Beyond the European Social Model

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Open Europe is an independent think tank set up by some of the UK's leading business people to contribute bold new thinking to the debate about the direction of the EU.

While we are committed to European co-operation, Open Europe believes that the EU has reached a critical moment in its development. 'Ever closer union', espoused by Jean Monnet and propelled forwards by successive generations of political and bureaucratic elites, has failed.

The EU's over-loaded institutions, held in low regard by Europe's citizens, are ill-equipped to adapt to the pressing challenges of weak economic growth, rising global competition, insecurity and a looming demographic crisis.

Open Europe believes that the EU must now embrace radical reform based on economic liberalisation, a looser and more flexible structure, and greater transparency and accountability if it is to overcome these challenges, and succeed in the twenty first century.

The best way forward for the EU is an urgent programme of radical change driven by a consensus between member states. In pursuit of this consensus, Open Europe will seek to involve like-minded individuals, political parties and organisations across Europe in our thinking and activities, and disseminate our ideas widely across the EU and the rest of the world.

Beyond the European Social Model

Introduction

A quick search on Google for the phrase "European Social Model" turns up more than 271,000 hits. If you type in "European Social Model + success" you get 93,000 results. So far so good, you might think. But "European Social Model + unemployment" turns up some 98,000 pages.

That straw poll of the internet sums up the debate about the European Social Model. Some say the member states of the EU have established a unique blend of economic competitiveness and equality. Others hold the model responsible for a decade and a half of economic decline, with slow growth, high unemployment and social *malaise.*

The "social model" is at the heart of the debate about the future of the EU. In fact it was directly written into the text of the rejected European Constitution, with Article 3 defining the EU for all time as a "social market economy".

But what does the idea of a common European Social Model *mean* anyway? With tax burdens ranging from 52% to 28% of GDP across the EU, and with 25 member states at very different levels of development, with very different cultures, can we really even talk about a common social model?

Beyond the European Social Model answers these questions. We look at both success stories and failures from around Europe and paint a picture of how reforms might work. We argue that the current model is not working, and that the time has come for the EU and its member states to take a different approach, and make a fresh start.

Lorraine Mullally &
Neil O'Brien

March 2006

Executive Summary

Section 1:
Is the Social Model working? If not, which policies are working in Europe?

Martin De Vlieghere contrasts the success of the low tax Irish economy with Scandinavia. While Sweden fell from being the 4th richest country in the world in 1975, to 14th today, Ireland has transformed itself from the 22nd to the 4th richest economy. Sweden and Finland have created no private sector jobs since 1981, while employment in Ireland has grown by 56%. De Vlieghere notes that as well as a low tax burden overall, Ireland's tax mix falls more on consumption, and less heavily on profits and labour.

Lorraine Mullally looks at whether the so-called social model is really "social" at all. It's often said that while the EU may be a less dynamic economy than the US, it is a better society. But long term unemployment in the eurozone is six times the rate in the US. And over the last decade 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. So isn't the social model really a failure in social terms too?

Dr. Constantin Gurdgiev warns that the European Social Model may yet sink the Irish miracle. "Over the last 5 years, the country has been sliding into the abyss of rising government spending, indirect taxation increases and more regulation and state involvement in the economy." He argues that Ireland's emulation of the EU's "social partnership" model in particular is a mistake and that liberal policies are the best way to ensure high productivity and better opportunities for women. He uses data from migration flows to show that people are "voting with their feet" – and moving out of the eurozone to more flexible economies.

Johnny Munkhammar says that despite the hype about the "Scandinavian model", other EU members should not try to emulate a model which means "low growth, unemployment and dependency on the state". He argues that hidden unemployment in Sweden means a real unemployment rate of nearly 20%. But the future can still be bright because even "limited reform might have substantial results."

Chresten Anderson rejects the whole idea of a common European Social Model. He writes that, "The imposition of a single welfare state model is unjustified from an economic perspective and undesirable politically". He argues that in so far as Scandinavian countries have had success in recent years it is because they have moved *away* from their original social models and adopted a series of free-market reforms. He concludes that if Europe wants to reduce unemployment it should stop talking about how to "create" jobs and start focussing on how to "grow the pie".

Section 2:
Lessons for reformers: the state of play and the way forwards

Reform in a consensual society:

Eline van den Broek looks at reform in the Netherlands and the so called "Polder Model". She argues that the model is not a suitable blueprint for reform across the EU. Although the government has managed to enact some reforms, the long process of negotiation inherent in the Polder Model has led to a lack of clarity and drained public support for the reform programme. Moreover, the official bodies involved in corporatist structures have become unrepresentative of an increasingly diverse and individualistic society. She suggests the Netherlands may be heading for a dramatic change of political culture, with the consensus approach coming under pressure.

Technology:

Meelis Kitsing notes that success in the information economy has made the Nordic model "as hot as stones in a sauna" among EU policymakers. But studies which try to show a link between Nordic welfare systems and the information economy suggest that this is less of a "model" and more of a coincidence. He argues that success stories like Nokia can be explained by getting a few big things like telecoms regulation right, and also by the "gales of creative destruction" unleashed on Scandinavia in the early 1990s by the collapse of the Soviet Union. He argues that if poorer member states want to break into the new economy they should learn from low-tax Estonia instead. He notes the story of the revolutionary telecoms company Skype: technology developed entirely in Estonia - by entrepreneurs who had left Denmark and Sweden.

Welfare reform:

Barry Watts looks at whether and how Europe can learn from welfare reform in the US. Due to poorly designed welfare and tax systems, the marginal rate of tax faced by people leaving welfare for work can be over 100% for many people in Europe. Earned Income Tax Credits are widely seen as a success in the US (across the party-political divide). In theory they could provide a better way to help people in Europe escape from the "unemployment trap". But so far Europe has made little progress on welfare reform, and may even be going about it the wrong way.

Regulation:

Malgosia Kaluzynska writes that the EU as a whole is committed to a "better regulation" programme, but that this programme needs to change and broaden if it is to be a success. The common approach which is now being taken up across the EU (known in the jargon as the "standard cost model") focuses too much just on the administrative costs of regulation and fails to really deliver better regulation. She argues that Europe needs to look at the wider costs of regulation, and that EU members need to think about cutting the regulatory burden on individuals as well as businesses. Member states need to reduce the burden on small businesses and remember that harmonisation is not the only way forwards.

Paul Stephenson argues that EU regulation needs to be rolled back. Despite positive rhetoric about "better regulation", so far the Commission is just tinkering around the edges. With most regulation on business now coming from the EU, and over 10,000 new pieces of EU legislation added to the EU statute book since 1997, it is vital that member states start to axe rather than tinker with EU regulations.

Contents

Biographies

Martin De Vlieghere is a doctor of philosophy. He is president of the "Free Association for Civilization Studies", member of the board of directors of Nova Civitas, and a researcher at Work For All, an independent think-tank based in Belgium.

Lorraine Mullally is a researcher at Open Europe. She previously worked for the Brussels based think-tank ISIS Europe, studying EU defence policy.

Dr. Constantin Gurdgiev is a Lecturer in Economics at University College Dublin, Research Associate at Trinity College, Dublin, Director of the Open Republic Institute in Ireland and Editor of Business&Finance Magazine.

Johnny Munkhammar is Programme Director at Timbro, the Swedish Free-Market Institute and author of *European Dawn: After the social model* (2005).

Chresten Anderson is the president and founder of the Copenhagen Institute, the leading free market think tank in Denmark.

Eline van den Broek is a senior fellow with the Centre for the New Europe in Brussels and founder of the European Independent Institute, the only independent free market think tank in the Netherlands.

Meelis Kitsing is a PhD Candidate at University of Massachusetts Amherst. He holds a MALD degree from the Fletcher School of Tufts University in Boston and an MSc from the London School of Economics. In the 1990s Meelis was involved in Estonian politics and worked for a number of multinational companies.

Barry Watts is a researcher at Open Europe and previously worked at the Centre for Economic and Social Inclusion, analysing recent welfare reforms in the UK.

Malgosia Kaluzynska is Head of the Lisbon Strategy Unit, Office of the Committee for European Integration, Poland.

Paul Stephenson is a researcher at Open Europe focussing on regulation. His recent publications include *The Services Directive: Can Europe Deliver?* (2006)

Section 1:
Is the Social Model working? If not, which policies are working in Europe?

CHAPTER 1

The Myth of the Scandinavian Model

Martin De Vlieghere

"America's social model is flawed, but so is France's," the Parisian newspaper *Le Monde* recently wrote. According to *Le Monde* Europe should adopt the "Scandinavian model," which is said to combine the economic efficiency of the Anglo-Saxon social model with the welfare state benefits of the continental European ones. On the eve of the EU's Hampton Court Summit in October last year, one could even read that "Britain might be forced to discuss the advantages of Scandinavian models, which rely on more social security."

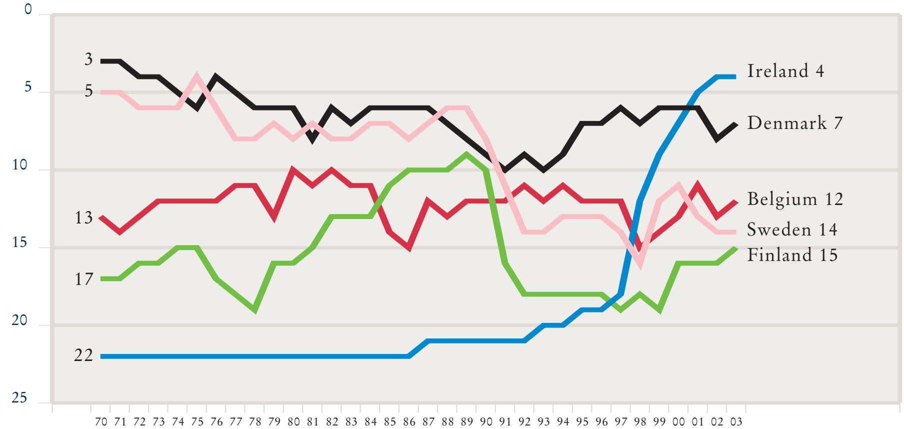
The praise for the Nordic model comes from Bruegel, a new Brussels-based think tank, "whose aim is to contribute to the quality of economic policymaking in Europe." The think tank is a Franco-German government initiative and is heavily funded by EU governments and corporations. In October Bruegel published a study "Globalisation and the Reform of European Social Models" propagating the Nordic model. A paper from the economics department of Ghent University does the same. This paper, *Fiscal Policy Employment and Growth: Why is the Euro Area Lagging Behind?*, was also subsidised by the government. In the selection of data comparing the performance of EU economies, the authors arbitrarily eliminated Ireland, Spain and Portugal (three of the four best performing EU economies) from their research and added oil-producing non-EU member Norway (which has a GDP of which more than 20% is based on income from oil). It is hardly imaginable that professors of one of Belgium's major universities would not be aware of how this arbitrary selection must distort the results. Hence one must read their text as an ideological pamphlet rather than a scientific study.

However, despite Bruegel, distorted academic studies and the European media's praise, the efficiency of the major Scandinavian economies is a myth. The Swedish and Finnish welfare states have been going through a long period of decline. In the early 1990s they were virtually bankrupt. Between 1990 and 1995 unemployment increased five-fold. The Scandinavian countries have not been able to recover.

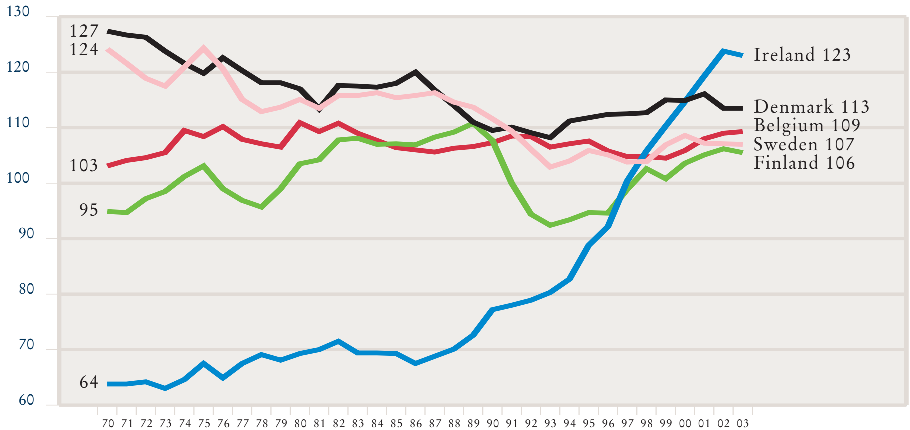
The implosion of the welfare state

In 1970, Sweden's level of prosperity was one quarter above Belgium's. By 2003 Sweden had fallen to 14th place from 5th in the prosperity index, two places behind Belgium. According to OECD figures, Denmark was the 3rd most prosperous economy in the world in 1970, immediately behind Switzerland and the United States. In 2003, Denmark was 7th. Finland did badly as well. From 1989 to 2003, while Ireland rose from 21st to 4th place, Finland fell from 9th to 15th place.

OECD Prosperity ranking (GDP/CAP)



Prosperity levels 1970-2003 (OECD=100)
GDP/CAP using current prices and current Purchase Price Parities

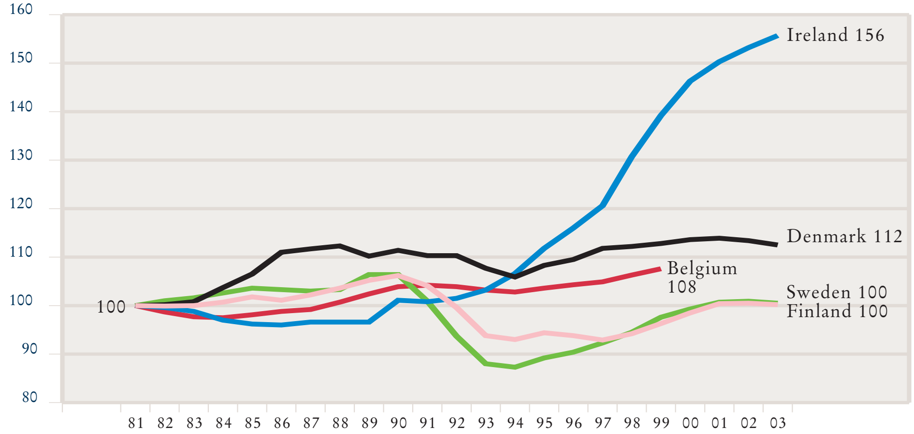


Together with Italy, these three Scandinavian countries are the worst performing economies in the entire European Union. Rather than taking them as an example, Europe's politicians should shun the Scandinavian recipes.

Jobs

While a poorly performing economy such as Belgium's was able to create 8% new jobs between 1981 and 2003, Sweden and Finland were unable to create any jobs at all in over two decades. Denmark did a little better because it "activated" its labour market by making it more "flexible." It became easier for employers to fire people. For workers in the construction industry the term of notice was reduced to five days. Unemployment benefits were restricted in time, while those who had been unemployed for a long time and young people found they could lose benefits if they refused to accept jobs, including low-productivity jobs below their level of training or education. The result is that productivity growth in Denmark is lower than in Sweden and Finland.

Job creation - Total civil employment (1981=100)



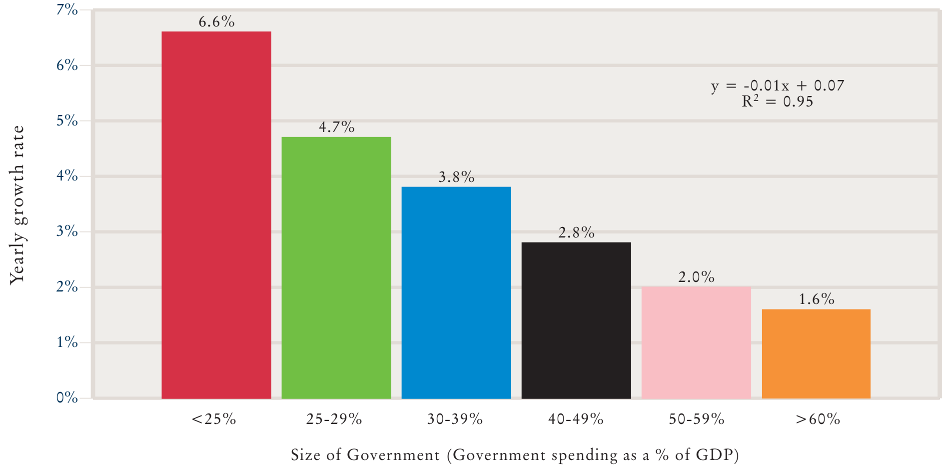
Source : OECD

These draconian measures reduced the unemployment rate, but did not eliminate the cause of unemployment, namely the total lack of motivation on the part of employees and employers resulting from the extremely high taxation level. Despite the painful measures, the growth of Danish productivity and prosperity has been substandard. Disappointment in Danish politicians is one of the reasons for the rise of the far right.

Weak government, bad government

Why are the Scandinavian countries doing such a bad job, despite their Protestant work ethic and devotion to duty? The main cause is the essence of the nanny state: its very high tax level. Between 1990 and 2005 the average overall tax burden was 55% in Finland, 58% in Denmark and 61% in Sweden. This is almost one and a half times the OECD average.

