

Social Tallies and Silicon Valleys

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A casual comparison of European countries and America usually leads to discussion of the trade-off between economic growth and the social model. For many years Europeans derived self-satisfaction by asserting that while European countries may have low growth rates in comparison to America, they compensate for this shortcoming by being more “social.”

Superficially, the European Social Model is seen as the opposite of the American system, with the either explicit or implicit assumptions being that European countries are more “social” than America. Once *übergeneralizations* are dropped and a deeper look is taken past superficial opposites, it becomes apparent that the word “social” takes on significantly different meanings in different European countries. It goes without saying that the word may be used as a camouflage for activities that are anti-social or asocial in nature (e.g. rent-seeking). Most importantly, the difference with America is found in degrees – not in absolutes – depending on the country.

The performance of most European countries has made it increasingly clear that it is difficult to be “social” in any European way without also exhibiting economic growth.

The Nordic model

It is now widely argued that the solution to Europe’s slow economic growth is not found in becoming more American, but rather in looking to a particular type of European Social Model: specifically, the one found in the Nordic countries. The ability of the Nordic countries to maintain their welfare states while also increasing economic competitiveness seems to suggest a viable alternative to the American approach. During a presentation given at Harvard University last fall, Joaquin Almunia, a Spanish social democrat and the European Union’s Commissioner for Economic and Monetary Affairs, praised the social model practiced in the Nordic countries. According to Almunia, the Nordic social model has achieved greater equality and greater efficiency than any other European Social Model. “The British model is efficient but lags in equality. Conversely, the continental model scores well in equality but lags in efficiency. The Mediterranean social model lags in both equality and efficiency.”

Indeed, the point made by Almunia is also supported by the international competitiveness rankings compiled by the World Economic Forum, a Geneva-based organization, which placed the Nordic countries at the top of the list. Finland has been ranked the most competitive nation in the world for several years now.

The Nordic countries have switched to knowledge-based economies and have developed global information technologies companies. Such transformation has fostered a connection between the Nordic welfare state and the competitive knowledge-based economy, which boasts growth rates that are higher than the European average. Sweden's former minister of trade, Leif Pagrotsky, drew a casual causal connection on the pages of the *Financial Times* in 2000 by arguing that Sweden is an example of how the welfare state creates preconditions for a successful knowledge economy. He wrote: "Sweden's success suggests there are two main ways that public spending enhances the performance of a modern market economy: first, by providing a broad-based education to increase the employability of the entire workforce; and second, by a welfare system that makes citizens less fearful of change."

More recently, leading political scientists Ronald Inglehart and Christian Welzel added to this argument when they identified correlations among welfare state, gender equality, and knowledge economy in their book "Modernization, Cultural Change and Political Institutions" (Cambridge University Press, 2005).

In their book "The Information Society and the Welfare State: The Finnish Model" (Oxford University Press, 2002), prominent information society scholar Manuel Castells and his Finnish co-author Pekka Himanen argue that the welfare state has not hindered the process of increasing Finland's competitiveness. The authors point out that countries need not become Silicon Valleys or Singapores in order to make the transformation from manufacturing-based economy to "informational economy" (a term used by Castells and Himanen).

However, according to Castells and Himanen, this is not to imply that other countries should adopt their lessons directly from Finland or follow specifically the Finnish model for their transformation. Rather, each country should follow its own path when making the transition from a manufacturing-based economy to the new informational economy. In the case of Finland, the welfare state has been combined with the informational economy. The argument made by Castells and Himanen does not explicitly argue a causal link, i.e. the welfare state and specific Finnish identity has led to the rise of new economy. Rather, their argument draws attention to the mere co-existence of the phenomena.

As a result, the studies presented above, in addition to many other similar ones, have made the Nordic social model as hot as stones in a sauna among policymaking circles and academics. Sweating in a sauna is healthy. So is the questioning of arguments in the marketplace of ideas.

The Nordic model – is it really working?

