CHAPTER 2

The social failure of the European Social Model

Lorraine Mullally

Introduction

It is often argued that slower economic growth – particularly relative to the 'Anglo-Saxon' economies - is a price worth paying for Europe's higher social standards. This is a comforting argument which has served as a rallying point for opponents of economic reform.

But how is Europe really performing in social terms? Unrest in the suburbs of Paris – and now the riots all across France against the "youth contract" – have ignited a new round of discussion about whether the so-called European Social Model is really a *social* model at all.

It's already widely appreciated that the EU has a serious problem with unemployment. This paper looks at new evidence showing that the social model is failing the poorest people in Europe in many other respects. In particular we examine how:

- **The social model has led to dramatically slower growth in incomes for the poorest.** Over the last decade 1995-2004 the incomes of the poorest 10% of the population have grown eight times faster in Ireland than in Sweden (and six times faster in Britain). As a result, so-called Anglo-Saxon economies like Ireland and the UK now have a smaller proportion of their population below the poverty line than Sweden for the first time.

- **Reducing the tax burden as a proportion of GDP boosts growth and so ultimately means *more* money is spent on public services in real terms.** For example Ireland has cut public spending *as a proportion of GDP* from 55% to 35% since the start of the 1980s, while the tax burden across the rest of the EU has stayed roughly the same. This reform dramatically accelerated growth in Ireland (which had historically been poor). This meant that public services were taking a smaller slice of a much bigger pie – and so Ireland has seen real spending on public services increase more than twice as fast as the rest of the EU (nearly two and a half times more).

- **The European Social Model is failing to provide a future for Europe's poorest.** Europe is falling behind in education and science – only 29% of EU citizens have a university education, compared with 39% in the US and 52% in Japan. And Europe's leaders are doing little to prepare for a severe demographic transition which will put government budgets under extreme stress.

We argue that endless fiddling with the Lisbon process (and all the EU's other processes) will never deliver real change. Europe's leaders are not focussing on the right priorities. As the OECD's 2006 *Going for Growth* report noted: "few moves are underway to reduce the still high implicit tax on working beyond certain ages, cuts in tax wedges have been modest if any and reforms of employment protection legislation, labour cost floors and wage bargaining system have been virtually absent."

We argue that the future for the EU is not the European Social Model. The future is a lean but progressive state, and a low tax economy with a highly educated workforce. This is the only way to solve today's problems, and cope with the looming challenges of tomorrow.

What exactly is the European Social Model?

Firstly what is meant by the idea of a European Social Model – and why does this discussion matter?

In reality the EU member states have widely diverging economic and social policies: for example tax rates varying from 52% to 28% of GDP. Nonetheless, the EU institutions have worked hard to promote the idea of a "European Social Model". In political terms, this is seen as a way to (a) build a sense of a common European identity, and also (b) to justify EU action to "protect" this model.

The European Commission has always been keen to define the EU against some "other". For some European leaders, like Jaques Delors, this meant hostility to the US. But overt anti-Americanism is divisive within the EU, and for this reason it is now more common in EU circles to hear politicians and officials talk about the need to defend against "globalisation" – a catch-all bogeyman which rolls together fear of the US, multinationals, China and India, and even Turkey. The idea of a "European Social Model" is key to this attempt to build a common identity against the rest of the world.

But as well as general identity-building, the European Social Model is also a justification for specific EU policies and programmes.

Commission officials talk about the European Social Model to justify projects which could have no justification if the idea of "subsidiarity" were really taken seriously – for example the forthcoming "EU globalisation adjustment fund". Such projects, and the political rhetoric which accompanies them, send a political message to voters that globalisation is a negative process, for which they need to be compensated.

As well as specific policies, the idea of a European Social Model is the intellectual inspiration for the vast number of informal programmes and processes which the EU coordinates: The Lisbon process, the Cardiff process, the Luxembourg process and the Cologne process – all of which are part of what is described in EU jargon as the "open method of coordination".

This means the EU does not legislate, but instead member states agree to undertake a process and measure themselves against a particular set of targets. These processes typically involve member states submitting a yearly national plan explaining how they plan to reform the economy or boost employment.

While well-intentioned, these programmes have a number of bad political side effects. Firstly, they are time and resource consuming (particularly for the civil servants of small member states). Secondly, they can easily distract from what should be real priorities. Focussing on hitting Lisbon targets for renewable energy production, or "strengthening the regional dimension of the Lisbon agenda" means that (laudable as these goals may be) politicians and civil servants are not focussing on the big picture.

If the European Social Model doesn't exist, how can we tell if it's working?

In this paper we take the European Social Model to mean a relatively high tax and spending economic policy, roughly along the lines of the French and German approach, in contrast to a more Anglo-Saxon approach in Britain and particularly Ireland. We also pull out figures for the Scandinavian economies, because they have come to be held up by the Commission and others as an exemplar of - or prototype for - the European Social Model.

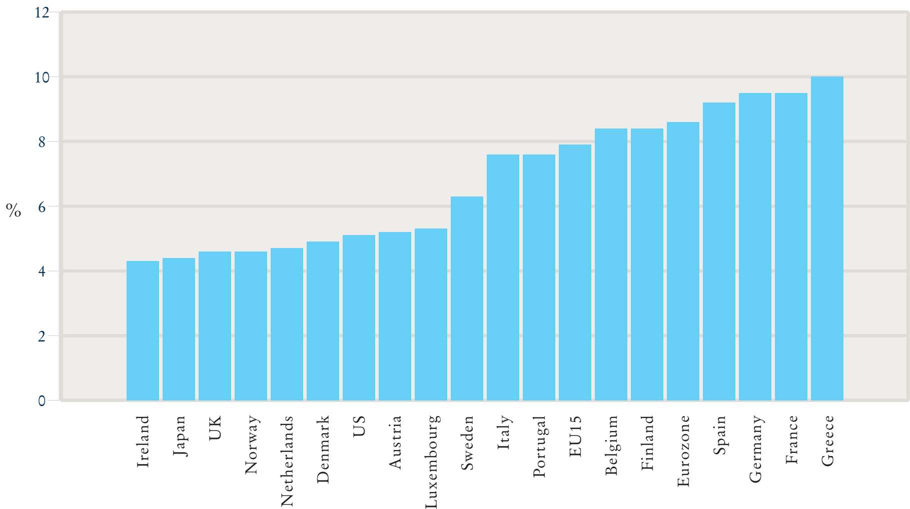
An extremely influential report for the Commission by the economist Andre Sapir acknowledged that there were four different groups of economic model in Europe. His paper argued that the so-called "Nordic model" (Sweden, Finland and Denmark) is the most successful, because they combine reasonable growth rates with high levels of equality. This idea is now very widely cited in EU discussions.

