authors systematically avoid throughout the book. But this is the bottom line: Europe is overwhelmed by extractive institutions (Acemoglu and James A. Robinson 2012), enabling very few, like notaries, to extract rent and increase their wealth at the expense of many. This is the Gordian knot of modern Europe, and it is barely mentioned in the book.

Removing barriers to trade on the service markets would undoubtedly have a beneficial effect on Europe. The authors point out the estimate that removal of these barriers would bring "additional growth as much as 1.6 percent a year for five successive years" (p. 79). Hence, at the end of the day, this is merely transitory growth, i.e. a one-off increase of the level of income, which is not to say that this increase is trivial, but only that the steady-state sustainable economic growth will not be affected by the implementation of this recommendation. That is precisely a fundamental problem with almost all recommendations in the book, save one focused on innovations, as only sustainable flow of innovations can produce steady-state economic growth. Taking this into account, increased competition in the market creates incentives for research and development, which is the only way to produce innovations, since they do not appear out of the blue. In that sense, increasing competition in the services market in Europe would have a beneficial effect on its long-term economic growth.

One of the conventional wisdoms is that too few Europeans work, but those who work do work too little. Accordingly, creating jobs (Chapter 6) is indispensable

issue when considering Europe's economic growth. Data confirms the conventional wisdom: the employment rate in Europe is 5 percent lower than in the US and the average working hours are lower by the same margin. Taking into account lower labour productivity (both in terms of level and growth rate), part of the divergence between the US and Europe can be explained in this way. There are a number of recommendations for this problem in the book; some of them are rather straightforward, such as expanding education and vocational training, while others are not substantiated, for example increasing participation of women, since conflicting data on their participation is provided on the different pages of the book (p. 94 and 98), let alone that this would provide only a one-off increase of the GDP. Absorbing immigrants is definitely a promising way of thinking for Europe, but obviously Europe does not have a long tradition of controlled and selected immigration mechanisms like the US, Canada and Australia; perhaps it is time to learn from others. The problem is also low intra-EU labour mobility (14 times lower than in intra-US mobility) and the authors linked this to the lack of certainty of social benefits, as one of the obstacles for that mobility, even though some other exogenous barriers, such as the linguistic and cultural ones, might contribute as well.

Two recommendations for creating jobs, given in the book, are straightforward and were quite expected: reducing the labour tax wedge and labour regulation reform. Nothing new, one would say. Significantly reducing the tax burden on labour is probably feasible only with thorough reform of pensions and it takes time. Taking a shortcut by increasing VAT to compensate revenues lost due to reduced payroll tax (whatever the short-term consequences might be) would be a step in the wrong direction, moving countries away from funded pension insurance. The existing labour regulations, especially, but not solely in Southern Europe, are designed to protect employed people at the detriment of unemployed. Hence there is a political economy involved with trade unions and other similar interest groups. Their interest is to decrease the level of competition in the labour market and any intervention in the opposite direction will inevitably generate strong resistance. The essence of the reform is how to overcome that resistance – a topic that was elaborated many years ago (Raquel Fernandez and Dani Rodrik 1991) – rather than what is the content of the reform. One would expect experienced reformers like Åslund and Djankov to share their vast experience in Eastern Europe about that with the readers, but the expectation is not fulfilled. Finally, the authors point out that the changes they suggest “to create more jobs would make Europe more competitive globally” (p. 108). Nonetheless, the problem is that these changes will perhaps increase employment, but not necessarily increase, and probably even decrease labour productivity and total factor productivity, and only an increase in productivity will make Europe more competitive globally.

Cutting red tape (Chapter 7) is undoubtedly a desired move, no one can dispute that, but readers expect much more from this chapter, based mainly on the description of actions in the past. The most important red tape consequence, barrier to entry to new firms, deserves a section in this chapter, but it seems that authors downplay the importance of new entries for economic growth. “A constant flow of startups into economy adds new jobs and services. It also increases competition, encour-

aging existing firms to improve productivity to maintain market presence” (p. 114). Not that this is untrue, but the most important consequence of the new entries – innovations – is disregarded. They are the crucial mechanism for increasing the total factor productivity and long-term economic growth for countries that are close to the technological frontier. Increased productivity of the incumbents (if it happens, the other option is their bankruptcy) is just a collateral benefit. The authors point out that “the main takeaway from this chapter is that Europe has all the knowledge and experience it needs to be the world’s most hospitable place to do business” (p. 121). Great, but what should be done to remove the political economy barriers that prevent Europe from becoming one? A disappointing chapter.

