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Which Socio-economic Model for Europe?

Disappointing growth rates and high unemployment in Europe have given rise to a debate on whether the European socio-economic model – or which of its variations – has a future in the face of increasing international competition. The following two articles discuss the current challenges facing Europe in this field and the options for meeting these challenges.

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The European Social Model: Cause of, or Solution to, the Present Crisis of the European Union?

A public controversy over the future of social policy in the European Union emerged in June 2005. It was triggered by negative referenda on the EU Constitution in France and in the Netherlands and the failure of negotiations on the EU financial framework for 2007 to 2013. France and Germany had voiced suspicions that the United Kingdom's unwillingness to enable an agreement on the financial framework by giving up its rebate on the contributions to the EU budget was based on reluctance to support social integration in the EU. Germany's Chancellor Gerhard Schröder said that in view of the crisis in the European Union the core question is: " 'What kind of Europe do we want? ... Do we want a united Europe capable of acting; that is, a real political union? Or do we only want to be a free trade area ...?' It would be a mistake to understand Europe purely economically, he said. There must not be a constant race to the bottom in a pure market economy."[1] Germany's Minister of Foreign Affairs, Joseph Fischer, added that Europe cannot afford a break in its activities in the face of the crisis. Following a market-radical "British" path would only mean strengthening the position of those who had voted against the Constitution in France.[2] Jacques Chirac made similar statements in public.[3]

Only days later the British Prime Minister Tony Blair fended off German and French allegations when he presented his programmes and ideas for the British EU presidency. In a much-applauded speech before the European Parliament, he said on June 23, "The issue is not between a 'free market' Europe and a social Europe … I believe in Europe as a political project. I believe in a Europe with a strong and caring social dimension. I would never accept a Europe that was simply an economic market."[4] Discussion of European social policy continued at summits in October at Hampton Court and in December in Brussels. But not very much has come of it. The only new aspect in the discussion was France's suggestion to create a globalisation fund to help workers to learn new skills and find jobs when their companies fall victim to global competition. However, this plan was short-lived, as it met with resistance from quite a few countries, among them Denmark, Sweden, the Netherlands, Estonia and Germany. In Germany it was neither supported by Chancellor Gerhard Schröder, who said that the fund would be impossible to finance, nor by his successor Angela Merkel, who made clear that a separate glo-

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[1] EU-Krise: Europa auf Freihandelszone reduzieren, in: Manager Magazin, 21.06.2005, http://www.manager-magazin.de/unternehmen/euro/0,2828,361519,00.html, author's translation.

[2] Fischer warnt vor möglicher Spaltung Europas, in: taz, 21.06.2005, author's translation.

[3] See for example Jacques Chirac: Opening Address, XIIIth French Ambassador's Conference, Elysee Palace, 29.08.2005, http://www.elysee.fr/elysee/francais/actualites/a_l_elysee/2005/aout/xiiith_french_ambassador_s_conference.31019.html.

[4] Quoted in: Blair: "It is time for a reality check", 23.06.2005, http://www.euractiv.com/Article?tcmuri=tcm:29-141403-16&type=News.

balisation fund is unnecessary, as EU regional funds already benefit the economically weakest areas.[5]

Apart from differing opinions on the globalisation fund, which did not take centre stage at Hampton Court, controversies over the future course of European social policy were kept to a minimum. The main agenda of the UK presidency turned out to be the avoidance of any topic that could lead to a deepening of the European crisis so as to pave the way for an agreement on the financial framework, a goal more pressing for the stabilisation of the EU. And indeed Social Europe, which Blair had originally announced to be the official topic of the summit at Hampton Court, would not have helped to restore harmony: [6] the UK, host and initiator of the summits, not only differs significantly in its national approach to social and economic policy from countries like Germany and France, but British governments have also already proved in the past to take quite a critical view of initiatives to extend Brussels's involvement in social policy. Since Margaret Thatcher, the UK has only reluctantly endorsed the EU's involvement and on several occasions has openly opposed it, as for example in the case of the European Social Charter, which it only signed a decade after all other member countries.

But what has actually been accomplished in EU social policy in the past, what are the current challenges to it and what are the options for dealing with these challenges in the future? More specifically, what contributions can Brussels make over and above those that are made by the member states? The newly awakened interest in EU social policy offers an opportunity to consider what the often cited but rarely explained term "Social Europe" stands for and, more specifically, what decisions on European social policy mean in the context of the current crisis in the European Union.

Challenges

European social policy is faced with several challenges, particularly with low economic growth and high unemployment. Due to these two factors, there is a drain on member states' public budgets and social security systems that reduces the room for manoeuvre for social policy compared to the post-war decades, in which high economic growth and low unemployment paved the way for a fast expansion of the welfare state. The problem that Social Europe faces in financing its expenditures is worsened by two structural factors that will shape policy decisions for a long time, even if growth can be boosted and unemployment lowered. They are (1) the rapid ageing of the population, which puts – *ceteris paribus* – an additional burden on the finances of the welfare systems, and (2) globalisation, which exposes member states to a structural adjustment process of their economies that not all of them are in an optimal position to cope with.

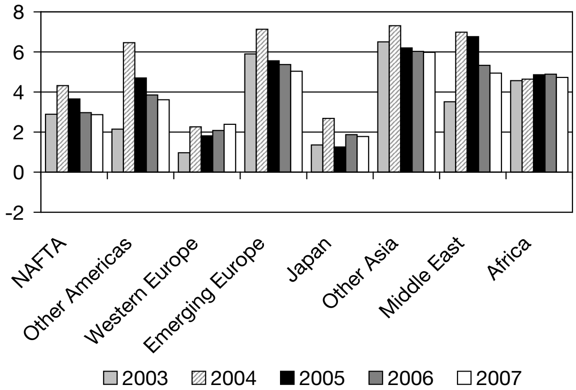
Although these four challenges to Social Europe are quite obvious, they are only gradually being understood by the population in the member states. In fact they are often plainly misunderstood and this in turn reduces the ability of democratically elected national governments to cope with them appropriately. And surely, in the aftermath of failed referenda in France and the Netherlands, the opinions of European citizens will also have to matter more in Brussels.

Few economists would disagree with the idea that economic growth is a necessary if not sufficient condition for financing the social needs of an ageing society and creating new policy programmes for education, child-care, infrastructure and forward-looking policies on issues such as the environment. Germany is a case in point of the lack of understanding of these necessities. Even more than blue-collar workers, Germans with a university degree have taken a critical view of economic growth for quite some time. Over recent decades a popular statement has been that "we don't want to grow to death" ("wir wollen uns nicht zu Tode wachsen"). The great majority of schoolteachers and other key civil society members would most certainly have cited the predictions of the Club of Rome of the early 1970s that economic growth could not continue because of the limited availability of natural resources. For decades this pessimistic view was also the dominant view in the media, in which magazines such as "Der Spiegel", a weekly that represents centre-left political viewpoints, applied the message of the Club of Rome to mean that for Germany, when it comes to economic growth, less somehow means more. Only after a long and painful increase in unemployment – from one million at the end of the 1970s to over five million last winter – and due to the fact that losing one's job is no longer exclusively the fate of low-skilled and unskilled workers, views on economic growth have gradually started to change. The final blow came in recent years when Gerhard Schröder's coalition of Social Democrats and the Greens was forced to make a serious attempt – the Hartz laws – to cut welfare expenditures in order to prevent the looming bankruptcy of the social security systems.

[5] Simon Jeffery et al.: Schröder to attack EU "failure fund" plan, in: Guardian, 27.10.2005, http://politics.guardian.co.uk/eu/story/0,9061,1601946,00.html.

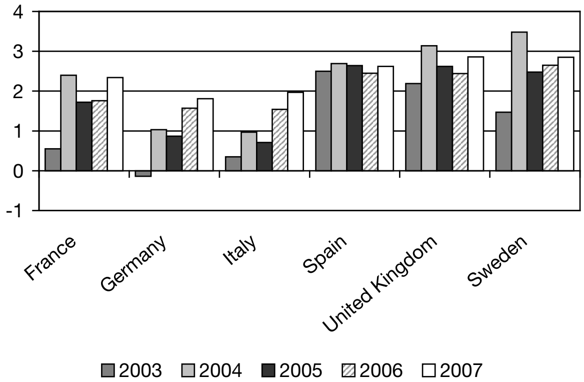
[6] Blair calls special summit to reform EU "social model", in: Telegraph, 02.07.2005,http://www.telegraph.co.uk/news/main.jhtml?xml=/news/2005/07/02/weu02.xml&sSheet=/portal/2005/07/02/ixportal.html.

Figure 1
World Economic Growth
(per cent change, real GDP)



Source: Global Insight: Various Charts. Presentation, International University Bremen 2005.

Figure 2
Economic Growth, Europe
(per cent change, real GDP)



Source: Global Insight: Various Charts. Presentation, International University Bremen 2005.

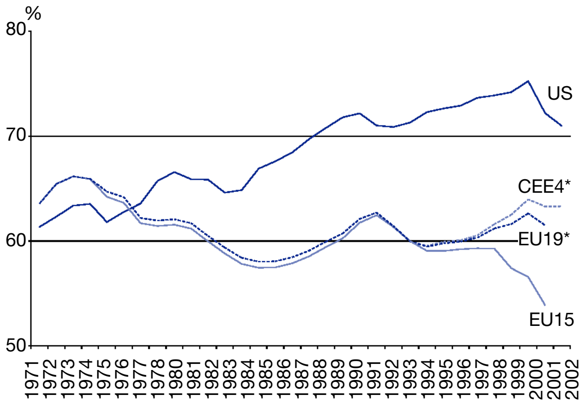
A look at growth rates for Germany, Europe and the world shows that nothing could have been more inappropriate for Germany's elite than to be afraid of too much economic growth. While Germany's public debate on the welfare state in the 1990s was still characterised by a "how-to-spend-it mentality",[7] focusing on equity considerations rather than on fiscal sustainability, the deterioration of the economic basis of the welfare state was already in full swing. Although the government, then a coalition of Christian Democrats and Liberals under Chancellor Helmut Kohl, increased public expenditure massively to expand the West German welfare state to include 17 million East Germans and to rebuild the infrastructure of the "new Länder", growth rates remained low. Despite a short-lived unification boom in the early 1990s, at 1.5% the average annual growth rate was only about half of that of the USA for the decade, and was one of the lowest among EU member states. But the situation has not improved since. While Japan is presently recovering from its economic malaise of the long 1990s, Western Europe is still showing a weak performance compared to North America. Within Western Europe, Germany once again occupies one of the last places. The fact that Italy is even worse off is sometimes proudly pointed to in the newly awakened awareness of the malaise of the German economy in the domestic policy debate. According to the predictions by Global Insight (Figures 1 and 2), there is also no change in sight for the next two years.

[7] "How to Spend It" is the title of a regular section of the weekend edition of the Financial Times.