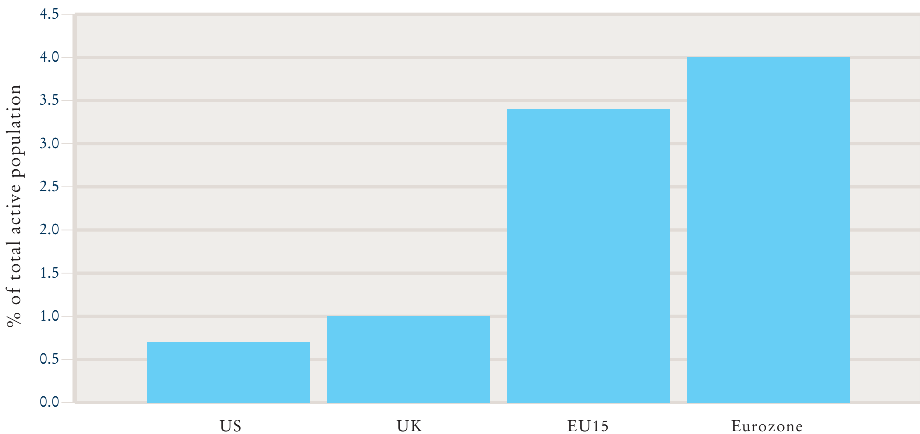
As we will argue below, this conclusion is a mistake. Firstly, growth has not been that impressive: since 1990 Sweden, Finland and Denmark have grown on average 2%, 1.8% and 2.1% a year respectively. This is quite a way behind the OECD average (2.6%) and a long way behind Ireland, which has grown 6.6% a year. Secondly, they are no longer performing as well in social terms as is often believed.

Social failure # 1: high, long term unemployment, and low job mobility

It is already widely appreciated that unemployment is high in Europe, particularly in those countries where labour markets are particularly rigid and the tax burden is high. What is less widely appreciated is the character of European unemployment.

All economies suffer from frictional unemployment, as people move between jobs, and the process of creative destruction means people have to move from declining to rising industries. What makes Europe different is the presence of *long-term* unemployment which undermines society in the areas which it blights. Long term unemployment in the eurozone is six times the rate in the US.





Source : Eurostat

In 2004 in the US only 13% of unemployed workers could not find work within 12 months, compared with 21% for the UK, 42% in France, 52% in Germany and 50% in Italy. In the EU as a whole the percentage of unemployed people out of work for longer than a year was 44%.[1]

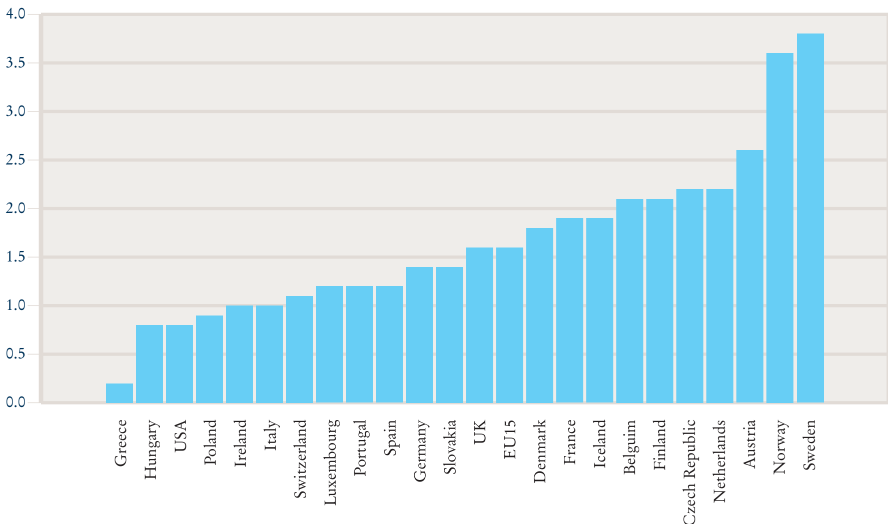
High and long term unemployment also reduces freedom and quality of life even for those in work.

The combination of the threat of unemployment and tight regulation on hiring and firing employees reduces people's freedom to shop around between jobs. In turn this means that more people are stuck in jobs they don't want, or which they may be unsuited to, which in turn reduces productivity. As US economist Diana Furchtgott Roth has noted: "Frequent job changes lead to better job matches and higher productivity."

In the US there were 54 million new hires in 2004 and 51 million job separations in a labour force of 147 million. Over half of job moves were voluntary – people leaving because of better opportunities. Younger baby boomers, born in 1957-1964, held an average of 9.6 jobs from age 18 to 36. [2]

One proxy measure of the number of people stuck in jobs they are unhappy with is the rate of absenteeism. The average person in the US takes less than a week off sick a year. The average in Sweden is nearly 4 weeks off ill a year. The other Scandinavian economies show high sickness figures.

