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A Social and Economic Model for Europe

The problems that social and labour market institutions are facing today are often attributed to globalisation and ageing. This article argues that globalisation merely exposes inherent weaknesses in social institutions while ageing aggravates them, but that neither of the two phenomena is the fundamental cause of the challenges. Moreover, there is no inherent trade-off between social and economic policies, but to reconcile the policies comprehensive modernisation is needed. Each country can face the challenges should they wish to do so and converging to a single social model is neither needed nor wanted. Finally, European (economic) and national (social) policies become increasingly intertwined and this calls for a new role for Europe.

European social models have been heavily debated in recent years. The discussion in both the political arena and in the academic literature is dominated by "models" discussions.[1] While discussions on the characteristics of various models certainly warrant merit, the discussions often boil down in the political arena to simple choices between social and economic goals. Either one has to accept a trimmed welfare state with increased inequality or persistent low growth and budgetary problems.

The aim of our paper is to enrich the discussion on the social model in four ways. First we will argue that social and labour market institutions of today do not meet modern social needs. More often than not the current problems are attributed to globalisation and ageing. We argue that globalisation merely exposes inherent weaknesses in social institutions while ageing aggravates them, but that neither of the two phenomena is the fundamental cause of the challenges. Second, we move beyond the models discussion by arguing that contrary to popular belief there is no inherent trade-off between social and economic policies, but to reconcile the policies comprehensive modernisation is needed. Third, we claim that each country or model can face the challenges should they wish so and that converging to a single social model is neither needed nor wanted. Fourth, we argue that European (economic) and national (social) policies become increasingly intertwined and that this calls for a role for Europe that is different from the traditional one.

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Unity in Diversity: the European Social Model

The European Social Model almost defies definition. The European Union is characterised by a diversity of national social systems, so it is easy to challenge the idea of a common European "model". Beyond this diversity, it can be observed that European social systems are based on a number of values that are held in common, such as universal access, solidarity and equality.

In this paper a pragmatic approach is taken. A "social model" is taken to be a collection of institutions that make up the welfare state. The welfare state exists to enhance the welfare of people who are (a) weak and vulnerable; (b) poor, or (c) neither weak nor poor but require insurance and consumption smoothing. Because of the strong interactions between the welfare state and labour market institutions, the social model is also taken to comprise the latter. This facilitates analysis on the interaction between economic performance and welfare states, which takes place largely through the labour market. It will be a theme of this paper that interactions between social protection systems, labour market institutions and economic performance are significant and can be either positive or negative according to the circumstances.

What makes a social model European? A unifying feature is the fact that the historical development of modern welfare states took place in Europe, initially as a reaction to the consequences of industrialisation and through the development of the Weberian nation state. Other countries, such as Canada and Australia and even in truncated form the United States, followed

[1] Karl Aiginger, Alois Guger: The Ability to Adapt: Why It Differs between the Scandinavian and Continental Models, in: INTERECONOMICS, Vol. 41, No. 1, January/February 2006, pp. 14-23; G. Esping-Andersen: Why we need a new welfare state, 2002, Oxford University Press; A. Sapir: Globalisation and the Reform of European Social Models, Background document for the presentation at ECOFIN Informal, Bruegel, Brussels 2005.

Table 1
Social Protection Expenditure 2003

	Social Protection Expenditure as % of GDP	Percentage of social expenditure financed by social security contributions	Percentage of social expenditure subject to means testing
EU-25	28.0	60.0	9.9
EU-15	28.3	60.0	10.2
Belgium	29.7	72.0	3.5
Czech Republic	20.1	75.4	6.7
Denmark	30.9	30.3	3.0
Germany	30.2	63.7	9.7
Estonia	13.4	79.8	2.1
Greece	26.3	61.0	8.2
Spain	19.7	68.7	11.5
France	30.9	67.1	12.3
Ireland	16.5	36.7	26.4
Italy	26.4	58.6	4.5
Cyprus[1]	16.4	36.8	8.5
Latvia	13.4	71.1	1.5
Lithuania	13.6	60.7	4.6
Luxembourg	23.8	51.6	4.4
Hungary	21.4	58.4	5.3
Malta	18.5	67.2	19.5
Netherlands	28.1	67.5	11.4
Austria	29.5	63.7	6.0
Poland	21.6	49.6	4.1
Portugal	24.3	50.3	9.0
Slovenia	24.6	67.2	9.8
Slovakia	18.4	68.5	7.2
Finland	26.9	49.9	11.4
Sweden	33.5	49.4	3.0
United Kingdom	26.7	48.9	16.0

[1] Cyprus 2002.

Source: Eurostat ESPROS.

Europe's lead so that the "European model" is not confined to Europe.

Another unifying feature of the European Social Model is the heavy reliance on public financing of social protection. On average, the EU-25 devotes 28% of GDP to public expenditure on social protection against 15% in the United States and 17% in Japan. Even here, the diversity is quite strong (Table 1).

National systems of social protection vary in two crucial ways: method of financing and method of delivery. Within Europe the dominant forms of finance for social protection are general government resources such as direct and indirect taxes founded on a residence principle (the so-called Beveridge system) and those founded on the insurance principle and therefore on occupation in which contributions are made by employers and employees to specialised funds (the so-called Bismarkian principle). Corresponding to major differences in sources of finance are major differences in the way provision is organised. Taking the example of health care, one model integrates public finance and public supply within a single system of national health care. The other model is based on independent contracts between a publicly financed buyer and private or public suppliers.

A further distinction can be made on the basis of whether benefits apply to all or almost all the population or whether they are restricted to a limited portion, for instance on the basis of means testing. The extent to which a country provides publicly financed social services, the way in which services are financed and the degree of means testing applied are three crucial dimensions that combine in different ways in EU Member States to produce a number of stylised "models" of social protection.

A further feature of the organisation of social protection systems in Europe is the important role played by social partners. Particularly in the Bismarkian system of finance, social partners can be entrusted with the task of collecting contributions and distributing them to beneficiaries, for instance on the basis of occupational funds. In countries without legal minimum wages, collective agreements may also apply negotiated minimum wages. At EU level, special arrangements allow agreements made between the social partners to be applied throughout the Union.

A final point on the definition of the European social model is that social models are based on the notion of reciprocity. There are rights *and* duties. People are more willing to invest in solidarity if the receivers of benefits exert effort and combine rights with individual responsibility.

The general approach adopted in the paper is that countries face common challenges in adapting their institutions to the needs of the twenty-first century. The intensity of the challenge and the nature of the required responses will depend very much on the circumstances of individual countries. For example, ageing is a common challenge, but obviously much less acute for countries with high employment rates and high fertility. Countries with very generous public pension systems face a problem of financial sustainability, but countries with inadequate pension systems will face the problem of how to provide a pension for an ageing population.

Notwithstanding this rather complex situation, certain significant differences in outcomes can be discerned. Among different countries, the initial starting point in terms of level of development obviously determines both the level of living standards and the potential for further improvement. Countries with below average performance on parameters such as growth rates, budgetary discipline, employment and income inequality will see their future prospects in large part being determined by the speed with which they catch up. Those countries obviously have a bigger mountain to climb than the countries that score better on these indicators. The difference between countries can be quite stark, since there are countries that score well on all four indicators mentioned, and there are also countries that score badly on all of them.