Developing a single energy market (Chapter 8) is a serious topic, but it is difficult to see its direct link to long-term economic growth. With issues such as security of energy supply, noted as a major concern, energy saving, controlling pollution, and development of new sources of energy, a growth economist wonders whether he/she is reading the wrong book, not the one with the title *Europe’s Growth Challenge*. Well, one of the mentioned EU aims is to “enhance efficiency through well-functioning markets” (p. 122), though such an increase of efficiency is a one-off increase of the GDP level. Regarding innovations in the energy sector, a crucial EU document stipulates that “Europe’s Energy Union is to be the world number one in renewable energies” but, as pointed out by the authors, it does not offer any solutions. So typical of contemporary EU documents: a wish list of Europe’s political elite. One way or the other, the chapter concludes with a long story on Nord Stream 2 and its impact on the Ukraine’s national budget – a topic completely irrelevant for the Europe’s growth. Another disappointing chapter.

The last topical chapter, Catching-up in Innovation (Chapter 9), has been long awaited by readers, as it is about the most important and for developed economies, like European, even the only important issue regarding long-term economic growth: innovations. Åslund and Djankov point out that Europe once used to be very innovative, but after the World War II, it did not “regain its innovation energy. The devastation made Europeans risk-averse” (p. 134). Be that as it may, since the risk-aversion protracted effect of the devastation that happen 70+ year ago cannot be empirically verified, the only way forward is by measuring the state-of-the-art innovations in Europe as of today. The authors are straightforward: according to Forbes, in 2015 only 11 of the world’s 100 most innovative technological companies were based in Europe; according to Reuters, only 17 of the 100 top global innovators in any industry are European; and according to the MIT, only 6 European companies are among the 50 smartest companies in the world (p. 134). Just a few paragraphs below (p. 135) readers can find astonishing information: among the 100 largest companies in Europe and the US, only 13 European companies were founded after 1950, and as many as 40 of the American. It is puzzling that the authors do not comment on the relation between the two, taking into account that contributions to contemporary growth theory (Acemoglu 2008; Aghion, Alesina, and Francesco Trebbi 2008) emphasize that predominantly new entries produce innovations, enabling innovation-based growth. Even two types of capitalisms have been suggested, big firms’ capitalism and entrepreneurial capitalism, based on new entries, with the latter one being

more innovative (William J. Baumol, Robert E. Litan, and Carl J. Schramm 2007). One could infer from the provided information that the main obstacle for innovations in Europe are barriers to the entry of new competitors, but the authors are silent about that. This is surprising, taking into account that one of them, jointly with others, produced a seminal empirical paper on legal barriers to entry (Simeon Djankov et al. 2002).

Instead, Åslund and Djankov focus on listing the reasons for Europe lagging in innovations (with patent application *per capita* being only 56 percent of the US figure): (1) small market size and national regulations; (2) shortage of venture finance in Europe; (3) rigid legislation; (4) lagging of the best university education in Europe; and (5) the low level of in-house research and development capacities of European companies.

Two of these obstacles are well-elaborated. The lack of venture capital is definitely a substantial obstacle for funding start-ups and European financial intermediation is biased towards bank lending, which is not exactly a funding of choice for start-ups. Not that venture capital in Europe does not exist, but its supply is rather limited compared to the US. Even public venture fund (European Investment Fund), funded by the EU, is not enough to compensate for the lack of private venture capital. The explanation could be that the average return on venture capital in Europe is only 2 percent per year, comparing to the American 13 percent approximately. The authors conjecture is that this difference is due to “European funds sell companies too early, missing out on larger returns that come from placing longer-lasting bets” (p. 142). An interesting suggestion, but the reader should be offered some explanation of such behaviour. And then, perhaps, the next move would be to understand what should be done to improve the supply of the venture capital funds in Europe.