Number of weeks lost due to sickness leave in 2002

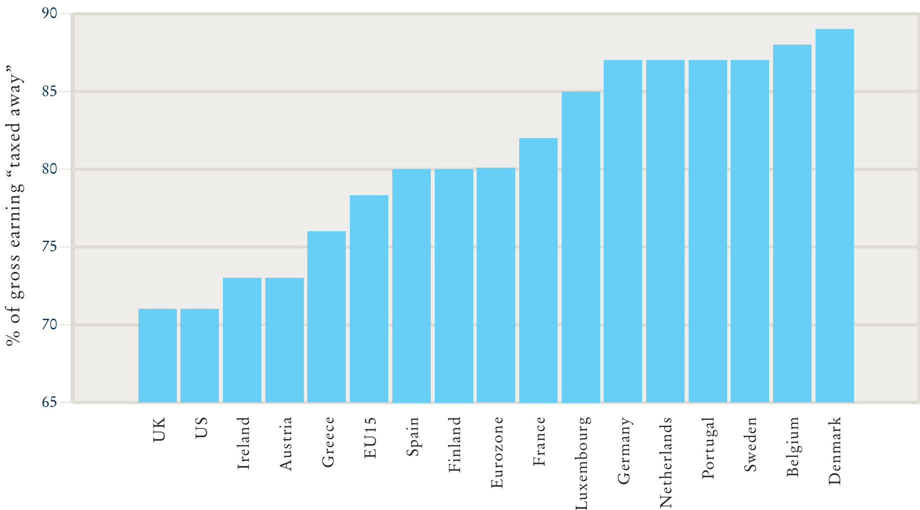


Source : OECD Going for Growth

Trapped in unemployment

Poorly designed tax and welfare systems make it difficult for people to escape from unemployment. As discussed elsewhere in this book, EU members have still made little progress on welfare reform.

The graph below shows the "unemployment trap" low-wage earners face. It is a measure of the percentage of gross earnings which is "taxed away" through higher tax and social security contributions and the withdrawal of unemployment and other benefits when an unemployed person returns to employment. It covers single persons without children earning, when in work, 67% of the average earnings of a full-time production worker in the manufacturing industry.



Source : Eurostat

In Sweden, for someone going from being unemployed to earning 1,500 euro a month, the difference between what they would have received out of work to what they receive while in work is only 5 euros a day. While unemployment compensation is high at around 23 euros a day, take-home pay is low after tax has been deducted – only 28 euros. Even this 5 extra euros is quickly absorbed by expenses associated with work, such as transport, eating out etc, meaning that there is literally no financial incentive for somebody unemployed to find work. [3]

Social failure #2: slower growth in income for the poorest households

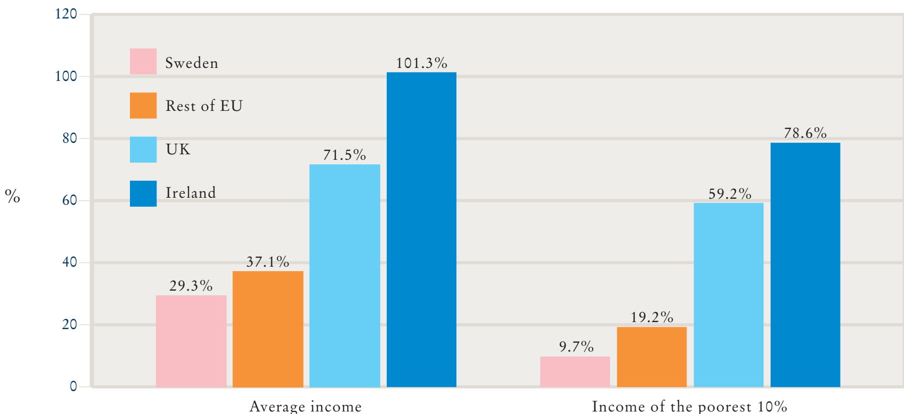
The key claim made for the Nordic model is that it delivers a more equal society, which is often assumed to be the same as saying that the poorest will be better off. But these are two very different things. Welfare economists and political philosophers distinguish between relative and absolute poverty.

Arguments for relative measures are often based on arguments about the effect on people's self esteem from having other people earn more, and often involve asserting a zero sum argument that many goods are so called "positional goods", the enjoyment of which depends on other people not having them.

However, many people find these arguments unconvincing: If Bill Gates walks into a bar, does everyone else in the room suddenly begin to suffer from relative poverty? Political theorists such as John Rawls have argued that policy makers should focus on the real or "absolute" welfare of the worst off groups.

The relative measure of poverty is captured by the widely used Gini coefficient, which is one of the official measures which the EU is tracking as part of the Lisbon programme. On the relative measure, Scandinavian societies do have a high level of equality.

Less widely reported are measures of the absolute income of the worst off. This measure suggests that despite previous success, Scandinavian economies are now doing less well in terms of the welfare of the worst off, and that the so-called Anglo-Saxon economies are actually doing better at lifting people out of poverty. Over the last decade 1995-2004 the incomes of the poorest 10% of the population have grown eight times faster in Ireland than in Sweden (and six times faster in Britain). As a result, so-called Anglo-Saxon economies like Ireland and the UK now have a smaller proportion of their population below the poverty line than Sweden for the first time. The average for the population as a whole is far higher, but in Ireland and the UK the



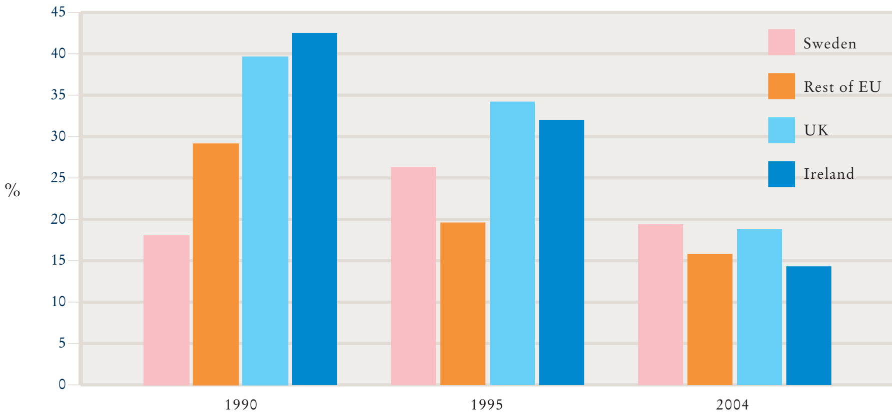
Source : Euromonitor

incomes of the poorest 10% have kept pace more closely with the rising average than in Sweden or the rest of the EU.

Looked at another way, this means that the proportion of households below a given poverty line is being reduced much more quickly in Britain and Ireland than in the rest of the EU.