Employment Rates

The situation in German and European labour markets is not much better and again a comparison of the EU and the USA is revealing. Instead of focusing on unemployment, it is more appropriate to concentrate

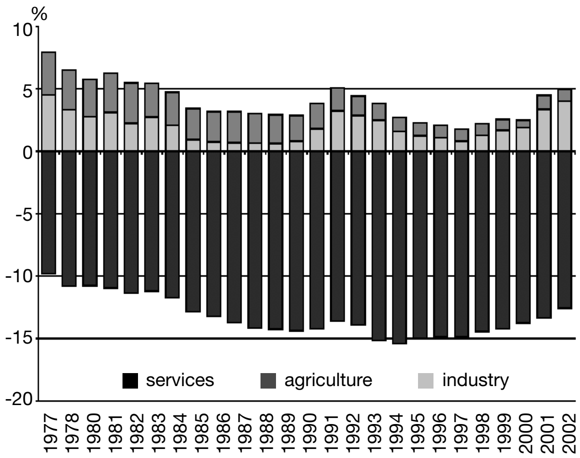
Figure 3
Employment Rates in the EU and the USA, 1971-2002
(% of working age population)



Notes: Employment rates using civilian employment in the age group 15-64, excluding employment in the armed forces and in institutional households, and census-based population figures; aggregate employment rates for EU15, include those countries with available data, with data missing for some of the countries missing in the following years: Austria (1973, 2002), Belgium (2000-2002), France (1990-2002), Greece (1970-1980, 2000-2002), Italy (1972-1976), Netherlands (1970-1974), Portugal (1970-1979, 1982-1985), UK (2001-2002); * among the new Member States, data are available for Poland (1993-2001), Hungary (1992-2001), the Czech Republic (1975-2000) and the Slovak Republic (1994-2001) only.

Source: European Commission: Employment in Europe 2004, Recent Trends and Prospects. Luxembourg 2004, p. 99. http://europa.eu.int/comm/employment_social/employment_analysis/employ_2004_en.htm.

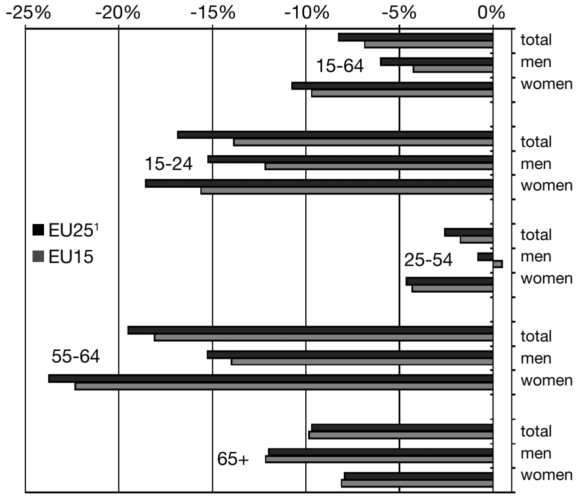
Figure 4
Evolution of EU-US Employment Rates Gap 1977-2002
(by broad sectors)



Notes: Due to missing information on employment by broad sector for a large number of EU member states before 1977, the data for the years 1971-1976 are not strictly comparable and therefore not reported in the chart. See also the notes on Figure 3.

Source: European Commission: Employment in Europe 2004. Recent Trends and Prospects, Luxembourg 2004, p. 100. http://europa.eu.int/comm/employment_social/employment_analysis/employ_2004_en.htm.

Figure 5
Decomposition of the EU-US Employment Gap 2003
(differences in employment rates by gender and age group with respective US rates in percentage points)



[1] EU25 includes those new member states with available data in the OECD database.

Source: European Commission: Employment in Europe 2004. Recent Trends and Prospects, Luxembourg 2004, p. 103. http://europa.eu.int/comm/employment_social/employment_analysis/employ_2004_en.htm.

on the employment rate, as this rate is more conclusive concerning the possibilities of boosting, or at least sustaining, economic growth (beyond the long-term trend resulting from labour productivity increases) in an ageing society. As Figure 3 shows, up to the mid 1970s, the European Union's proportion of the working-age population that is employed exceeded that of the USA. The rate stood at 64% in the EU, compared to 62% in America. By 1997 employment had dropped to 60.5% in the EU, whilst that of the USA had improved significantly. It had reached 74%, i.e. there was a difference of almost 14 percentage points, the so-called EU-US employment gap. In 1997 this gap was equivalent to about 34 million "missing jobs" in the European Union. Although this gap has narrowed somewhat in the meantime, it is still large.

What are the reasons for this divergent development in the Atlantic labour markets? Figure 4 shows that the employment gap can be attributed to a slower transformation of the EU from a goods-producing to a service-producing economy. While Europeans have slightly higher employment rates in industry and agriculture, their employment rates in services industries are significantly lower than in the USA. Figure 5 shows that with respect to age and gender, the main sources of the EU-US employment gap are three specific groups: young people (age 15-24), older people (55-64) and prime-age women (25-54). Employment in these groups is significantly lower in the EU whilst employment among prime-age males is at similar levels in the EU and the USA.

Germany's employment rates have been stagnating at a high level since 2000 while unemployment rates have risen and exceptionally high rates of structural and long-term unemployment have continued to be sad hallmarks. In 2004 the overall employment rate (65%) was about at the EU15 average (64.7%). Its performance concerning youth employment was better than average (41.9% versus 40.0%), for older people it was slightly worse than average (41.8% versus 42.5%) and it was considerably better than average for prime-age women (72.1% versus 68.8%).[8] These numbers are strongly influenced by more or less effective government policies. Relatively high employment levels among younger Germans show that Germany's dual education system works quite well, although rising unemployment rates in this segment of the labour market

[8] European Commission: Employment in Europe 2005. Recent Trends and Prospects, Luxembourg 2005, Statistical Annex 2, http://europa.eu.int/comm/employment_social/employment_analysis/employ_2005_en.htm.

also show that this group will need more attention in the future. The situation of older Germans would be better if they had not been laid off in the 1990s in great numbers with generous government support with a view to reducing the more publicly visible unemployment rate. The employment rate of prime-age women could be improved in the future if more attention was paid to the compatibility of family and work, for example by expanding the public day care system for children, a goal quite explicitly formulated in the Coalition Agreement of the new government of Social and Christian Democrats. Progress with the integration of all these groups into the labour market would not only help the welfare state indirectly by broadening the tax base and limiting social security expenditures; it would also lead to a direct benefit as it would mean a considerable improvement in social inclusion. Younger and older people as well as both women and men should participate in the labour market on equal terms with equal opportunities.

Ageing Population

Ageing, the third challenge to the welfare state, serves as a magnifying glass for existing problems.[9] The over-65 age group will increase by more than 50% in Europe by 2030. An employment rate of close to 80% would be needed to offset the resulting negative effects on economic growth, social pension schemes and the welfare state as a whole. All industrial countries face such problems related to ageing, but to different degrees. Due to an exceptionally high total fertility rate of more than 2 children per woman, the USA is again in a rather comfortable position compared to other OECD countries. The reform of Social Security, the US public pension scheme, has recently been put on the back burner in Washington DC as problems in the system are currently predicted not to occur until as late as 2041 and as Americans do not seem to see a reform of the system as a high priority. Germany on the other hand was one of the first countries in the EU to be confronted with the stagnation of its working-age population. With 1.3 children per woman, its fertility rate is lower than the EU average of 1.5 and considerably lower than that of member states with a more successful family policy, such as Finland, Sweden and Denmark, which each have birth rates of 1.7. The consequences are visible at all levels of the federal system in Germany. Saxony, one of the new Länder which has already had to cope with out-migration to the old Länder over the past 15 years, will over the course of the next 15 years see a decrease of 590 000 people, equivalent to 13% of its total population (or equivalent to one of its major cities, Leipzig, plus a smaller one, Plauen). Due to the changing age structure, the 13% population decrease translates into a decrease of 25% of the working-age population. Assuming that growth rates remain as unsatisfactory as at present, Saxony will have to deal with a 23% reduction in state and local taxes in 2020. At the same time, costs for old age pensions and care of the elderly will increase tremendously.[10]

Globalisation, the fourth challenge to the welfare state, has often been overestimated relative to the other three challenges in the public debate in Germany. There are at least two misconceptions: first, that globalisation is a new phenomenon which brings with it totally unprecedented challenges and second, that Germany is unfit to deal with these challenges. While today's dynamic globalisation process goes back to the 19th century and was only temporarily interrupted by two World Wars and the Great Depression, Germany enjoys a spectacularly strong position in the world economy even today. The country was world champion in the export of goods, ahead of the United States and China, in 2003. In the years 1999 through 2004 nearly all of the cumulative economic growth of 6% was due to the net external contribution. Contrary to public belief, trade has not had a negative, but a tremendously positive influence on the German economy. In other words, without international trade, economic growth would have been significantly lower than it already was.

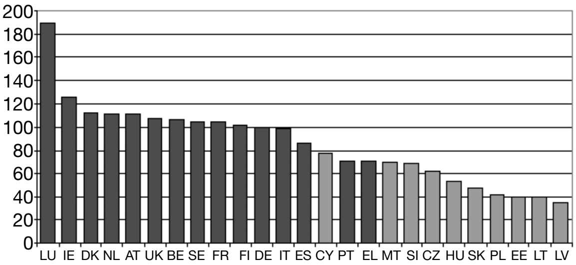
What Social Model?

The social policy challenges that lie ahead of national governments lend urgency to the question as to how Brussels can contribute to meeting these challenges. As indicated by recent German and French comments, public discussion centres on the idea that the European social model is at a crossroads. Thus, the key question is whether Europeans will be able

[9] Klaus Kwasniewski: Europe's Demographic Challenge, in: INTERECONOMICS, Vol. 40, No. 2, March/April 2005, pp. 54-55.

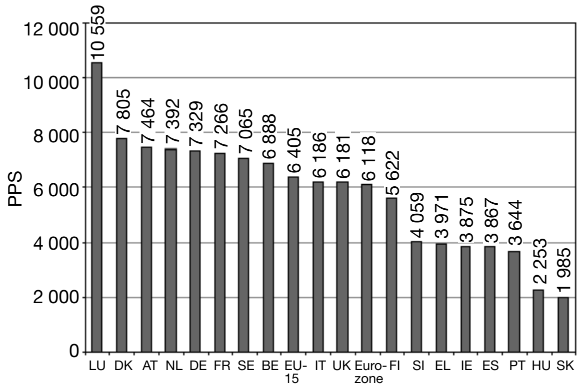
[10] Georg Milbradt: Sachsens Zukunft in der Mitte des vereinten Europas. Regierungserklärung des Sächsischen Ministerpräsidenten, Prof. Dr. Georg Milbradt, 22.04.2004, in the Parliament of Saxony, http://www.sachsen.de/de/bf/reden_und_interviews/reden04/milbradt-2204.html. First ideas for this paper, which the author presented at the Economics Department at Seoul National University and the China Center for Comparative Politics & Economics in Beijing in the autumn of 2005, were developed for the opening presentation at the summer academy "Armut in der Wohlstandsgesellschaft. Eine Herausforderung für den sozialen Rechtsstaat", which was held at the Sächsische Fachhochschule für Verwaltungswissenschaft in Meissen, Sachsen in August 2005. For great hospitality and enlightening remarks and questions the author wishes to thank especially Rolf-Dieter Kubitza, Yang Xuedong and Donghyu Yang. He is also indebted to the VolkswagenStiftung for its support of the project "Globalization: Challenges For Labor Market and Social Policy" as part of its programme "Future Issues of our Society – Analysis, Advice and Communication between Academia and Practice".