A causal link between Nordic welfare states and economic competitiveness might not exist at all. The fact that the Nordic countries have been successful in their transformations to knowledge economies may have nothing to do with the welfare state. While a correlation may well exist between the two variables, correlation does not equal causation. The rise of Nokia like Phoenix from the dust and the rapid transformation of Finland's economic model may be unintended consequences brought on by the creative gales of destruction that gained momentum from the collapse of the Soviet Union and by Finland's regulatory governance of the telecoms industry, which encourages competition.

Indeed there might very well be a trade-off between competitiveness and welfare state. Castells and Himanen point out that the Finns are not entrepreneurial; they do not start as many new small enterprises as do the Americans. Finland's economic success has relied heavily on one large company, Nokia, therein justifying the country's nickname: "the Republic of Nokia." In other words, the achievements of the Nordic countries may have materialized despite their being welfare states. Without the welfare state, the Nordic countries could have potentially higher growth rates.

If Nordic welfare states are not linked to success, there may be other explanations of why Scandinavian economies perform well despite their welfare model. This brings us back to Mancur Olson who, in his book "How Bright are the Northern Lights?" (Institute of Economic Research, Lund University, Sweden, 1990), stated that the Nordic countries had relatively good economic performance in comparison to other European countries – despite their being welfare states. This observation contradicts standard economics, which assumes that welfare states stunt initiative and that powerful unions would have negative externalities for economic performance. Olson saw the Nordic countries as an exception to neoclassical economic theory and made the case that the negative externalities of labor unions' power could be mitigated in cases where labor market institutions are "encompassing." The highly centralized labor unions of the Nordic countries are able to internalize the externalities that occur in the countries with fragmented labor unions (e.g. the UK). In other words, these relatively homogenous countries were run like business partnerships. Nevertheless, even Olson argued that Sweden, for instance, could perform even better without the expansive welfare state and that Sweden's outward-looking economy has compensated for high public sector spending.

Furthermore, it is plausible that some welfare policies are contributing to economic growth while others do not. Indeed, some policies may carry negative effects by offsetting the achievements of other policies, and yet others may be neutral. The next question to follow naturally asks whether the net effect is positive or negative.

Spending on education is superior to other welfare spending and regulations. For instance, Castells and Himanen draw attention to the fact that labor protection regulation in Finland has evolved in an unexpected way whereby “information professionals enjoy much more protected employment than the labor force at large.”

An old Finnish saying holds that “You cannot fill a well by pouring in bucketfuls of water.” In essence, studies that have attempted to establish a relationship between the social model and the competitive knowledge economy practiced in the Nordic countries have tried to do just that. Even if the wildest premise (that Nordic welfare states have contributed to the achievement of competitive knowledge economies) were accepted, there is no telling that this approach would necessarily be applicable in other European countries. Even true welfare state pundits would not argue that the only way to go over to a knowledge economy is to adopt the Nordic social model. Indeed, the example of Estonia offers quite a different story.

Estonia – a more realistic approach for new member states?

In recent years Estonia has consistently ranked in the Top 10 of the Heritage Foundation/Wall Street Journal annual Index of Economic Freedom and has scored as a “freer economy” than the United States. Other similar indexes have also placed Estonia at the top of their lists, all indicating that Estonia has less state intervention in the economy and redistribution than in the Nordic countries. The difference with progressive over-taxation in Nordic countries could not be more telling. Estonia abolished the corporate income tax on reinvested profits in the late 1990s. A flat personal income tax of 26 per cent, introduced more than a decade ago, has been gradually reduced to 23 percent (and will be reduced to 20 percent by 2009). These policies were combined with free trade, liberal foreign direct investment regimes, and sound macroeconomic policies based on a currency board and the constitutional requirement of a balanced central government budget. Indeed, Estonia has had a constant budget surplus during the last years while most other European countries have struggled with deficits. Its economic growth rates have been higher than most of the old and new member countries of European Union. The rate of unemployment has been reduced to almost 6 percent during the last years.