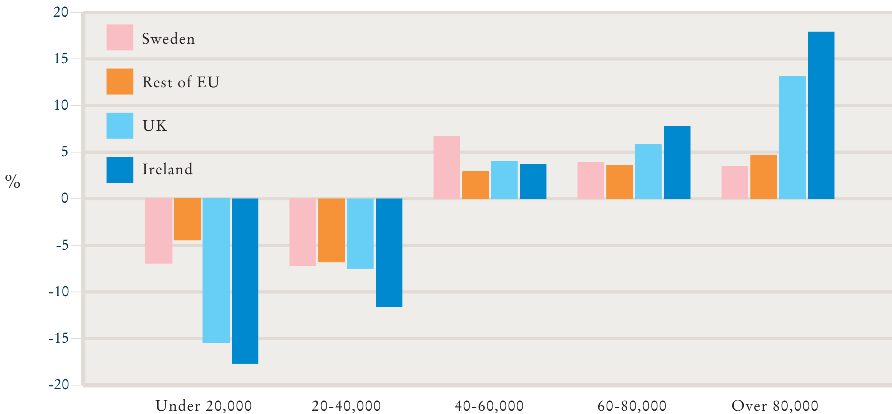
Back in 1990 Sweden was a long way ahead of Britain and Ireland in terms of the proportion of households on low incomes. But this lead has been eroded away (indeed the proportion of poor households in Sweden has risen slightly.) By 2004 Britain had a smaller proportion of households below the poverty line than Sweden. Overall people are being shifted up the income scale much more quickly in Ireland and the UK than in Sweden or the rest of the EU.

Proportion of households with post-tax income of less than $20,000 (£11,400)



Source : Euromonitor

Proportion of households in different income brackets % change 1995-2004



Source : Euromonitor

Social failure #3: slow growth means less to spend on public services

Tax cuts vs. public services?
No – tax cuts *for* better public services

One irony of the current high tax and spending European Social Model is that by maintaining a high tax burden, economic growth is reduced, meaning that in the long term public spending is lower than it could have been. This will make it increasingly difficult for public services to keep up with people's rising expectations, and to cope with the sharply increased load on public services as Europe's societies age.

Below we present new evidence about the powerful link between high public spending and slow growth. We also examine how, in the Irish case, reducing public spending as a share of GDP has led to higher public spending in real terms.

Lower taxes, higher growth: the economic evidence

Independent academics' work on the link between low tax and faster growth has produced a large body of empirical evidence that lowering taxes boosts growth. A seemingly small boost to the rate of growth can accumulate over time to have a very large impact on the size of the economy and living standards.

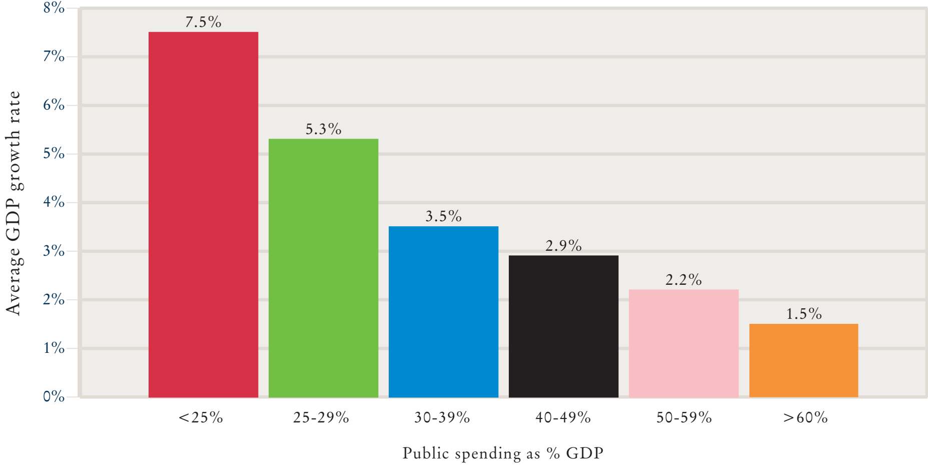
Estimates of the effect of changes in the tax burden

Study	Effect on yearly rate of growth of reducing tax by 10 % of GDP	Cumulative increase in GDP after 20 years compared to baseline growth of 2.5 %
Engen & Skinner (1996)	+0.8 – 1.2	+28 – 39 %
OECD (1997)	+0.5	+16 %
Folker & Henrekson (2000)	+1.0	+35 %
European Commission (2001)*	+0.25*	+8 %

***Assuming distortionary tax and productive spending**

These figures are intuitively plausible. Among the developed economies, the US government takes roughly 10 percent of GDP less than the EU average, and estimates of its trend growth rate are roughly 1 percent higher, at around 3.5 percent a year compared to around 2.5 percent in the EU.

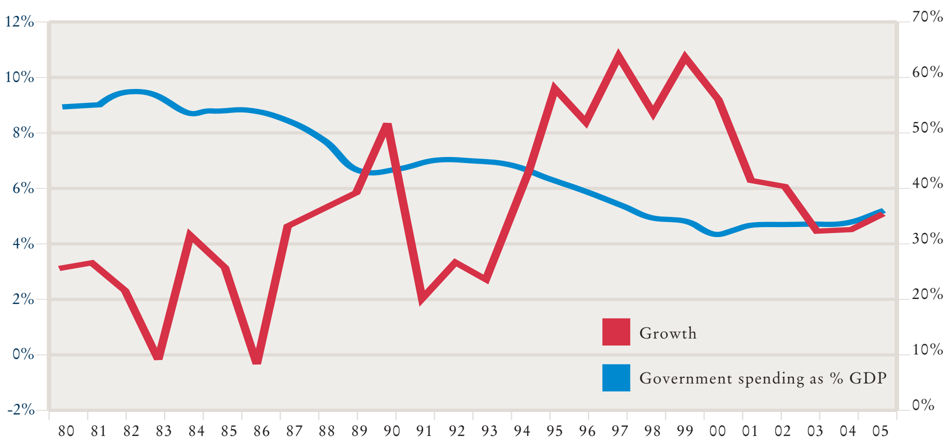
It also seems to have been borne out empirically. Looking at 30 OECD countries since 1960 suggests a very clear and strong link between lower tax and higher growth.