How Social is the European Social Model?

The shortcomings of social models are often attributed to ageing and globalisation. Yet, both phenomena play a somewhat different role than the one with which they are credited. Ageing has a direct impact on the financing of health care and pensions, but has also more subtle consequences for the labour market and intergenerational solidarity. However, even in the absence of ageing, problems would arise to finance pensions and health care at existing levels of provision. Problems are aggravated, not caused, by ageing.

Globalisation exposes countries to outside forces. It thereby exposes social and labour market institutions to shock. Appropriate institutions, those that meet the social needs of today, can meet this challenge. Globalisation therefore exposes rather than causes problems.

Social performance can be analysed in a number of ways, with regard to the situation in different countries, with regard to the degree to which social policy meets its current objectives or the extent to which new social needs are catered for. All of these are useful and provide insights into the question, "How well is the European social model replying to needs?"

Poverty

Considerable effort has been invested in developing indicators that can be used for assessing social performance at both EU and international levels.[2] These indicators are followed on a regular basis and reported by both the European Commission and the OECD.[3] Poverty and social exclusion remain major challenges for the European Union and its Member States, with more than 68 million or 15% of the EU population living at risk of poverty in 2002. They range from 10% or less in the Czech Republic, Sweden, Denmark, Hungary and Slovenia and 20% or more in Ireland, the Slovak Republic, Greece and Portugal.

The risk of poverty tends to be significantly higher for the unemployed, single parent households (mainly headed by women), older people living alone (also especially women) and families with several dependants. Children tend to be more exposed to poverty: children who grow up in poverty are more likely to suffer from poorer health, do less well educationally and are at higher risk of future unemployment and of anti-social behaviour.

The decline in poverty rates during the second half of the nineties was driven by an improving employment situation in which incomes from the market rose markedly for those previously without employment (the unemployed and discouraged workers), partially offset by limitations in transfers from government.[4] Since then the employment situation has deteriorated in several European countries. Available evidence shows that the poverty rate generally started to rise again between 2000 and 2004, reversing some of the previous gains.

Employment

Paid employment provides opportunities for social interaction, improved access to training and possibilities for advancement as well as constituting the most effective means of combating poverty. Therefore, particular attention has to be paid to the labour market and its impact on different segments of the population, especially those at greatest risk of social exclusion. In addition, employment contributes to output and has a positive impact on public finances through both a reduced need for social transfers and higher tax revenues. As a result, Europe's poor employment record, at least in major parts of "core" Europe, represents a social as well as an economic loss.

Long-term unemployment rates constitute an important indicator of social exclusion since long-term unemployment is very often a prelude to a worsening social situation both materially, when benefits run out, and psychologically through the sentiment of social rejection that is induced (Figure 1).

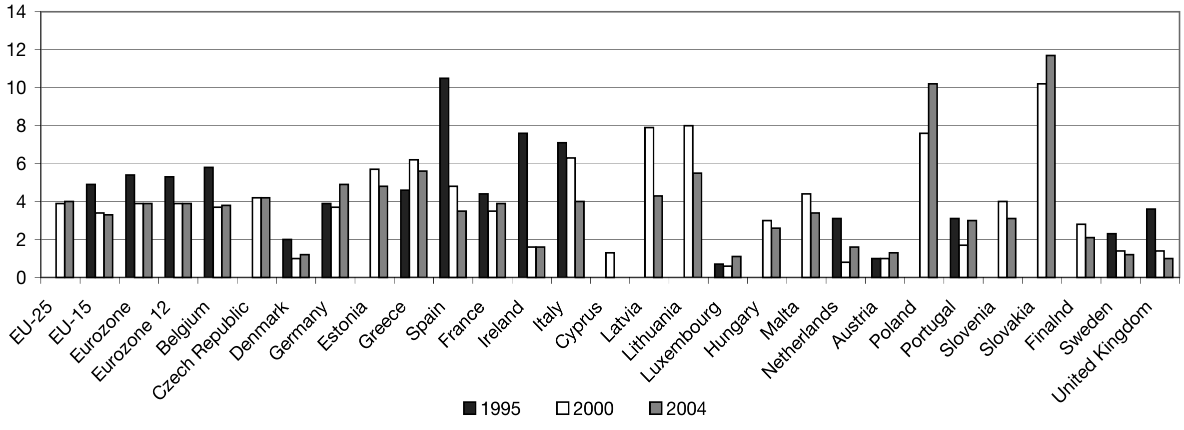
Within the EU, the situation concerning long-term unemployment is very varied with both high unemployment countries with long-term rates near or above 4% (Belgium, Baltic countries, Czech Republic, Germany, Greece, France, Italy, Poland and Slovakia) and low unemployment ones with long-term rates below 2%

[2] T. Atkinson, Bea Cantillon, Eric Marlier, Brian Nolan: Social Indicators – The EU and Social Inclusion, 2002, Oxford University Press; G. Esping-Andersen: Indicators and Social Accounting for 21st Century Social Policy, OECD 2004.

[3] European Commission: Commission Staff Working Document in support of the report from the Commission to the Spring European Council, 22-23 March 2005, on the Lisbon strategy of economic, social and environmental renewal, Brussels 2005; European Commission: Joint report on social protection and social inclusion, Brussels 2005; European Commission: Delocalisation: Which challenges for the EU economy?, DG ECFIN, Note for the Economic and Policy Committee, Brussels 2005; OECD: Society at a Glance: OECD Social Indicators, Paris 2005.

[4] Michael Förster, Marco Mira d'Ercole: Income Distribution and Poverty in OECD countries in the second half of the 1990s, OECD Social, Employment and Migration Working Papers No. 22, 2005.

Figure 1
Long-term Unemployment Rates



(Denmark, Ireland, Luxembourg, Netherlands, Austria, Sweden and UK).

In parallel with the overall improvement in the employment situation, long-term unemployment rates decreased, often substantially, in the second half of the nineties (with the exception of Greece). Since 2000, the situation has become much more mixed. Generally speaking long-term unemployment on the periphery of Europe has continued to decline in both old and new Member States with the exception of Poland, Slovakia and Portugal. However, among the core countries of continental Europe there has been a general, although modest, rise. Here, only in Germany is long-term unemployment substantially above the rate of the mid 1990s.