Figure 6
GDP per Capita in Purchasing Power Standards 2002
(EU15=100)



Source: European Commission: The Social Situation in the European Union 2004, Luxembourg 2005, p. 16. http://europa.eu.int/comm/employment_social/social_situation/docs/SSR2004_en.pdf.

Figure 7
Expenditure on Social Protection 2001
(per capita)



Source: European Commission: The Social Situation in the European Union 2004, Luxembourg 2005, p. 60. http://europa.eu.int/comm/employment_social/social_situation/docs/SSR2004_en.pdf.

to maintain their high level of welfare expenditure or whether they will have to give in to the radical dismantling of the welfare state often referred to as the "neoliberal" path, for which the USA is usually taken to be a negative example. A look at the political realities in the European Union, however, leads to quite a different question: are there actually policies at the European level worthy of the name "Social Europe", or more specifically, is EU social policy more than the sum total of the social policies of its member states?

A look at policies and institutions at the national level indicates whether there is a common European denominator in social policies. The most often cited typology of welfare states is that by Esping-Andersen,[11] according to which there are three different social welfare models in western industrialised states: the social democratic, the conservative, and the liberal model. The social democratic model focuses on the state as provider of social insurance programmes which are universal in coverage and homogeneous in benefit levels. The conservative model places the emphasis on the role of the family as the nucleus of the welfare state. It is characterised by a strong differentiation of contributions to, and payments from, social insurance programmes. The liberal model leaves more responsibility to the market than the other two models, for example by emphasising the role of private as opposed to public retirement and health insurance plans. As the public plans are means-tested they do not provide homogenous benefits or universal coverage.

All three models can be found in the EU, although the liberal model was not as strongly represented here as the conservative and the social democratic models at the time of Esping-Andersen's analysis in the 1980s. But the analysis is not up-to-date. Since the 1980s, three developments have altered the face of European social policy dramatically. Firstly, over the last 25 years the UK and Ireland have increasingly relied on the market as they stress high employment levels as one of the most important weapons against social exclusion and poverty. Secondly, Scandinavian countries, most of which feature as prime examples of social-democratic welfare systems in Esping-Andersen's study, have made important changes as well. These countries have put strong emphasis not only on improving education, starting in early childhood, but also on labour market participation. Countries like Denmark have successfully boosted employment with a strategy of "flexicurity", a combination of a high level of flexibility in the labour market, unthinkable in countries like Germany and France even today, and generous payments to those who are out of work or who have to be retrained. Thirdly, and probably most importantly, the EU enlargement has brought ten new member states with yet another set of national welfare systems into the Union. It is not quite clear yet what the main characteristics of these systems are going to be as they are still under construction. The economic basis of the welfare systems of the new members is however so different from that of the old ones that enlargement undoubtedly means a further drifting apart of already quite different national systems.

GDP per capita for the population living in the most prosperous member states of the European Union of 25 (excluding Luxembourg) is currently three times higher than the GDP per capita for the population living in the least prosperous member states (Figure 6). Not surprisingly, social protection expenditures also

[11] Gøsta Esping-Andersen: The Three Worlds of Welfare Capitalism, Princeton 1990, Princeton University Press.

show considerable disparities in the enlarged EU (Figure 7). Expenses on social protection per capita are 3 to 4 times higher in countries like Denmark, Austria, Netherlands, Germany and France than in Hungary and Slovakia. But there are even dramatic differences among the old member countries concerning relative spending levels.[12] While countries like Sweden, France and Germany spend up to 30% of their GDP on welfare, Ireland, the country with the lowest level of welfare expenditures to GDP, spends only 14%. As with quite a few other welfare state indicators, the USA does not emerge in this comparison as an outlier, as in fact its welfare per GDP expenditure is somewhere at the lower end of the spectrum of the EU-15. Moreover, exceptionally high economic growth rates in Ireland suggest that in absolute terms living standards of the poor in this part of the EU have been catching up quickly with those of the poor in countries like France and Germany.

Given the significant differences in national welfare systems in the EU it is hard to imagine what influence Brussels could have had in the past on national social policies or what opportunities it will have in the future to play a decisive role in these policies. And indeed since the establishment of the European Economic Community in 1957 the focus of the integration process has not been on social but on economic integration. Since the signing of the Treaties of Rome the most important achievements of the EU have been the dismantling of tariff barriers in the late 1960s, a considerable reduction of non-tariff barriers through the Single Market Programme in the 1990s, and the adoption of a single currency, the euro, at the end of the 1990s. Compared to the many other preferential treatments that have developed over recent decades in other parts of the world, the high degree of economic integration accomplished in Western Europe is unique. Apart from helping to secure peace on the war-ridden continent, the economic integration contributed considerably to the breathtaking improvement of living standards experienced in the second half of the 20th century by both the well-to-do and the needy.

Slow Start

Compared to economic integration, social integration had a slow start in the European Economic Community. Early initiatives focused on facilitating labour mobility, one of the four fundamental freedoms agreed upon as long-term goals in the Treaties of Rome.[13] However, efforts to make vastly different social security systems more compatible with each other for migrant workers have only made minor progress and are still one of the most important tasks of European social policy today. An all in all fruitless period of social activism started in Brussels in 1972 with a summit meeting held in Paris, at which heads of government defined social policy as a new field of Community action. Inspired by the expansion of the welfare state that had taken place at the national level in the 1950s and 1960s, these activities ran dry after only a few years. The fast rise of stagflation in the 1970s led many European governments to a first serious reconsideration of the route that post-war national economic and social policies had taken and – more importantly – to a concentration on national economic and social policy and a retreat from the European integration process.

A renaissance of European social policy occurred only with the revitalisation of economic integration through the formulation of the Single Market Programme in the mid-1980s and the introduction of the euro. Important new social policy initiatives were started with the Single European Act (1986), which introduced majority voting and covered work health and safety and established a dialogue between management and labour; with the European Social Charter (1989), which was originally signed by all members but the UK; with the Maastricht Treaty (1993), which expanded majority voting to areas such as equal opportunity, information and consultation of workers; and with the signing of the EU Constitution (1994). If ratified by the member states, the Constitution would have given full legal status to the ratified Charter of Fundamental Rights. As supporters of a more active EU social policy point out, the Charter could have then been used by the European Court of Justice to advance Brussels's social policy agenda independently of the formal EU policy process.

Lisbon Strategy

An important modification of EU social policy came with the introduction of the Open Method of Coordination (OMC) at the turn of the century.[14] After it was introduced to European labour market policy in 1997 in the so-called Luxembourg process, it was expanded

[12] Organisation for Economic Cooperation and Development: OECD Factbook 2005: Economic, Environmental and Social Statistics, Paris 2005, p. 167.

[13] The four fundamental freedoms are free movement of goods, persons and capital, and the freedom to provide services.

[14] The formulation of the European Employment Strategy can be attributed to social democratic plans and initiatives. Cf. Wolfgang Merkel, Tobias Ostheim: Policy Making in the European Union: Is There a Social Democratic Space?, Friedrich-Ebert-Stiftung, Internationale Politikanalyse, Bonn 2004; Manuela Glaab, Werner Sesselmeier: Experimentierfeld Deutschland? Reformstrategien in Deutschland auf dem Prüfstand, Friedrich-Ebert-Stiftung, Gesprächskreis Arbeit und Soziales, Bonn 2005.

to social policy as part of the Lisbon strategy in 2000. Instead of setting minimum standards for all members through directives, this policy encourages a process of mutual learning across national boundaries under common guidelines. According to this new method, the key to progress in EU social and labour market policy is learning from "good practices" (or "best practices") of other member states. In its substance, the Lisbon strategy reflects weaknesses of the European economy compared to that of the US economy: its most important foci are long-term structural unemployment, a poor employment rate, and underdevelopment of the service sector.[15] Moreover, the Lisbon strategy states explicitly what the history of the development of Western European welfare states had already taught: a close relationship between economic growth and international competitiveness on the one hand and social concerns on the other. In an often-quoted sentence, the Lisbon strategy has (somewhat immodestly) prescribed for the EU the strategic goal of becoming "the most competitive and most dynamic knowledge-based economy in the world, capable of sustainable economic growth, with more and better jobs and greater social cohesion".[16]

But what has emerged from decades of a more or less active EU social policy? According to public announcements by the European Commission, the EU's social model spans a wide field today: "From education and training to employment; from welfare and social protection to dialogue between trade unions and employers; from health and safety at work to the fight against racism and discrimination."[17] But enumerations of this kind and similarly optimistic statements by EU diplomats are problematic. In reality, Brussels' influence on social policy is rather limited. Directives for social and employment policies are highly selective in their reach. At least 95% of all laws and regulations are still national.[18] If evaluated by their influence on decisive policy issues, national policies could play an even stronger role than might be concluded from this figure. Because EU decisions on social and labour market policies have to be made either unanimously or with a qualified majority, the great majority of directives are drafted so as not to disturb national priorities and processes. The only field in which Brussels has clearly set standards above those in many member states is work health and safety.

The modest influence that Brussels has had on social policy until the present can also be described in terms of financial resources. EU social expenditures are minuscule compared to the social expenditures of the member states. In 2002 the total EU budget was roughly €100 billion, only €34 billion of which were spent on "Structural Operations". Combining Structural Funds and the Cohesion Fund, these operations have a focus on assisting less prosperous regions and can thus be characterised as social expenditures only in the broadest sense of this term. Still, Germany's social expenditures alone, an amount of €685 billion in 2002, were about 20 times as high.

What will the Future Bring?

While the role of EU social policy is presently limited, the chances that Brussels will significantly expand its role in this policy field over the next few years are small to zero. Independently of individual preferences for or against an expansion of the EU's influence on national policies, there are quite a few factors that suggest that a change of course is highly unlikely.