Source : OECD Economic Outlook, author's analysis

The Irish experience

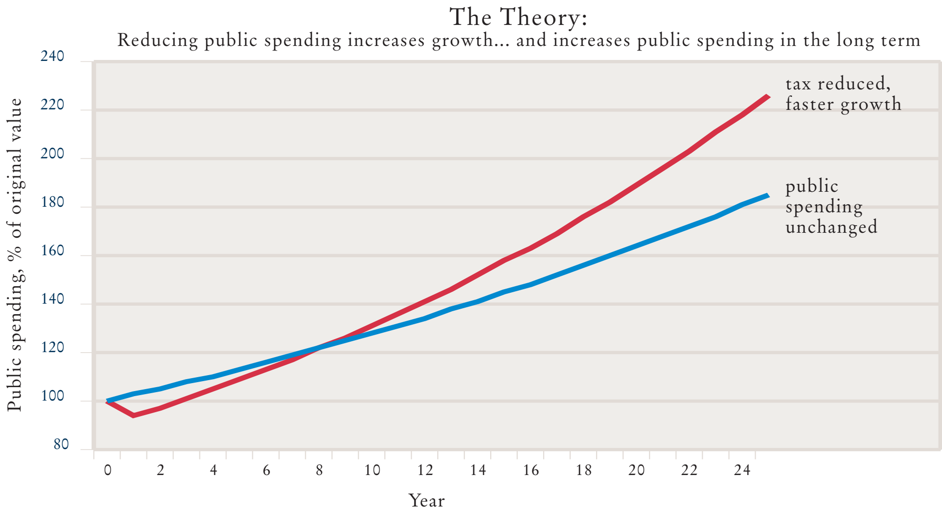
Having cut tax from nearly 55 to 35 percent over the last two decades Ireland has enjoyed growth rates of over 10 percent a year. Ireland has been transformed from one of the poorest to one of the richest countries in Europe.



Source : OECD Economic Outlook

Public spending and tax reform – the theory

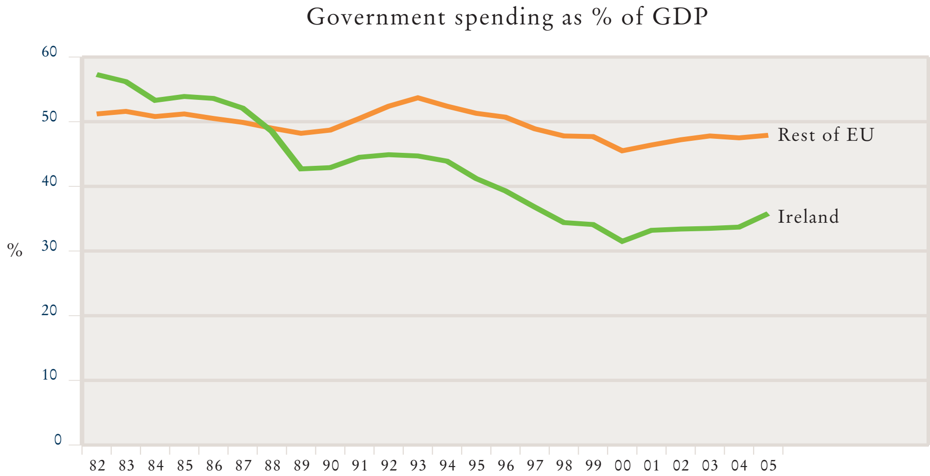
Having stronger growth ultimately means that more money is available for public services. If, as suggested above, a ten percent of GDP cut in public spending increases the rate of growth by just one percentage point, (from 2.5 to 3.5 percent in the case of the UK) then, after eight years, more money is spent on public services than would have otherwise been the case. After twenty five years, even though public spending accounts for a smaller *proportion* of the economy, real public spending will be a quarter higher.

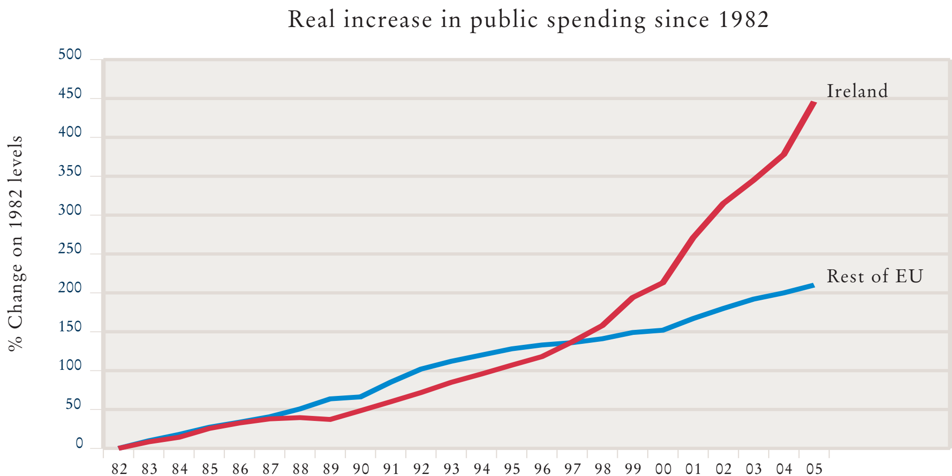


This effect can be clearly seen in the case of Ireland. Public spending as a proportion of GDP in the rest of the EU has remained almost unchanged since the early 1980s, while in Ireland it fell from roughly 55 percent of GDP in 1982 to 35 percent today. But because Irish GDP grew faster, in real terms spending increased more in Ireland. Since 1982 real public spending has grown 200 percent in the Eurozone, but almost double that amount - 450 percent - in Ireland.

By holding back public spending growth as a percentage of GDP, Ireland boosted growth. In the longer term the increased growth has meant that public spending in real terms has been able to grow much faster than the Eurozone average, despite the fact that it now accounts for a smaller percentage of the economy.