Public spending and wealth growth - OECD countries 1960 - 1996



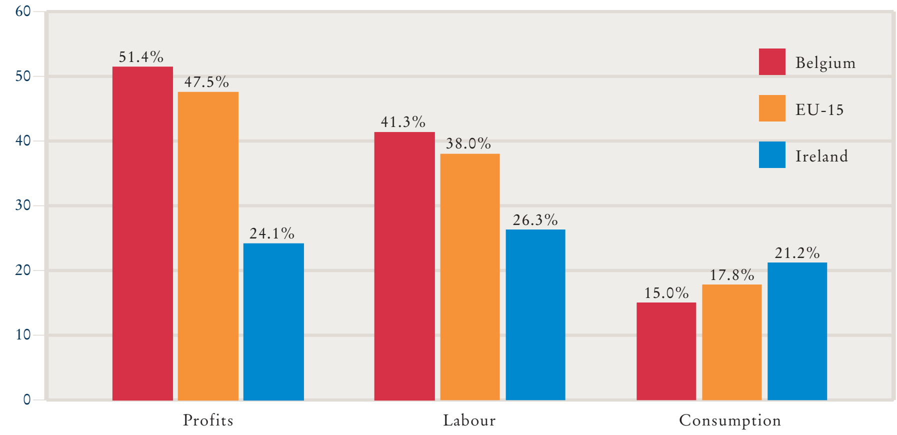
In his research into the causes of growth differences between OECD economies the American economist James Gwartney showed that there was a direct correlation between economic growth and tax burden. The higher the level of taxation, the lower the growth rate. The explanation for this phenomenon is as logical as it is simple. The higher the tax level, the lower the incentive for people to make a productive contribution to society. The higher the fiscal burden, the more resources flow from the productive sector to the ever more inefficient government apparatus.

Ireland: the efficient alternative

Ireland has proved that a substantial lowering of the taxation level can become the motor for launching even the most slackish economy into full gear. A drastic reduction of the Irish tax rate, from 53% in 1986 to its current 35%, has led to a continuous boom of wealth creation at an average rate of 5.6% during the past two decades, while the number of jobs has grown by over 50%. In barely 18 years Ireland jumped from 22nd to 4th place in the OECD prosperity ranking. Ireland did not reduce its social welfare benefits. On the contrary. The unprecedented growth led to an increase in fiscal revenue and social expenditure. It was sufficient to improve the productivity of the government.

One crucial element of the Irish model is its “fair tax” system, in which there is less emphasis on taxing labour and profit and slightly more on taxing consumption. This balance between direct and indirect taxation motivates labourers and entrepreneurs to make productive contributions. It stimulates new initiatives and guarantees a high degree of participation.

Tax burden - 1990 - 2000 (% on taxable base)

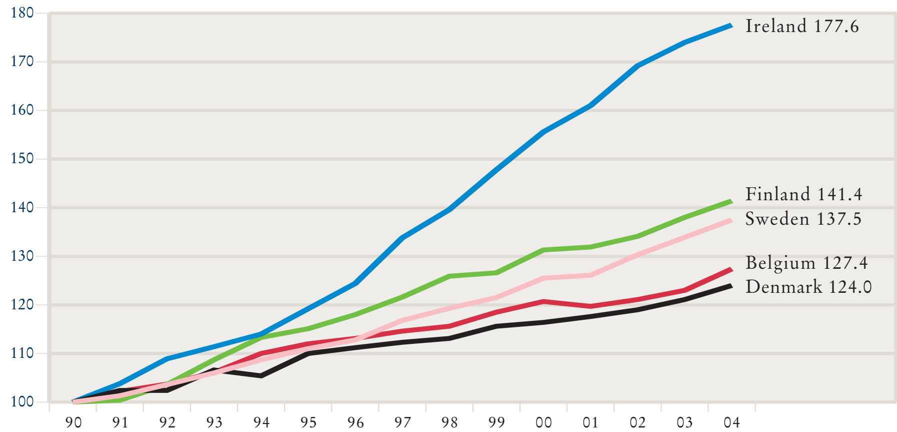


Source : OECD

Such a fiscal system does not put the entire burden of financing social security on domestic production. Indeed, a consumption tax ensures that foreign production also contributes evenly.

The Irish model combines the so-called "active welfare state" of continental Europe with the Anglo-Saxon liberal economy in a balanced fashion. The model is efficient. Ireland surpasses all other EU members in prosperity, job creation, social expenditure and productivity per working hour.

Productivity per working hour (1990=100)



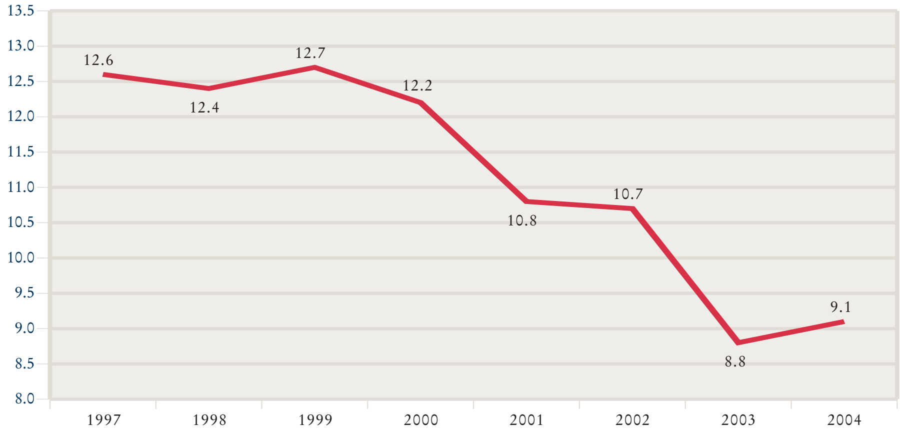
Source : OECD

Investing in the future

The difference between the wealth destructive Scandinavian model and the booming Irish alternative is obvious for all to see. Strangely enough, however, the French and German governments do not seem to notice. Those in Belgium do not, either.
The Belgian government recently proposed a new policy plan inspired by the Danish model. The tax level is not reduced, the fiscal burden is not being shifted from production to consumption, but instead from one production factor (labour) to another (capital) which is already overburdened.

Saving is discouraged, too. After deducting inflation and the withholding tax, which under the European savings taxation directive will soon amount to 35%, the real net interest rate will be –2%. This means that every person in his thirties who is saving 1.00 euro today, will only have the equivalent of 0.54 euro when he turns 60. In barely six years the Belgian savings rate has already dropped by more than a quarter: from 12.4% in 1998 to 9.1% in 2004. The savings rate will drop even further, thereby drying up all reserves for investment. Like work, saving and investing, too, must be profitable if people are to engage in these activities.

Belgian savings rate (% of disposable income)

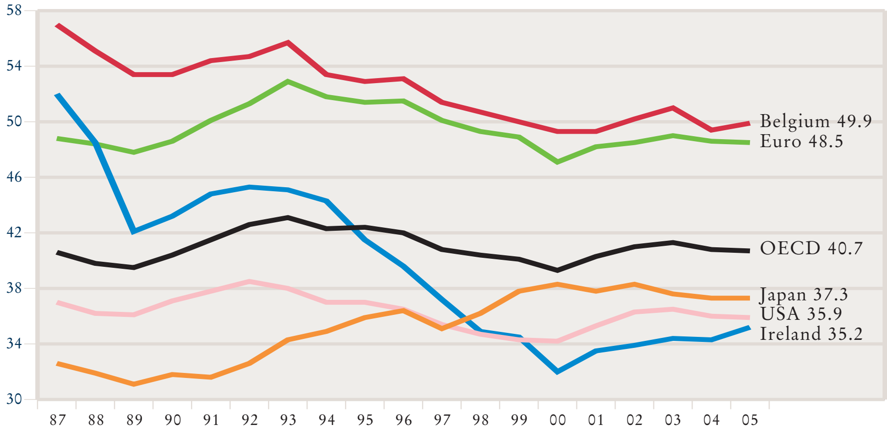


Source : OECD

Excessive taxation

2004 witnessed a record world economic growth of 5%. China and India are booming, the US and Japan are recovering. Gwartney's findings explain why continental West European countries, such as Belgium, did not see their economies grow. The Belgian tax rate is 9% higher than the OECD average and 15% higher than the tax level in the US and Japan. If continental Western Europe does not change its policies, its relative impoverishment today will soon turn into absolute pauperisation.

Public Spending as a % of GDP



Source : OECD

Its tax structure is not adapted to the challenges of globalisation. Taxes on production are the opposite of import taxes. They double Europe's production costs and, in doing so, halve its productivity. Like protectionism they lead to distortions in world trade, but they do so in the opposite direction. Ever more rapidly, continental Western Europe is losing its semi labour-intensive sectors to countries where productivity is even lower than in Western Europe. This move from high productivity to low productivity countries is a waste. It is not only a catastrophe for Western Europe's employment. It is also bad for the world at large because the highly productive production apparatus and infrastructure of Western Europe is not used to its full capacity. This leads to less than optimal global labour division and wealth creation. Politicians must realise that economic growth is not brought about by fiscally punishing productive citizens, nor by collective impoverishment and social welfare cuts, but by cutting taxes and bureaucracy. Ireland has shown that it can be done and how to do it.

Martin De Vlieghere is a doctor of philosophy. He is president of the "Free Association for Civilization Studies", member of the board of directors of Nova Civitas, and a researcher at Work For All, an independent think-tank based in Belgium.

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.

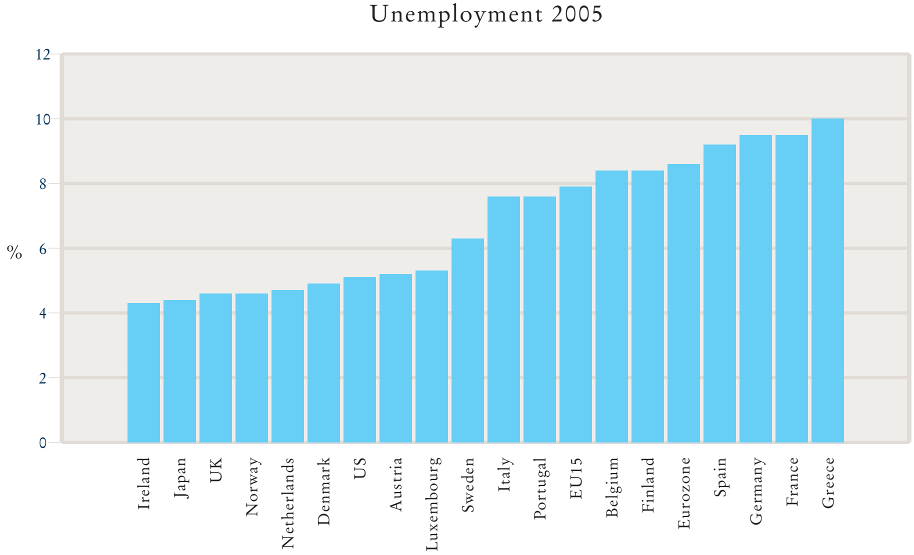
An extremely influential report for the Commission by the economist Andre Sapir acknowledged that there were four different groups of economic model in Europe. His paper argued that the so-called "Nordic model" (Sweden, Finland and Denmark) is the most successful, because they combine reasonable growth 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]

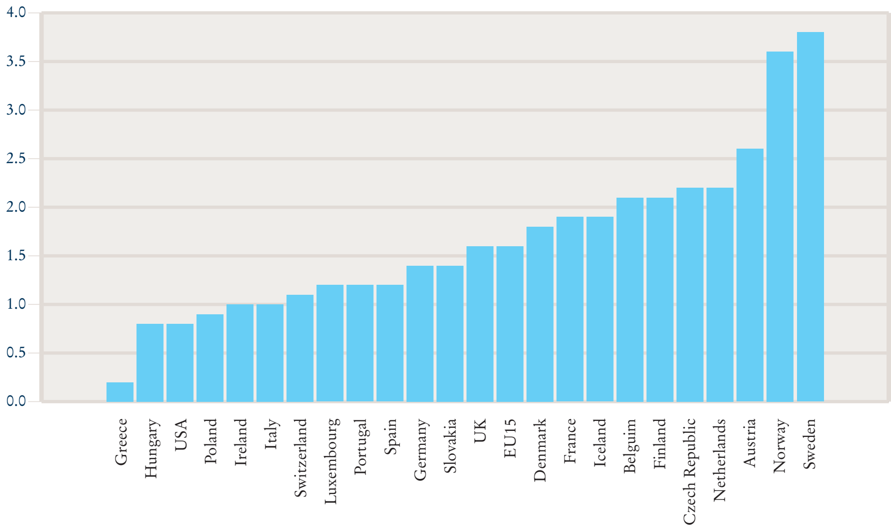
High and long term unemployment also reduces freedom and quality of life even for those in work.

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

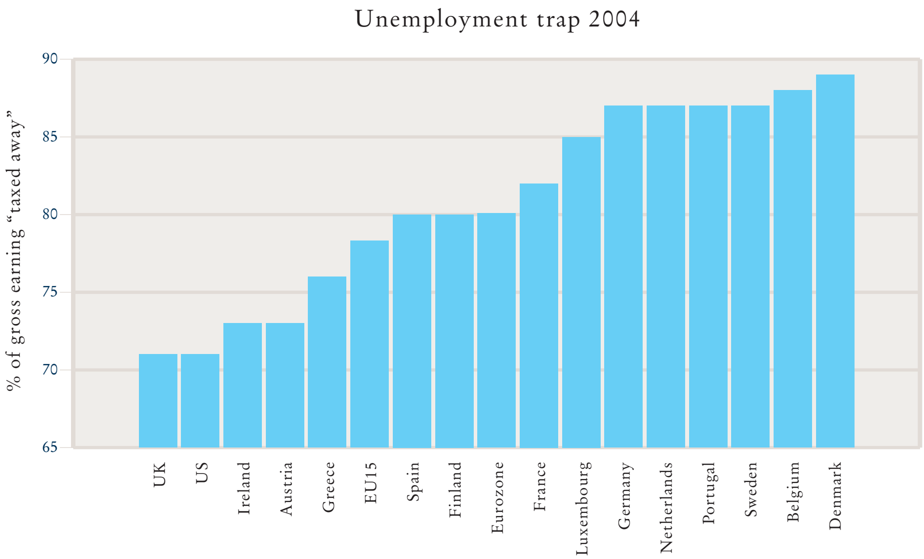


Source : OECD Going for Growth

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.

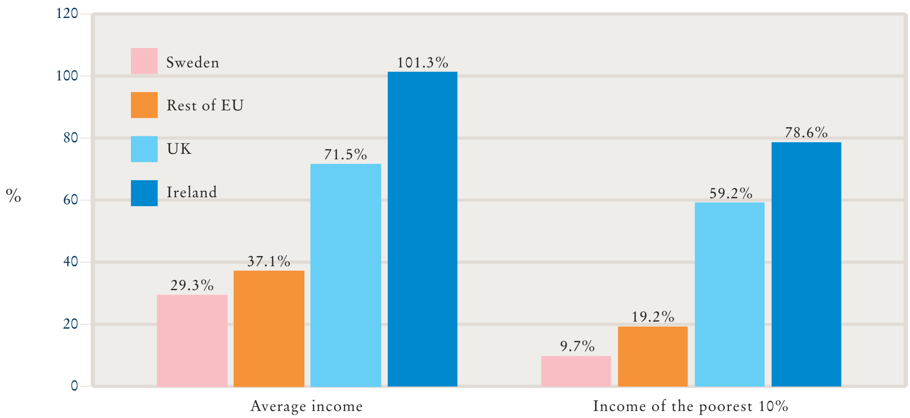
Arguments for relative measures are often based on arguments about the effect on people's self esteem from having other people earn more, and often involve asserting a zero sum argument that many goods are so called "positional goods", the enjoyment of which depends on other people not having them.

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

Income growth 1995 - 2004



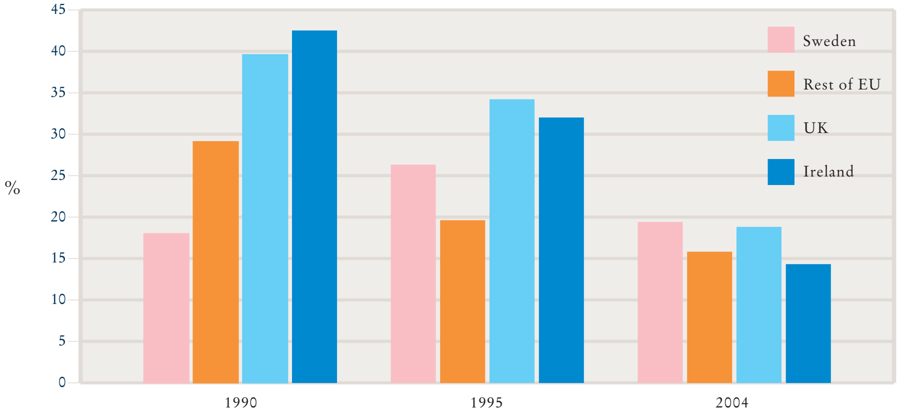
Source : Euromonitor

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.