- As mixed as the signals are that come from the complex system of primary and secondary European law that has emerged over a period of almost 50 years, the little action in crucial areas of social and labour market policies such as pay, the right of association, the right to strike or the right to impose lock-outs, represents a wide consensus among the member states about keeping Brussels's involvement to a minimum. The parameters of this consensus become apparent if not EU web sites, brochures and official commentaries are considered but the facts concerning how much political power has been delegated from national governments to Brussels and how this power can be used to formulate EU social policies that set meaningful new standards for national policies. The constraints that come from majority, and especially unanimous, decision-making and from limited EU budgets will also keep the influence of the EU on social and labour market policy at a low level in the years to come.
- Another important point to consider is the British government, which presently holds an important negotiating chip in its hands in the form of the rebate on the contributions to the EU budget. The argument that the British government gave for its refusal to give up on the rebate and thus pave the way for an

[15] EurActive: The Lisbon strategy and the open method of co-ordination, 2005, http://www.euractiv.com/Article?tcmuri=tcm:29-136232-16&type=Analysis.

[16] Ibid.

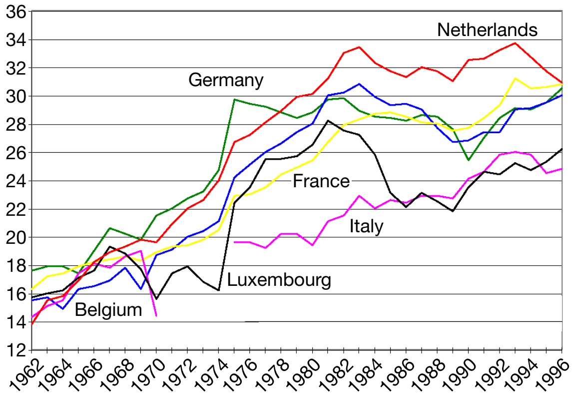
[17] European Commission: European employment and social policy: a policy for people, Brussels 2000, http://europa.eu.int/comm/publications/booklets/move/24/index_en.htm, p. 32.

[18] Wolfgang Däubler: Die Europäische Union als Wirtschafts- und Sozialgemeinschaft, in: Werner Weidenfeld (ed.): Europa-Handbuch, Gütersloh 2002, pp. 477-489, here p. 483.

agreement on the EU financial framework for 2007 to 2013 is the necessity for reform of the EU's Common Agricultural Policy (CAP), which, according to Tony Blair, cannot wait until 2014. And indeed this policy is not at all suited for solving pressing challenges such as low growth, high unemployment or ageing. With its uneven payments to regions and member states that eat up 40% of the EU budget, the CAP is in fact a bad example of European redistribution policies and may even deter people who otherwise might be in favour of them from supporting such policies. Having said that, solving the problem of the CAP is one of the few chances the EU has to make more room for active labour market and social policies along the lines of the Lisbon Strategy.

- Even if more member states were to join France and Germany in their view that expanding the role of European social policy should be a priority for the EU in the future (and in the unlikely case that the new German government follows up on the public statements of the old one), the key question remains: what is Social Europe? Is it an endeavour to find common ground, i.e. to facilitate a convergence of heterogeneous national welfare models towards a common European model? If so, would this mean divergence towards a European average concerning welfare expenditures and minimum standards? If it does, would this in turn mean that countries like Germany and France would have to accept a much lower level of social protection than they have at present? Would the new member states have to try, on the other hand, to afford expenditures and reach standards that Germany and France did not when they were at the new members' stage of economic development?
- Because a common-ground scenario that aims at a European average appears unrealistic from the perspective of various member states of the enlarged EU, plans that aim at a common ground on either a lower-than-average level or a higher-than-average level seem to be even less feasible. Consequently authors like Merkel and Ostheim suggest a "two-speed Europe" as the most promising "social democratic option" for the future.[19] But given the differences in welfare state philosophies within the EU-15 even this plan does not look very realistic.
- What are the solutions at the institutional level? What for example can be done about different pension systems like the Beveridge systems and Bismarck systems? What about the fragile distributional balances that each and every one of these national systems support within each member state?

Figure 8
Welfare Expenditures as a Percentage of GDP 1962-1996



Source: Hermann Berié, Ulf Fink: Europas Sozialmodell. Die europäischen Sozialsysteme im Vergleich. Eine volkswirtschaftliche Analyse, WISO Institut, Berlin 2000, Diagramm 3.

- While it is difficult to envision a path that European social policy could realistically take, another question is whether a convergence process is necessary or desirable. One of the most important arguments in favour of a stronger role for the EU in social policy is that without it the social policies of the member states will face a race to the bottom. And this is of course a serious issue, not only for the member states of the EU but for all industrialised countries. In the long run, high international mobility of capital might indeed strike a new balance between the rich and the poor within countries, which could be unfavourable for labour or at least for low-skilled and unskilled workers in industrialised countries in North America and Western Europe. But contrary to this argument, trends in welfare spending of EU member states and other Western industrialised countries give no clear indication of the existence of such a race to the bottom. Rather, they indicate a consolidation of welfare expenditures at a historically high level (Figure 8).

In other words, although change in EU social policy is not likely to occur in the next few years or even in the next decade, this does not necessarily mean that Social Europe faces a problem. A great part of the answer to the question as to what will become of Social Europe in the future has already been given in the past with the introduction of the Open Method of Coordination and its emphasis on mutual learning across national boundaries instead of harmonisation. Instead of seeing the EU's many differences in welfare state in-

[19] Wolfgang Merkel, Tobias Ostheim, op. cit.

stitutions and social protection levels as a weakness, this new method recognises them as a strength. But of course not everybody will be satisfied with such an outcome, as it indeed sets no minimum standards.

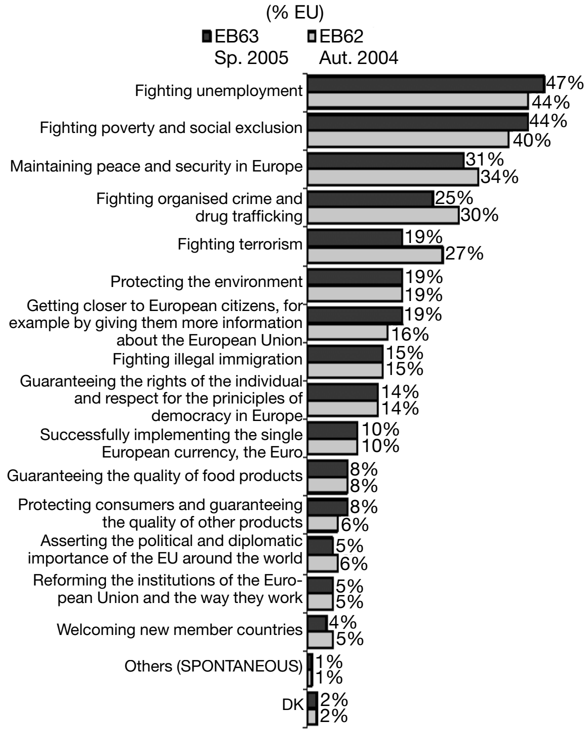
Only those who believe that competition is a useful principle not only for organising production but also for effective public governance, and who equally believe that even a totally homogenous Social Europe would have to rise to external challenges to secure the living standards of its citizens, will find this new path promising. Indeed the "European Social Laboratory" provides the EU with an impressive wealth of information on what can go right and what can go wrong in social and labour market policies. The countries most often cited for successful policies are not only the UK and Ireland, whose approaches to social protection in many respects indeed closely resemble that of the USA. Many examples of good practices come also from Scandinavian countries like Sweden and Denmark, who have given up old welfare traditions only where it seemed necessary, for example through the introduction of more flexibility in the labour markets. These countries provide proof not only that economic growth can be improved significantly in a European environment but also that high growth rates can be combined with social inclusion, a strong social safety net, and forward-looking policies on issues such as equal opportunities and the environment. In quite a few areas, even countries that are latecomers on the scene of economic and social reform, like Germany, have to offer good practices to other countries. The integration of young people into the labour market through the dual system of vocational training is a case in point.

The general lesson that can be learned from mutual learning under the OMC is that yesterday's welfare state and class ideologies, no matter from which part of the political spectrum they come, are today's enemies of a successful modernisation of the welfare state. New challenges demand new thinking and, if welfare is to be sustained, a new mix of social and labour market policies.

Social Policy and the Crisis

Back to the main question: What role does social policy play in the current crisis in the EU, that is against the background of negative referenda on the EU Constitution in France and in the Netherlands? The central lesson that can be learned from the crisis is that Europe needs support for its policies from its citizens if it wishes to survive. The only way to gain this support is to start a candid dialogue with European citizens over

Figure 9
The Actions that the European Union Should Follow in Priority
(% EU)



Source: European Commission: Eurobarometer 63: Public Opinion in the European Union, First Results, Brussels 2005, p. 47. http://europa.eu.int/comm/public_opinion/archives/eb/eb63/eb63.4_en_first.pdf.

what Brussels can and cannot do in various policy fields, not least of all regarding social policy.

The most recent opinion polls of the euro barometer show that expectations of EU social and labour market policies are quite high among citizens. While the poll results indicate decreasing trust in the EU as an institution they also show that expectations are highest and rising in the areas of social and labour market policies, i.e. in fields in which the EU is not in a very strong position to make major changes in the near future. Citizens are convinced that fighting social exclusion and unemployment should be Brussels's top priority (Figure 9). While for example in the EU25 some 47% of the population shares the view that Europe's number one policy priority should be the fight against unemployment, in Germany this rate stands at a remarkable 60%.[20] Although these demands are by all means understandable, especially for countries in which the national reform process has not yet been

[20] European Commission: Eurobarometer 63: Public Opinion in the European Union, First Results, Brussels 2005, http://europa.eu.int/comm/public_opinion/archives/eb/eb63/eb63.4_en_first.pdf.

very successful, they might very well go unmet given the basic constellations of EU social policies.

Encouragingly, first steps in the direction of more frank communication with European citizens have already been taken. Jean-Claude Juncker, the Luxembourg Prime Minister and one of the supporters of a strong Social Europe, when he was recently repeatedly asked by German journalists about the future of "the European social model" said, "It is obvious in any case that there is not one, single, European social model. There are many varieties ..." and "There is a new version of the Lisbon strategy. It states that we need a more competitive economy, but that we should not ignore social and environmental policy aspects in our efforts at modernisation."[21]

More such frank statements from European politicians may frustrate the European electorate in the short run but will help the European project in the long run. On the other hand, it would certainly be preferable for Europeans to have a common vision of a Social Europe worthy of the name, as present challenges to the sustainability of social protection are indeed one of the most pressing issues for Brussels and for national governments. But great words have to be based on realistic concepts and concrete suggestions. Those who have them should put them on the table.

[21] Der Friedensdiskurs reicht nicht mehr, Interview with Jean-Claude Juncker, in: Frankfurter Allgemeine Zeitung, 29.7.2005, http://t4h.faz.net/s/Rub99C3EECA60D84C08AD6B3E60C4EA807F/Doc~E33DBF3579D0A454586FAD7417C3208A7~ATpl~Ecommon~Scontent.html.