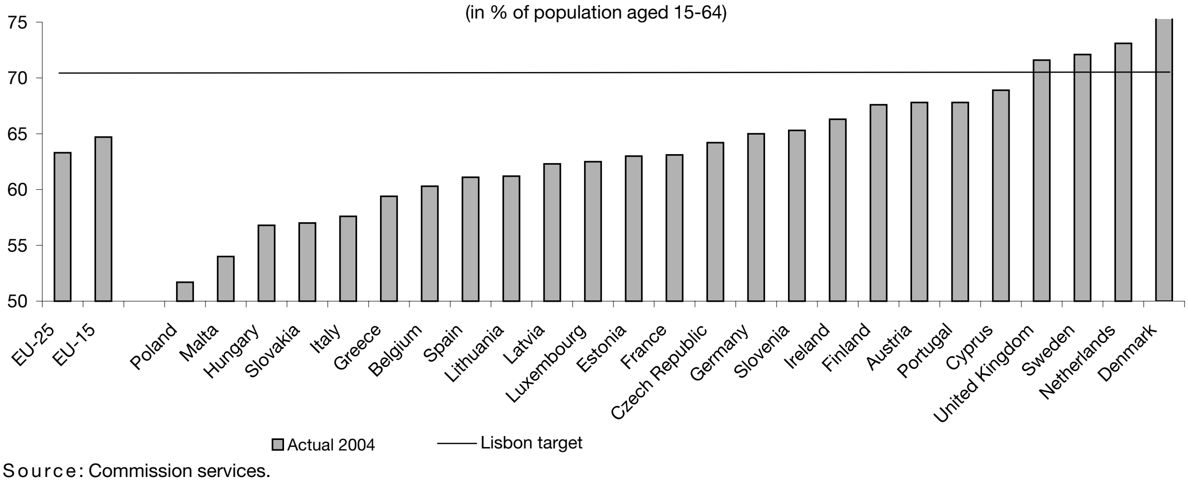
The challenge of improving employment performance is formidable (see Figure 2 and Table 2). While diverse across Member States, unemployment in general and youth unemployment in particular, as well as female unemployment, have persistently been at levels that challenge the notion that Europe's social model promotes inclusion and equity for all.

The EU has made greater progress in reaching the interim (2005) employment target of 57% for women than for total employment (67% in 2005, 70% in 2010).[5] Achieving an employment rate for older workers of 50% by 2010 from less than 40% in 2003 remains a significant challenge.

Furthermore, the data suggest that working time in the EU is lower than in the US (Figure 3) and, given the generally lower average level of hourly productivity in

[5] European Commission: Commission Staff Working Document in support of the report from the Commission to the Spring European Council, 22-23 March 2005, on the Lisbon strategy of economic, social and environmental renewal, Brussels 2005.

Figure 2
Employment Rates in the EU
(in % of population aged 15-64)



Source: Commission services.

Table 2
European Employment Strategy
(in %)

	2000	2004	Target
Overall Employment Rate	62	63	70
Female Employment Rate	54	55	60
Employment Rate of Older Workers	36	41	50

the EU compared to the US, GDP per capita in the EU-15 is lower by as much as 30%.[6]

The question is often raised whether the lower average number of hours worked in Europe is the result of choice because Europeans prefer to work less long hours and take longer holidays or because the labour market is not providing opportunities for working longer. If preference for leisure is the reason, policymakers should not be concerned if individuals are making an optimising choice. However, the contrast between the US and the European experience in their labour supply in the market leads to the question why individuals in advanced economies such as these might respond in such a diametrically different way in their patterns of consumption of leisure.

More specifically, it is noticeable that the number of hours worked steadily fell throughout the last decades.[7] It could be argued that tax systems trigger the fall in hours worked. It should be noted that a large part of the recent fall in the number of hours worked can be attributed to the increase in part-time work, the share of which in total employment increased by five percentage points between 1992 and 2004 in the EU-15, while it remained stable in the US over the same period. The degree of involuntary part-time work is both higher than in the US and varies with the availability of full-time employment. The source of the diverging behaviour with regard to hours worked could then be sought in diverging taxation policies or inappropriate social and labour market institutions.[8]

How Well Does the European Social Model Insure Against Risks?

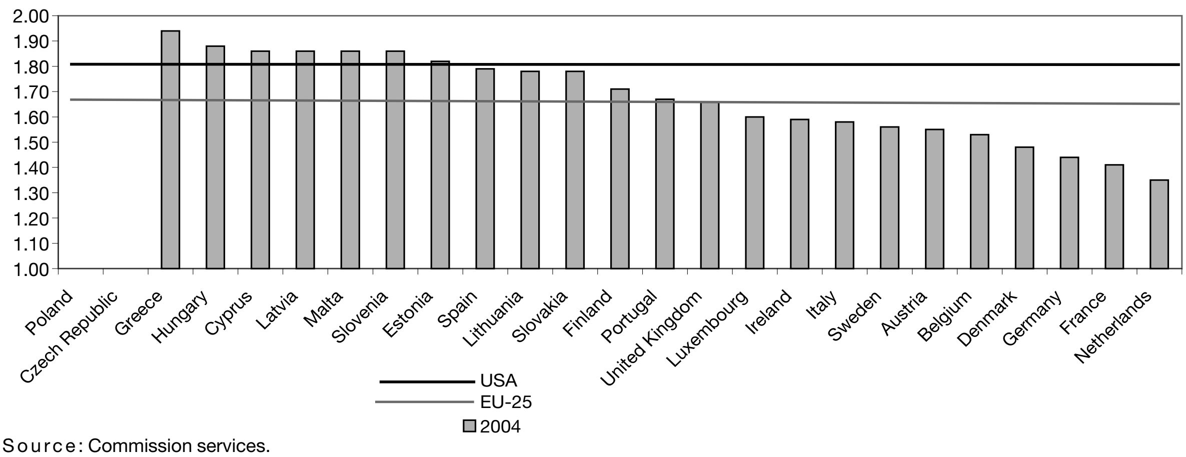
A different type of approach examines the degree to which the European social model achieves the original objectives that were set for the welfare state during the period of its creation and development. In particular, the creation of comprehensive pension and health care systems were intended to deal with the problem of poverty in old age and the catastrophic effects of illness for those unable to afford good quality health care. In both of these areas there have been major advances. The incomes of the elderly population have made steady gains both in absolute terms and relative to other age groups over a considerable period of time and led to declines of their relative poverty. These gains are common to members of the OECD and not restricted to Europe. Relative income poverty among the elderly tends to be concentrated among the very

[6] See European Commission: European Competitiveness Report, 2003 edition, Brussels 2003, especially chapter 1, for a discussion of these issues as well as the relevant evidence.

[7] The decline in hours worked in the EU is well documented and has attracted considerable comment in public policy discussions; see for example "Growth, Productivity and Employment", chapter 1 in European Commission: European Competitiveness Report, op. cit., for a review of the issues and references below.

[8] A. Alesina, E. Glaeser, B. Sacerdote: Work and leisure in the US and Europe, Prepared for the NBER Macroeconomic Annual, 2005; Olivier Blanchard: The Economic Future of Europe, NBER Working Paper No. 10310, 2004; E. Prescott: Why Do Americans Work So Much More Than Europeans?, in: Federal Reserve Bank of Minneapolis Quarterly Review, Vol. 28, No. 1, July 2004, pp. 2-13.

Figure 3
Working Time in the EU
(Average annual hours worked per person employed, in 1 000)



Source: Commission services.

old and those living alone, often women lacking their own pension entitlements. However, the amount of spending on old-age pensions does little to influence poverty among the retirement age population. Because pensions are usually related to earnings, relative income distribution follows that of the working age population. Instead, public transfers and taxes play the major role in combating relative poverty among the elderly, again as they do for the population as a whole. Overall, therefore, welfare states do a reasonable job in ensuring that the elderly are able to live out their lives with adequate means to sustain them. As will be seen, the overriding issue is now whether this relatively generous provision can be maintained in future.