Public spending and tax reform - the Irish evidence

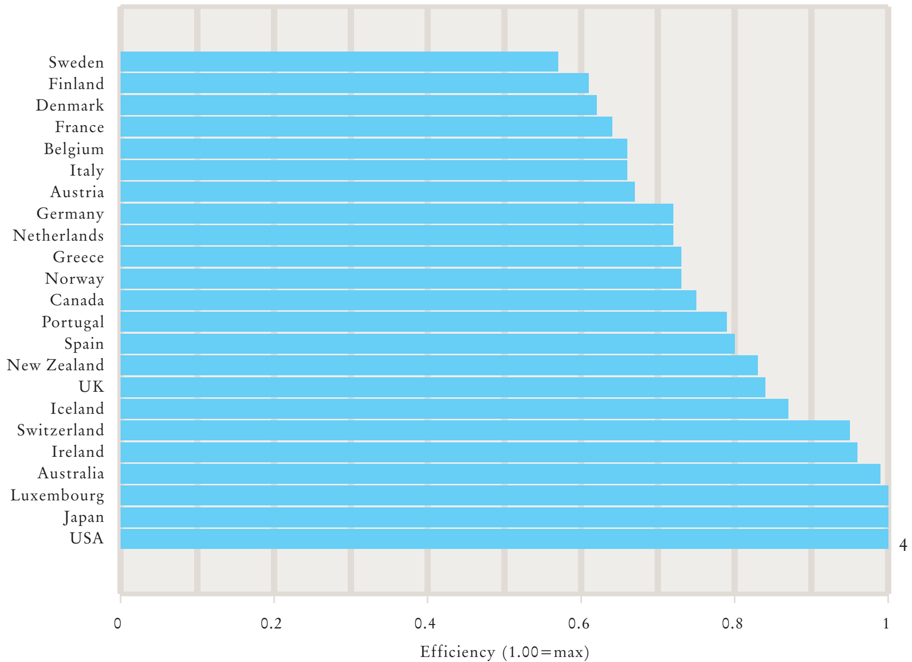




Reform as well as more money

Public sector efficiency is very low by comparison with the US, and the majority of member states lag far behind the most efficient member, Luxembourg. While member states have been moving towards reform, progress so far has been relatively limited.

Research for the European Central Bank found that the highest taxing and spending member states (Sweden, Finland and Denmark) have the least efficient public services. Lower spending members (e.g. Ireland) have more efficient public services.

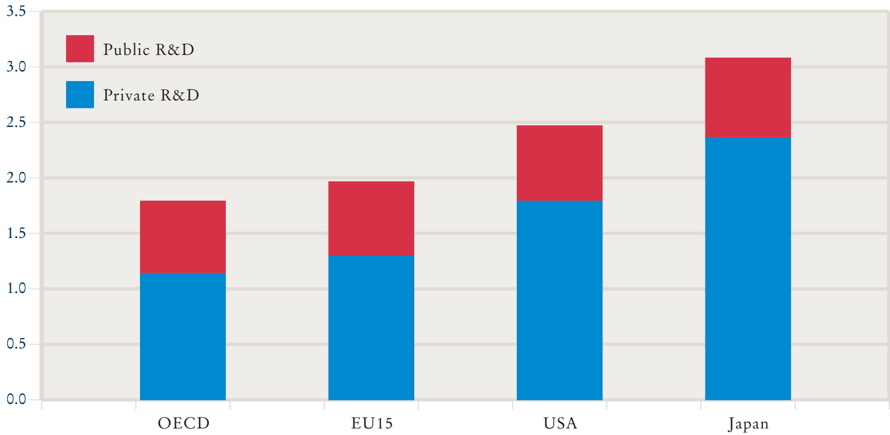


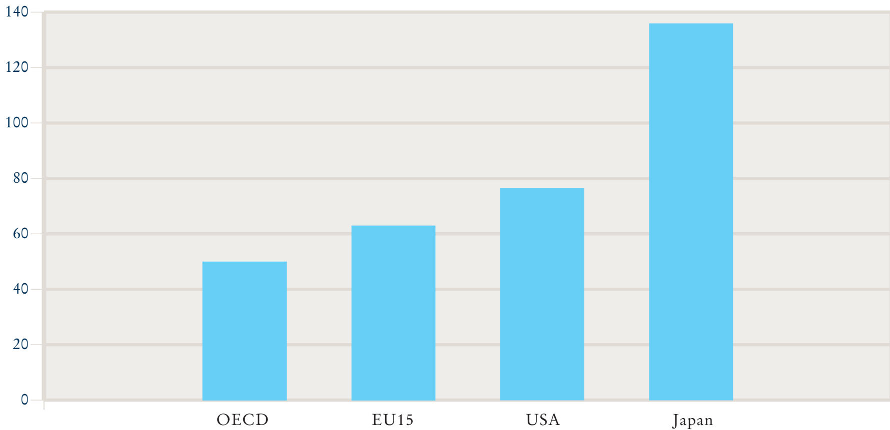
Social Failure #4:
The failure to provide for the future – Education, science and pensions

Falling behind on innovation and education

Innovation is central to future economic growth, and in turn, to material standards of living. But whether it is measured in terms of research and development spending, or the number of patents granted, the EU is falling behind the US and Japan.

This represents a dramatic reversal: In the first three decades of the twentieth century, nationals of France, Germany and Britain each won more Nobel Prizes in science and economics than America (which collected just three per cent of the total). Since 1970, America has picked up almost sixty per cent more than the whole of Europe combined.





Source : OECD Going for Growth 2006

Weakness in higher education

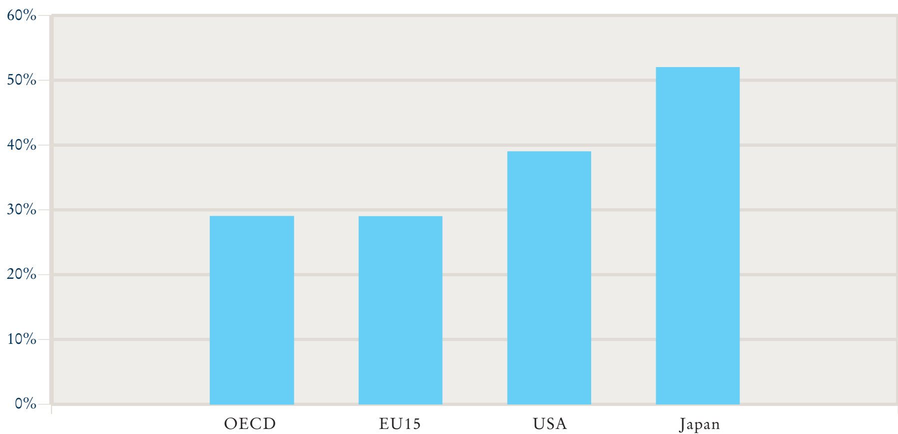
The weakness of the EU member states in research and development is closely linked to their weaknesses in higher education.