The other obstacle is best university education, as the strongholds of technological progress in the US are located around the top universities such as Stanford (Silicon Valley), and Harvard and MIT (Route 128). The number of the US and European (save the UK) universities in the Shanghai Ranking’s top 50 universities provides one of the reasons why these relations have not been replicated in Europe with equal success. The authors find the root of the problem to be the status of European universities: too many of them lack independence from the state, which can push them towards goals that do not necessarily coincide with education of high quality, and even less research on the cutting edge of human knowledge. Furthermore, state universities usually have strict salary regulations, unable to attract the top people in the field, or even to prevent their own staff from moving to the US in a substantial brain-drain that has been going on for decades. Although the authors provide a number of recommendations, they are not very optimistic about the outcome, admitting that “it takes time to build a university of top quality, finding the right combination of freedom and stimulus” (p. 147). With Europe being so proud of its (state) universities, it seems that the odds of success are not great.

In short, all the considerations focused on catching up in innovations prove that there is no great reason for optimism regarding the technological progress in Europe as a basis for its economic growth. As a kind of encouragement, the authors provide an example, a case of European innovative company, Italy’s Ferrero, which

invests nearly 10 percent of its revenue in R&D. So, readers go through innovations in chocolates, ice crimes, frozen products, etc. Is this really a match for innovations in electronics, hardware and software, aerospace industry, nanotechnology, pharmaceutical industry, and biotechnology? Or anything else based on cutting edge scientific knowledge?

No one can criticize that the book lacks a substantial number of very specific recommendations for boosting Europe's economic growth. Nonetheless, most of these recommendations, if implemented, would be only one-off improvements, generating a one-off increase of the income level. They would create transitional economic growth, but the sustainable long-term, steady-state growth rate would remain unchanged. The only exceptions are recommendations in the area of innovations and those that improve competitive pressure in the market, which should create incentives for R&D, both to the incumbents and new entries.

Furthermore, there are substantial political economic obstacles to the implementation of many of the recommendations. At the very begging of the book, Åslund and Djankov proclaim that they will steer clear of political economy, as this is "well-researched sphere, which primarily pertains to political science, and we leave the discussion on the restructuring of European institutions to better-qualified scholars" (p. 4). Modesty, such a rare virtue in the contemporary academic world, should be praised, but excluding political economic considerations from this book inevitably decreases the creditability of the recommendations. And it is not that political economy is reduced to a discussion of the restructuring of European institutions, it is about the feasibility of the implementation of the recommendations given in this book.

Within that framework readers should consider the general recommendation of the book for European nations – look to what your neighbour is doing. In the book the authors continuously emphasise good solutions; the best practices exist in some of the European countries. They look at the Netherlands in the case of pension reform, at Sweden in the case of reducing public expenditures, etc. The problem is that the political economy of each of these reform moves is very specific for each country, allowing for such reforms in one country and preventing it in the other. It is not the lack of information that is crucial constraint for the reform moves, but rather the political and economic context, i.e. the political economy constellation in every country, that matters. Taking that into account, it is counterproductive to limit the best practices to European countries; why not the US, Canada, Australia, etc.? Without the political economy context, the experience of the successful country is only proof that it can be done, with some rather limited technical information, and this is not a very useful piece of information.

Now, let us suppose, for the sake of the argument, that Europe or any European state is led by some of the populists that have recently acquired the ambition to enter the history books. And let us suppose that they have read this book, at least the concluding chapter with the recommendations abstract. So, they start to implement them and that very move backfires immediately. One can expect them to apply the words of US President Donald Trump regarding the health care delivered on the Capitol Hill: "Now, I have to tell you, it's an unbelievably complex subject. Nobody

knew health care could be so complicated". Well, for the record, economic growth is rather complicated, and there is still a substantial mystery about it (Elhanan Helpman 2004).

Åslund's and Djankov's book gives at least *prima facie* impression, if not the illusion, that the authors have formulated recommendations based on extensive and deep considerations of the issue. There are many technically very clear and straightforward recommendations to the policymakers, irrespective of whether they can be implemented. So, this is an excellent technocratic manual. But it is hardly anything else.

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