All developed countries have seen significant improvements in health outcomes such as life expectancy and infant mortality. However, the degree of variation both within Europe and between Europe and other developed countries is much more marked. New members, formerly with centrally planned systems of health care, have in many cases seen a deterioration of life expectancy which has only recently been reversed. If per capita income is an important determinant of overall outcomes, the United States does significantly worse than would be expected and many western European countries significantly better. In terms of public health, there is only a weak link between expenditure on health care and health outcomes. Instead, income inequality and life style, particularly nutrition, exercise and the extent of particularly unhealthy habits such as smoking or abuse of alcoholic drinks have a very significant impact on health outcomes. European welfare states taken in their entirety have a good record in terms of health outcomes. However, there are questions about the capacity to improve further on the gains made in the past and in the financial sustainability of health care systems, which, while often providing good value for money, will nevertheless require more resources in future.

New Social Demands and Risks

In Europe today there is a concern that reforms could lead to loss of the variety of acquired benefits. Comparatively few realise that, even without financial and economic challenges, social institutions need to be modernised. Many social systems have failed to respond to new social demands and risks arising from major changes in social, economic and cultural parameters since the inception of the systems.

Welfare state institutions of today were designed to deal with the challenges of growing industrial economies. Yet risks have changed. The transformation of modes of production in the move to a post-industrial society yields faster obsolescence of skills, discontinuity in professional careers, labour market demands for women's participation, part-time work and short-term contracts. Greater competition creates a need for more mobility and flexibility of workers and firms. Technological advances imply improved productivity, instant communication, the rise of the service economy, development of a knowledge society, new demands on democratic systems. Demographic evolutions lead to ageing and a multicultural composition of societies. The roles of women and men have changed, in both their private and their public lives (two-wage earner families, family breakdowns, single mothers, higher cost of children).

It is necessary to adapt the existing social institutions by considering the actual risks people face today and will face in future. The most striking example concerns the lack of consideration given to changes in family functions and structures. As a result, most of the European social systems inherited from the postwar era failed to account for the home and care work as women were becoming full participants in the labour market. Hence fertility rates are below the renewal level in most Member States as parents cannot afford and/or cope with having children and a labour participation of women at the edge of the labour market.

One of the main challenges for today's societies is to find quality and affordable solutions to the new "caring" needs faced by families. Answers to demand for childcare when children have become rare and care of the elderly in a rapidly ageing society are the two wheels to reinvent: we need more children, educated to perform in a knowledge society. These children will keep the machine going for, inter alia, a very old baby boom generation with high caring needs.

In that context it is worthwhile mentioning that any remedy that is being put in place after early childhood tends to be much more expensive than early childhood policies.[9] In several Member States childhood poverty is rising. Female employment is the key to resolving child poverty.[10]

The conclusion therefore is that while welfare states do a good job of meeting the risks that they were designed for, they are much less well attuned to those of today. In addition, they are increasingly failing to meet the challenge of social exclusion, which is dominated by changes in the demographic composition of the population, of the particular needs of particular seg-

[9] James J. Heckman, Lance Lochner: Rethinking Education and Training Policy: Understanding the Sources of Skill Formation in a Modern Economy, in: S. Danziger, J. Waldfogel (eds.): Securing the Future: Investing in Children from Birth to College, New York 2000, Russell Sage Foundation, pp. 47-83.

[10] G. Esping-Andersen: Why we need a new welfare state, op. cit.

ments and a jobs market which, in many countries, is very far from full employment.

Ageing

We have identified the inability to meet social goals as driving the need for modernisation. Demographic developments essentially create additional problems for the financing of existing levels of provision for pensions and health care (including long-term care which may not be directly health-related).

Independently of ageing, the cost of health care has been rising with the application of new technology, greater recourse to more expensive drugs and wider coverage. Generous pension provisions established under entitlement programmes at a time of full employment and high productivity growth need to be financed during a period of slow growth and high unemployment. Social exclusion and higher income inequality before tax and transfers implies greater public expenditure if income poverty is not to rise. New social risks can imply a need for different types of coverage to those in the past. A publicly financed social model is particularly sensitive to these developments.

It is important to recognise that there are two different types of financial challenge. The first is the challenge to public finances, irrespective of whether social protection is contributory or tax-based. The second is the challenge to finance increased expenditure from whatever source. Needs for income in old age, for health care and for long-term care do not disappear when a block is put on public expenditure. They must still be financed by savings, by the family or by charity. In the end, all expenditure must be financed from the productive base, by those in employment.

Pensions

Comparing the financial sustainability of pensions is quite complex. Systems of funding, generosity of entitlements, effective and statutory ages of retirement are among the factors that differ substantially from country to country. Financial sustainability needs to be compared to the social adequacy of the pension arrangements. If insufficient provision is made for pensions (either public or private) then it is likely that public safety nets and minimum income support will be called for, so that pension systems that appear to be financially sustainable from the point of view of public expenditure prove not to be so.

According to the OECD, workers on average earnings can expect post-tax pensions to be worth around 70% of their earnings after tax.[11] Low income workers will receive a net replacement rate on average of about 85%. Where pension provision is inadequate some sort of safety net is in place for older people. The average minimum retirement benefit for full-career workers across OECD countries is worth a little under 29% of average earnings.

In order to provide an accurate picture of entitlements the pension provision for different levels of earnings needs to be calculated across the wage distribution. The weighted average is shown in column 1 of Table 3. Across EU members of the OECD the average pension level varies between a low of 31% of average earnings in Ireland to a high of 99% in Luxembourg. Apart from Ireland, Belgium and the UK have low entitlements. High entitlements (above 70% of average earnings) are to be found in Austria, Finland, Greece, Hungary, Italy, Portugal and Spain in addition to Luxembourg. High entitlements are spread out across the EU, including both new members and members of EU-15 and across different types of social protection system. Uniformly high entitlements are to be found in the southern Member States.

The most comprehensive indicator of future pension liabilities is the net present value of future pension entitlements or pension wealth (column 2 of Table 3). Currently most EU members of the OECD have a net present value of pension wealth of more than €200,000. Pension wealth is a factor of the replacement rate, on the one hand, and average earnings, on the other hand. Not surprisingly, Luxembourg has the highest pension wealth, over twenty times that of the Slovak Republic.

Dealing with the financial effects of ageing on pensions can essentially take two routes. One is to deal directly with the demographics, the other is to increase the resources devoted to the problem either by higher contributions and private saving or by higher public spending – implying a rising tax burden. In terms of the demographics, there is limited scope for dealing with the problem of ageing through higher immigration. But it will not be a structural solution since immigrants are also subject to ageing. Higher fertility however holds out the possibility of lessening the impact of ageing in a durable fashion – even though the immediate impact is a worsening of the dependency ratio.