According to a widely used global ranking by the Shanghai Jiao Tong University, 17 of the world's top 20 universities are found in the US, American universities currently employ 70% of the world's Nobel prize-winners, 30% of the world's output of articles on science and engineering, and 44% of the most frequently cited articles.[5]

According to a separate survey by the Times Educational Supplement, only 11 of the world's top 50 universities are found in the EU, and 8 of those are in the UK.[6]

An average of 23% of people in the EU (15) aged 25-64 have tertiary-level education, compared with 44% in Canada, 38% in the US, 31% in Australia and 37% in Japan.[7] Looking just at younger age groups (i.e. reflecting current policies rather than previous policies) shows that the EU is still lagging behind its key competitors. This crucially reflects the fact that the US spends far more on education than Europe does by making use of private as well as government funding. Only two universities in Europe would get into a list of the top one hundred and fifty in America for the size of their private endowments.

As Chris Patten argued in a recent speech: "To be clear and blunt, much of our higher education system is in severe difficulties; our research base is threatened; we are losing many of our best researchers; we face more not less competition in the knowledge business; and there are consequences for our future as an economy and a civilisation."



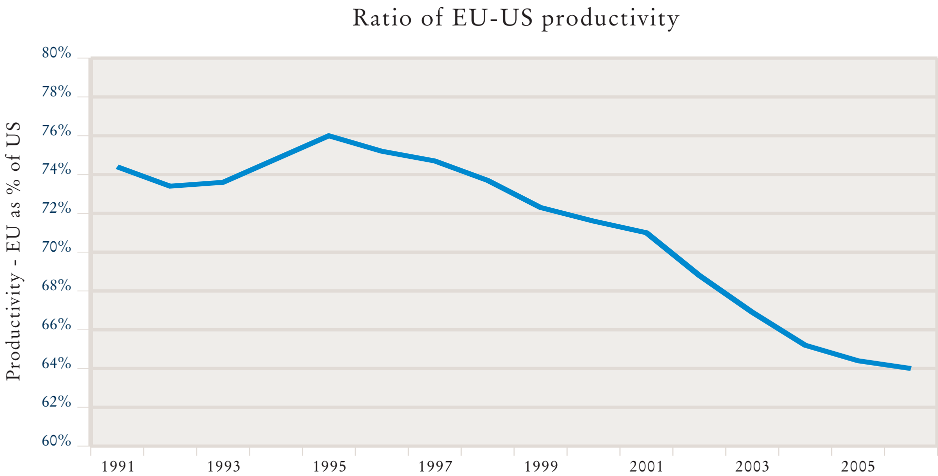
Source : OECD Education at a Glance, 2005

Falling productivity

The combination of high regulation with weakness in science and higher education has meant that Europe's historic productivity catch-up with the US between the Second World War and the 1980s has gone into reverse.

Economic theory suggests that the productivity and living standards of less advanced countries should tend to catch up with the world's leading economies over time. While leading economies are already at what economists call the "productivity frontier", and have to spend heavily on research to make further progress, less developed countries can simply copy technologies and working practices form the leading economies. So it is alarming that Europe is no longer catching up with the US.

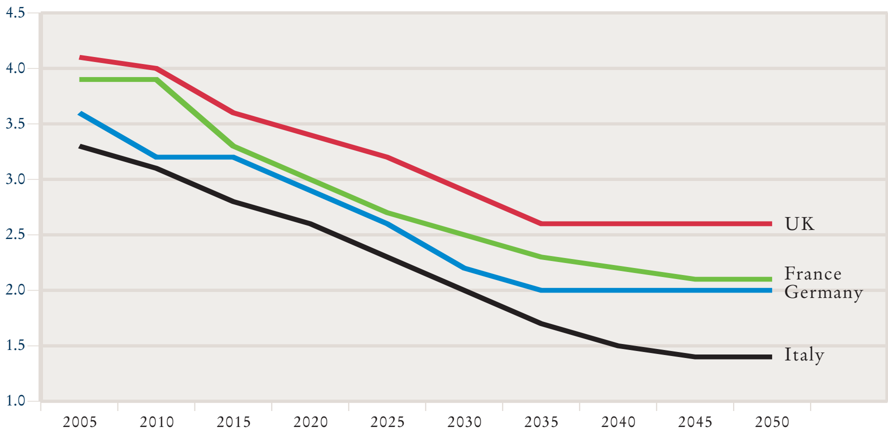
After fifty years of catching up to the US level of productivity, Europe is now falling behind. Robert Gorton of Northwestern University argues that "The growth rate in output per hour over 1995-2003 in Europe was just half that in the United States, and this annual growth shortfall caused the level of European productivity to fall back from 94% of the US level to 85%. Fully one-fifth of the European catch-up (from 44 to 94%) over the previous half-century has been lost over the period since 1995."[8]



Pensions: failing to prepare for the future

The other respect in which Europe's leaders are failing to provide for the future of their citizens is the failure to deal with Europe's looming pensions crisis.