Karl Aiginger* and Alois Guger**

The Ability to Adapt: Why It Differs between the Scandinavian and Continental European Models

It is well recognised today that European economic performance has deteriorated since the beginning of the 1990s. This is the case whether we compare the performance with that of the past, with that of the USA or that of the fast growing economies in China or India. Growth has also been disappointingly low and unemployment high compared to the expectations raised by the European integration and enlargement project. Many authors blame the high level of taxes and government expenditures, the degree of regulation, and the costs of welfare ("big government hypothesis") in Europe as the main reason for European underperformance.

Differences in Performance

This article explores the differences across European models in order to learn about the reasons for underperformance and about successful strategies to keep European countries competitive in the world economy. We largely follow the standard definition of model types, specifically distinguishing between a Scandinavian version, a continental version and an Anglo-Saxon version of the European model. We add a Mediterranean model and a catching-up model for the new member countries but focus on the differences among the three "main models". The Scandinavian group – while not performing better in the long run and struck by many crises up to the early 1990s – since that time has enjoyed higher growth, high employment, decreasing unemployment and finally a budget surplus. We try to find out how these countries specifically adapted their economies to the new challenges of the globalising economy in which higher "business flexibility" and "worker adaptability" is needed: for firms it should be easier to establish new businesses by abolishing unnecessary rules and easing access to capital markets for small and medium-sized firms;[1] for workers this means that employees are enabled to respond flexibly to changes and to take advantage of new opportunities, such as high-quality education and first-class schools, housing, transportation and affordable child care.

A tentative hypothesis is that the Scandinavian countries realised the extent of new challenges, since the burden of welfare, the prediction of upcoming

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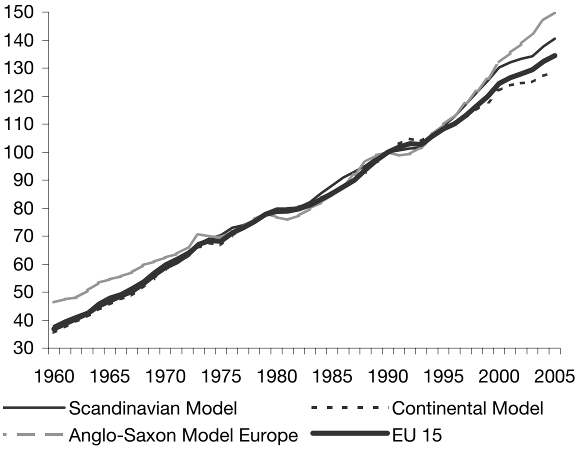
[1] Extended by a "secondary" capital market where loans are easily securitised and where there is better income protection in the case of bankruptcy.

Figure 1
Performance: Growth of Real GDP; 1990=100



Source: Eurostat (AMECO); as to sub-aggregates weighted average over countries; EU 15 reported.

problems as well as the experience of severe crises had made it crystal clear that the economies had to become more flexible and that the institutions of Scandinavian society cooperated with experts efficiently to develop a long-run strategy with a strong commitment to the welfare state, a consensus across society and deep trust among all members of society. The necessity to increase flexibility may have been lower in liberal countries – though these countries made some moves in similar directions. Their problem has not been macro-economic underperformance – low growth and high unemployment – but high and rising inequality and poverty. However, for "liberal" countries the evidence in Europe is limited to two countries (United Kingdom and Ireland) with very different economic policies, histories and growth experiences over the past decades. The necessity for change was underestimated in the continental countries where institutions did not cooperate to face the new challenges. The difference in the adaptability of the three main European models has some similarity to the well-known Calmfors-Drifill[2] hypothesis that countries with a medium degree of centralisation did worst in wage bargaining, compared to countries with centralised bargaining processes on the one hand and to decentralised bargaining at the firm level on the other hand. Of course the arguments relate to different issues and have different drivers, but common ground is that a medium position may not always be the best.

The paper is structured as follows. First, we briefly repeat the common characteristics of the European model and which model types we choose to distinguish. We prefer to speak of a model of European society or a socio-economic model, since the models and reforms relate not only to social issues, but also to regulation, incentives and the innovation system. We then compare the performances of different types of models, first by examining the dynamics of GDP, productivity and employment and then investigating a wider set of indicators.[3] This is followed by a description of the differences between the Scandinavian countries and the continental countries in three policy areas: size of government and dynamics of social expenditures, regulation and improving incentives on the labour market and, finally and most important, the level and dynamics of investment into the long-run drivers of economic growth. Finally, the differences are summarised between the old European welfare model and the reformed model, elements of which are emerging in many European countries, most of them Scandinavian, and to a much lesser extent in the big continental countries. The new European model certainly differs from the old European welfare state model but also from the US model.

Model(s) of European Society

There has been no agreement on a common definition of the European model. We prefer to define the European socio-economic model in terms of the responsibility of society for the welfare of the individual. Labour and product markets are regulated, with regulation (partly) shaped by the social partners. Income differences between rich and poor are limited by taxes and transfers.[4] These three basic characteristics – responsibility, regulation, redistribution – reflect the fact that the European model is more than just a social model in the narrow sense. Indeed, it also influences production, employment and productivity, and thus growth and competitiveness as well as all the other objectives of economic policy. Furthermore, the European model influences social relationships, cultural institutions and behaviour, learning, and the creation and diffusion of knowledge. We therefore prefer to speak of a European socio-economic model rather than merely a social model.

In differentiating between several versions of the European model it is standard practice since the work of Esping-Andersen[5] to distinguish between a

[2] L. Calmfors, J. Drifill: Bargaining structure, corporatism and macroeconomic performance, in: Economic policy, Vol. 3, No. 1, 1988, pp. 14-61.

[3] K. Aiginger: The three tier strategy followed by successful European countries in the 1990s, in: International Review of Applied Economics, Vol. 18, No. 4, 2004, pp. 399-422.

[4] K. Aiginger, A. Guger: The European Social Model: from an alleged barrier to a competitive advantage, in: Journal of Progressive Politics, Vol. 4.3, Autumn 2005, pp. 40-47.

Table1
Performance across Models: GDP and Employment

	1960/ 1990	1990/ 2005	GDP per capita at PPP 2005	Employ-ment rate 2005	Unem-ployment rate 2005
	Annual growth in %		1,000 €		
Scandinavian Model	3.3	2.3	29.0	74.2	5.6
Denmark	2.7	2.2	28.6	77.2	4.6
Finland	3.9	2.0	26.6	68.6	8.4
Netherlands	3.4	2.2	28.7	73.6	5.1
Sweden	2.9	2.0	27.0	73.7	6.8
Norway	3.9	3.2	34.7	77.7	4.0
Continental Model	3.5	1.7	25.2	66.2	8.9
Germany	3.2	1.7	25.0	70.0	9.5
France	3.8	1.9	25.9	63.8	9.6
Italy	3.9	1.3	23.7	62.0	7.7
Belgium	3.4	1.9	27.6	61.8	8.0
Austria	3.5	2.2	28.0	74.8	5.2
Anglo-Saxon Model Europe	2.6	2.7	27.8	71.9	4.6
Ireland	4.1	6.5	31.9	68.6	4.3
United Kingdom	2.5	2.4	27.6	72.1	4.6
Mediterrean Model	4.6	2.8	21.8	63.6	9.1
Greece	4.5	3.0	19.5	55.0	10.4
Portugal	4.8	2.1	17.5	70.5	7.4
Spain	4.6	2.9	23.1	64.1	9.2
EU 15	3.4	2.0	25.3	67.2	7.9
Japan	6.1	1.3	26.3	77.2	4.5
Catching-up Model	.	2.5	15.7	61.2	7.5
Czech Republic	.	1.3	16.7	65.4	7.9
Hungary	.	3.9	14.5	56.2	7.0
Anglo-Saxon Model Overseas	3.6	3.1	35.0	72.9	5.2
USA	3.5	3.1	35.8	72.9	5.1
Canada	4.0	2.8	29.5	74.1	6.8
Australia	3.8	3.5	27.6	72.1	5.2
New Zealand	2.4	3.2	22.1	59.6	4.0
Scandinavian Model without NL	3.3	2.3	29.2	74.6	5.9
Continental Model without IT plus NL	3.4	1.6	23.3	61.2	8.3
Mediterrean Model plus IT	4.2	1.2	9.2	26.8	3.8
Anglo-Saxon Model Total	3.5	3.0	34.1	72.7	5.1

Source: Eurostat (AMECO); as to sub-aggregates weighted average over countries; EU 15 reported.

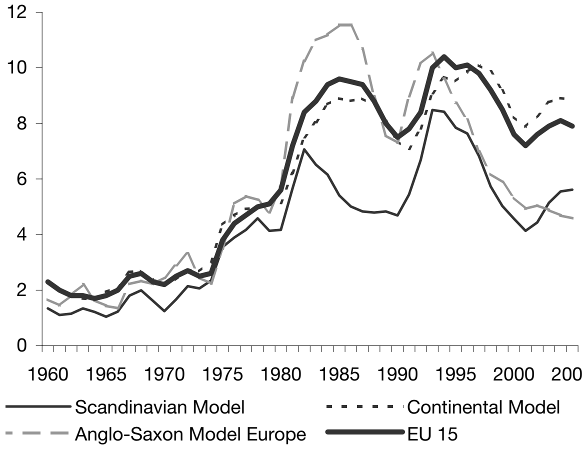
Scandinavian model (often called the Nordic model), a continental model (also known as the corporatist model and sometimes as the Rhineland model) and an Anglo-Saxon model (the liberal model). We may add a model where low levels of social expenditures are combined with supportive family networks. This is the case in southern European countries ("Mediterranean model"), where some characteristics of agrarian societies still prevail. A fifth model, not yet elaborated, may emerge for the new member countries of the European Union. Several social institutions were first founded after the transition; these countries are short of the financial means for a comprehensive welfare system and they are determined to catch up with the old member countries e.g. by attracting foreign direct investment. We will therefore call this fifth model the "catching-up model". Outside of Europe, the US model serves as the standard benchmark for an Anglo-Saxon model overseas. The USA is grouped together with Canada, Australia and New Zealand as the "Anglo-Saxon overseas model". Japan, as well as the other industrialised Asian economies, remains an outsider to this discussion.

The Scandinavian model is the most comprehensive, with a high degree of emphasis on redistribution; social benefits are financed to a large extent by taxes. Institutions work closely together with the government, wage bargaining is centralised and trade unions are involved in the administration of unemployment insurance and training, and the model is characterised by an active labour market policy and high employment rates. The continental model emphasises employment as the basis of social transfers. Transfers are financed through the contributions of employers and employees. The social partners play an important role in industrial relations, and wage bargaining occurs less at the firm level but either at the industry level or at an even more centralised level. Redistribution and the inclusion of outsiders are not high on the agenda. The liberal model emphasises the responsibility of individuals for themselves, its labour market is not regulated and its competition policy is rather ambitious. Social transfers are smaller, more targeted and "means tested" than in the other models. Labour relations are decentralised, and bargaining takes place primarily at the firm level.