As is by now well known, the two main mechanisms for increasing directly the resources available to pay for pensions is to raise the effective age of retirement (thereby increasing contributions and decreasing pension outlays) and by increasing private pension saving in order to compensate either for reductions in public pension provision or the inadequacy of public pension provision. If invested domestically, higher saving increases the stock of capital and may lead to higher

[11] OECD: Society at a Glance: OECD Social Indicators, op. cit.

Table 3
Weighted Average Pension Level and Pension Wealth

	Pension Level (%)	Pension Wealth (€)
Austria	72.5	288.706
Belgium	36.3	226.311
Czech Republic	41.7	49.704
Denmark	43.2	321.489
Finland	71.2	338.409
France	52.7	233.714
Germany	42.6	277.073
Greece	83.1	152.284
Hungary	72.2	58.164
Ireland	30.6	151.227
Italy	77.2	258.037
Luxembourg	99.2	620.770
Netherlands	67.7	334.179
Poland	55.5	53.934
Portugal	70.4	98.350
Slovak Republic	47.9	28.553
Spain	75.4	203.046
Sweden	68.5	296.108
United Kingdom	37.1	181.895
United States	36.5	193.528
Japan	47.9	301.396

Note: Weighted averages for the relative pension value and pension wealth use the OECD average earnings distribution. Pension wealth in value terms is the simple average of the results for men and women. The conversion to US dollars is performed using 2002 average market exchange rates.

Source: OECD pension models.

growth. However, the highest returns are likely to be found in dynamic developing countries where the investment risk is also the highest.

Health and Long-term Care

In many ways the problems related to the future financing of health care are even more intractable than those related to pensions. Ageing of the population is only one factor driving increases in the cost of health care, which after a short period of consolidation during the 1990s has now resumed its seemingly inexorable upward march (see Table 4). Since health care remains overwhelmingly publicly financed, the overall cost increase is reflected also in increases in public expenditure. Indeed, as a share of total public spending, health care increased by between 3 and 5 percentage points between 1990 and 2002 ranging from 6.6% in Greece to 16.1% in the UK.

Among the main drivers of increasing health care expenditure are convergence within the EU between countries with low levels of expenditure and those with higher levels linked to levels of development, widening accessibility to health care services to ensure universal access, increasing quality demands from health care systems, technological progress both in medical

Table 4
Total Expenditure (Public and Private) on Health Care as % of GDP

	As % of GDP				Change		
	1970	1980	1990	2001	70-80	80-90	90-00
Belgium	4.0	6.4	7.4	9.0	2.4	1.0	1.6
Denmark	8.0	9.1	8.5	8.6	1.1	-0.6	0.1
Germany	6.2	8.7	9.9	10.7	2.5	1.2	0.8
Greece	6.1	6.6	7.4	9.4	0.5	0.8	2.0
Spain	3.6	5.4	6.7	7.5	1.8	1.3	0.8
France	:	:	8.6	9.5	:	:	0.9
Ireland	5.1	8.4	6.1	6.5	3.3	-2.3	0.4
Italy	:	:	8.0	8.4	:	:	0.4
Luxembourg	3.6	5.9	6.1	5.6[a]	2.3	0.2	-0.5
Netherlands	6.9	7.5	8.0	8.9	0.6	0.5	0.9
Austria	5.3	7.6	7.1	7.7	2.3	-0.5	0.6
Portugal	2.6	5.6	6.2	9.2	3.0	0.6	3.0
Finland	5.6	6.4	7.8	7.0	0.8	1.4	-0.8
Sweden	6.7	8.8	8.2	8.7	2.1	-0.6	0.5
United Kingdom	4.5	5.6	6.0	7.6	1.1	0.4	1.6

[a] 2000

Source: OECD Health Data 2003.

equipment and in development of new drugs and population change.

Unlike pensions, rising expenditure on health care is mainly a problem for the sustainability of public finances since there is no reason why a richer society should not devote more resources to health care provided it results in an increase in the years of life spent in good health. Countries have sought to contain public spending on health care via aggregate cost containment measures such as the regulation of prices, input resources and volumes of health care, caps on health care spending and shifting part of the cost onto private sources of financing. All of these policies have proved problematic in terms either of containing costs or of maintaining universal access to health care.

Lack of success with aggregate measures has led to increasing attention to micro-economic measures to improve the efficiency of spending, through for instance attempts to introduce incentives or competition in the process of allocating health care. These measures have yet to yield the concrete improvements that will be necessary for them to contribute substantially to the future sustainability of public financing of health care. The area of health care is subject to many specific attributes that make improving efficiency intractable. For instance, a shift from payment per medical act to a payment per patient, which in principle should reduce the incentive to over-prescribe medical acts, runs into the problem of adverse selection. The easiest way for a doctor to limit the number of medical acts is to take on only healthy patients. Also, reductions of visits to general practitioners and use of medicine tend to yield socially regressive outcomes.

Financial and Economic Impact of Ageing

The implications of these developments for the financial sustainability of the European Social Model are indeed severe. Conservative estimates suggest that public expenditure as a result of ageing in the EU-15 will increase by 3 to 7 percentage points in terms of GDP by 2050 without policy change. OECD projections put the increase in expenditure at the top end of this range. The largest part of this increase reflects expenditure on pensions, health care and long-term care whereas the reduction in education, unemployment and other youth-related spending associated with the decline in the younger cohorts is insufficient to offset the former. The budgetary impact of ageing would begin in 2010 and become most severe during the years up to 2030.[12]

The situation is not uniform – some Member States are in a situation where the sustainability of current policies is more secure, but in others the course of current policies will lead to insolvency (Table 5). Only Estonia and Poland are projected to see a decrease in age-related expenditure. In addition to demographics, sustainability is conditional upon the state of entitlements and of the parameters that generate the resources to finance these policies as well as the performance of the economy. Clearly, *ceteris paribus*, strong medium-term economic growth and high employment provide a better environment to support policies compared to one where these developments are worse. But even in this case, the demographic shock is sufficiently severe to ultimately require adjustment in the policy course.

Projections of the European Commission show that the "pure" impact of ageing populations will be to reduce the potential growth in the EU from the present rate of 2-2.25% to about 1.25% by 2040. While the impact on Japan will be even more negative, that on the US will be much less severe – thus widening potential growth even more (Figure 4).

We conclude that European social models face significant future financing problems for pensions and health care. These problems are exacerbated by the impact of demographic change on growth, on the low level of employment that both adds to expenditure and reduces the revenue raising base on which to finance expenditure and on rising income inequality from the market that generates a need for more redistribution to maintain post tax and transfer inequality within acceptable limits.

