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GLOBALISATION AND THE REFORM OF EUROPEAN SOCIAL MODELS

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INTRODUCTION

Notwithstanding considerable other achievements, the EU economic system is increasingly failing to deliver a satisfactory growth performance. As I and my co-authors argued in the 2003 report *An Agenda for a Growing Europe*, the EU's growth problem is a symptom of an economy stuck in a system of mass production, large firms, existing technology and long-term employment patterns that is no longer suitable in today's world characterised by rapid technological change and strong global competition. The report insisted that Europe needs to undertake massive economic and social reforms in order to develop an innovation-based economy, focused on R&D, technology and human capital. It concluded that growth must become Europe's number one economic priority – not only in the declarations of its leaders but above all in their actions. It also warned that failure to deliver on growth would threaten not only the sustainability of the European model, but also the very process of European integration which is built on the twin foundations of peace and prosperity.[2]

That message resounds loudly today after the No votes in the French and Dutch referendums, which are attributed by many to Europe's poor economic performance. Indeed, there is broad agreement that voters have expressed not only their frustration with Europe's poor response to the economic challenges it faces but above all their sense of economic insecurity stemming from those unresolved challenges.

In this paper I attempt to make three points.

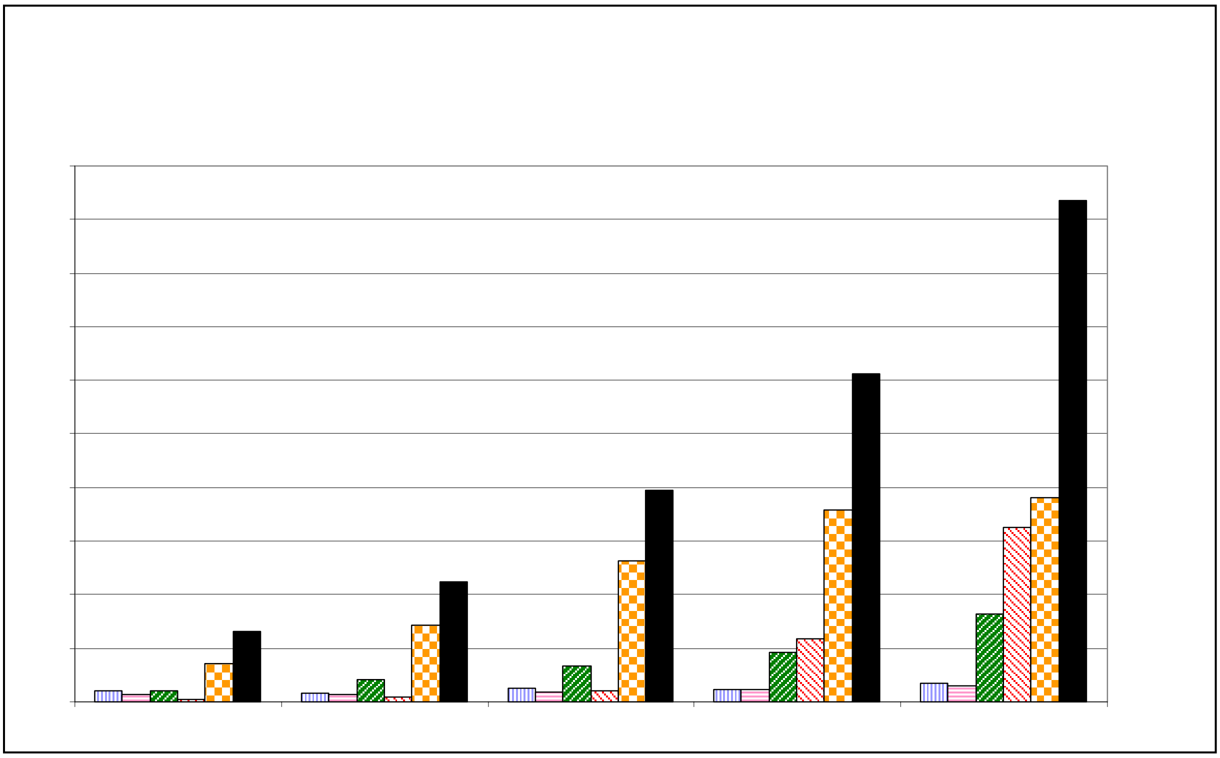
First, the global economy of the twenty-first coordinating these reforms with other necessary reforms, especially for the countries in the eurozone which share a common currency. A two-handed strategy combining reforms at EU and national levels would be best. The Lisbon Agenda tried this but is rapidly failing. All EU efforts should now be geared towards completing the Single Market among the 27+ members of the EU. For their parts Member States should concentrate on reforming labour market and social policies.