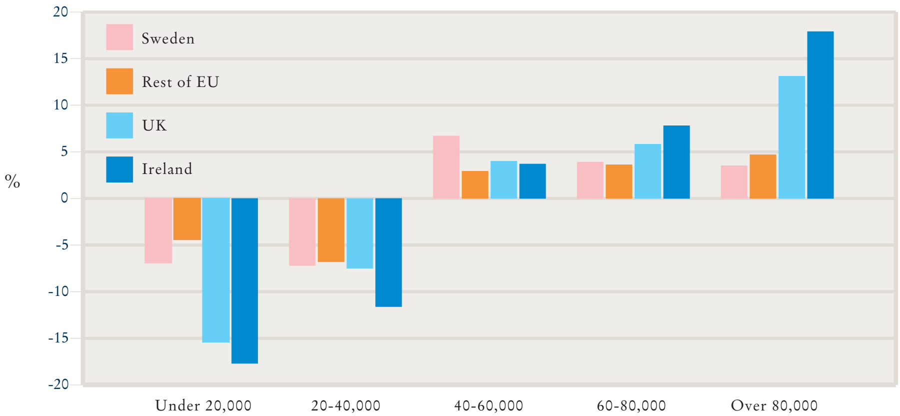
Back in 1990 Sweden was a long way ahead of Britain and Ireland in terms of the proportion of households on low incomes. But this lead has been eroded away (indeed the proportion of poor households in Sweden has risen slightly.) By 2004 Britain had a smaller proportion of households below the poverty 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.

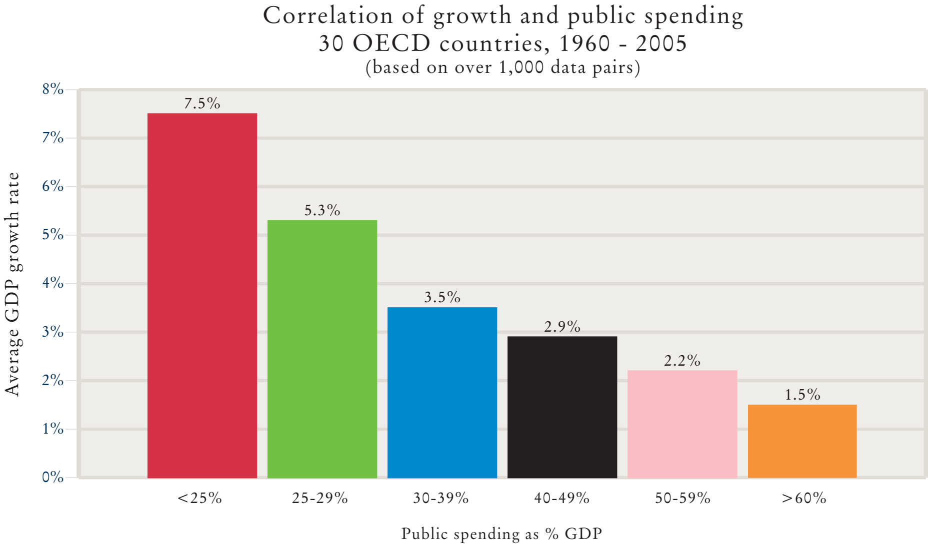
Estimates of the effect of changes in the tax burden

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.

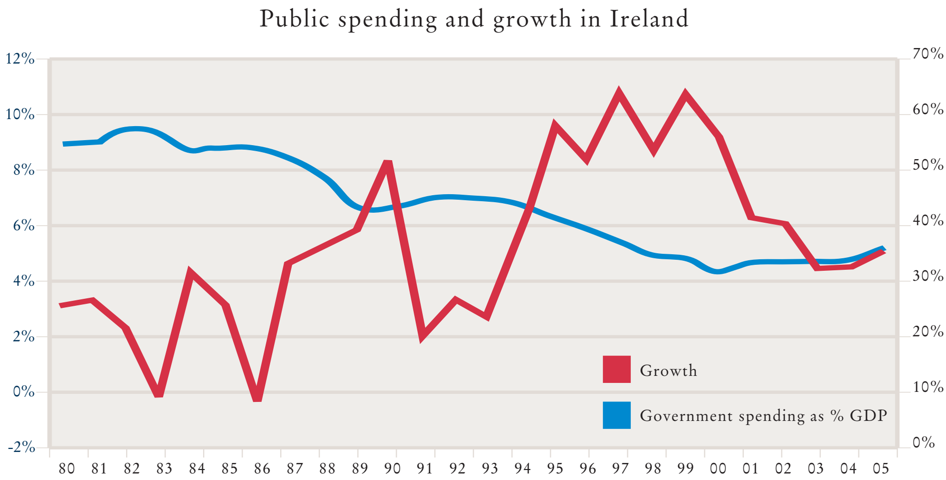
It also seems to have been borne out empirically. Looking at 30 OECD countries since 1960 suggests a very clear and strong link between lower tax and higher growth.



Source : OECD Economic Outlook, author's analysis

The Irish experience

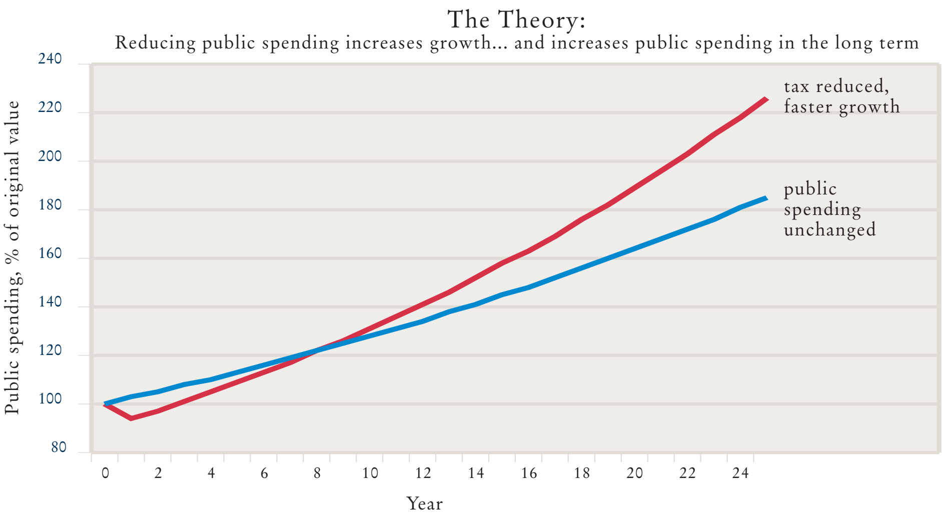
Having cut tax from nearly 55 to 35 percent over the last two decades Ireland has enjoyed growth rates of over 10 percent a year. Ireland has been transformed from one of the poorest to one of the richest countries in Europe.



Source : OECD Economic Outlook

Public spending and tax reform – the theory

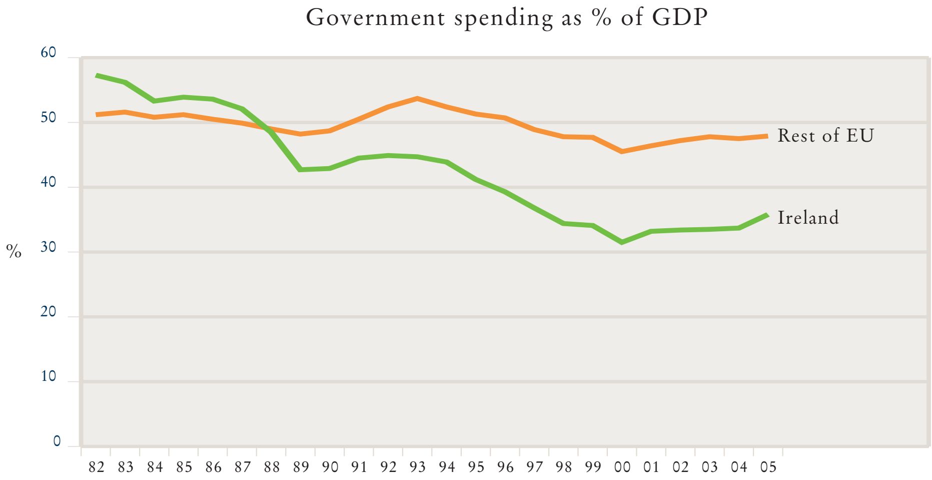
Having stronger growth ultimately means that more money is available for public services. If, as suggested above, a ten percent of GDP cut in public spending increases the rate of growth by just one percentage point, (from 2.5 to 3.5 percent in the case of the UK) then, after eight years, more money 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.

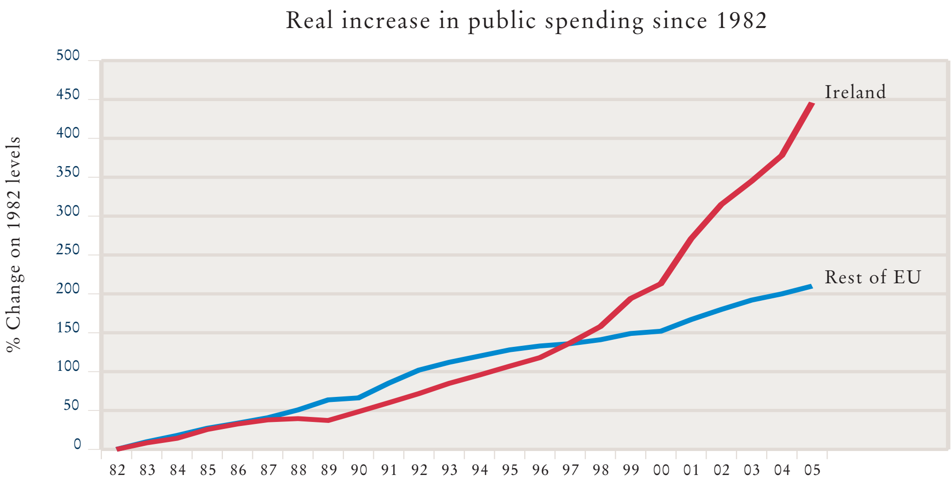


This effect can be clearly seen in the case of Ireland. Public spending as a proportion of GDP in the rest of the EU has remained almost unchanged since the early 1980s, while in Ireland it fell from roughly 55 percent of GDP in 1982 to 35 percent today. But because Irish GDP grew faster, in real terms 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



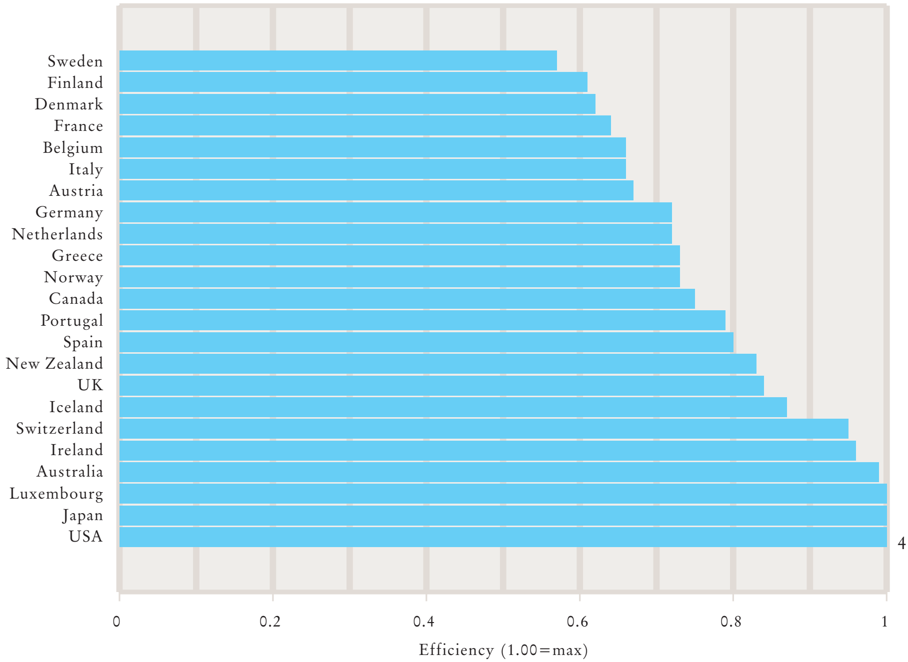


Reform as well as more money

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.

Public sector efficiency (input)



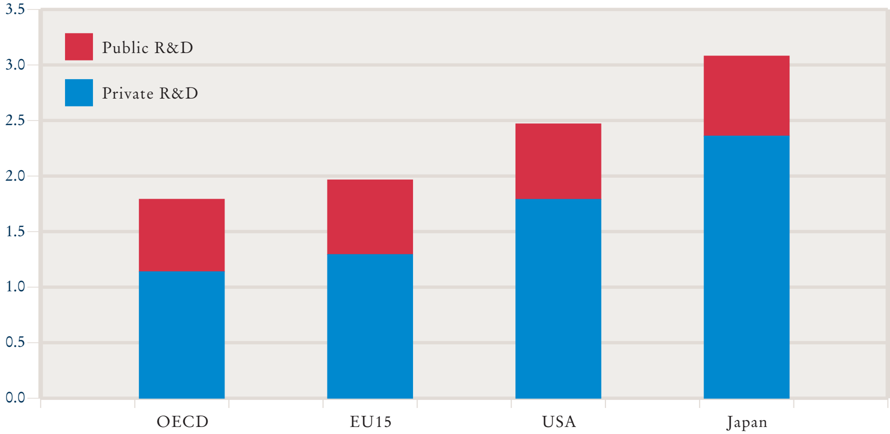
Social Failure #4:
The failure to provide for the future – Education, science and pensions

Falling behind on innovation and education

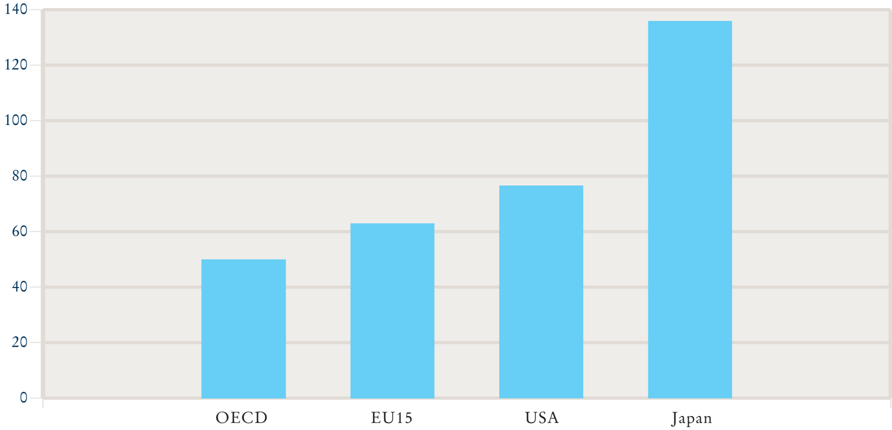
Innovation is central to future economic growth, and in turn, to material standards of living. But whether it is measured in terms of research and development spending, or the number of patents granted, the EU is falling behind the US and Japan.

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.

Public and private spending on R&D as % of GDP 2003



Number of patents per million of working age population 2001



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.

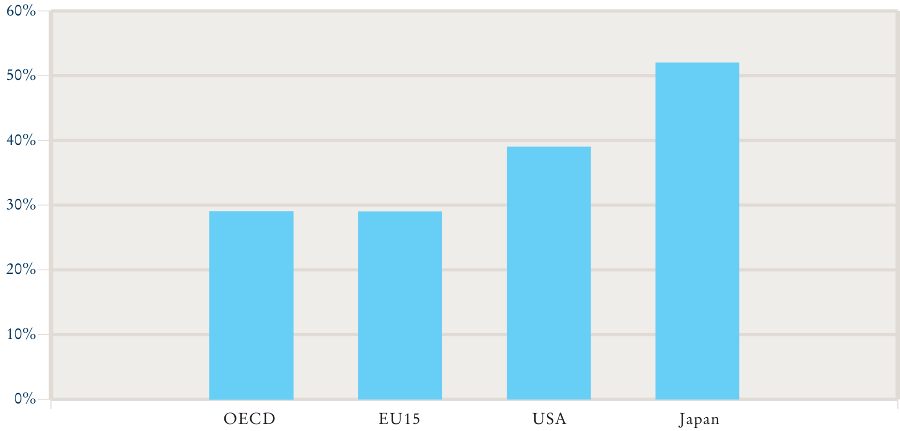
According to a widely used global ranking by the Shanghai Jiao Tong University, 17 of the world's top 20 universities are found in the US, American universities currently employ 70% of the world's Nobel prize-winners, 30% of the world's output of articles on science and engineering, and 44% of the most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

Proportion of 25-34 age group with university education



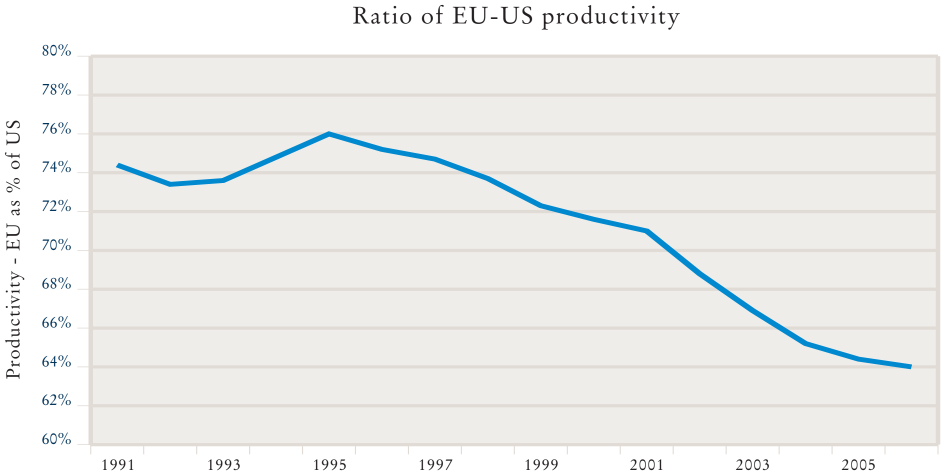
Source : OECD Education at a Glance, 2005

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]

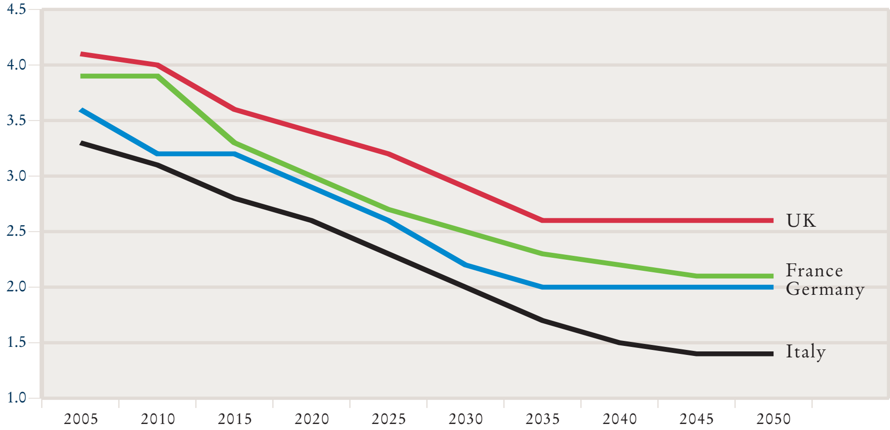


Pensions: failing to prepare for the future

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.