Table 5
Projected Changes in Expenditure and Revenues between the First Year of Projections and 2050 (in percentage points)

	Age-related expenditure					Total revenues	Net change
	Pension	Health care	Education	Other age-	Total		
Belgium	4.2	2.9	-0.4	-1.6	5.1	0.0	5.1
Czech Republic	6.6	2.8	-0.2		9.2	0.0	9.2
Denmark	2.3	2.8		1.3	6.4	3.0	3.4
Germany	2.9	2.5	-0.3	-1.4	3.7	3.2	0.5
Estonia	-2.7	0.0			-2.7	-0.6	-2.1
Greece	10.3	1.5	0.0	-0.1	11.7	0.0	11.7
Spain	5.0	1.4	-0.2	-0.2	6.0	0.0	6.0
France	1.6	4.5	-0.4	-0.3	5.4	0.0	5.4
Ireland	3.6	1.7	-0.7	0	4.6	0.0	4.6
Italy	0.8	1.6	-0.3	-0.1	2.0	0.0	2.0
Cyprus	5.0	0.5			5.5	0.0	5.5
Latvia	0.2	0.4	-0.1		0.5	-1.5	2.0
Lithuania	1.7	0.0			1.7	-1.5	3.2
Luxembourg	1.8			0.0	1.8	0.0	1.8
Hungary	0.2				0.2	0.0	0.2
Malta	0.2	2.4			2.6	0.0	2.6
Netherlands	3.1	3.2	-0.1	0.4	6.6	3.4	3.2
Austria	-0.6	1.2	-0.6	0.5	0.5	0.0	0.5
Poland	-2.6	-0.9			-3.5	0.0	-3.5
Portugal	3.2	1.6	-0.2	-0.5	4.1	0.0	4.1
Slovenia	5.4	2.8			8.2	0.0	8.2
Slovakia	0.5	1.6	0.0	-0.2	1.9	0.0	1.9
Finland	2.9	3.1	-0.2	-0.9	4.9	0.0	4.9
Sweden	0.8	2.3	0.4	2.1	5.6	0.2	5.4
United Kingdom[a]	1.0	2.1	-0.1	0.0	3.0	0.0	1.2

[a] A decline in non-age related expenditure of 1.8 percentage points of GDP were incorporated in the "net change".

Sources: Commission services, EPC and national updated stability and convergence programmes (2004).

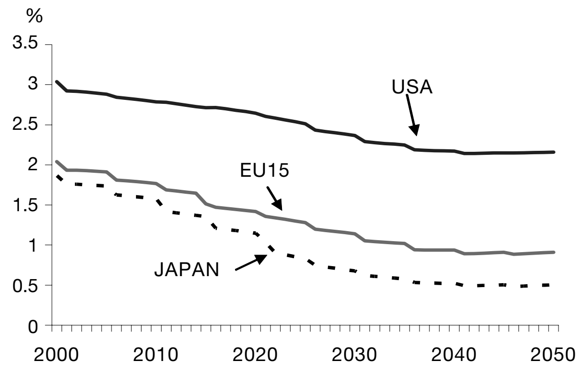
The Link between Open Market Policies and the Social Model

Having concluded that ageing is not at the root of the need to modernise, but instead creates financing problems that merely emphasise the need for modernisation, we go on to show that globalisation is also not at the root of the need to modernise, but instead exposes countries with vulnerable institutions.

In many Member States there are discussions and fears that a stronger internal market, trade, competition policy and globalisation will jeopardise the social model. These concerns should be qualified and be made more precise. In what sense do open market

[12] See the details in Economic Policy Committee: The impact of ageing populations on public finances: overview of the analysis carried out at EU level and proposals for future work programme, Economic Policy Committee, EPC/ECFIN/435/03 final, 22 October 2003. The literature on the financial viability of current arrangements in view of the demographic shock is large.

Figure 4
Impact of Ageing on Potential Growth per Capita Rates



Source: European Commission, Directorate General for Economic and Financial Affairs.

policies put pressure on the social model? Can open market policies also support the social model?

We analyse circumstances under which there exists a trade-off between open market policies and the social model. This trade-off is a variant of the well-known efficiency-equity trade-off that dates back to 1975 when Arthur Okun wrote that, "The pursuit of efficiency necessarily creates inequalities. And hence society faces a trade-off between equality and efficiency".[13] The textbook trade-off emerges because protection and taxes reduce incentives to work. There is a growing empirical literature that denies the *general* validity of the claim that such a trade-off exists. However, the literature is less precise on the conditions under which the trade-off can emerge.[14] We shall now attempt to get closer to the conditions in the specific case of EU open market policies.

In a general sense increased international competition strengthens the mobile factor (capital) potentially at the expense of the immobile factor (labour). In addition the demand for skilled workers rises relative to that for unskilled workers. However, neither of those effects implies that countries have difficulties redistributing income should they wish to do so. Empirically, there are many examples of countries that have succeeded in redistributing income despite increased global competition (for example the Nordic countries). Theoretically, there are a number of factors that provide nuance or even contradict the trade-off.

First, it depends how one defines equity. It is one thing to find oneself temporarily in shortened straights and quite another thing to be permanently excluded from improving one's position. Opening up opportunities for those who are permanently excluded is also an important dimension of equity, not to be confused with a point measure such as those below a specific poverty line. Second, an effective way of reducing inequality is to provide jobs for low-income groups. There are many efficiency enhancing strategies available that do just that. Finally, there is the political economy reason that it is easier to redistribute when there is more to share.

If the evidence at the macro level is mixed, the obvious way to get closer to the conditions under which a trade-off exists is to verify on the *micro level* where open market and social policies "meet". The central meeting place is the labour market. An important consequence of policies that open up markets to competition is that companies will have to restructure their business more often or faster than before.

To this well-known phenomenon there are several new elements that have emerged recently, in part exogenously, in part stimulated by economic policies, notably (1) the emergence of new trade partners: China and India accounted for 6.0 and 0.8% respectively of world exports as well as for 5.4% and 1.1% respectively of world imports in 2003, and their shares are rising fast; (2) trade in services has become more important; (3) delocalisation and outsourcing/offshoring activities denote the internationalisation of production linkages, with semi-final products moving across borders to be processed at different locations.[15] Foreign ownership of some originally domestic firms has become a fact of life. The 100 biggest trans-national corporations employ about 50% of their labour force outside their home country.[16] Labour migration has already increased.[17] While these facts are by itself a healthy and normal practice in a market economy, it is important to analyse the implications on the labour market of these restructurings.

A first implication of business restructuring is that it may punish inappropriate labour market institutions and reward appropriate ones. Open market policies expose countries and their enterprises to outside forces, which can reveal certain institutional weaknesses of a country that would otherwise have been concealed (or revealed at a later stage).

[13] A. Okun: Equality and Efficiency: The Big Trade-off, Washington 1975, Brookings Institution.

[14] G. Esping-Andersen: Why we need a new welfare state, op. cit.; Andrew Jackson: Why we don't have to choose between social justice and economic growth: the myth of the equity/efficiency trade off, Canadian Council on Social Development, Ottawa 2000.

[15] European Commission: Delocalisation: Which challenges for the EU economy?, DG ECFIN, Note for the Economic and Policy Committee, Brussels 2005.

[16] UNCTAD: Trade and Development Report 2004.

[17] The effect of migration is not dealt with in this report.