CHALLENGES

During the past 25 years the world economy has undergone rapid technological change. Together with political change leading to the adoption of market capitalism by China, India and the former Soviet Bloc, this has led to the emergence of "One World", characterised by strong global competition. The upshot is a global economic transformation at a speed and of a scope unparalleled in history.

One measure of the change in global trade patterns is the increase of the share of emerging economies in manufactured product markets long dominated by advanced country suppliers. As recently as 1970, the share of developing countries in developed countries imports of manufactured products was barely 10 per cent. Today their share is over 45 per cent (see Figure 1). Most of this phenomenal rise comes from East Asia, with the involvement of China happening relatively late but extremely rapidly – its share of developed countries manufactured imports rose from just 2 per cent in 1985 (at the start of its economic transformation) to more than 15 per cent today. As far as the EU is concerned, China has become in 2004 the second largest supplier of manufactures, and of goods in general, overtaking Japan.

Figure 1



Note. From left to right: Africa, Middle East, Latin America, China, Other Asia and Total.
Source: own computation based on WTO data.

The emergence of developing countries as major suppliers of products, both manufactures and services, which compete with European producers, has only just started. Over the coming decades, the trend is bound to accelerate as new suppliers join the fray. In particular, developing Asia (including China and India), which accounts for more than 50 per cent of world population but 25 per cent of world GDP (at PPP), is expected to continue growing steadily at more than 6 per cent per annum for at least one generation, drawing on vast resources of labour combined with increasingly sophisticated technological capability. Such a prospect is not only inevitable, but also desirable given the current distribution of world income, where the G-7 accounts for nearly 45 per cent of world GDP (at PPP) with barely 11 per cent of world population [the respective figures are 21 and 7 for the EU-25 and 21 and 5 union, by fostering both macroeconomic stability and the Single Market ('One Market, One Money'), can also be seen as part of Europe's response to the challenge of globalisation.

Yet these important institutional achievements seem to have failed to generate greater economic dynamism. On the contrary, Europe's economic performance has steadily declined, its potential growth falling by nearly one full percentage point during the past 25 years. According to most estimates, the EU's potential growth is now only 2 per cent a year, compared with almost 3.5 per cent in the United States and more than 4 per cent for the entire world.

One reason for Europe's poor performance is clearly that the speed and intensity of its institutional achievements have been insufficient in comparison with the speed and intensity of globalisation and technological change. The completion of the Single Market is progressing too slowly; the EU budget remains a relic of the past, allocating far too much resources to agriculture and far too little to research and innovation; and the fiscal framework of the monetary union has not yet succeeded in raising sufficiently the quality of national public finances in terms of growth and stabilisation.

But probably the main reason for this poor performance is that changes at the EU level have not been accompanied by necessary changes at the national level. Outdated labour market and social policies simply do not allow the Single Market, public spending on R&D and the currency union to unleash their full potential in meeting the challenges of globalisation and technological change.

Today European policy makers face a simple but difficult choice. Either they can reform national labour market and social policies, in which case globalisation turns into an opportunity, not least because the Single Market becomes more dynamic, public R&D spending generates more innovation and the currency union becomes more flexible. Or national labour market and social policies continue to hinder change, in which case not only does globalisation become a major threat, but both the Single Market and the currency union are perceived as threats as well.

Consider first the Single Market. Transforming the enlarged European Union of 27+ members into a genuine Single Market, where goods, services, capital and labour are allowed to freely circulate, would offer great opportunities to old and new Member States alike. Giving countries the opportunity to exploit their full comparative advantage and companies the chance to restructure their activity on a pan-European scale, would much improve the attractiveness of Europe as place to create wealth and employment.