Ratio of workers to pensioners

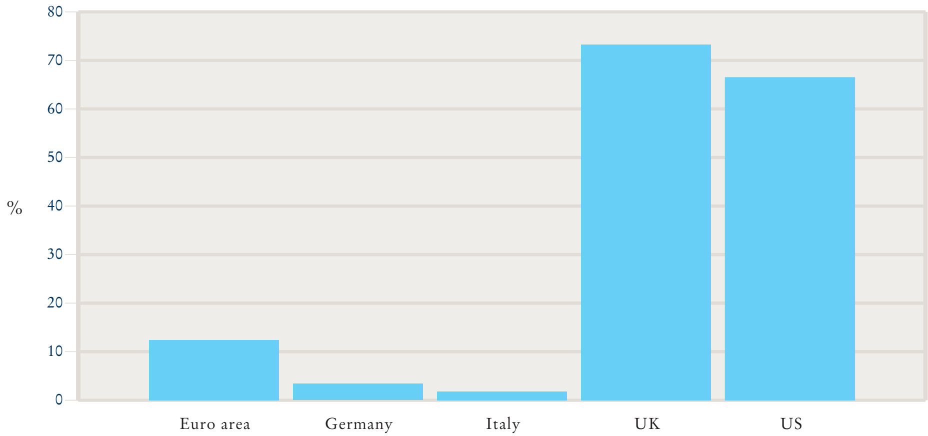


Lack of pension assets

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]

Pension savings as a proportion of GDP



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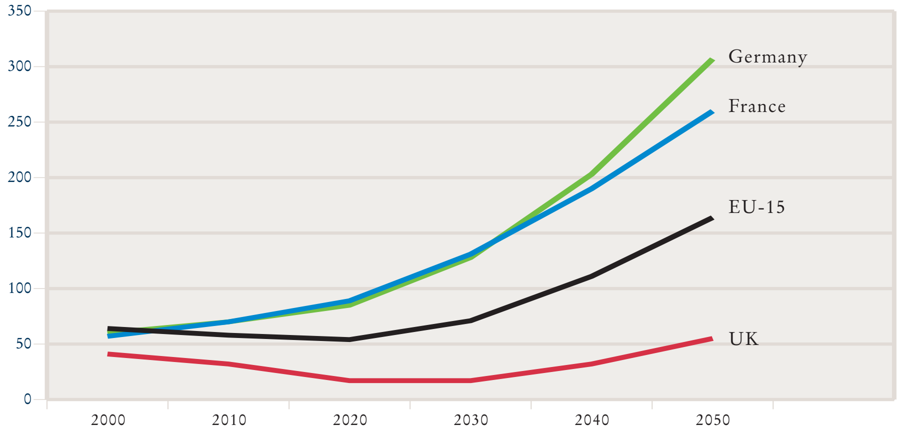
The outlook

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

Lorraine Mullally is a researcher at Open Europe. She previously worked for the Brussels based think-tank ISIS Europe, studying EU defence policy.

CHAPTER 3

Will the European Social Model wreck the Irish miracle?

Dr. Constantin Gurdgiev

Ireland is commonly regarded around the world as a shining example of private markets at work. Yet, unnoticed by many, over the last five years, the country has been sliding into the abyss of rising government spending, indirect taxation increases and more regulation and state involvement in the economy.

Ireland's corporatist government and the so-called Social Partners - a group of narrow and self-centred vested interests that includes the largely public sector-centred Trade Unions, welfare-hungry NGOs and the official business interest bodies - have recently started a new round of negotiations aimed at securing a new "Partnership" deal for the future of Ireland. The new Partnership will replace the existing arrangements that effectively set the floors for wage increases across the economy and dictate the long-term labour markets and social spending programmes in the economy.

Over the last 15 years, as the relevance of the Trade Unions in the Irish economy steadily declined, the government continued to promote the interests of the organisations that, by-and-large, represent the employees in the public sector and semi-state monopolies. The government has begun to insist on collecting an ever rising share of domestic private sector added value and distributing it to the Partners at the expense of the general taxpayers. This has contributed to higher inflation and an astronomically high cost of living in general, leading to growing voter discontent with the government.

Yet, judging by his statement made at the opening of the new social partnership talks, our Taoiseach (Prime Minister) believes in a bipolar world of economic and social policy making. On one side of Mr. Ahern's imaginary divide, there are 'liberal' free-market ignoramuses, who believe in the theory of freely operating labour markets and oppose the corporatist non-meritocratic model of wage setting – a model that has insured a 20-45% wage premium for the public sector without asking for an ounce of accountability and efficiency from state employees. On the other side, there are the 'enlightened' policy makers who firmly adhere to the idea of Social Partnership, because "partnership works in practice".

Speaking about his vision for the future of Ireland, Mr Ahern left no doubt in anyone's mind as to which camp he belongs. "I don't want any race to the bottom... I want improved take home pay and an improved quality of life" stated Ireland's leader, fully endorsing the idea that a closed-doors agreement on wages between the state, large corporate interests, the NGOs and the Trade Unions is the only means for delivering prosperity for all.

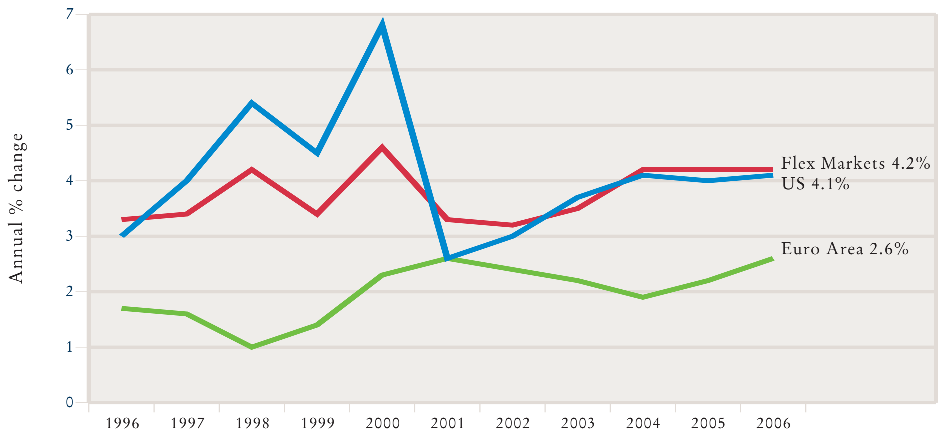
Let us test the European Socialist Model proposition that labour markets with more centralised bargaining arrangements deliver better (a) pay, (b) working conditions and social integration, and (c) quality of life than the markets with free wage setting arrangements.

The figures below are based on comparing Australia, New Zealand, the UK and the US - the countries with more flexible labour markets - to the more partnership-styled labour markets of the eurozone countries, including Ireland.

Delivering a better pay...

As shown in the figure below, the wage growth rates in the countries with more flexible and less corporatist models of labour markets have been consistently higher than in the 'partnership'-styled eurozone countries. In fact the US - the economy that is commonly cited throughout old Europe as an example of "race-to-the-bottom" capitalism - saw higher wage growth in the business sector than both the eurozone and indeed the other flexible economies.

Compensation per employee in the business sector



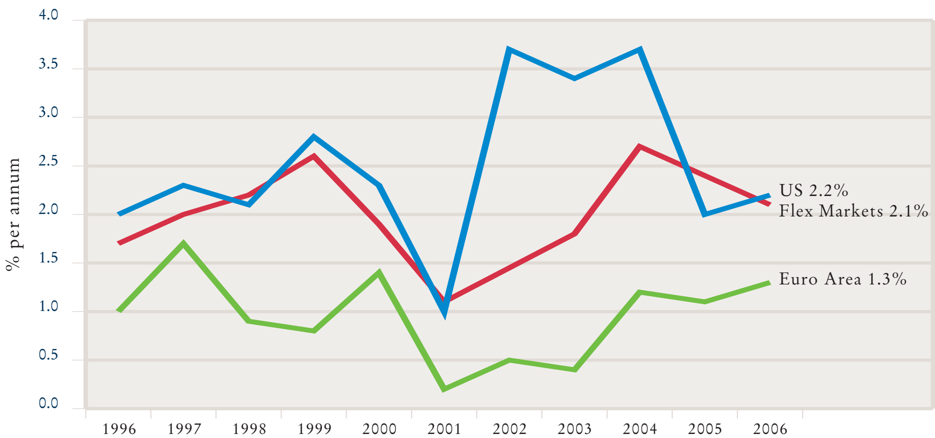
A recent study by US and European researchers found that since 1976, the wage and benefits returns to long-term employees in France have been consistently lower than in the US. The authors conclude that "in a low-mobility country such as France, there is little gain in compensating workers for long tenures because they tend to stay in the firm for most... of their career. In contrast, [in] a high-mobility country such as the United States... firms are induced to pay the premium... to avoid losing their most productive workers." In fact, the long-term workers in France tend to earn 3.05 times less per each extra year they stay with the firm than their American counterparts. [1] Studies by the Stockholm Institute and the IZA institute in Berlin reported similar trends for Sweden and Germany.

So instead of benefiting workers with longer tenures, social partnership agreements ironically lead to the under-payment of more skilled employees. This explains at least in part why the majority of unionised skilled workers in Ireland take any opportunity to exit their 'protected' jobs for the business sector, leaving the less skilled segment of our labour force in the unionised employment.

... a better workplace...

The chart below shows the effects of the labour market restrictions on productivity growth rates in the euro area relative to that of the countries with more flexible labour markets. Since 1996, the cumulative effect of the productivity gap between the two groups stands at 13.4% in favour of the more flexible labour market arrangements. Amongst the latter, the US workers have gained 31.1% in their productivity relative to 11% in the eurozone since 1996.

Labour productivity growth in the business sector

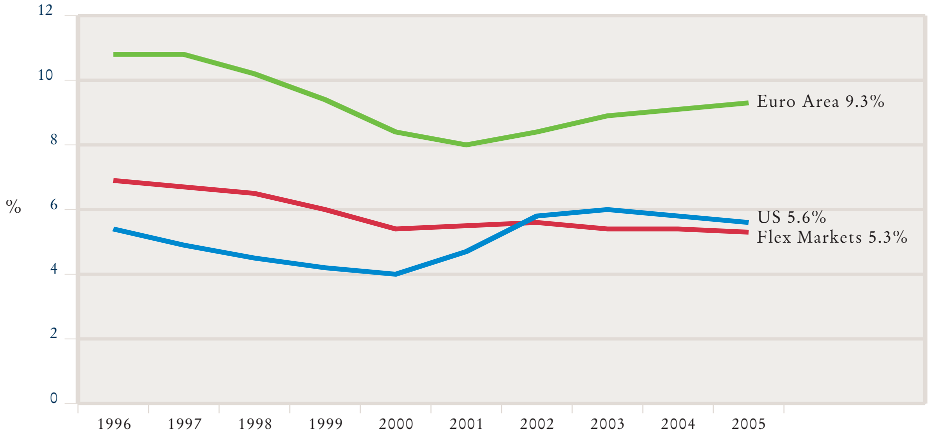


The productivity gains mentioned above coincide with the period of lower unemployment in the flexible markets than in the 'social partnership' economies. The latter fact disputes the argument that US productivity increases are due to workers' displacement through capital investment and outsourcing. Yet, European Socialists are keen on insisting that the US model of development favours large capital owners at the expense of the workers. The whole premise of the European social model based on partnership agreements over wages, including the one practised in Ireland, is supposed to ensure that the state protects workers' interests.

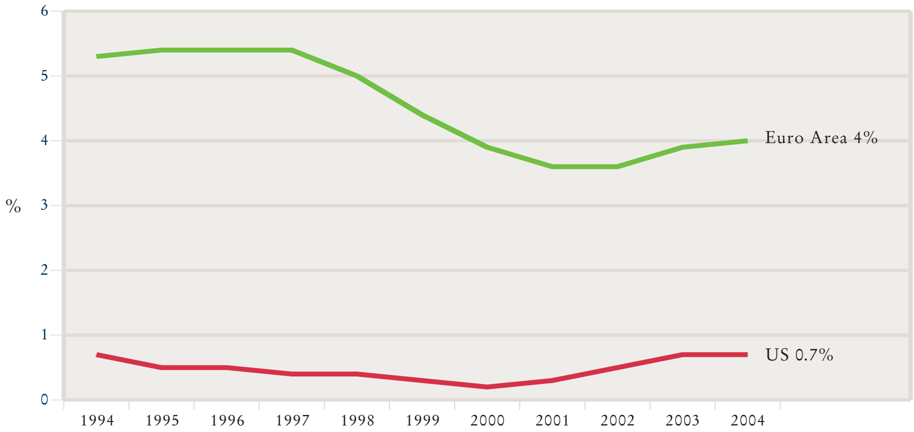
This stated objective of the European corporatist model is not supported by hard evidence. In fact, cumulative wage growth in the US since 1996 was 55.7% - a full 24.6% higher than labour productivity gains alone, making US workers the greatest beneficiaries of the total productivity growth. For the eurozone, the cumulative wage growth was just 24.2% as opposed to 44.6% in the group of flexible labour market economies. Thus, less partnership-driven economies saw greater gains to workers, while more corporatist economies saw greater returns accruing to the capital owners - hardly evidence in support of the 'caring partnership' vision of our Taoiseach.

Economists around the world agree that happier workers are more productive than those facing adverse workplace conditions. In an October 2005 study, the German Institute for the Study of Labour showed that more competitive "high performance workplaces elicit greater involvement and productivity from employees". According to the authors, "the evidence reveals that high performance workplaces are more likely to keep commitments to provide family friendly workplaces." The study compared employer practices in Britain in competitive flexible firms against those in the unionised and public sectors. In the end, "[union] members report their employers do less well than nonmembers' firms in keeping the [workplace] commitment." The public sector employers fared even worse. Another study from the UK shows that labour market arrangements supported by the unions are associated with reduced availability of flexible hours and work at home arrangements but greater availability of leaves and job sharing, "leading to lower reported job satisfaction including satisfaction with employers keeping a commitment to provide family time". Similar results were found in the US.

Standardised unemployment rates

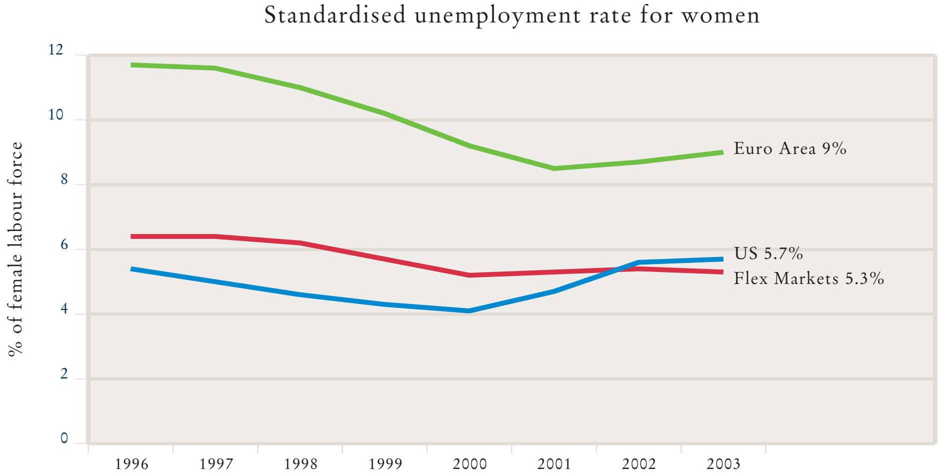


Long term unemployment rate



Macroeconomic data from the OECD shows that more flexible labour markets support lower long-term unemployment, with a gap between the eurozone countries and flexible wage economies remaining relatively stable at approximately 25% between 1996 and 2005, as illustrated above. Amazingly, unemployed residents of the 'socially caring' eurozone have a 4 times greater probability of being out of work for the rest of their lives than their counterparts in the 'race-to-the-bottom' US.