Table 6
Fate of Trade Displaced Workers

	High international competition, manufacturing	Medium international competition, manufacturing	Low international competition, manufacturing	All manufacturing	Services	All sectors
			Characteristics of workers			
Age at displacement						
15-24	10.4	13.1	11.6	11.8	12.2	11.4
25-54	75.1	75.8	78.1	76.4	78.0	76.9
55-64	14.5	11.2	10.3	11.9	9.8	11.7
Mean	40.9	38.8	39.4	39.7	37.9	39.2
Share women	31.7	44.9	26.2	34.8	43.2	38.2
Predisplacement occupation						
White collar	31.9	20.0	27.1	25.9	73.3	48.5
Blue collar	68.1	80.0	72.9	74.1	26.7	51.5
Job tenure at time of displacement						
More than 10 years	32.1	30.4	27.7	30.0	18.6	21.5
Mean job tenure	7	6.6	6.2	6.3	4.7	5.0
Hourly earnings in old job						
Mean (€)	9.51	9.15	9.08	9.43	9.15	9.08
		Adjustment costs				
Share reemployed after two years	51.8	58.7	59.6	57.0	57.2	
For reemployed						
Share with no earnings loss or earning more	44.0	45.7	47.3	45.8	49.6	47.1
Share with earnings losses greater than 30%	5.4	7.0	6.8	6.5	8.4	7.5

Countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom.

Source: European Household Panel, waves 1 to 8, April 2003, as quoted in OECD: Society at a Glance: OECD Social Indicators, Paris 2005.

Think of relocation discussions. As a result of open market policies firms restructure their business, relocating certain activities to low-wage countries and potentially getting some high-skilled jobs in return. What might happen with the people who lose their jobs in countries with rigid labour markets? The people who lose their jobs are not easily re-employable because either they have obsolete skills, they make use of early retirement or other exit schemes, there are no appropriate jobs available for them or they are not prepared to move.

Empirically, negative effects can translate in different ways. First, there are significant divergences between displaced workers. While some fare well, others have significant problems finding a new or equally well-paid job. One reason could be that displaced workers are on average older, less educated, and more senior or possess inadequate skills. Second, there are also differences between the US and Europe. In the US, displaced workers tend to find a new job, but often take a significant wage cut. In Europe, displaced workers tend to face long-term unemployment or complete withdrawal from the labour market.

Table 6 shows how displaced workers fare in 14 European countries. It shows that blue-collar workers are more exposed to adjustment than white collar ones. Moreover, these workers tend to have been employed for a long time. It also shows that a large part of those employed in manufacturing sectors facing high international competition fail to find a new job within two years. However, if they find a job, they do not have to take too much of a cut in wages.

Depending on the conditions, relocation can be positive for both countries involved, when complementarities are strengthened, or negative for the sending country when it is losing production because of an unfavourable domestic business climate. In the second case, not only do firms decide to find their luck elsewhere, but also the impact of relocation on the labour market is visibly negative, both in real terms and in the perception of the people involved. So the economic and social costs of relocation are high and the benefits low. However, in this particular case the problems are not *created* by open market policies but *revealed* by them.

There is a clear parallel with government subsidies of obsolete industries. On the surface such subsidies may seem “social”, but in the long run they are wasteful. The social and economic impact of delaying restructuring is that the problems emerge later anyway and will be bigger.

So far the link from open market policies to the labour market has been considered. What about the reverse? Consider two polar cases. Suppose that as a result of institutional changes a substantial percentage of low-skilled people, men, women, ethnic minorities, young and old, who previously relied on social benefits have now found a new enthusiasm in finding a job. What might happen?[18]

In a world characterised by low trade, lenient competition policy and lack of innovation the labour market is like a game of musical chairs. There are a limited number of jobs out there, so adding a large quantity of low-skilled people on the job market only has reshuffling consequences. Some of the new ones might find a job, but at the expense of others. And wages may drop too as a result of the increased competition for the chairs. Ineffective competition policy favours incumbent companies and workers, and mobility is lacking.

A dynamic economy will generate new employment opportunities and mobility is high. The rewards of modernising the labour market will be much higher, since more people will improve job matches. In a world with appropriate competition policy, innovation and trade, new opportunities are taken either by startups, by foreign direct investment or incremental innovations by multinationals. Competition policy helps by not favouring the incumbents and jobs are created.

To conclude, open market policies can only be effective if labour markets are sufficiently flexible. But for labour market reform to be successful open market policies should be in place. Labour and product markets are communicating vessels. One explanation for the mixed evidence at the macro level is that some countries (Nordic countries) are more successful in letting the vessels communicate than others (Germany, France). Successful countries design policies that make vessels communicate, policies that combine flexibility on the labour market with security for the individual affected (protecting the person not the job).

The second way in which open market policies affect equity is by the distributional effects they have. Here one must be careful how to measure distribution. Empirical studies generally show that the magnitude of macro distributive effects remains limited as compared with the potential gains.[19]

However, the political impact can be much greater for several reasons. The effects are generally concentrated in certain sectors or regions, therefore their political impact can be much greater than if they were uniformly distributed across the whole population. Costs tend to be more significant in the first years, while most gains require more time to take full effect. Costs and benefits are typically dissociated in space. Some regions suffer from the adjustments induced by trade opening in certain sectors, while others benefit from the expansion of sectors based in their area. The spatial dimension is thus critical: in declining regions, job losses constitute a clear cost; benefits derived from comparative advantages are only apparent in dynamic regions.

It follows that standard ways of measuring distribution such as the Gini coefficient are too aggregated to pick up distributional effects in time and space, but those effects can be politically vital. Notice also that there is a link between the communicating vessels argument and redistribution. Lack of labour mobility and inappropriate labour market institutions aggravate the spatial dimension of the distributive effects.

To conclude, open market policies and the social model can go hand in hand when a country realises that they are communicating vessels and designs policies to enable the vessels to communicate. Failing to do so runs the risk of inflexible labour markets suffering from open market policies.

No Convergence of Models

Recent papers point at the successes of Anglo-Saxon and Nordic models. For example, Sapir states that "There are several signs that the less efficient continental and Mediterranean models face severe sustainability constraints … This suggests that both Nordic and Anglo-Saxon models are sustainable, while continental and Mediterranean models are not and must be reformed in the direction of greater efficiency by reducing disincentives to work and to grow."[20] Similarly, Aiginger and Guger, in a section called "towards a new European Model", also hint at some form of convergence: "Specific elements of the political reforms in these Northern European countries might lead to a reformed European Model which combines welfare with efficiency …"[21]

Although neither author explicitly states that there should be a one-size-fits-all socio-economic arrangement for all Member States, they still plead for some form of convergence to either an Anglo-Saxon or Nordic model.[22] While we acknowledge that lessons from successes can be learned, this need not lead to con-

[18] R. Solow: Work and Welfare, Princeton 1998.

[19] Richard E. Baldwin, Philippe Martin: Two waves of globalisation: fundamental differences, NBER Working Paper 6904, 1999.

[20] A. Sapir: Globalisation and the Reform of European Social Models, op. cit.

[21] Karl Aiginger, Alois Guger: The Ability to Adapt: Why It Differs between the Scandinavian and Continental Models, op. cit.

[22] And this is in any case very likely how policymakers would read their results.

vergence of models. There are five arguments against convergence.