We include five countries in the Scandinavian group. The inclusion of the Netherlands is the most contentious choice, because the Dutch model is less ambitious, redistributes less and places less emphasis on gender equality (at least up to the 1990s). We pool five countries in the continental model – France, Germany and Italy, which are the three big continental countries, plus Belgium and Austria, two high-growth countries with top positions in per capita GDP. There is a certain amount of disagreement as to whether Italy fits better into this group or into the Mediterranean

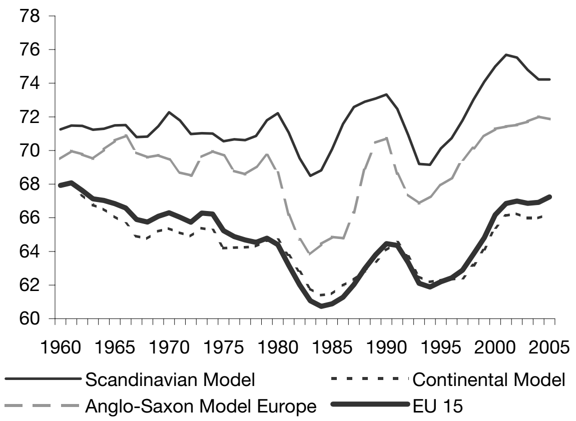
[5] G. Esping-Andersen: Three Worlds of Welfare Capitailsm, Cambridge 1990, Polity Press.

Figure 2
Unemployment Rate



Source: Eurostat (AMECO); as to sub-aggregates weighted average over countries; EU 15 reported.

Figure 3
Employment Rate



Source: Eurostat (AMECO); as to sub-aggregates weighted average over countries; EU 15 reported.

group. We decided to delegate Italy to the continental group due to the economic importance of Northern Italy, and the Mediterranean model therefore comprises Spain, Portugal and Greece. The Anglo-Saxon model is championed in Europe by the United Kingdom. As far as the low degree of regulation and the social system are concerned, Ireland exhibits a certain degree of similarity to the United Kingdom, but policy interventions have been intense, as is typical of a catching-up country: high shares of inward FDI, low taxes for business, and a regional policy supporting small and medium-sized firms. In Europe, these strategies are now the paradigm for catching-up economies. Outside of Europe, we group Canada, the USA, New Zealand and Australia together, under the heading "Anglo-Saxon model overseas".

The results presented are robust whether we use a weighted or an unweighted average over the individual countries in building performance indicators for groups.[6] We decided to use weighted averages. The result is also robust if we change the members of the groups slightly, for example by shifting the Netherlands to the continental model and Italy to the Mediterranean model or integrate European and new European countries into an "Anglo-Saxon model total" (see the last four rows in Table 1).

Economic Performance According to Type of Model

Table 1 shows that long-run economic growth had been very similar for the three main models (Scandinavian, continental, Anglo-Saxon), and that in the period 1960 to 1990 it was also rather similar in Europe to that in the USA. Performance in the nineties (1990/2005) diverged however. The Scandinavian group enjoyed a growth rate of 2.3% for these 15 years – despite a severe crisis in many countries in the early 1990s.[7] The growth rates of the countries associated with the continental model plummeted to 1.7%, due to low growth in Germany and Italy. France and Belgium came near to the average of the EU15 and Austria surpassed it, but none of them reached the level of dynamics attained by the Nordic group. The countries of the Anglo-Saxon model Europe enjoyed high growth – including the highest for a single country. However, this group consists in Europe of only two members with very different economic histories. Ireland is a late, and then very successful, catching-up story, while the UK rebounded from three decades of slow growth, in which it had lost its historical lead in per capita GDP. In highlighting the differences between successful and less successful strategies, we concentrate on the Scandinavian and the continental group, reporting the average of the EU15 and that of the Anglo-Saxon countries Europe as "benchmarks".

The differences in economic performance between the Nordic countries and the big continental economies are elaborated by Aiginger,[8] who uses a set of 12 indicators for the dynamics of output, productivity and employment, as well as for the level and changes in unemployment and fiscal balances to derive a more comprehensive "performance evaluation" of countries. Aside from the Irish growth experience, Sweden,

[6] With the exception of the Anglo-Saxon model Europe, where the United Kingdom dominates if we use weighted averages and Ireland dominates if we use unweighted averages.

[7] K. Aiginger, op. cit.; K. Aiginger, A. Guger, op. cit.

Table 2
National Finances and Social Expenditures

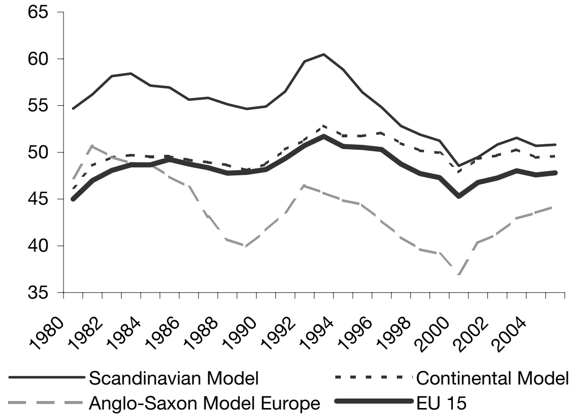
	Public revenues			Public expenditures			Budget deficit			Total social expenditures	
	1990	2000	2005	1990	2000	2005	1990	2000	2005	1990	2003
	In % of GDP										
Scandinavian Model	51.5	54.2	53.3	52.8	48.6	50.8	-1.0	5.6	2.5	29.7	29.5
Denmark	54.7	56.5	58.0	55.9	53.3	54.4	-1.3	3.2	3.5	28.2	30.9
Finland	53.5	55.9	53.5	48.1	48.8	51.7	5.4	7.1	1.8	25.1	26.9
Netherlands	47.4	45.6	46.4	52.5	43.4	48.2	-5.1	2.1	-1.8	31.1	28.1
Sweden	.	62.4	58.2	.	57.4	57.1	0.0	5.0	1.2	33.1	33.5
Norway	56.2	58.2	56.8	54.0	42.6	43.6	2.2	15.6	13.3	26.2	27.7
Continental Model	44.3	47.8	46.1	48.8	47.9	49.6	-4.5	-0.1	-3.5	25.9	29.5
Germany	42.1	46.4	43.1	44.1	45.1	46.9	-2.0	1.3	-3.8	25.4	30.2
France	47.7	50.4	50.6	49.8	51.8	53.9	-2.1	-1.4	-3.2	27.4	30.9
Italy	42.6	46.2	44.9	54.3	47.0	49.2	-11.8	-0.8	-4.3	24.7	26.4
Belgium	45.5	49.1	49.0	52.2	49.1	49.2	-6.7	0.0	-0.1	26.4	29.7
Austria	49.7	49.8	47.6	52.0	51.4	49.6	-2.4	-1.6	-2.0	26.2	29.5
Anglo-Saxon Model Europe	40.0	40.8	41.0	41.7	37.0	44.2	-1.7	3.8	-3.2	22.6	26.1
Ireland	40.0	35.9	34.9	42.8	31.5	35.3	-2.8	4.4	-0.4	18.4	16.5
United Kingdom	40.0	41.2	41.4	41.6	37.4	44.8	-1.6	3.8	-3.4	22.9	26.7
EU 15	42.7	46.2	45.1	48.2	45.3	47.8	-4.6	0.9	-2.7	25.4	28.3

Source: Eurostat (AMECO; ESSOSS); as to sub-aggregates weighted average over countries; EU 15 reported.

Finland and Denmark have been the best performers and were therefore designated by Aiginger as the "top countries".[9] Germany, Italy and France are the worst performing countries, and specifically for France a comprehensive evaluation reveals a worse performance than a comparison based on economic growth alone.[10]

In trying to find out the differences in the reaction of economic policy between the Scandinavian countries and the continental countries, we investigate the role of government, of labour markets and investment in the long-run growth determinants.

Figure 4
Government Expenditures as a Percentage of GDP



Source: Eurostat (AMECO); as to sub-aggregates weighted average over countries; EU 15 reported.

The Role of Government, Fiscal Deficits and Social Expenditures

The Scandinavian countries traditionally have a larger government sector and higher social expenditures than the continental economies, also in relation to the European average. Both indicators are lower for Anglo-Saxon European countries (and still lower in Mediterranean countries and in the Anglo-Saxon model overseas). In the last 15 years there has been a significant convergence between the models for expenditure rates but not for taxes. The difference in the share of public revenues, which was seven percentage points higher in the Scandinavian countries than in

[8] K. Aiginger, op. cit. The strong performance of Sweden, Finland and Denmark is based upon three pillars. First, these countries contained private and public costs in order to restore profitability and fiscal prudence. Secondly, they improved incentives by fine-tuning their welfare systems and deregulating part-time work and product markets. And thirdly, they significantly increased investment in future growth. In contrast, the large continental economies (France, Germany and Italy) underperformed in terms of investment in growth drivers, refrained from labour market reform and ran into persistent fiscal deficits.

[9] K. Aiginger, op. cit.

[10] K. Aiginger: Insufficient investment into future growth: the forgotten cause of low growth in Germany, in: Christoph Hausen, Marc Resinek, Nicolin Schürmann, Michael H. Stierle (eds.): Determinants of Growth and Business Cycles: Theory, Empirical Evidence and Policy Implications, INFER Annual Conference 2003, INFER Research Edition Vol. 9.