Looking at the data for unemployment among women in the chart below dispels the myth that less flexible public partnership arrangements are capable of improving workplace opportunities for women. Similar results hold for the ability of labour markets to support integration of foreign migrants.



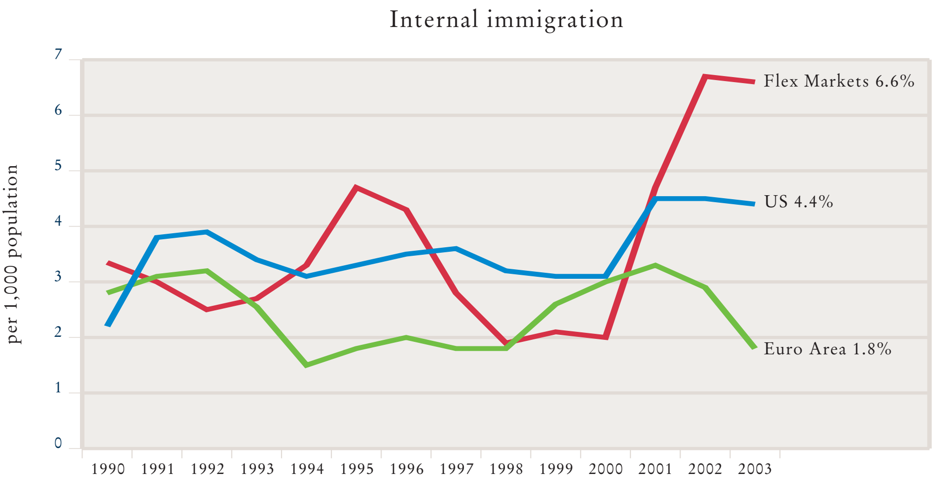
... and a higher quality of life

Another CEPR (July 2005) study forcefully argued that less flexible "European labour market regulations, advocated by unions... explain the bulk of the difference between the US and Europe" in hours worked.[2] Since the 1970s, corporatist labour policies "do not seem to have increased employment, but they may have had a more society-wide influence on leisure patterns" inducing higher demand for leisure in Europe than in the US.

However, despite taking more time off from work, Europeans, who spend more of their free time in household production, enjoy less time in quality-adjusted leisure than Americans. A University of Chicago study from 2004 showed that adding together time spent working at home and at work, Swedes labour 29 days more per annum than their American counterparts - largely due to lower utilisation of professional services.[3] This is not surprising, given that in Sweden for each €1 collected by a contractor for services rendered, Swedish consumers are forced to pay €12 in costs and taxes.

Higher taxes, coupled with far lower incomes in Sweden than in the US make it hard to argue that taking more time off formal work yields greater quality of life for social-partnership-bound Swedes. This explains why self-reported happiness is at best weakly correlated with hours outside work in the eurozone. The same holds within the US, with less flexible, more unionised states trailing behind the states with higher mobility in terms of quality-adjusted leisure.

The fact that more flexible markets support better economic and social environments is strongly supported by data on the inflows of foreign migrants. Since 1990, with the exception of 3 years, the flexible labour market economies have consistently outperformed the eurozone countries in the number of foreigners willing to immigrate into developed economies. Adjusting for refugee inflows, the economic immigrants almost unanimously voted with their own feet in favour of the US, UK, New Zealand and Australia in every year reported.



All of this evidence strongly contradicts the assertion, forwarded by supporters of the Working Time Directive, that the costs of limiting working hours allowed in the economy yields quality of life benefits that offset the policy costs in terms of lower productivity and income. It also negates the arguments that heavier regulations of labour markets practiced in the eurozone are conducive to better worker protection and more equitable pay.

Conclusion

The above discussion establishes that the Irish government is wrong in supporting the proposition that European social partnership-styled agreements on wages and labour markets can deliver on their objective of better pay and life for workers. Instead, global experience has time and again shown corporatist controls over labour markets to be an impediment to workers' interests.

To assure that Ireland Inc delivers the benefits of growth to our working taxpayers and consumers, Mr. Ahern should walk away from the partnership table once and for all.

To achieve conditions required for robust growth, entrepreneurship, efficient investment and betterment of taxpayers' lives throughout Europe, the Continental model of serial surrenders to the blackmail of the militant trade unions must be chugged into the dustbin of history.

1 Beffy, M et al, 2006, The Returns to Seniority in France (and why are they lower than in the United States?), CEPR

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Dr. Constantin Gurdgiev is a Lecturer in Economics at University College Dublin, Research Associate at Trinity College, Dublin, Director of the Open Republic Institute in Ireland and Editor of Business&Finance Magazine.

CHAPTER 4

Welfare State or Unfair State?

Johnny Munkhammar

Dominique de Villepin, France's Prime Minister, talks about "economic patriotism" and has launched a number of protectionist policies. Barriers to global trade, subsidies to agriculture and industry, and stopping foreigners from investing in French companies are just a few examples. A country that recently had riots because of its economic and social failure now wants more of the same policies.

German Finance Minister Peer Steinbrück has urged the new EU member states to raise taxes, since their currently low rates have "nothing to do with fair tax competition", he says. Steinbrück obviously wants to force new EU members to get rid of one of the main reasons for their success. Instead of lifting Germany up, he wants to drag others down. Would he be happier if all European countries had the growth and unemployment levels of Germany?

The European Parliament has approved a worthless and watered-down Services Directive. By removing healthcare and education from the scope of the directive MEPs have removed the sectors that would have benefited most from free trade in services. They have also removed the important and simplifying 'country of origin' principle. The gains could have been enormous: independent studies pointed to 600 000 new jobs. Some 70 per cent of EU GDP already comes from services.

These are only three examples of how the spectre of protectionism is haunting Western Europe more today than for a long time. Indeed most of Western Europe is in economic trouble. But if there are problems, isn't the most logical consequence to see what we are doing wrong and change it? If you can't compete well, then why not become more competitive instead of trying to shut out the world or forcing others to become less competitive?

The Model is the problem

Never before have so many countries been as successful as today. Economic growth is strong in many countries and poverty is decreasing faster than ever. People are living longer and healthier. A global market economy is spreading opportunities for a better future. But most of Western Europe is in economic trouble and faces a choice: market-oriented reforms that decrease the size of the state, or keeping the current model, and attempting to "protect it" by shutting out the world.

Nobody denies that the problems are real, but governments have a tendency to fob off voters with assurances that neighbouring countries are even worse off. Economic growth is low, unemployment is high, dependency on the state is increasing and welfare services are deteriorating. These problems in many Western European countries are obvious. Still, most politicians don't want radical reform; they want to keep the European Social Model.

Let's be clear: the so-called 'social model' is all about having a very big state financed by high taxes, and that model creates the current problems. The evidence for this is overwhelming. The state takes care of large parts of people's lives – especially concerning social matters such as social security and welfare services – with their own money. It is sometimes called the welfare state, but it is really an unfair state.

There are differences between the Western European countries, but there are clear main features of the European Social Model. The tax burden is very high and rose from about 20% in 1950 to between 40 and 50% in 1980 – where it finally stopped. Governments finance and provide - one way or another - welfare services such as education, health care, child and elderly care. In various forms, the model also contains social security systems: public pensions and income transfers for unemployment, sick leave, early retirement, etc. The labour market also tends to be highly regulated or arranged in a corporatist way.

Low growth, unemployment, dependency on the state

First of all, a big state financed by high taxes definitely brings low – or negative – economic growth. Western Europe has clearly lagged behind mainly the US since the emergence of the big state in the 1970s. The famous aim of the EU's Lisbon process in 2000 was to close the wealth gap with the US by 2010. Since then, the gap has widened further. In fact, in 38 American states the average person is richer than the average person in any country in Europe, except Luxembourg. And the average American is about 40 % richer than the average European.

Second, high taxes on work indirectly punish workers and make hiring more expensive. And by giving these taxes to the increasing amount of people who are not working, the unemployed are rewarded. In many Western European countries, the economic difference between working and living off the state is very small. In this way the Model leads to fewer people working and more people being supported by those who are working. Between 1970 and 2003, employment in the US rose by 58.9 million, which is equivalent to a 75% increase. In France, Germany and Italy combined it rose by 17.6 million people, or 26%.

Third, a highly regulated labour market protects existing jobs and stops new ones from emerging. This is a direct consequence of the Model, since its very purpose is to prevent people losing their jobs. Those who do have jobs are protected, but afraid of losing their job, and those who don't have jobs, are kept out of the labour market. The more regulated the labour market, the fewer new jobs there are. This effect was particularly clear in Denmark, which has de-regulated its labour market in recent years and has subsequently experienced very good development.

Fourth, monopolies cannot deliver either goods or services efficiently, on time, with good quality or at a good price. And in most of Western Europe, social security and welfare services are public monopolies. The Swedish Association of Local Authorities and Regions reports that doctors see an average of four patients a day, down from nine in 1975. The number of hospital beds is down by 80 percent since 1975. More than 50 percent of patients have to wait over 12 weeks for an examination and then at least 12 more weeks for treatment.

Some EU leaders seem to look to the Nordic countries for inspiration. In some respects that may be a good idea – there have certainly been a few reforms in recent years. But these countries are still clinging on to an extreme version of the big state, which is still creating the same problems as those apparent in the rest of Western Europe. In Sweden, youth unemployment is the sixth highest in the EU, and the total (partly hidden) unemployment rate is about 20%. Growth during the last 15 years has been 1.4% on average, lower than the US, EU and OECD average.

Direct consequences of the Model

The state was supposed to provide welfare services and social security. But in the public sphere, private companies, private property, free competition, free financing, interest in profit are all prohibited, which explains much of why it is going wrong. These are the forces of growth, and if you prohibit them, you prohibit growth.

Imagine prohibiting these forces in other fields: would we have such a range of mobile phones to choose from if there was only one state telephone monopoly? Or take a more fundamental need - food. What kinds of food and drink would we have if it weren't produced and delivered by private companies? We would have queues of people waiting for bread, most likely, as we do have now in health care.

This model of big government is largely based on the assumption that there are resources just waiting to be shared by everyone. There is a big cake which government can just distribute to people. That is a fundamentally false assumption. All resources have to be created; nothing – not cars, nor hospitals, nor food, nor heating for your house – is just there in nature for the taking. Thus, we have to create a society with the best opportunities for the forces that create the resources. The European Social Model does, to a large extent, the opposite.

A new dawn

The problems shared by most Western European countries are serious and the Model itself is causing them. The defenders of the Model claim they like it because it is all about solidarity and social justice. Reality suggests the opposite; it is a truly unfair Model. Those on low incomes pay very high taxes and become dependent on the state – that can't be solidarity. Elderly people do not receive good care from monopolies – that is not social. Young people never get a job despite a good education – that is destructive.

These problems will get worse unless there are reforms. The globalised economy means opportunities for more people than ever, and increases competition for production and jobs more than ever before. We simply have to be competitive. The demographic situation, whereby we live longer – a great success – implies that we should change our out-dated systems to stop public expenditure from exploding.

We need to reform today - the sooner the better. If we actually reform, Western Europe could face a new dawn and start on the road to prosperity, with more jobs, increased growth and better living standards. We could have a society that gives young people hope and elderly people a good life. Since the size of the state is the problem – i.e. its interference with taxes and regulations – the emphasis of reform should be on decreasing that size.

Other countries have done it with great success. Not only Eastern and Central Europe, but also New Zealand, Australia, Iceland, the US and many other countries. There have even been a few good examples of reform in Western Europe, but more is needed. The state should use its resources to help those in need, not to run everyone's lives. If reforms decrease the size of the state, the forces that create resources – entrepreneurs and working people – will be freer.

Reform works

There is recent new empirical evidence that this kind of reform works:

Employment growth has been high in several of the 'old' 15 EU member countries, notably Ireland, Spain and the Netherlands. But employment has grown very poorly in many countries, worst of all in Germany. Sweden, sometimes regarded as a positive example, had the fourth poorest employment growth. Employment grew by 18.5% on average in the five countries with the best growth, and by only 3.5% in the five poorest ones. The question is: what differences are there in policies that can directly affect employment?

There are naturally many reasons behind the different growth rates, but there are clear connections with the degree of market-oriented reform. According to the OECD the total tax on employment in the five countries with the best growth was

30.5% and in the countries with the worst growth it was 41%. In Ireland, with the best growth, the tax on work was 15.5% and in Germany, with the very worst, it was 45.5%.

Looking at the degree of regulation on the labour market, the pattern is also quite clear. The Economic Freedom of the World Annual Report for 2005 from the Fraser Institute contains a scale between 1 and 7 with 1 being the most regulated and 7 the freest labour market. The average for the five countries with the best growth was 5.06 and for the five with the worst growth it was 3.64. For Ireland, again, the figure was 5.4 and for Germany, it was 2.8.

The levels of contributions from the state to unemployed people and those on sick leave are lower in the countries with good employment growth. On average, they are ten percentage points lower in the countries in the top half than in the countries in the lower half. Naturally, this makes it easier to also keep lower taxes on work.

If the differences do not seem dramatic, this shows that limited reform might have substantial results. But of course, if you combine them all, the results will multiply. Several conclusions can be drawn from these facts. One is that it is indeed possible for "Old Europe" to be successful too in terms of employment. Another is that the determinants of growth are not beyond control. Instead, any country can adopt the policies that have obviously been successful in several countries: low taxes on work, a free labour market and low contributions from the state.

Conclusion

It is essential to avoid attempts to keep the anti-social Model intact by pursuing protectionist policies. We need to do the opposite and embrace reform. There may well be obstacles: many people are dependent on the system and don't want change, many taxes are hidden so people can't see the full extent of the state, and politicians find it hard to reverse their old policies. But still we must reform for the future to be bright.

Clearly everything cannot be done at once. Reform must take place on a step by step basis. If initial reforms are carried out and lead to positive results, there will be more support for further reform. That way, a country can start off a positive development with more reforms and more improvements: a positive circle instead of the vicious one we have today.

Johnny Munkhammar is Programme Director at Timbro, the Swedish Free-Market Institute and author of *European Dawn: After the social model* (2005).

CHAPTER 5

The European Social Model - One size doesn't fit all

Chresten Anderson

Europe's leaders should keep two points in mind:

- First, the imposition of a single welfare state model is unjustified from an economic perspective and undesirable politically.

- Second, the EU Commission's Social Agenda is too heavily focused on job creation, which does not benefit Europeans at large.

A Joint Model?

The EU institutions insist on the need to come up with a single model for a Social Europe, and the idea rests on the assumption that convergence towards one model is desirable both economically and politically. But there are no empirical economic arguments that support the need for it. Coordination could potentially be relevant in the presence of economies of scale and spill-over effects, as well as increasing efficiency of the welfare state (read: slimming it down substantially).

However smaller countries have a better redistribution record than large countries. They have proved better able to reduce poverty, protect citizens against risks such as unemployment and reward labour market participation. This is probably because in smaller entities local information is more easily available – this is effectively an argument in favour of social policy decentralisation.

So while Europe doesn't need a 'one size fits all' approach to the social model, it must instead make use of political decentralisation, which is grounded in diversity and take account of the various traditions across Europe.

But should other European countries look to the Nordic region for answers to a politically decentralised European Model? The answer is no!

It is of course true that the Nordic countries have achieved success in recent years. But most of that success is owed to the enactment of free-market and market-oriented reforms, rather than the welfare system. It is these reforms to which Europe should look for inspiration, for they form the nucleus of a new, *second-generation* model.

This *new* model contains two very different and distinct aspects – both of which seem highly unlikely to pass in most other countries in Europe.

The first aspect of the *new* model is exemplified in the social model of Denmark. Due to its highly homogenous population it has to a very large extent been possible to slowly, and mildly, reform the present welfare system – to such a degree that bankruptcy is not around the corner – but rather a few blocks away.

In the mid-80s the conservative government started pension reform, which included more private savings – both individual and employment based. This created a three pillar system where most people will get an additional pension on top of the unfunded government pension. During the 80s and 90s there have been a number of adjustments to the unemployment system and early retirement plans, all of which has helped reduce the pressure on government coffers, reforms which are comparable to those introduced by Jason Turner and Rudi Giuliani in New York. These reforms have been passed in Denmark, mostly with support from the Social Democrats, and it seems very unlikely that they would pass in many other European countries – all we have to do is look to Germany and France these days.

The second, and potentially even more important, aspect of the *new* Danish model is the level of economic freedom in Denmark. In Heritage's most recent Index of Economic Freedom, Denmark ranks as the 8th most free country in the world. On a scale where a low number means a more free economy, most scores are at an incredible 1.00, except for the Fiscal Burden (where Denmark scores 3.8), and government intervention (where Denmark ranks 3.00). Overall Denmark scores 1.78. This is the true secret behind the Danish model – and why Denmark is so economically successful, despite the high and counter-productive welfare state.

There are many defenders of the big state model and they often point to the Nordic countries as evidence of its viability. But the exact opposite is true. The Nordic countries still have high taxes, a regulated labour market and extensive public monopolies that create problems. It is the reforms *away* from that Model that are producing good results.

The Nordic countries need much more market-oriented reform. The current situation should not be seen as an argument against reform, but for more of it – for the Nordic countries as well as others.

But what about job creation? Shouldn't the EU keep that in mind?