First, European social models are rooted in different socio-cultural histories. Institutional choices can only be understood against a certain cultural background. Think of high taxes in Nordic countries, reliance on families in Mediterranean countries, centralised schemes in France or social dialogue in the Netherlands. One cannot simply inject a particular aspect of one country into another if institutional choices are not embedded into the culture. Suggesting that Mediterranean or continental countries should “choose” between an Anglo-Saxon and a Nordic model is way beyond being politically feasible.

Second, even within each model there are huge differences. Denmark can be considered emblematic of the Nordic system, with a heavy reliance on tax as opposed to social security financing of social protection (63% of the total against an EU average of 36%), provision of a very high level of services to the public irrespective of income and attendant very high overall expenditure on social protection. However, in spite of belonging to a recognisable Nordic model both Sweden and Finland finance half of social expenditure from social security and Finland also subjects benefits to means testing to an extent above the EU average. The Netherlands is often grouped with the Nordic countries but has very different institutions and lower taxes, making it more in line with the continental European system.

Ireland is the best example of the liberal or “Anglo-Saxon” system with relatively low overall expenditure on social protection (15% against an EU average of 27%) and a high proportion of means testing (26% of social expenditure against an EU average of 10%). In spite of belonging to the liberal tradition, the UK spends just above the EU average on social protection, while the proportion subject to means testing is well below that of Ireland (15% against 26%).

Belgium is most representative of the continental system with a very high share of social protection financed by social security contributions (73% against an EU average of 61%) and very little means testing of benefits, for which qualification is through contributions. France however combines a mainly social security based system of financing with a relatively high proportion subject to means testing.

These examples illustrate the high degree of diversity even within so-called homogenous types of institutions. In practice most institutional systems combine elements from the different models. Furthermore, systems are evolving away from the pure models to more complex systems to achieve greater efficiency or equity or both. For example, several of those countries that rely on the Bismarkian system of insurance financing such as Austria, France and Germany now finance more than 30% of their social protection systems through taxes. In France, the share of social protection financed by general government contributions increased from 17% to 30% between 1990 and 2002 while that financed by social security contributions fell from 80% to 67%. This can be explained by the substantial replacement of social security contributions by taxes for health insurance and by the reduction of social security contributions for the low-paid to increase employment for the low-skilled.

Third, there are no unique solutions to social problems. Within each model there have been successes and failures to meet social goals. Spain has reformed its labour market for core workers, while France has not. Sweden has undertaken a major reform of pensions, but not of its employment protection legislation, whereas for Denmark it is the opposite. And there is nothing liberal about the UK’s health care system.

Successful efforts at modernisation have comprised comprehensive reforms of national welfare systems to make them more efficient, in social as well as economic terms. Reforms typically combined fiscal stabilisation with product market liberalisation and reforms of labour institutions that deal with the conditions of employment for insiders as well as outsiders. The reforms were implemented over a sustained period of time and in a coordinated rather than a piecemeal manner. However the approach taken, the way in which reforms were negotiated and implemented as well as the details of individual measures all differed significantly from one country to another.

Fourth, while it obviously has certain limitations, it is possible to compare countries with similar initial levels of development and to attempt to determine to what extent policy choices over the last decade or so have determined outcomes. During the eighties and nineties a number of highly developed countries of northern and north-western Europe introduced major changes to their social protection and labour market institutions (Finland, Sweden, Denmark, Netherlands and the United Kingdom), usually as result of a crisis that made the status quo unsustainable. This can be compared to a number of core countries of continental Europe (Germany, Belgium, Luxembourg, Austria, France and Italy). While this second group of countries have undertaken major reforms such as Agenda 2010 in Germany, the shift from social security to general government financing in France along with partial reform of pensions and health care or pension reform in

Italy, they have not been as systematic or sustained as those in the first group.

The first group of developed reform-minded countries in northern and north-western Europe achieved annual GDP growth of 2¾% per year between 1992 and 2004 – nearly double the 1½% achieved by the core countries of continental Europe over the same period. Even more dramatically, they brought down their unemployment rates from 8.6% to 5.0% over this period, while in the core countries it rose from 7.5% to 8.6%.

Interestingly, the so-called reform group of countries comprises members from each of the above three different models of welfare state. Reforms were all far-reaching but in accordance with the different traditions of those Member States. It would appear therefore that substantial improvements in performance can be made within the different institutional contexts. The implication is that at EU level we should be chary of making prescriptive judgements but that in certain circumstances some things do work better than others. In any case, there is nothing inevitable about poor performance either in terms of growth or of employment or in social cohesion.

Finally, one of the attractive features of different institutional choices across Europe is that it allows for policy experimentation and learning.

The final argument appears paradoxical. If there is no need for convergence it appears there is also no merit in experimentation since successes cannot be exported. However, the fact that there is no need for convergence does not imply that no lessons can be learned. Some successes *can* be copied elsewhere. In all Member States there are discussions on forms of flexicurity these days. The point here is that each country has to choose its own form, consistent with its own culture. A second caveat is that we do acknowledge that Mediterranean and continental models face more demanding challenges, but again there is nothing that fundamentally prevents these countries from engaging in successful reform.

European Economic Policies and the European Social Model

From the above it follows that to have sustainable social models and to benefit fully from the economic potential of open market policies, Member States have to modernise their institutions. Member States have a clear responsibility for the design of their social institutions. Europe has an important responsibility for product and financial market policies.

European open market policies can only be successful if the social models have the capacity to absorb the consequences of open market policies such as corporate restructuring. The reverse is also true. Member States have been active, some more than others, in reforming their labour markets. But it is of no use to push large quantities of benefit recipients to the labour market if there are no jobs. People in difficult circumstances do not like to play games of musical chairs with their future as the stake.

Innovation, internal market and trade policies are needed to create new opportunities for start-ups or foreign direct investment. Competition policy helps by not favouring the incumbents. So for open market policies to be effective job markets need to be sufficiently flexible. But for labour market reform to be successful open market policies should be in place.

In addition to this we observe that structural reforms have important long-term macro effects, while EU macro policies such as the growth and stability pact trigger reform. There are increased interdependencies within the Eurozone (but also beyond). And finally the internal market has deepened.

The symbiotic relationship between economic and social policies creates a need for realigning policies at different levels. One cannot live without the other, but decisions are not made on the same level. To resolve this problem of coherence, a seemingly obvious solution would be to bring decisions concerning the two sets of policies together on the same level. This could take place either at EU level, implying greater centralisation of powers, or at national level, implying decentralisation.

In practice, neither would be desirable. Following the literature on fiscal federalism and the debate on subsidiarity, centralising decisions on labour market institutions and welfare systems would lead to inefficient outcomes because of differing preferences within Europe. Decentralising decisions on product market reform to Member States would mean forgoing the scale economies and advantages of economic integration that membership of the European Union brings.

The issue of how to achieve coherence and complementarity between EU and Member States' policies is therefore at the heart of the current European dilemma. The discussion on the Lisbon agenda can easily be understood in this context. This is a political problem with economic consequences rather than the reverse, as is sometimes believed. This political issue is flagged here as a challenge for the future, but it is beyond the scope of this paper to propose how in practice it can be addressed.