Table 3
Social Expenditures in Detail

	Total social expenditures		Sickness and health care		Disability		Old age		Survivors		Family/ Children		Unemploy-ment		Housing and social exclu-sion n.e.c.	
	1990	2003	1990	2003	1990	2003	1990	2003	1990	2003	1990	2003	1990	2003	1990	2003
Scandinavian Model	29.7	29.5	7.5	8.0	4.1	3.8	8.9	9.9	1.0	0.8	2.5	2.6	2.5	1.9	1.2	1.4
Denmark	28.2	30.9	5.5	6.1	2.7	4.0	10.0	11.1	0.0	0.0	3.2	4.0	4.2	2.9	1.6	1.7
Finland	25.1	26.9	6.9	6.5	3.8	3.5	7.2	8.7	1.0	1.0	3.3	3.0	1.5	2.6	0.6	0.9
Netherlands	31.1	28.1	8.4	8.2	4.9	2.9	9.5	9.2	1.6	1.4	1.7	1.3	2.5	1.6	1.2	1.6
Sweden	33.1	33.5	.	8.5	.	4.6	.	12.2	.	0.7	.	3.1	.	1.9	.	1.3
Norway	26.2	27.7	7.7	9.4	4.1	4.8	7.7	7.7	0.4	0.3	2.8	3.2	1.8	0.9	1.1	0.9
Continental Model	25.9	29.5	7.3	7.9	1.7	1.9	10.3	11.8	1.4	1.5	2.0	2.4	1.6	2.0	0.8	0.7
Germany	25.4	30.2	7.8	8.1	1.5	2.3	10.6	12.0	0.6	0.4	1.9	3.1	1.5	2.5	0.7	0.7
France	27.4	30.9	7.4	8.9	1.7	1.4	9.4	10.6	1.7	2.0	2.7	2.6	2.3	2.3	1.0	1.3
Italy	24.7	26.4	6.6	6.5	1.7	1.6	11.2	13.1	2.4	2.6	1.0	1.0	0.6	0.5	.	0.1
Belgium	26.4	29.7	6.6	7.6	1.9	1.9	7.6	9.7	2.9	2.9	2.3	2.2	3.4	3.5	0.5	0.5
Austria	26.2	29.5	6.6	7.1	2.3	2.4	11.7	13.4	0.6	0.4	2.6	3.1	1.2	1.7	0.4	0.5
Anglo-Saxon Model Europe	22.6	26.1	5.3	7.6	1.9	2.3	8.7	10.2	0.9	0.9	2.0	1.8	1.4	0.7	1.5	1.7
Ireland	18.4	16.5	6.0	6.6	0.8	0.8	4.2	2.9	1.2	0.8	2.0	2.5	2.6	1.3	0.9	0.9
United Kingdom	22.9	26.7	5.3	7.7	2.0	2.4	9.0	10.7	0.9	0.9	2.0	1.8	1.3	0.7	1.5	1.7
EU 15	25.4	28.3	6.8	7.7	2.0	2.1	9.8	11.1	1.3	1.3	1.9	2.2	1.8	1.8	0.8	1.0

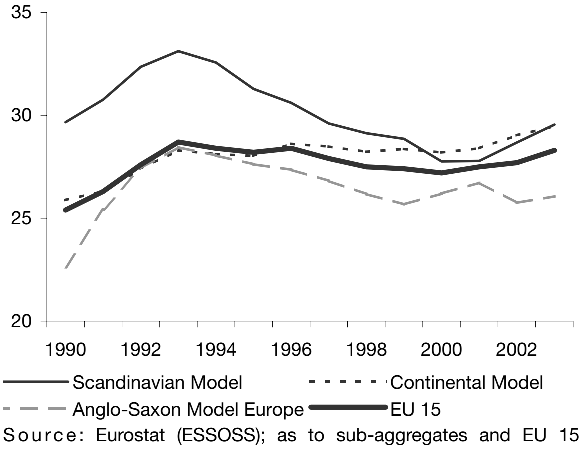
Source: Eurostat (ESOSS); as to sub-aggregates weighted average over countries; EU 15 reported.

the continental countries in 1990, did not change but the difference in public expenditures, which had been four percentage points, is now about one percentage point. The most dramatic change happened for budget deficits. The fiscal deficit reached a record of 5% of GDP in the Scandinavian countries in 1993 and these countries now have a surplus of 2.5% in 2005. The countries of the continental models, specifically Germany and France, had low deficits in 1990 but all three major countries are running deficits above 3% and the group average reaches 3.5%. This gives a six point difference to the Scandinavian countries.[11]

This fiscal prudence is part of the new strategy implemented by the Scandinavian countries, which had not been known for budgetary discipline before.[12] They tried to get rid of their structural deficits by imposing limits in the expenditures, but tax cuts were not high on the agenda. The traditional sensibility of Scandinavian countries not to impose too high taxes on business (while taxing energy consumption and

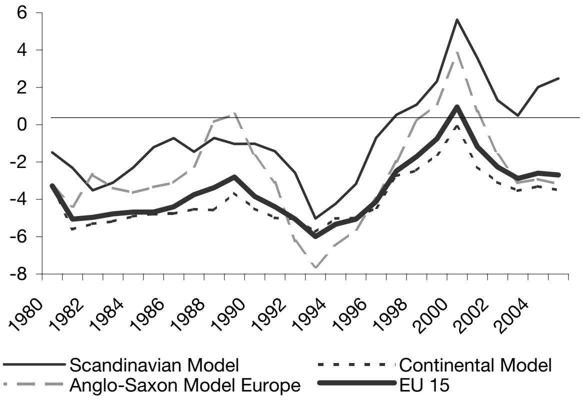
[11] The group averages are to some extent misleading due to the large deficit of Italy in 1990, and the high surplus of Norway. The surplus in 2005 was 0.4% for the Scandinavian countries without Norway (and 2% if we also exclude the Netherlands).

Figure 5
Social Expenditures as a Percentage of GDP



Source: Eurostat (ESSOSS); as to sub-aggregates and EU 15 weighted average over countries.

Figure 6
Fiscal Deficits as a Percentage of GDP



Source: Eurostat (AMECO); as to sub-aggregates weighted average over countries; EU 15 reported.

Table 4
Product and Labour Market Regulation

	Product market regulation		Labour market regulation			
			All contracts		Temporary contracts	
	1998	2003	1990	2003	1990	2003
Scandinavian Model	1.9	1.3	2.8	2.3	3.0	1.7
Denmark	1.4	1.1	2.3	1.8	3.1	1.4
Finland	2.1	1.3	2.3	2.1	1.9	1.9
Netherlands	1.8	1.4	2.7	2.3	2.4	1.2
Sweden	1.8	1.1	3.5	2.6	4.1	1.6
Norway	2.4	1.4	2.9	2.6	3.5	2.9
Continental Model	2.2	1.5	3.1	2.6	3.9	2.4
Germany	1.8	1.3	3.2	2.5	3.8	1.8
France	2.4	1.6	2.7	2.9	3.1	3.6
Italy	2.7	1.8	3.6	2.4	5.4	2.1
Belgium	1.9	1.4	3.2	2.5	4.6	2.6
Austria	1.8	1.3	2.2	2.2	1.5	1.5
Anglo-Saxon Model Europe	1.1	0.9	0.6	1.1	0.3	0.4
Ireland	1.4	1.0	0.9	1.3	0.3	0.6
United Kingdom	1.1	0.9	0.6	1.1	0.3	0.4
EU 15	1.9	1.4	2.8	2.4	3.0	2.0

Source: OECD (ECO/CPE/WP1(2004)9/ANN3); index between 0 (unregulated) and 6 (regulated).

property) was maintained and strengthened. The final success of the fiscal policy came however, as growth rebounded.[13]

The share of social expenditures had been 29.7 % in the Scandinavian countries in 1990, which was four percentage points higher than in the continental countries. It peaked at 33 % in the Nordic countries due to the deep recession in 1993. The percentage came down to 29.5 in 2003, about the same level as in the continental countries, in which social expenditures increased from 26% to 29.5%.[14] Germany and France have now higher public expenditure shares than the Scandinavian average. One of the reasons is that unemployment benefits expenditures are increasing in the continental countries and decreasing in the Scandinavian ones; other major factors are stronger increases in contributions for old age pensions in continental Europe.

Labour Market Institutions and Changing Incentives

Regulation of both product and labour markets is higher in continental Europe. The difference had existed for a long time but became more pronounced since the 1990s. The empirical data were collected by the OECD and are partly qualitative assessments; they are scaled from 0 (no regulation) to 6 (highly regulated) and exist for product market regulation between 1998 and 2003 and for labour market regulation between 1990 and 2003 (Table 4).

In 1998, the Scandinavian countries had product markets as regulated as on European average, now they are as deregulated as in the Anglo-Saxon countries at least in Denmark and in Sweden. The countries of the continental model started and ended with a marginally higher regulated product market, with Italy and France lagging Germany and Austria as far as product market deregulation is concerned. The Mediterranean countries have more regulated product markets (Table 4).

As far as labour markets are concerned Scandinavian countries have traditionally somewhat less regulated labour markets and have kept this position. Specifically Denmark and Finland have now considerably less regulated labour markets than France, Germany and Belgium. An interesting feature is that the Scandinavian countries did not change the regulations for regular contracts (they are marginally more regulated than those of the continental model countries), but for temporary contracts. Specifically Sweden, Denmark and the Netherlands cancelled most administrative limits for temporary contracts (while providing *pro rata* benefits to them), and temporary contracts are now much less regulated than in countries of the continental model (with the exception of Germany and Austria). Regulation is stricter for all contracts in the countries of the Mediterranean model.[15]

The very high trade union density has not changed in Scandinavia in general, with a rate of 59% and rates above 75% in Sweden and Denmark. Col-

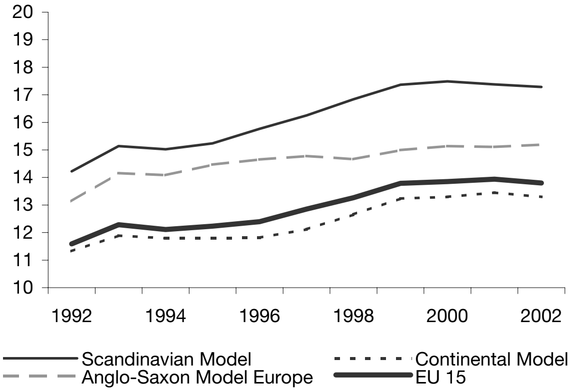
[12] Alesina and Ardagna define episodes of loose fiscal policies for OECD countries between 1960 and 1994. Finland and Sweden lead the table with ten loose periods, Norway and Denmark have five and six respectively, while the average amounts to three per country. Cf. A. Alesina, S. Ardagna: Tales of fiscal adjustment, in: Economic Policy, Vol. 13, No.27, October 1998.

[13] This proves that "even the most successful structural reform in Europe will not generate growth if the macroeconomic conditions are not right. Weakness in aggregate demand can ruin any economic party". M. N. Baily, J. F. Kirkegaard: Transforming the European Economy, Washington 2004, Institute for International Economics, p.18, available at http://bookstore.iie.com/merchant.mvc?Screen=PROD&Product_Code=353. Cf. also A. Sapir et al.: An Agenda for a Growing Europe, Oxford 2004, Oxford University Press; J. P. Fitoussi, F. K. Kostoris Padoa Schioppa: (eds.): Report on the State of the European Union, Vol. 1, Houndsmills 2005, Palgrave Macmillan.

[14] According to the latest published figures from the OECD, which reports only public expenditures, these are higher on average in relation to GDP in the continental countries than in the Scandinavian countries in the last published figures.

[15] K. Aiginger: Labour market reforms and economic growth - the European experience in the nineties, in: Journal of Economic Studies, Vol. 32, No. 6, 2005, pp. 540-573.

Figure 7
Investment in the Future as a Percentage of GDP (Growth Determinants)



Source: Eurostat; EITO; as to sub-aggregates weighted average over countries; EU 15 reported.