But this rosy scenario, held by the elites of Europe, who see enlargement as a positive-sum game for old and new Member States and a chance to meet the challenge of globalisation, can only materialise if national labour market and social policies become more conducive to changes in specialisation, especially in "Old Europe", where those losing their jobs in old activities have little chance of finding employment elsewhere. There, citizens often tend to view enlargement as a zero-sum game, where the gains for the new Member States come at the expense of the old ones. The pan-European industrial reorganisation is then seen not as an opportunity in the face of globalisation, but as a burden that comes on top of the weight of global competition and which not only increases the threat of impo

And since enlargement is not an option any more but a reality, the backlash comes in terms of opposition to the Single Market itself. As the debate over the services directive has shown, by greatly increasing economic and social disparities and the pressure to restructure inside the European Union, enlargement has certainly complicated the goal of completing the Single Market. Yet, the Single Market not only constitutes the keystone of European integration but is the most potent European instrument to address the challenge of globalisation. The chances of Europe being able to seize the opportunity of globalisation are low if it considers the creation of an enlarged Single Market as a threat. Once again, the key to turning the Single Market and globalisation into opportunities is the capacity to reform labour market and social policies in the right direction. Failing to do so would only exacerbate the fear towards "Polish plumbers" and delocalisation.

Dysfunctional labour market and social policies are not only a threat to globalisation and the Single Market, but also endanger the currency union. Any European country is bound to suffer from structural changes, be they caused by enlargement, globalisation or technological progress, if its markets are inflexible and do not allow the necessary transfer of resources across firms, sectors or regions. For members of the eurozone, market-led flexibility is even more important since they share a common monetary policy which precludes the use of the exchange rate as an instrument of flexibility – albeit very inadequate for responding to structural changes. The lack of appropriate market mechanisms is bound to lead to attempts to use fiscal policy as a temporary remedy. However, such attempts are bound not only to the United Kingdom) feature relatively large social assistance of the last resort. Cash transfers are primarily oriented to people in working age. Activation measures are important as well as schemes conditioning access to benefits to regular employment. On the labour market side, this model is characterized by a mixture of weak unions, comparatively wide and increasing wage dispersion and relatively high incidence of low-pay employment. *Continental countries* (Austria, Belgium, France, Germany and Luxembourg) rely extensively on insurance-based, non-employment benefits and old-age pensions. Although their membership is on the decline, unions remain strong as regulations extend the coverage of collective bargaining to non-union situations. Finally, *Mediterranean countries* (Greece, Italy, Portugal and Spain), concentrate their social spending on old-age pensions and allow for a high segmentation of entitlements and status. Their social welfare systems typically draw on employment protection and early retirement provisions to exempt segments of the working age population from participation in the labour market. The wage structure is, at least in the formal sector, covered by collective bargaining and strongly compressed.[3]

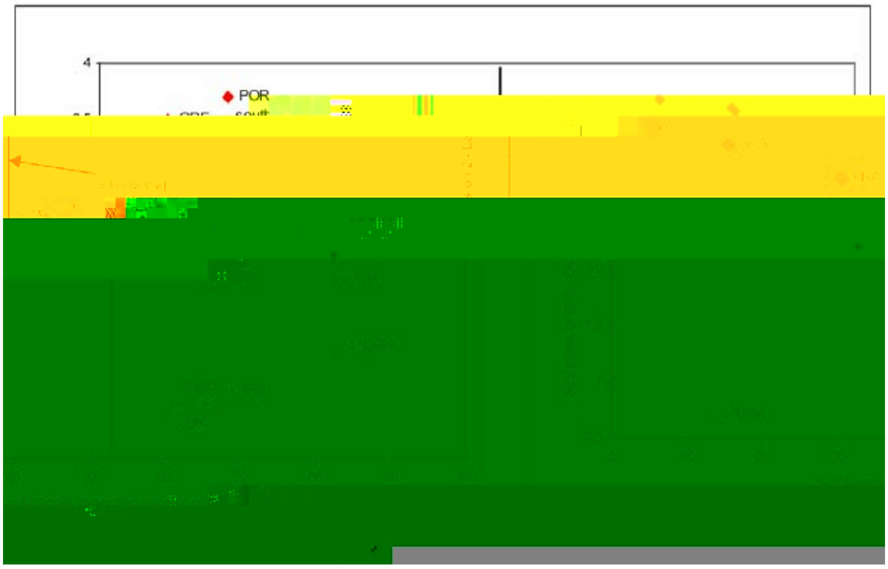
I should say at the outset that I am obviously aware that there are not only wide differences between these four models but also within each of them. An in-depth analysis would obviously require paying close attention to such differences as well. However this will not be done here for the sake of brevity. I will therefore refrain from comments on individual countries, sometime at the cost of great oversimplification.