Despite hype about the “Estonian flat tax revolution”, 26 percent, or the more recent 23 percent, is still quite high for income tax rate (e.g. Russia has 13 percent tax rate as a result of reforms under Putin). Only people with a very small income (below circa EUR 1000 per year) are exempt from paying income tax. Furthermore, Estonian employers are obligated to pay 20 percent for social security tax and 12 percent for health taxes, not to mention a small unemployment tax on employee salaries and that the value added tax on purchases is 18 percent. Most education and health care is publicly financed in Estonia. The government does pay unemployment benefits. However, these amounts are smaller than even those in Latvia and

Lithuania. The bottom-line is that Estonia has significant social spending and re-distributional policies even if these policies lack the extensiveness and intensiveness of those found in the Nordic countries. Again, the difference is found in degrees and details, not in absolutes.

So far so good, but what does Estonia's tremendous economic performance have to do with the knowledge economy? A recent study on innovation published by the European Commission includes Estonia among the best performers of new member countries for its outcomes in innovation and entrepreneurship by ranking it as 13th out of 25 EU members. However, the number-crackers in the Commission argue that Estonia belongs in the worst "losing ground" category due to its weakness of knowledge creation, measured by the amount of spending dedicated to research and development. Indeed, Finland's government and businesses (read: Nokia), combined, together spend at least four times more on research and development than Estonia. However, total R&D spending is only a part of the real story. A study completed by Slavo Radosevic, a researcher at the School of Slavonic and East European Studies in London, and published in the *Journal of Common Market Studies* in 2004, offers a more complete analysis by looking at innovation capacities of European countries including absorption, demand and diffusion of technologies, in addition to R&D supply. Radosevic finds Estonia to have higher innovation capacities than any Central Eastern European countries and several old EU members, such as Spain and Italy. This finding is supported by the World Economic Forum, which ranks Estonia ahead of all new EU members and many old members in terms of its economic competitiveness.

These findings are modest in comparison with those published in a *New York Times* article last December, which called Estonia "a sort of Silicon Valley on the Baltic Sea." A recent PBS broadcast "Foreign Exchange" hosted by Fareed Zakaria went even further and simply called Estonia "a new Silicon Valley."

American journalists see something that Brussels bureaucrats emphasizing "commodity statistics" don't see. In a typical fashion, the EU Commission, in its way of looking at the world, misses the whole marginal revolution in economics with emphasis on changes in the margin and incentives. A leading historian of technology and economy, Joel Mokyr, points out in his book "The Gifts of Athena, Historical Origins of the Knowledge Economy" that the technological advances do not depend so much on the total stock a country allocates for R&D, but rather by its distribution and tendency - not all money allocated for R&D will translate into useful, new knowledge. According to Mokyr, the chances of wasting R&D money are reduced, if spending is focused on "alterations and permutations of existing knowledge." This focus on what Mokyr calls "microinventions" is precisely what Estonian companies have been doing.

Nothing could be more telling than the story of Skype, a peer-to-peer Internet telephony company, which has its entire research and development based in Estonia. The company, which was sold to eBay last year for \$2.6 billion, has not come up with a completely new technology, but rather combined and altered existing technologies. The two Skype founders came from the Nordic welfare states of Denmark and Sweden, and have worked in Estonia with a team of programmers since the late 1990s on several projects before coming up with Skype. Skype is not alone – over the years a whole network of knowledge-intensive technology companies has emerged in Estonia. One of them, Playtech, is about to release an IPO in the \$1 billion range on the London Stock Exchange.

The experiences of Estonia, with its weak initial starting position when compared to its Nordic neighbors, show that the Nordic social model does not offer a viable way ahead for other countries. This is supported by the story of Skype, in which entrepreneurs left welfare states to settle in an economically freer environment despite perceived benefits of the Nordic social model. Particularly, the new member countries of the EU have more to learn from Estonia than from its Nordic neighbors and realize that trade-offs between wasteful social spending and economic performance are fundamental. If the temptations of Estonian politicians to follow the Nordic welfare model do not change the course of the country, this Northern Light will be brighter than any of those reflected by its neighbors in the years to come.

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