Table 5
Investment in the Future (Growth Determinants)

	Investment in the future		
	1992	1995	2003
	In % of GDP		
Scandinavian Model	14.2	15.2	17.3
Denmark	14.4	15.4	17.8
Finland	13.8	14.8	16.9
Netherlands	13.3	13.7	14.7
Sweden	15.6	17.7	21.1
Norway	.	.	.
Continental Model	11.3	11.8	13.3
Germany	11.8	11.8	13.4
France	12.3	13.2	14.2
Italy	8.9	9.9	11.3
Belgium	12.2	12.6	15.1
Austria	11.6	11.8	14.3
Anglo-Saxon Model Europe	13.1	14.5	15.2
Ireland	12.7	13.5	11.3
United Kingdom	13.2	14.5	15.5
EU 15	11.6	12.2	13.8

Source: Eurostat, EITO; as to sub-aggregates weighted average over countries; EU-15 reported.

lective agreements cover 82% of employees in the Scandinavian countries, and the trend is on the rise, and they cover about as large a share of employees in the continental countries (the rate is stable at 80%). With the exception of Belgium, trade union density has declined in the continental countries since 1980; on average from more than one third to one quarter. This is to a large extent due to the rise in unemployment and structural changes in employment: the decline in big business manufacturing employment, on the one hand, and the increase in service production in firms of small and medium size on the other. Despite this decline in trade union density there was on average hardly any change in the coverage of collective agreements in these countries. In the United Kingdom, the coverage of collective bargaining plunged from 70% in 1980 to 40% in 1990 and 30% in 2000.

The labour market institutions were reformed to make the markets more flexible but also to help people find new jobs by offering genuine and even personalised assistance and re-qualification. Active labour market policy and lifelong education has a high and increasing priority in the Scandinavian countries. The obligations for the individuals were increased as far as sectoral and regional mobility is concerned. If they do not fulfil the obligations or refuse to accept jobs, the benefit duration period and the benefit level are reduced. Part-time jobs have increased, but the gender distribution is more equal in Scandinavian countries and the share of voluntary part-time – due to personal priorities – was increased. *Pro rata* benefits are associated with part-time, return to full time is possible, and switching from irregular contracts to regular contracts is favoured. These strategies and several innovative measures in individual countries (such as sabbaticals in Denmark, decentralisation of institutions, complementary private agencies) are summarised as strategies of "flexicurity" or "balanced and managed flexibility". Trust among institutions and individuals, and a high level of macroeconomic activity are favourable for such reforms.[16]

The difference between gross earnings and net earnings (tax wedge) is specifically important for the functioning of a labour market since employees supply labour if net earnings are high and firms demand labour if labour compensation is low. The tax wedge decreased in Scandinavian countries from 46.1% in 1979 to 45.4% in 1991 and to 43.2% in 2004, while it increased in continental countries from 42.4% to 47.2% to 48.6%. Thus a lower wedge in continental countries (by 4 percentage points) turned into a higher wedge of 5.4 percentage points in two decades (and from 1.8 to 5.4 since 1990). Scandinavian countries were very careful to prevent their high taxes from distorting the labour markets too much.

Future Investments

While fiscal prudence has been a precondition for a long-run growth strategy and making the labour market more flexible in a balanced way is an important

[16] G. Tichy: Die 'Neue Unsicherheit' als Ursache der europäischen Wachstumsschwäche, in: Perspektiven der Wirtschaftspolitik, Vol. 6, No. 3, 2005, pp. 385-407.

second pillar of the success, the sufficient part of the strategy – and maybe the most important long-run difference between the Scandinavian and the continental economies – is the emphasis of the Nordic countries on technology, education and growth. According to growth theory, the medium-term growth rate of an advanced economy depends on R&D, human capital and the speed of diffusion of new technologies. Under the heading "future investment", we summarise expenditures on research, education, and information and communication technology (as a proxy for the diffusion of a new technology). In the Scandinavian countries future investment increased from 14.2% to 17.3%, while in the continental countries future investment used to be lower and increased in the 1990s only from 11.3% to 13.3%. Thus the Scandinavian countries increased their lead from three points to four points, and the difference would be more than 5 percentage points if we did not put the Netherlands into the Scandinavian group. Sweden, Finland and Denmark are countries fulfilling the Lisbon goal of a 3% research expenditures rate (ranking places 1, 2 and 4 in the share of R&D in GDP in Europe). Future investment in the EU15 is 13.8%, in the USA 16.1%; thus the Scandinavian countries surpass the USA in these investments which decide about long-run growth.

The continental countries have not raised their R&D ratio, have average expenditures on education, are moderate in the PISA ratings and underinvest in ICT.

Towards a New European Model

The Scandinavian countries have embarked on a strategy of fiscal prudence, and they are improving institutions and incentives without abandoning the principles of the welfare state. Specific elements of the political reforms in these Northern European countries might lead to a reformed European model which combines welfare with efficiency and adaptability to new challenges.

- The social system remains inclusive and tight, but social benefits are partly made dependent on the input of the individual and transfers become conditional to certain obligations; replacement rates are lower than they used to be in order to provide stronger incentives to work but are still high by international standards.
- The welfare system is more service oriented (care facilities for children, the aged and the handicapped) than transfer oriented, in order to increase equality and to increase female employment.
- Taxes are relatively high, but in line with expenditures, aiming at budget surpluses in the medium term, to cover future pensions and to repay current debt. The "quality" of public finances is monitored, and expenditures for education, innovation and lifelong learning have priority.
- Wages are high, but the position of the individual is not guaranteed, as business conditions vary. People losing their jobs get assistance and training (flexicurity). The public services are complemented by private agencies. Welfare-to-work elements have been introduced, the background philosophy being one of giving help without incriminating the unemployed of being idle and inactive.
- Part-time work and the adaptation of work to life-cycles are encouraged, not prevented. Social benefits are extended *pro rata* to part-time work, which is valued as a right of the individual and as an instrument of personal choice (managed and balanced flexibility), rather than a fate preventing gender equality.
- Technology policy and investment in the future are seen as a precondition for economic growth, competitiveness and the survival of the welfare state, they lead to more challenging and interesting work.[17]

Some of these reforms are similar to parallel reforms in the Anglo-Saxon model (e.g. welfare to work strategies), while others are very different.

- Environmental and social goals, as well as the equity of income distribution and the prevention of poverty remain high on the political agenda. Public institutions also provide the largest share of education and health care, which is open to all residents, of high quality and available at affordable conditions.
- Government and public institutions play a proactive role in promoting innovation, efficiency, structural change, higher qualifications and lifelong learning. This contradicts the approach that governments have just to deregulate the markets, and to expect – given markets are flexible – that innovation and growth will rebound automatically ("Paris consensus").
- Social partners (institutions representing employers and employees) negotiate wage formation, develop labour laws and co-determine economic policy in general. They monitor that flexibility is balanced and profits accruing from flexibility are shared.

[17] The policies pursued by the leading countries have many similarities with the economic policy recommendations of the Steindl-Kalecki tradition, as described in A. Guger, M. Marterbauer, E. Walterskirchen: Growth Policy in the Spirit of Steindl and Kalecki, WIFO Working Papers 240/2004, Vienna 2004.

- Government is large and taxes are high, even if there are mechanisms to limit increases in spending and goals for achieving a sound fiscal policy ("fiscal rules") in periods of high demand. Firms are partly sheltered from high tax rates; there are high taxes on consumption and specifically on energy.

Summary

International organisations often blame the higher welfare costs and the stricter regulation of labour and product markets for the lack of dynamics in European economies ("big government hypothesis"). However, an assessment of performance differences across Europe reveals that the model type performing best since the 1990s is the Scandinavian model.[18] The Scandinavian countries traditionally have the highest share of government and social expenditures; they emphasise redistribution and social inclusion. Many of these countries have experienced periods of structural and cyclical crises, which appeared to confirm some of the bleak predictions for welfare states in general. Over the past ten years, however, they have been able to adjust their institutions and incentives better than the continental countries, where growth is lower and unemployment is higher. The underperformance of the continental countries holds specifically for the larger continental countries, while the smaller managed to come close to (Belgium) or surpass (Austria) the European average in growth and employment.

The Scandinavian countries applied a three-tier strategy of fiscal prudence, improving incentives on the labour market and boosting long-run growth, thereby combining welfare with higher efficiency. Government expenditures to GDP, which had been 6 percentage points higher in 1990 is now equal to that in the continental countries at about 50% of GDP, declining gradually in the first group and increasing in the second. Taxes (incl. other revenues) are still higher in the Scandinavian group and tax rates did not decline while they increased in the continental group. The fiscal balance is now 2.5% in surplus in the Scandinavian group, while the deficit in the continental countries is 3.5%. Surpluses were intended in the Scandinavian countries, high growth helped to achieve them and there was even space for a counter-cyclical fiscal policy over the past years without accruing a deficit. In the continental group the deficit was largely the consequence of low growth, not due to strategies to support demand or accelerate future investment in a low growth period. Social expenditures relative to GDP mirror the expenditure trend in general; they had been four percentage points higher in the Scandinavian countries in 1990 and they are now about the same in Scandinavian and continental countries.

Labour market regulation had always been slightly lower in the Scandinavian countries; specifically temporary contracts are now easier than in 1990. On the other hand replacement rates are high in Scandinavian countries and an active labour market policy fosters re-qualification and re-employment. Thus flexibility for the firms as well as security for the employees was intensified. This is about to become a role model called flexicurity. Trade union density is high and unchanged in the Scandinavian countries, while it decreased in continental countries and plummeted in the Anglo-Saxon countries. The reform agenda is strategic and consensual; trust has a high value in the Scandinavian countries.

The Scandinavian countries realised that high growth and best technology is necessary for the maintenance of a welfare state with high taxes. Investment in research, education and new technologies had been higher and increased faster than in the countries of the continental model. On average they invest 17.3% in these future areas as compared to 13.3% in the continental countries.

It is interesting to ask why the Scandinavian model is better able to cope with the challenges of globalisation and competition. One reason might be the experience of the crises which hit Denmark and the Netherlands in the eighties, and then Sweden and Finland in the early 1990s. The second reason might be that these countries realised that their model was an extreme case as far as government share, taxes, social inclusion and welfare goals were concerned and that they wanted fervently to keep their welfare model in principle, and therefore realised that they had to make changes and reforms at the margin and to improve incentives. A third reason could be that the coherence of the society is larger, trust is higher and policy is more strategic. The continental countries on the other hand did not feel the same pressure and underestimated the necessity for change. And the reforms – if they were made at all – were made in a more controversial, less strategic and less consensual way. Further research is still needed, however, to find the underlying causes for the differences in the adaptability of the Scandinavian and the continental model.

[18] Together with the United Kingdom and Ireland, which are part of the Anglo-Saxon model but had rather different and specific histories in the previous three decades.