A substantial aspect of the European Commission's Social Agenda is a focus on "job creation". Last year the EU Commission sent out a communication report on the Social Agenda, with the motto: "A Social Europe in the global economy: jobs and opportunities for all." This is all part of the Commission's proposed Lisbon Agenda, after it was re-launched with a new focus on the "social agenda."

The long-winded aim of the European Union, in accordance with the Lisbon Agenda, is to ensure the "sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress and a high level of protection and improvement of the quality of the environment."

This is the basis for the European Social Model, which is focused on jobs and growth. But the problem is that the focus on job creation has nothing at all to do with the focus on growth – or even improving welfare.

In the book *What Everybody Should Know About Economics and Prosperity,* Professors Gwartney and Stroup write:

> "Politicians often erroneously talk as if the creation of jobs is the source of economic progress. While campaigning, a recent political leader argued that his economic program had three pillars: "Jobs, jobs, and jobs." But focusing on jobs is a potential source of confusion. More employment will not promote economic progress, unless the employment expands output. We do not need more jobs, per se. Rather we need more productive workers, more productivity-enhancing machinery, and more efficient economic organization so we can produce more output per capita."

What politicians forget is that:

> "A higher income and standard of living are dependent upon higher productivity and output. There is a direct relationship between a nation's per capita (per person) income and its per capita output. In essence, output and income are opposite sides of the same coin. Output is the value of the goods and services produced, as measured by the prices paid by purchasers. Income is the revenue paid to the people (including the entrepreneur's residual revenue), who supply the resources that generate the output. This too, must equal the sale price of the goods.

> Consider the following example: suppose that a construction company hires workers and purchases other resources, such as lumber, nails, and bricks, to produce output - in this case, a home. When the home is sold to a buyer, the sale price is a measure of output. Simultaneously, the sum of the payments to the workers, suppliers of the other resources, and the residual income received by the construction company (which may be either positive or negative) is a measure of income. Both the output and income add up to the sale price of the good, which represents the value of what was produced.
>
> Once the linkage between output and income is recognized, the real source of economic progress is clarified. We improve our standard of living (income) by figuring out how to produce more output (things that people value). Economic progress is dependent, for example, on our ability to build a better house, computer, or video camera with the same or a lesser amount of labour and other resources. Without increases in real output - that is, output adjusted for inflation - there can be no increases in income and no improvement in our living standards."

But clearly the European Commission has not made this linkage yet, since they write in their communication that the EU's Social Agenda develops a two-pronged strategy:

> "Firstly, it emphasises its role in strengthening citizens' confidence. This confidence is essential for managing the process of change and plays a key role in encouraging economic growth. The Agenda describes the combination of Community instruments for improving the quality of its implementation and presents, in this context, three key conditions for success: an intergenerational approach, a partnership for change and the need to seize the opportunities offered by globalisation.
>
> Secondly, it presents key measures under two major headings, which are covered by the Commission's strategic objectives 2005-2009: (1) employment (under the prosperity objective) and, linked to that, (2) equal opportunities and inclusion (under the solidarity objective). The Agenda combines the consolidation of a common European framework with the implementation of diversified measures to respond to specific needs. In this way, it supports the motto "United in diversity", which is proclaimed by the draft Constitutional Treaty."

This strategy (particularly the second part) will be a major roadblock in promoting economic growth, which is the only way to secure the economic wellbeing of European citizens.

The European Commission should discard the whole Social Agenda, and drop its desire to centralise all political decisions in Brussels – and it should put a halt on its "job creation" policies. Until the European Commission recognises this key economic truth that jobs do not create wealth by default – rather growth and wealth creation can help ensure jobs – then the focus on economic well-being in Europe may very well turn out to be counterproductive.
What may very well happen when politicians seek to "create jobs" is that they re-allocate resources from one area of the economy to another – at best this does not create growth or jobs but simply moves them around. Of course politicians will point to the jobs in the industry sector that they have supported and happily exclaim "We did this!", but will never look to the areas of the economy from which the resources have been taken away and point to the job losses there.

This is as described by the French economist Frederic Bastiat in his well-written *What is Seen and What is Not Seen*:

> "Have you ever been witness to the fury of that solid citizen, James Goodfellow, when his incorrigible son has happened to break a pane of glass? If you have been present at this spectacle, certainly you must also have observed that the onlookers, even if there are as many as thirty of them, seem with one accord to offer the unfortunate owner the selfsame consolation: It's an ill wind that blows nobody some good. Such accidents keep industry going. Everybody has to make a living. What would become of the glaziers if no one ever broke a window?
>
> Now, this formula of condolence contains a whole theory that it is a good idea for us to expose, *flagrante delicto,* in this very simple case, since it is exactly the same as that which, unfortunately, underlies most of our economic institutions.
>
> Suppose that it will cost six francs to repair the damage. If you mean that the accident gives six francs' worth of encouragement to the aforesaid industry, I agree. I do not contest it in any way; your reasoning is correct. The glazier will come, do his job, receive six francs, congratulate himself, and bless in his heart the careless child. *That is what is seen.*

> But if, by way of deduction, you conclude, as happens only too often, that it is good to break windows, that it helps to circulate money, that it results in encouraging industry in general, I am obliged to cry out: That will never do! Your theory stops at *what is seen.* It does not take account of *what is not seen.*"

And that is what European politicians forget in the Social Agenda – when they focus on job creation.

It cannot be done – because all that happens when the focus is on jobs rather than on growth creation is that we simply scramble to redistribute the same pie, rather than making it bigger.

Chresten Anderson is the president and founder of the Copenhagen Institute, the leading free market think tank in Denmark.

Section 2:
Lessons for reformers: the state of play and the way forwards

CHAPTER 6

Sex, Drugs and the Dutch Social Model

Eline van den Broek

In Quentin Tarantino's movie 'Pulp Fiction' one of the actors tells the story of the mind-blowing lack of authority and clout of Dutch cops. According to the movie scene, Amsterdam cops are not allowed to arrest a driver who is stopped for a traffic violation, if the cops find drugs in the boot of the car. The script of Pulp Fiction was written in Amsterdam many years ago, and it is indeed an interesting hub of free thoughts and rather free practice on drugs and sex too.

However, fact and fiction obviously never coincide. Where fiction portrays individual freedom in the Netherlands, the facts show us opposite signs of state control.

The Dutch Polder Model –
Where building consensus thwarts individual freedom (and vice versa)

Even in the 17th century Dutch Republic, consensus building between the various provinces was crucial for economic success and political unity. In essence, Dutch society can historically be seen as strongly divided between dichotomies, such as the poor and the rich, the Protestants and the Catholics, and left and right. But this 'Republic of rivalries' never in history caused a civil war. Observers of the Polder Model and its economic success relate it directly to the Dutch centuries-old tradition of consensus building.

Throughout history, the Netherlands, a low-lying nation, has had to battle the flood waters of the North Sea in order to preserve and cultivate its farmland. To do so effectively required a 'consensus culture', in which all the individuals and corporations who had a stake in the preservation of the dykes worked together to build and maintain them. These 'bodies of surveyors of the dykes' have long been a feature of Dutch society. In October 1880, the anti-revolutionary leader and former Prime Minister Abraham Kuyper referred to these informal groups as "polderkringen", the polder circles. During WWII, this consultative culture emerged at a national level between government, employers and employees, who came together informally to negotiate terms of employment and broader economic policies. Including all these groups in negotiations ensured that once a consensus was reached, it would be adhered to.

Two organisations were subsequently founded which both played an important consultative role in the Dutch economy. The Social-Economic Council (SER) was established in 1950 and still provides the government with social and economic advice. Likewise, the Foundation for Labour, an organ for consultation between the 'social partners' (representative central employers' and employees' organisations), was founded in 1945. It has been responsible for several significant social accords, including the Treaty of Wassenaar in 1982.

This Treaty has been considered a textbook case of the success of the 'economy of consultation', as under pressure from increasingly high unemployment figures, the employees' unions accepted wage diminution in return for reduced working hours. Indeed, many have argued that the Polder Model underpinned the Dutch economic success of the 1980-90s.

But it is not only the SER and the social partners that are being consulted under this system. What makes the Polder Model unique is that not only trade unions, but also other organisations, such as interest groups in health care and education, are all institutionalised. In healthcare, for example, these organisations make decisions on tariffs and prices. This means that pressure groups always have a seat at the table of such negotiations, and consequently, the cabinet always has to consult such bodies.

Ultimately, conflicts have always been solved peacefully by a sort of corporatist co-operation of the upper layers of the existing societal pillars. In sum, the Netherlands can be seen as a nation in which on a permanent basis differences have been peacefully *regulated,* in many cases by law. This is not exactly in harmony with the literal idea of the liberal Netherlands and the Dutch concept of freedom.

Freedom, both in the political, the spiritual, and material sense, is an essential element of mankind's development and has been the reason why the Dutch have become famous for their tolerant behaviour. Everyone is entitled to freedom without any form of discrimination whatsoever. Society should be a community of equals, which means accepting cooperation with others whenever possible *for the benefit of the entire society*. Thus, non-discrimination and respect also play an important role. And this is where the mere corporatist co-operation of the upper layers of the existing societal pillars, inherent to the Polder Model, has increasingly thwarted the idea of freedom and tolerance.

The Polder Model certainly contributed strongly to the increase of private wealth, but neglected at the same time the public sphere and the quality of living conditions. This has finally caused strong embarrassment among the population. Consensus in reality has become more of a *shadow consensus*, meaning that new majorities are not or insufficiently represented in the existing political system.

On the other hand, social norms and values have become less enforcing. This has caused an unprecedented increase of individual freedom experience and has subsequently vitalised the behaviour of individuals. Paradoxically, this much larger individual freedom has created at the same time a significantly bigger need for social safety. This new (social) risk, or , stated differently, *safety utopia*, and its resulting individual and social discomfort, converges with a sort of spectator democracy .

Balkenende II and the implications of *polderen*

On 16 May, 2003, representatives of the ruling Christian Democrats (CDA), and their coalition partners, the Peoples Party for Freedom and Democracy (VVD, the Classical Liberal party) and the Democrats 66 (D66, a centre-left party), reached agreement on the main points of government policy for the next four years. The second Balkenende cabinet program would be based around the slogan: "Mee doen, Meer Werk, Minder Regels" (Participation, More Employment, and Less Regulations). The cabinet has sought to address the problems of integration of ethnic minorities (participation), the economic recession (more employment) and the lack of trust in government (less regulations). The cabinet, however , took power at a time when the Netherlands' economy was in poor shape, with increasing unemployment and slight economic contraction. In order to jump start economic growth the cabinet has proposed tax cuts and reform of the system of social welfare.

Even though the social partners have fought back, the cabinet ultimately managed to implement a new law for disability pensions. Most people who enjoyed disability pensions under the old disability law received pensions even if they were only partially disabled and could still work. The pensions of these people are cut, and they are forced to return to work. Furthermore the cabinet has limited the possibility of early retirement. Without exception all Dutch employees will be forced to work until they have become 65, or possibly longer.

The cabinet has also cut government spending by 5700 million euro, making a total of 11 billion euro, when combined with the cuts announced by the previous cabinet. Among other measures, free dental care, physiotherapy and anti-conception medication were cut, 12000 positions were to be eliminated in the armed forces and some of their bases closed, the link between benefit payment rates and salaries was to be broken, and the rental housing subsidy was reduced. At the same time, 4 billion euro in extra spending was made available, mainly in education and justice.[1]

The implications of the long process of ‘polderen’ it took the cabinet to pursue its plans are characterized as a form of “managed liberalization.” This characterization points to the paradoxical nature of these changes. On the one hand a certain liberalization can be observed (an increase of social insurance and the administration of social security via the market) while on the other hand the control of the system by the state is also increasing. This process of managed liberalization, however, takes place under an umbrella of lasting universal social protection: entitlements are still determined by law and remain collective.

The best example of this is the new Dutch Health Reform Act. Through the adoption of a statutory General Insurance Provision, all Dutch residents are obliged to have insurance, and accordingly there will no longer be a wage ceiling for sickness funds. The statutory insurance will also establish that insurers have a duty of acceptance for the basic package. All Dutch people have to pay a nominal premium to their insurers, which should serve as an incentive for the competition between insurance providers. Added to that, people pay income-dependent contributions. Via the taxing system, the money is redistributed. To ensure risk solidarity, there will be a system of risk equalization, meaning that the government will compensate for people with higher risks. Reorganization of care supply means that the Dutch government intends to affect a shift from regulating the supply of healthcare to stimulating competition, especially competition among insurance companies. For them to be able to compete, the Reform Act provides insurance companies with many tools to make negotiations with care providers easier.

Successful implementation of these reforms depends on the public responding positively to these changes, believing them to be in their own best interest. But this is not the case. This Health Reform Act was not designed all at once and is a product of years and years of ‘polderen’. The implications? People are dissatisfied with the end result, do not understand the actual changes made, and ultimately start a further rounds of strikes which will cause another round of modifications to the plans. This vicious circle does not help the cabinet’s plans to jump start economic growth with tax cuts and real reform of the system of social welfare.

The Need for a Cultural Revolution

In this post-modern era citizens are no longer committed to regulated and institutionalised politics. A number of important things have changed, compared to the past. So on the basis of the various developments, especially the last few years, one can conclude that for the first time in modern history the consensual cultural mindset of the Netherlands could change fundamentally from the consensual Polder Model towards a more conservative model.

This might imply a far reaching dismantling of the Dutch welfare state, as we have known it in the post war years. A combination of recent developments has paved the way for this:

- Political moves to the right, starting with the movement of Pim Fortuyn, plus the privatisation of social security, and the shift from functioning consensus democracy to a "democracy of spectators"

- Economic problems (slow growth, high inflation and unemployment)

- Demographic changes (ageing)

- Cultural shifts (individualisation)

The whole shift appears no less than a social revolution with far-reaching consequences for social policy and the Welfare State in the Netherlands.

Now what implications can a potential cultural revolution in the Netherlands have for the Dutch identity in the European Union? As there is no such thing as a European nationality, since each nation has its own historical and cultural background, a cultural revolution will not necessarily affect other member states.

The definition of a European citizen, however, includes people who share common norms and values, especially with regard to the democratic, liberal and free society. European citizens should be willing to cooperate in a system, whose aim it is to achieve progress and full individual development. The Polder Model has definitely proved itself to be unsuitable to be copied throughout the EU and needs to be replaced by a system in which progress and individual development flourish.

If the Dutch government can manage the transition into a 21st century social model which allows for *cross-national diversity* and individual freedom, it may be a European gateway to economic growth. If there is — or should be — a model that leads European integration, this blue-print would have to be as much about Europe's unity of *shared social* values, institutions and structures as well as a guide on how to manage the historically entrenched cross-national diversity. Only then can we agree to become "the world's most dynamic and competitive economy".

Eline van den Broek is a senior fellow with the Centre for the New Europe in Brussels and founder of the European Independent Institute, the only independent free market think tank in the Netherlands.

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CHAPTER 7

Social Tallies and Silicon Valleys

Meelis Kitsing

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 *über*generalizations 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 off-setting 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.

Meelis Kitsing is a PhD Candidate at University of Massachusetts Amherst. He holds a MALD degree from the Fletcher School of Tufts University in Boston and an MSc from the London School of Economics. In the 1990s Meelis was involved in Estonian politics and worked for a number of multinational companies.

CHAPTER 8

Employment and welfare reform in the EU

Barry Watts

The Lisbon summit in 2000 set the ambitious target of making the EU "the most competitive and dynamic knowledged based economy in the world, capable of sustainable growth with more and better jobs and greater social cohesion."[1]

One of the main goals of the Lisbon Agenda was to increase employment throughout the EU in an attempt to address the impact of an ageing population on the supply of labour, sustain public finances and improve the EU's competitiveness.

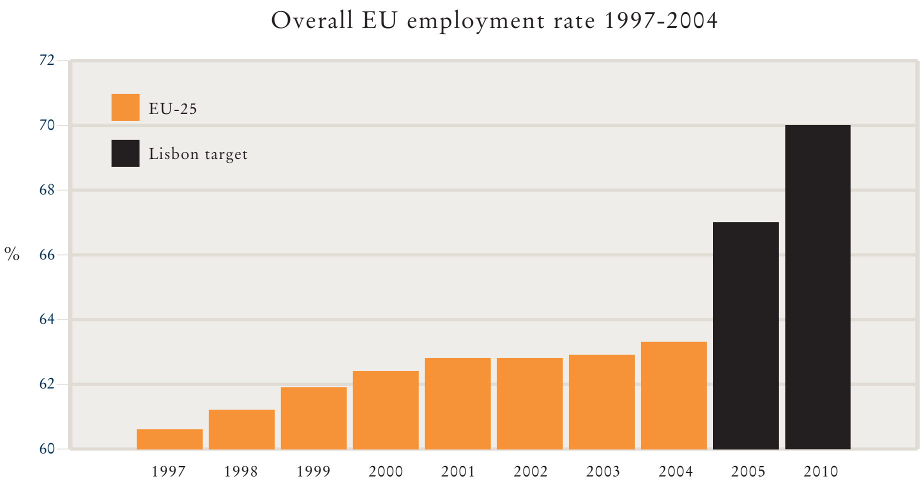
EU leaders agreed to set a target for the EU to have 70% of the working age population employed and to increase the number of women in employment to 60% by 2010. A year later, at the Stockholm European Council in March 2001, an intermediate employment target was set to increase the employment rate to 67% by 2005. Today these ambitious targets are far from being met.