Boeri (2002) compares the performance of the four models in terms of meeting three objectives of social policies: (1) reduction of income inequality and poverty; (2) protection against uninsurable labour market risk; and (3) reward to labour market participation.

Regarding the *reduction of income inequality and poverty*, he finds that the extent of redistribution effected via taxes and transfers is highest in Nordic countries (with 42% reduction of inequality) and lowest in Mediterranean countries (35% reduction), with Anglo-Saxon and continental countries in the middle (39% reduction). However, the ranking of the four groups is somewhat different when it comes to the incidence of poverty after taxes and transfers (measured as the share of persons with a disposable income below the risk-of-poverty threshold, which is set at 60% of the national median disposable income). Nordic countries still come first (with as incidence rate of only 12%) and Mediterranean countries last (20%), but this time continental countries perform as well as the best and Anglo-Saxon ones as bad as the worst.

Protection against uninsurable labour market risk can be provided either by employment protection legislation (EPL), which protects workers against firing, or by unemployment benefits (UB). The differences between these two systems are clear: EPL protects those who already have a job and does not impose any tax burden, whereas UB provide insurance to the population at large and are typically financed by a tax on those who work. Thus insiders, those with a stable and regular job, typically prefer EPL to points in the trade-off between the two main instruments to protect individuals against unemployment

Figure 2
The Employment Protection Legislation/Unemployment Benefits Trade-off



62%), with much of the difference being attributable to differences at the two ends of the age spectrum. For workers aged 55-64, the employment rate is considerably higher in Nordic (56%) and Anglo-Saxon (53%) countries than in continental (34%) and Mediterranean (40%) countries. For workers aged 15-24, the unemployment rate is significantly lower in Nordic (13%) and Anglo-Saxon (10%) countries than in continental (17%) and Mediterranean (22%) countries.

This comparative analysis of the four models can be usefully summarised with a typology based on two criteria: efficiency and equity. A model will be considered efficient if it provides sufficient incentive to work and, therefore, if it generates relatively high employment rates. It will be deemed equitable if it keeps the risk of poverty relatively low.

Figure 3 plots the probability of escaping poverty against the employment rate for the four country groupings and each of the 15 members of the old EU-15.

Figure 3
Employment Rates and Probability of Escaping Poverty of European Social Systems

All Nordic and Anglo-Saxon countries rank above average in terms of overall employment rate, whereas most continental (with the exception of Austria) and Mediterranean (with the exception of Portugal) countries rank below average. Comparing figures 2 and 3 indicates a strong connection between the employment rate generated by a social system and the

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All Nordic and continental countries rank above average in terms of the probability of avoiding poverty, while all Anglo-Saxon and Mediterranean countries rank below average. What accounts for this difference? The extent of redistribution (via taxes and transfers) cannot be the major explanatory factor since it is fairly high in most countries with the exception of those in the Mediterranean group. A better explanation is the difference in the distribution of the human capital which individuals bring to the market. The proportion of the population aged 25-64 with at least upper secondary education is highest in Nordic (75%) and continental (67%) countries and lowest in Anglo-Saxon (60%) and Mediterranean (39%) countries, a ranking that perfectly matches the position of country groups in terms of poverty risk. The lower the level of secondary education attainment, the higher the risk of poverty.[6] By contrast, the extent of redistributive policy only plays a secondary role.[7]

The chart below provides the results of the typology exercise in terms of efficiency and equity for the four country groupings.[8]