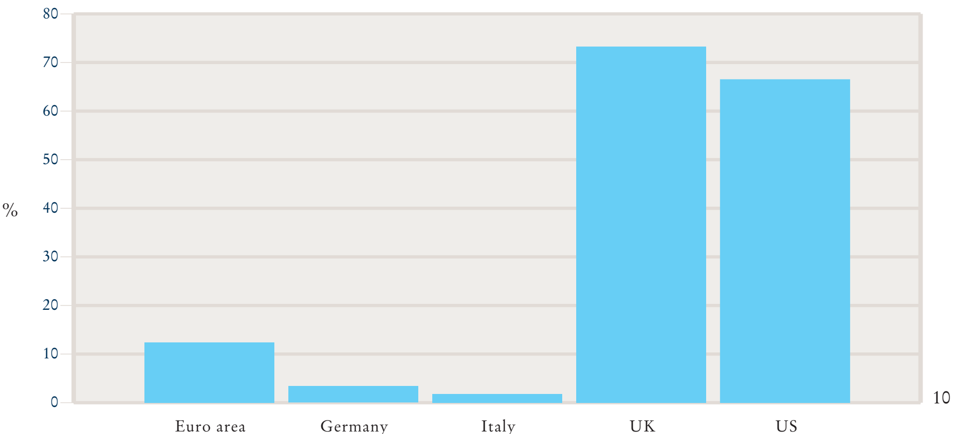
As the population grows older, the ratio of adults in work to those claiming pensions will fall dramatically. By 2050 the UK will have to survive with 2.6 workers for every pensioner, in France it will be 2.1, Germany 2.0 and in Italy it will be just 1.4.



Lack of pension assets

These demographic problems will be made even more acute by the lack of provision that most eurozone governments have made for their state pension schemes. Looking at private pensions schemes, most of the EU is a long way behind the US (and indeed the UK).

According to figures by the European Federation for Retirement Provision, in 2002 Britain had almost 40 percent of Europe's total non-state pensions assets while France had just 1.9 percent, Italy 1.4 percent, Spain 1.9 percent and Germany 14.5 percent.[9]

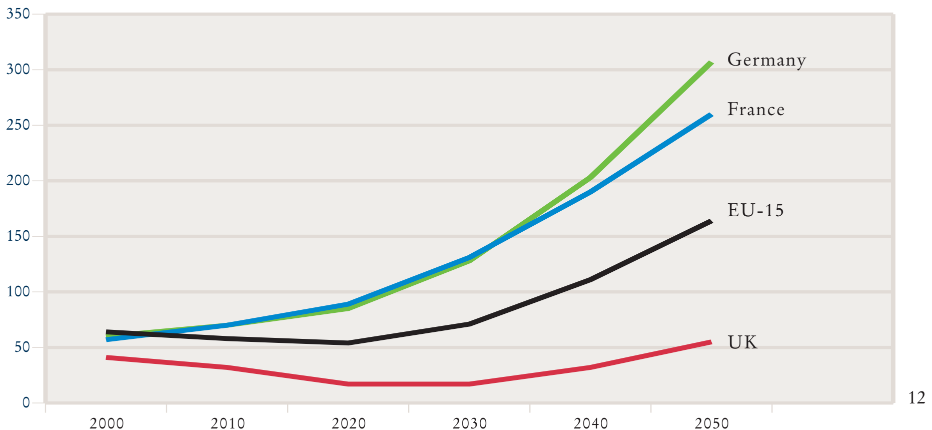


The outlook

The combined effect of ageing and shrinking populations, a declining ratio of workers to pensioners, and a lack of pension assets, means that the EU faces an increasingly difficult future.

According to Standard & Poor's, a world-leading credit-rating firm, many eurozone countries would have a debt burden of over 200 percent of GDP by 2050. Comparatively, countries with better pensions provision, such as Sweden and the UK, will be able to keep their debt below 70 percent of GDP. The report says, "Drifting along and hoping for some economic miracle to take away the pain will be utterly insufficient. If political leadership does not resolutely correct the looming intergenerational imbalances, the dramatic fiscal turmoil …might materialize."[11]

Europe is going bust



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Several EU countries are now slowly introducing measures to decrease the disincentive to work among older people. For instance, Germany will reduce the length of time to which older workers are entitled to unemployment benefits as of 2008, and the government plans to phase-in an increase in the statutory retirement age from 65 to 67 (including public sector workers) over a long period. Belgium will raise the minimum age limit for entry into the early retirement pension scheme, and France has announced measures to increase the incentives to work at ages over 57. However, most EU government have made little progress on pensions reform, despite decades of discussion and analysis. Unless urgent action is taken, the scene is being set for the most catastrophic failure of the European Social Model yet.

Conclusion:

Asked by a correspondent what he meant by his description of a "social market" economy, the great German Chancellor Ludwig Erhard said that "When I talk of the social market economy, I mean that the market is social, not that it needs to be made social." He argued that the market undermines cartels and vested interests and gives outsiders like the unemployed a chance to get on the inside.

Europe urgently needs to rediscover its own liberal traditions. Economic liberalism is not a malign outside force but part of Europe's heritage and future. Not an-anti-social force but the only way to ensure good outcomes for all.

Therefore:

- EU member states should abandon the comforting idea that their current troubles are a "price worth paying" to preserve a successful social model. The high tax high regulation approach is already failing in social terms, and this model will lead to a major crisis in the not too distant future if it goes unchanged.

- The EU institutions should cease their attempts to justify wrong headed programmes in the name of an attempt to "defend the European Social Model." Indeed the EU institutions should be concentrating on the areas which are actually under their control, rather than constantly trying to interfere in what should be its members' domestic policies. If the EU wants to help its member states, it should focus on cutting trade barriers, hacking back its own over-regulation, and redeploying its €120 billion a year budget towards more useful programmes.

1 Diana Furchtgott-Roth, Financial Times, 11 August 2005

2 Diana Furchtgott-Roth, Financial Times, 11 August 2005

3 Johnny Munkhammar, European Dawn : After the social model, 2005

4 Public Sector Efficiency: An International Comparison,
Afonso, Schuknecht & Tanzi, July 2003

5 The Economist, September 8 2005

6 Times Higher World University Rankings 2005

7 OECD, 2003 Figures

8 Why was Europe left at the station when America's productivity locomotive departed? NBER Working Paper, August 2004

9 Reuters, 5 August 2004

10 OECD report 2004, Global Pension Statistics Project: Measuring the Size of Private Pensions with an International Perspective

11 The Western World Past Its Prime—Sovereign Rating Perspectives in the Context of Ageing Populations, Standard & Poor's, 2004

12 The Western World Past Its Prime—Sovereign Rating Perspectives in the Context of Ageing Populations, Standard & Poor's, 2004

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