The state of play

The European Commission carried out a mid term review of the Lisbon Agenda in 2004 conducted by the former Dutch Prime Minister Wim Kok. The report - Facing the Challenge, The Lisbon Strategy for growth and employment - found that little progress had been made over the first four years.[2] Indeed progress seems to have slowed, rather than accelerated, since the Lisbon summit.

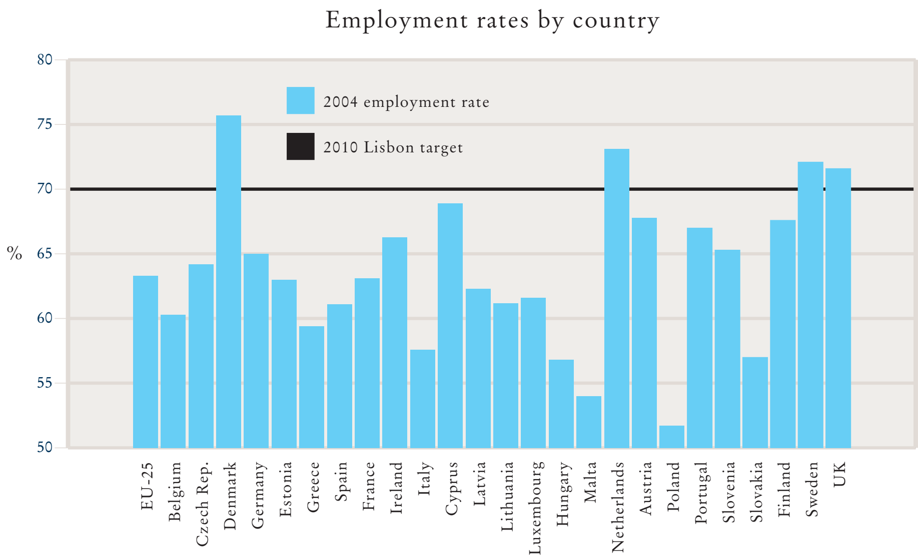
As Figure 1 below shows, from 2000-2004 EU employment levels rose less than 1% from 62.4% in 2000 to 63.3% in 2004, far below even the intermediate target of 67%. There are substantial differences in the employment levels in the EU. Figure 2 shows that employment levels vary from less than 52% in Poland and 65% in Germany to nearly 76% in Denmark. In 2004 only 4 member states[3] had over 70% employment rate and only 8 out of 25 member states were meeting the 2005 67% target[4].

Figure 1



Source: Eurostat

Figure 2



Source: Eurostat

Welfare reform to increase employment

Governments can call upon a range of policies to increase employment. The macro-management of the economy plays a big role, and the use of the tax system affects employment levels. For example, employers' social contributions are often seen as a tax on jobs. Several member states have "active" labour market policies aimed at reequipping the unemployed with new skills, such as the New Deal in the UK.

Others have tried to introduce job subsidies for employers - i.e. payments to employers for creating jobs, such as Italy's recently introduced IRAP scheme. Employment is also affected by regulation on hiring and firing workers, such as the French government's current attempt to reduce employment protection legislation on young workers to reduce youth unemployment.

Any attempt to increase employment in the economy faces two challenges: getting people who are either inactive or on welfare benefits into work and encouraging people already in the labour market to work longer hours. The combination of the way that benefits are paid and means tested, plus the effects of the tax system, can give individuals little incentive to come off welfare or work harder, trapping people into welfare dependency. There are three specific problems that governments face: unemployment, inactivity and the low wage traps.

UNEMPLOYMENT TRAP

The unemployment trap exists where the market wage is too low to offer an incentive to take up work compared with the welfare benefits individuals receive. This is a result of the effect of benefit withdrawals and higher tax rates as they move into work. This can be solved by either cutting or time limiting welfare benefits or offering in-work benefits to encourage the transition into work.

INACTIVITY TRAP

There is also a challenge to get those who are out of work but not claiming benefits into employment. The so called inactivity trap exists where employment is judged not to pay because income related benefits may be lost with the uptake of paid work. For example partners or spouses of working individuals may not take up work if pay is jointly taxed, or if the couple may lose family benefits if household income is raised.

LOW WAGE TRAP

A low wage trap, sometimes referred to as the poverty trap, can also exist where there are no financial incentives to work longer hours or for higher salaries. This can be caused by both taxes and benefits, when an increase in gross income does not translate into a sufficient increase in net income to incentivise the extra hours of work.

European economies face many of these problems to increasing employment, but what is key to achieving the Lisbon Agenda is getting people into employment. This means that adopting effective measures to address the unemployment and inactivity traps are important. European countries have high levels of means tested benefits which are a major cause of the unemployment trap. Table 1 below outlines the different unemployment benefit schemes in each of the 25 EU member states.

The majority of member states have a two layered welfare regime, consisting of unemployment insurance and assistance. Insurance is paid immediately after becoming unemployed and assistance is for those who have used up their insurance contributions.

Table 1: Different welfare regimes in each member state

Country	Unemployment Insurance	Unemployment Assistance
Austria	55% of daily net income, lasts 5-18 months depending on insurance duration and age	Income based assistance of 92% of previous insurance benefits, with no time limit
Belgium	55-60% of earnings depending on circumstances, for first year unemployed. Decreases in second year. Has no time limit	None
Czech Republic	For the first 3 months get 50% of average net monthly earnings, reduces to 45% thereafter, max 6 months	None
Cyprus	60% of weekly wage, increases depending on circumstances	None
Denmark	90% of earnings, for up to 48 months	None
Estonia	50% of average daily earnings for up to 100 days then 40%	Flat rate per month
Finland	Basic and earnings related allowances (basic + 42% of difference between wage and basic allowance). 16 month duration	Labour market support amount per day
France	57% of daily wage, 4-60 months	Provision for older workers
Germany	60-67% depending on circumstances for up to 18 months	53-57% of net earnings, no time limit

Table 1 continued: Different welfare regimes in each member state

Country	Unemployment Insurance	Unemployment Assistance
Greece	40% of daily wage for manual workers, 50% of monthly wage for white collar workers, up to 15 months	17-20% depending on reason for losing job
Hungary	65% of average salary for 6 months	None
Italy	40% of average pay over last 3 months or 80% of previous earnings for up to 9 months for those in the building trade	None
Lithuania	Fixed and variable parts, paid in full for 3 months then reduced by 50%	None
Ireland	Flat weekly rate for up to 13 months	Unlimited fixed amount per week
Latvia	Amount depends on insurance contributions (from 50-65% of average wage) and amount declines over 9 months	None
Luxembourg	80% of earnings for 24 months	None
Malta	Fixed amount per day depending on circumstances, maximum of 156 days	Fixed amount per day
Netherlands	70% of last salary or 70% of minimum wage for short term benefits lasting from 6-60 months	70% of minimum wage for up to 24 months
Poland	Flat rate benefit depending on length of economic activity	None
Portugal	65% of wage, 12-30 month duration	80-100% of minimum wage, lasts 12-30 months
Slovakia	50% of average gross earnings over last 3 years, for up to 6 months	None
Slovenia	70% of average monthly earnings for first 3 months, falls to 60%. Length depends on insurance payments, up to 24 months	80% of employment benefit up to 15 months

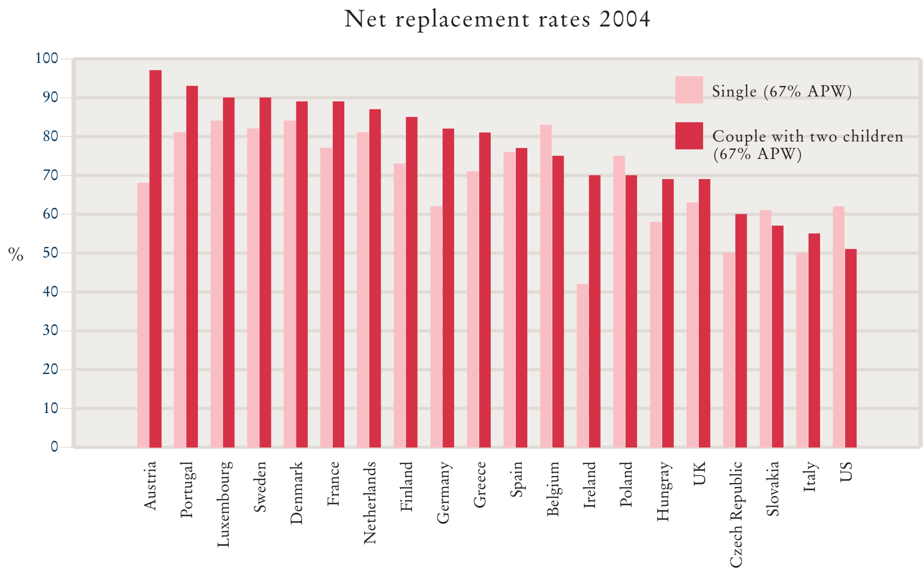
Table 1 continued: Different welfare regimes in each member state

Country	Unemployment Insurance	Unemployment Assistance
Spain	70% of earnings for 6 months, reduced to 60% for 18 months	75% of minimum wage up to 18 months
Sweden	80% of earnings, usually 300 days but can be extended to 600	Basic daily allowance with no time limit
United Kingdom	Contributions-based Job Seekers Allowance, flat rate with a 6 month limit	Income based Job Seekers Allowance, varies according to family and income, no limit
US	26 weeks maximum receipt, level of benefit varies by state	None

Source: Based on MISSOC 2005 data

Figure 3 shows the net replacement rates for each member state. This is a comparison of in-work incomes and out-of-work incomes showing the loss of income when losing a job and getting unemployment benefits.

Figure 3



Source: OECD, Tax Benefit Model: www.oecd.org/els/social/workincentives

Overall Denmark has the most generous unemployment insurance system providing 90% of earnings that can last for up to 48 months. Luxembourg and Sweden have 80% of earnings, whereas the Netherlands, Slovenia and Spain have 70% of employment benefits. These countries also have high net replacement rates. As we can see some countries, such as Sweden (90%), France (89%) and Luxembourg (90%) have very high levels of net replacement rates for couples with two children. This means there is little or no incentive to come off benefits in these countries as moving into work would not result in any financial gain. For the single person the net replacement rate is usually lower but still very high in Denmark (84%), Belgium (83%), Sweden (82%), Portugal (81%) and Luxembourg (84%). In comparison the UK, Greece, Italy and Ireland have low unemployment benefits and net replacement rates.

Another way to measure the unemployment trap is to look at the marginal effective tax rate (METR). It is the rate at which benefits decrease and taxes increase as an individual starts employment and it measures the short-term financial incentives to move from unemployment into paid employment. In the following graphs the net income line shows the METR. The flatter the net income line the larger is the part of any additional earnings that gets taxed away. We can see that for Sweden and Germany the line is horizontal at low wage levels meaning that any increase in gross income is completely taxed away. In comparison, for the US the line is upward sloping, creating an incentive to move into employment.

Figure 4

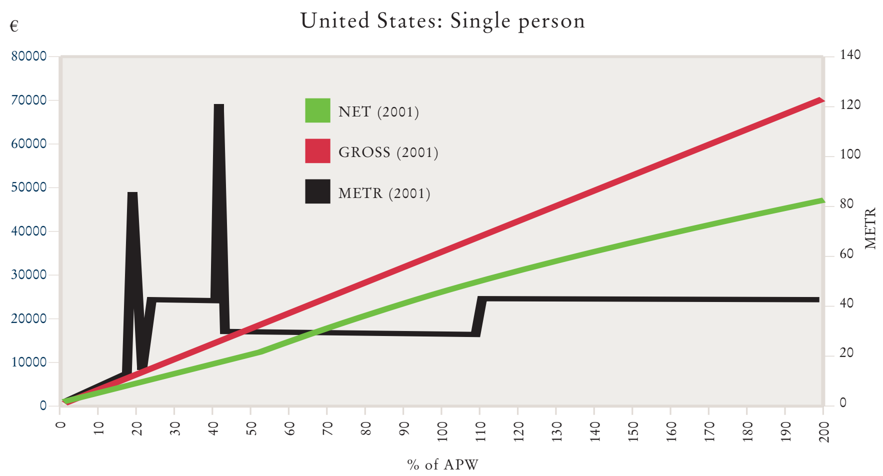
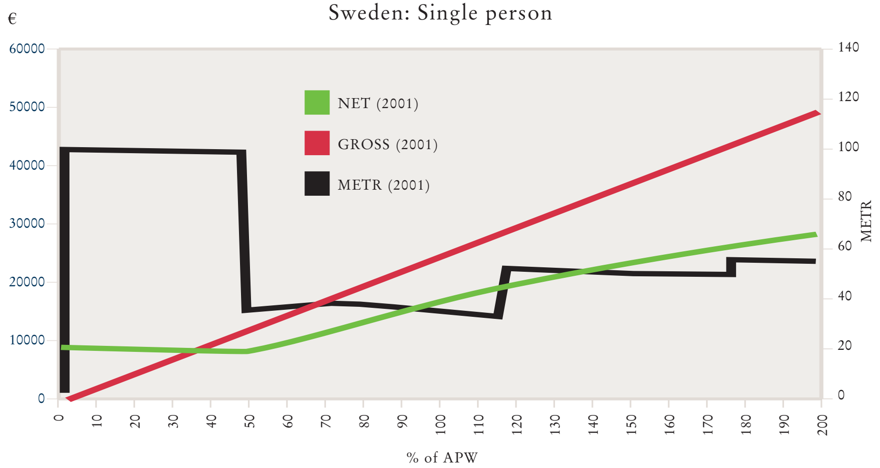
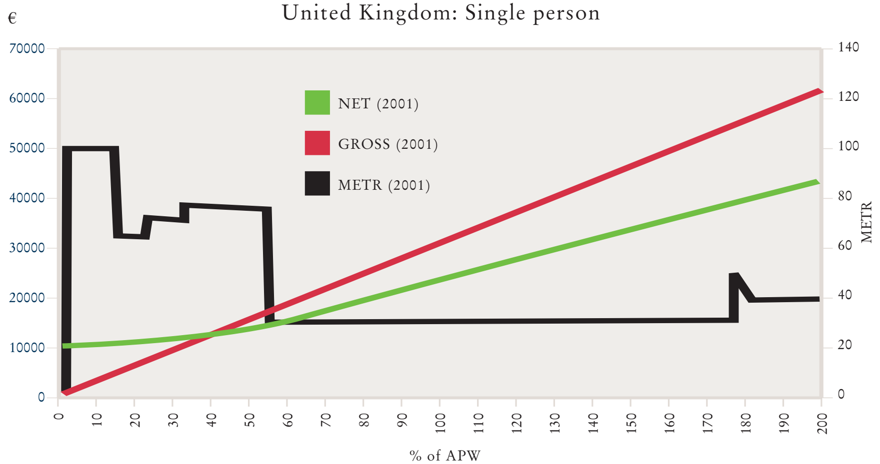


Figure 4

Sweden: Single person



United Kingdom: Single person



Germany: Single person

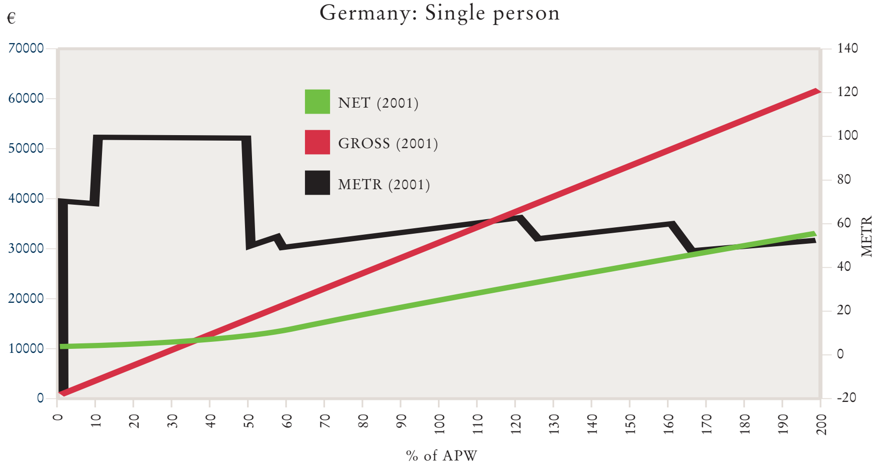


Figure 5:
Prevalence of marginal tax rates of over 100% and over 80% - by wage earned by welfare leaver and family type (2003)

Family type	Wage as % average	BE	DK	DE	GR	ES	FR	IE	IT	LU	NL	AT	PT	FI	SE	UK	CZ	HU	PL	SK
Single	50%	100	106	100	97	97	78	88	65	104	92	87	110	90	105	79	80	74	87	88
	67%	90	93	89	77	78	83	73	58	87	86	75	87	81	87	71	66	64	74	73
	100%	79	78	78	57	63	68	59	53	69	73	64	66	69	70	58	53	56	61	56
	150%	72	73	71	49	52	58	55	49	61	60	57	55	62	61	50	46	57	52	48
1 earner couple No children	50%	90	75	100	100	96	60	100	66	102	96	100	73	92	100	84	91	72	76	105
	67%	81	85	89	79	74	84	90	55	104	92	87	69	89	98	82	78	63	74	95
	100%	71	78	75	58	59	65	69	53	84	79	72	64	76	77	67	64	55	61	72
	150%	65	72	66	50	49	54	57	50	65	64	63	51	67	66	55	53	57	52	57
2 earners couple No children	50%	96	106	99	70	97	101	53	75	104	88	79	112	83	105	44	76	72	75	85
	67%	88	90	87	56	78	84	47	65	84	77	69	90	72	87	41	63	63	65	69
	100%	77	77	76	43	63	69	41	57	65	67	60	68	62	70	38	51	55	55	53
	150%	71	72	68	39	52	57	38	52	55	56	55	53	58	61	37	44	57	48	46
Lone parent 2 children	50%	91	106	100	110	96	67	48	73	101	90	100	73	94	103	57	93	86	79	92
	67%	81	90	93	86	78	90	24	51	94	86	84	69	87	91	65	79	68	67	79
	100%	73	82	80	63	60	74	37	52	68	77	71	71	78	79	68	67	54	66	64
	150%	68	76	70	50	49	58	38	52	58	63	62	58	68	68	59	56	56	56	54
1 earner couple 2 children	50%	85	76	100	110	96	53	96	77	101	93	100	74	92	100	63	100	86	100	106
	67%	77	82	85	86	78	90	88	52	104	89	99	69	94	100	70	95	68	87	111
	100%	68	80	75	63	58	74	73	53	90	80	80	65	87	83	73	76	54	73	86
	150%	64	74	66	50	48	58	59	52	67	64	68	62	74	70	63	62	56	64	68
2 earners couple with children	50%	96	106	116	72	99	101	69	83	115	86	85	110	91	105	68	77	72	95	92
	67%	88	90	100	58	79	83	59	73	89	76	73	85	78	87	59	64	63	79	74
	100%	77	77	84	44	63	66	49	64	66	67	63	64	66	70	50	55	55	64	57
	150%	71	72	73	37	52	54	43	57	55	56	57	51	61	61	45	46	57	54	51

Source: European Commission, European Economy 2/2005

As figure 5 above shows, the marginal tax rate faced by people leaving welfare is often above 80% or even 100% in many member states, particularly for those taking up low paid jobs. Italy and the UK have relatively few ultra-high marginal tax rates. Germany has a large number – for example the spouse of someone who is already working and has children would face an 84% tax rate even if he or she got a job at the average wage.