Table 1
The Four European Models: A Typology

	EFFICIENCY	
	Low	***High***
High	Continentals	Nordics

Table 1 can be read in terms of the familiar *trade-off* between efficiency and equity. Nordic and Mediterranean countries apparently face no such trade-off. Nordics enjoy an envious position, with a social model that delivers both efficiency and equity, whereas Mediterraneans live in a social system that delivers neither efficiency nor equity.[9] On the other hand, Anglo-

[6] The correlation coefficient between the index of poverty and the measure of educational attainment for 14 EU countries is -0.76.
[7] Once educational attainment is taken into account, adding the income redistribution has no impact on variations in the risk of poverty across models or even countries. A regression of the index of poverty risk on educational attainment and income redistribution for 14 EU countries produces a very significantly negative coefficient for education and a coefficient not significantly different from zero for redistribution. This implies that educational attainment is the key factor driving poverty risk in the EU.
[8] Figure 3 indicates that the four country groupings are far from homogenous. In particular, Austria seems to be more Nordic than continental, and Portugal more Anglo-Saxon than Mediterranean. Nonetheless, I will retain the country groupings as defined so far.
[9] Denmark is a prime example of a Nordic country with an efficient and equitable model. It has the highest employment rate (75%) and one of lowest poverty indexes (12%) in the EU-15. In the opposite corner, Italy is a

Saxon and continental countries both seem to face a trade-off between efficiency and equity. Anglo-Saxons have an efficient but inequitable social model, while continentals enjoy far more equity but far less efficiency.[10]

Another reading of Table 1 emphasises *sustainability* of social models. Models that are not efficient are simply not sustainable in the face of growing strains on public finances coming from globalisation, technological change and population ageing. There are several signs that the less efficient continental and Mediterranean models face severe sustainability constraints. One is the level of public debts as a share of GDP which tends to be far higher in continental (73%) and Mediterranean (81%) countries than in Anglo-Saxon (36%) and Nordic (49%) countries. Another is the public perception of globalisation. A recent Eurobarometer survey shows that the proportion of those considering that globalisation either represents a threat to employment or has a rather negative effect on employment is far greater in continental (52%) and Mediterranean (45%) countries than in Anglo-Saxon (36%) and Nordic (37%) countries. On the other hand, models that are not equitable can perfectly be sustainable, provided they are efficient. The reason is that, at least in Europe (but also obviously in America), the degree of equity of a social model reflects a viable political choice.

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. On the other hand, there is no reason a priori to assume that such reform must go hand-in-hand with changes in terms of equity. It is perfectly possible for the continental model to become more like the Nordic one, and for the Mediterranean model to become more like the Anglo-Saxon model. Nonetheless, one cannot reject the possibility that a reform towards greater efficiency may also unleash a change towards more or less equity if the previous political equilibrium were itself affected by the drive towards more efficiency.

In conclusion, there is a strong case for reforming European labour market and social policies, especially in continental and Mediterranean countries. There are two overriding reasons for social health of these countries is therefore of paramount importance for the smooth functioning of the entire European Union and of the eurozone.

POLICIES

I have argued that Europe needs to better respond to the economic challenges it faces and that this requires reforms of labour market and social policies which have become outmoded. I have also argued that labour market and social policies are far from being uniform across EU countries and that different social policy models perform differently in terms of efficiency and equity. Finally, I have argued that it is above all inefficient models, with wrong incentives for work, which need to be reformed.

In view of the fact that countries with inadequate labour market and social policies were found to account for two-thirds of the EU GDP and 90 per cent that of the eurozone, the question arises as to what can and should "Europe" (either the European Union or the

Lisbon process.

Unfortunately Lisbon has not delivered.

Coordinating structural reforms and macroeconomic policy?

The lack of interest displayed by EU countries in coordinating their structural reforms via the Lisbon process may be due to uncertainty concerning the extent of spillovers generated by the Single Market. There is, however, a subset of EU Member States for which spillovers, and therefore the case for coordination, are undeniable.

Countries belonging to the eurozone share not only the Single Market. They also share a common currency and therefore a common interest rate which is set by the ECB with respect to the average inflation rate of the eurozone. To starting point and others carrying out ambitious programs even though their initial conditions were already relatively favourable.[12] Moreover, there is no evidence of an acceleration of reforms during the second half of the period, after the launch of the Lisbon Strategy, on the contrary.

The Luxembourg Presidency earlier this year was a perfect opportunity to try and inject new impetus to the Lisbon Strategy thanks to the conjunction of three interconnected processes: the midterm review of the Lisbon Strategy, the reform of the Stability and Growth Pact (SGP), and the negotiation on the future EU budget. Under ideal circumstances, these three processes would have converged and translated into a clear vision of Europe's economic objectives and instruments. The goal should have been to use the reformed SGP and the new EU budget as *incentives* for a streamlined Lisbon Strategy concentrating on the Single Market and increased financing for research and innovation at the EU level along with labour market and social policy reforms at the national level. There was some progress on the SGP, but together with the lack of progress in the right direction (i.e. more resources for research and innovation and less for agriculture) on the EU budget and the still insufficient focus of the Lisbon Strategy this hardly qualifies as a new method capable of delivering the necessary reforms at the EU and national levels.

The failure to significantly improve the Lisbon method does not augur well for the Lisbon Agenda. Yet, its two-handed approach and its rationale – the urgent need to reform economic and social policies to face up the challenge of globalisation and technological change – remain as valid today as they were five years ago when they were put forward.

What should be done?

At this stage, the best strategy would be to go back to basics and focus all efforts at the EU level on ***completing the Single Market***.

The Single Market and an active competition policy are the cornerstone of efforts at EU level to improve the functioning of markets and, thereby, Europe's capability to respond to the challenges of globalisation and technological change. Reforms in product and capital markets not only foster productivity but also facilitate labour market reforms to the extent that they increase the demand for labour and the growth of jobs.

By removing barriers to the mobility of products and capital and by fostering competition, the Single Market Programme (SMP) was expected to raise productivity, employment and growth in the European Union. Yet, growth has been mediocre, with Europe's performance deteriorating – both absolutely and in comparison with the United States – during the past 20 years since the launch of the SMP. Besides German reunification and other shocks, there are three main reasons for this.

First, the SMP was never fully implemented. Since 1993, the Single Market is a reality for goods. On the other hand, service markets - including financial markets - remain highly fragmented. Yet efficient provision of services - many of which are vital inputs for producers in almost all other sectors - is crucial for the growth of a modern economy.

[12] Brandt, Burniaux and Duval (2005).

Second, the conception and implementation of the SMP were rooted in yesterday's thinking. They were based on the assumption that Europe's fundamental problem was the absence of a large internal market that would allow European companies to achieve big economies of scale. It has now become clear that the problem lay elsewhere. In the modern world, characterised by rapid technological change and strong global competition, what European industry needs is more opportunity for companies to enter new markets, more retraining of labour, greater reliance on market financing and higher investment in both research and development and higher education.

Third, the SMP naturally excluded the liberalisation of labour markets, since it falls within the

Market, instead, holds the promise of boosting Europe's economy, thereby creating the real conditions for the sustainability of a more efficient social model.

Refusing to transform the enlarged EU into a genuine Single Market is a blow to new and old Member States alike. It denies countries the opportunity to exploit their full comparative advantage and companies the chance to undertake the kind of pan-EU restructuring which probably holds the best chance for Europe to foster its competitive position in the global economy.

Twenty years ago, the Commission White Paper to the June 1985 European Council on *Completing the Internal Market* concluded:

"Europe stands at the crossroads. We either go ahead – with resolution and determination – or we drop back into mediocrity. We can now either resolve to complete the integration of the economies of Europe; or, through a lack of political will to face the immense problems involved, we can simply allow Europe to develop into no more than a free trade area.

The difference is crucial. A well developed free trade area offers significant advantages: it is something much better than that which existed before the Treaty of Rome; better even than that which exists today. But it would fail and fail dismally to release the energies of the people of Europe; it would fail to deploy Europe's immense economic resources to the maximum advantage; and it would fail to satisfy the aspirations of the people of Europe."

This conclusion is as valid today as it was twenty years ago. Completing the integration of the 27+ economies of the European Union must be the utmost priority of efforts at EU level to revitalise the European economy. But Member States must also proceed in parallel with national reforms of labour market and social policies geared towards improving the capacity of their economies and their citizens to take full advantage of the opportunity offered by the changes associated with globalisation. Only

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