Are Tax Credits the way forward?

One labour market policy that has been successful in increasing employment in the US and the UK are Tax Credits, which supplement the income of low wage earners and create a financial incentive to enter the labour force. The US Earned Income Tax Credit (EITC) system originally set up in 1975[5] has been credited with lifting more than 5 million people out of poverty.[6] Approximately 19 million Americans[7] take part in the scheme which is designed to offset the burden of social security taxes, supplement earnings and complement efforts to help families make the transition from welfare to work.[8]

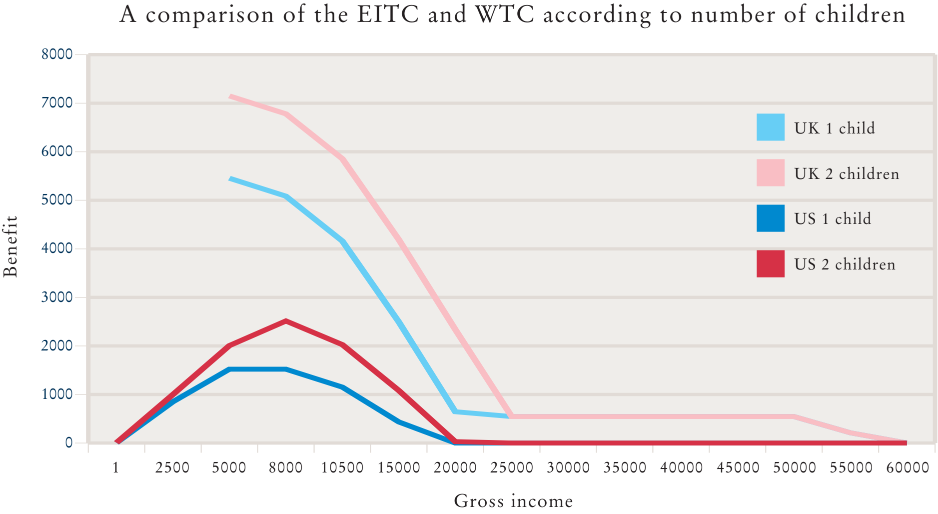
The UK's Working Tax Credits (WTC) and Child Tax Credits (CTC) introduced in April 2003 replaced the Working Families Tax Credit. The WTC is available to everyone over 25 years olds working more than 16 hours a week. The amount of credit depends upon hours worked, number of children and earnings. The CTC is paid to people on low incomes to help with the costs of bringing up children. Both the UK and US schemes are examples of refundable Tax Credits which means if the credit amount is larger than the family tax bill, the family receives a refund.[9] This allows families to take advantage of the Tax Credit even if they owe little or no income tax.[10]

The Tax Credit system is a so-called "in-work benefit" that encourages those who are economically inactive or unemployed to enter the labour market by offering financial incentives which increase as earnings increase. In the case of the US' EITC the incentives increase until they reach a plateau approximately at the poverty level. They remain consistent and then phase out at high levels of income.

The WTC is slightly different, with a working condition of 16 hours and more generous benefits and a longer "drop out" at the end (i.e. it is phased out more slowly, and is available to higher earners). The disadvantage of the hours criteria is it creates a spike at the threshold level, as figure 6 below shows. This reduces the incentive to increase work efforts after the threshold.

The WTC encourages someone to get a job that consists of at least 16 hours of work, but there is little or no incentive to get a full time job because the marginal loss of benefits and leisure time outweighs the gains from higher wages. The WTC has a much larger phase out rate and income distribution. Although a longer phase out means there is a lower substitution effect, it increases the cost of the programme and the number of recipients with relatively high income.

Figure 6



In the UK system, Tax Credits count as income in means tested benefits. This can outweigh the benefits that Tax Credits provide. Richard Blundell (2004) argues that this is "deliberate and ensures that there are no implicit tax rates on earnings exceeding 100%."[11]

The EITC can push up incomes by 40-60% depending on conditions. Someone earning $6.25 per hour in the US would make $12,500 per year. With the EITC and other benefits this gets pushed up to $8-9 per hour or $16-18,000 per year. In the UK a single mother who is earning £15,000 per year and works more than 30 hours can get £6,131 in tax credits, pushing her income up to £21,131 per year.[12] The WTC is reduced by 37p for every £1 of gross earnings in excess of the first income threshold of £5,220 per year.

In-work benefits in the EU

Several European countries have introduced Tax Credits systems, as shown in table 2 below, but they are modest in size and relative to the UK and US' systems they have been of limited use in attracting people back to work.[13]

For example, Belgium has been operating an in-work benefit scheme called Credit d'impot. When it was introduced in 2002 it was subject to a maximum payout of €90 per year. This rose to just €496 in 2004. Belgium's in-work credit is meant for individuals earning around the minimum wage.

Similarly an evaluation of France's "Prime pour l'emploi" programme showed financial support to be very low, "accounting at most for 4.7% of declared income." This compares to 40% on average for the US EITC.[14]

The French scheme also excluded those with the lowest earned income, the group that would have benefited the most from a Tax Credit system that reduced the unemployment trap.

Table 2: In-work benefits in each member state

Country	In-work benefits
Austria	Single-earners' Tax Credit Wage Earners' Commuting Tax Credit Children's Tax Credit Increased amounts in 2004 and 2005
Belgium	Limited Tax Credit introduced 2002
Denmark	Tax Credit 2004- where taxpayer can deduct 2.5% of earned income in calculation of taxable income
Finland	Earned Income allowance- calculated on basis of taxpayer's income from work
France	Prime pour l'emploi 2001- at least one person must work in a tax household. 2 parts to credit; variable part depends on number of hours worked, amount of lump sum depends on family situation, additional for child and spouse
Germany	Small benefit for those taking seasonal work Non-Income Family Tax Credit
Greece	Refundable Tax Credit- for low income families with children and in rural areas
Hungary	Employment Tax Credit- 18% of wage income earned Child Tax Credit
Italy	Tax Credits for employees Child Tax Credit Tax allowances which have introduced a "no tax area", leading to tax savings for low/middle income earners
Ireland	Back to Work Allowance-receive 75% of unemployment benefit for 3 years Enterprise Allowance- receives 75% of unemployment benefit for 4 years Part Time Job Incentive Scheme- Long term unemployed receive a weekly allowance Family Income Supplement- weekly payment for families at work on low pay

Table 2 continued: In-work benefits in each member state

Country	In-work benefits
Luxembourg	Child Tax Credit
Netherlands	Combination Tax Credit for parents with children under 12 Supplementary Tax Credit for single parent families Tax Credit for organised child care, long term unemployed, job acceptance and old age
Poland	Non-refundable Tax Credit for all workers
Portugal	Limited Tax Credits which vary according to circumstances
Slovakia	Non-Wastable Child Tax Credit
Spain	Non-Wastable Tax Credit for workable women, and with children under 3. Women who work and contribute to a social security scheme get rebate of €100 per month for each child under 3
Sweden	Refundable Tax Credit- where 75% of social security contribution is returned to payer Non-standard relief Tax Credit- equal to 25% of the trade union dues and 40% of the unemployment insurance fee Special Tax Credit- for statutory minimum local income tax
United Kingdom	Working Tax Credit Child Tax Credit

Source: OECD 2006

Very few of the attempts to introduce Tax Credits so far have made a significant difference to the marginal rate of tax faced by welfare leavers. As Chart 7 below shows, only the reforms in Hungary and Slovakia seem to have made a significant impact. The majority of EU member states and the EU average are unchanged. The unemployment trap seems to have worsened in Poland and Greece.

Figure 7

Source: European Commission New Chronos database

Advantages of Tax Credits

There are several advantages to the Tax Credit system over traditional welfare provisions. Traditional welfare systems often provide high, means tested unemployment benefits that offer a disincentive to find work, creating an unemployment trap, as was outlined above.

Tax Credits have a positive participation effect, encouraging people with the promise of higher wages, to come off benefits and take up employment. The OECD estimated in 1995 that in the US the net replacement rate with EITC in a 2 children family was 63%. Without the EITC it would have been 97%.[15]

Tax Credits have also been useful in encouraging single parents back into work, a key target for the EU. The Lisbon Agenda set a target for a 60% employment rate for women and the challenges faced by an ageing population and declining birth rates means that it is important to encourage more women in to work. Tax Credits could help to achieve this. Evidence from the US suggests that the EITC has been responsible for increasing the labour market participation of single women with children from 62-81%[16].

Tax Credits ensure people receive an income that is sufficient to avoid poverty whilst avoiding imposing high labour costs on employers. As the OECD argues “high non-wage labour costs can reduce demand for low-skilled workers...employment subsidies can be an important link between work that pays and is affordable for the low skilled.”[17]

They are also cost effective compared to traditional welfare programmes. The OECD in its 2005 report found that traditional welfare systems, which redistribute to non-working poor, meant that redistributing one additional euro to low income individuals required a reduction in welfare of the high income people by 2-4 euros[18]. In comparison the OECD found that the economic loss of redistributing to the working poor with Tax Credits is substantially lower. They argued that if Tax Credits were introduced in Denmark, Ireland, France, Portugal and Spain there could be an aggregate welfare gain, where one euro redistributed could lead to an increase in the income of higher earners.[19]

Tax Credits are not means tested, thus avoiding some of the stigma related to seeking benefits, and ensuring everyone that is eligible receives them. The EITC has a positive image and Scholz estimates the take-up is very high at around 80-85% of those who are eligible.[20]

Some European countries have opted to introduce tax cuts instead at the lower end of the income threshold. The disadvantage with this is that it benefits the rich as equally as the poorest people and is fiscally “expensive”. As Raymond Gradus (2001) argues, “if the main objective of the tax reform is to reduce the unemployment among low skilled, an in-work Tax Credit is more effective than reducing the basic rate of income.”[21]

Conclusion

Although efforts have been made to make work pay and reform EU members’ benefit systems, the EU has a long way to go to achieve its objectives on employment and looks likely to miss the Lisbon target. Unemployment traps are still very high. Means tested benefits need to be lowered and Tax Credits such as the US’ EITC need to be adopted across the EU to tackle rampant unemployment.

Tax Credits offer a number of advantages over other in-work benefits and are preferable and more effective than tax cuts. They should not be viewed as a panacea for Europe’s employment problems, for they are good at encouraging people to enter the labour market but not so efficient at stimulating additional supplies of labour. In combination with improved education and other policies, Tax Credits can help the EU begin to approach the Lisbon Agenda targets.

1 Kok, W, Facing the Challenges, The Lisbon strategy for growth and employment, 2004, p7

2 "Over the last four years, the overall performance of the European economy has been disappointing. The economic upturn in Europe has been weaker than in the US and Asia over the past two years," Kok, W, 2004, p11

3 Denmark, Netherlands, Sweden and the UK

4 Austria, Cyprus, Denmark, Finland, Netherlands, Portugal, Sweden and the UK

5 The EITC originally provided modest income tax rebates and has gone through a number of changes (1986, 1990, 1993, 2001)

6 Johnson, N et al, 2001, Center on Budget and Policy priorities, A Hand Up- how state earned income tax credits help working families escape poverty, p2

7 Beamer, G, 2005, State Tax Credits and making work pay in post-welfare reform era, The Policy Studies Organisation, Review of Policy Research, volume 22, no 3, p2

8 Johnson, N et al, 2001, p13

9 This is in comparison to a non-refundable tax credit which does not refund any excess credit to the taxpayer.

10 Johnson, N et al, 2001, p14

11 Blundell, R, 2004, Labour Market Policy and Welfare Reform: Meeting Distribution and Efficiency Objectives, De Economist 152, No 2, p241

12 HMRC, 2005, Child Tax Credit and Working Tax Credit a guide, p37

13 OECD, 2005, Welfare Reform in European Countries: A Micro simulation Analysis, paper number 28, p21

14 OCD, 2003, Making Work Pay Making Work Possible, p121

15 Doudeujns et al, 1999, Arbeitsanreize fur einkommensschwache Familien mit Kingdern, infor MISEP 66, p99

16 Ellwood, R.T., 2001, The Impact of the Earned Income Tax Credit and Social policy reforms on work, marriage and living arrangements, National Tax Journal, 53(4). Also see Meyer, B.D., and Rosenbaum, D.T., 2001, Welfare, the Earned Income Tax Credit, and the labour supply of single mothers, Quarterly Journal of Economics, 116(3)

17 OECD, 2003, Making Work Pay Making Work Possible, Employment Outlook 2003, chapter 3, p114

18 OECD, 2005, Welfare Reform in European Countries: A micro-simulation analysis, Paper no 28, p8

19 Ibid, p26

20 Scholz, J, 1994, The earned income tax credit: Participation, compliance and anti-poverty effectiveness, National Tax Journal, vol. 47, p 70-71

21 Gradus, R, 2001, Comparing Different European Tax's Policies Making Work Pay, Info Studien 3/2001

Barry Watts is a researcher at Open Europe and previously worked at the Centre for Economic and Social Inclusion, analysing recent welfare reforms in the UK.

CHAPTER 9

The Better Regulation initiative and EU values

Malgosia Kaluzynska

The social and economic model for the European Union has been a focus of public debate for a long time. Lately the discussion has picked up the pace due to the need to seek answers to the challenges of globalisation and to counteract a perceived decline of the competitiveness of the economies of the member states.

Unfortunately, there is no clear definition of the term "European Social Model", which in principle makes it difficult, if not impossible, to reach a consensus on this matter. Andre Sapir's report "Globalisation and the Reform of European Social Models" confirmed that within the European Union there is not one commonly binding and accepted social model.

A core of common principles

Instead it is broadly recognised that the European Union is characterised by a set of common principles and values. Those principles and values are enshrined in the treaties and member states should obviously recognise them and put them into practice. The principles apply to such ideas and rules as the free movement of labour, equal terms of employment for women and men, support for the close cooperation between member states in such areas as: employment, right to work and terms of employment, social security, vocational training, prevention of accidents at work and occupational diseases, health and safety at work, right of association and conclusion of collective agreements. All the above-mentioned provisions have already been elaborated by secondary legislation, both by regulations, directives and recommendations and opinions.

A common policy: the Better Regulation agenda

Regulatory reform is one of the key elements in seeking to attain the goals of the reviewed Lisbon Strategy and improve the competitiveness of the European Union. The Commission linked the Better Regulation initiative directly with the Lisbon Strategy. In March 2005 the Commission produced a communication on "Better Regulation for Growth and Jobs in the European Union".

The renewed Better Regulation agenda has been incorporated into several of the EU's policies together with horizontal actions such as the new simplification program and measurement of administrative burdens.

If the better regulation agenda is to be a success, there are several challenges it must address, and a number of ways in which it should change and broaden.

(1) A test for Better Regulation - reducing the burden on small businesses

One of the themes that runs through the social dialogue and Better Regulation discussion is related to the challenges of introducing alternatives to traditional legislative instruments and involving the small and medium sized businesses (SMEs) in social dialogue both at national and European levels.

SMEs would like to see more of the non-regulatory alternatives and are interested how the structural dialogue between employers and trade unions can create the right environment to arrange this without the need for formal legislation. SMEs constitute 99% of all enterprises and two thirds of employment in the European Union. They are collectively big but the sector consists of many family firms. Improving the quality of their interactions with regulations would be a social act in itself.

Regulation affects SMEs disproportionately because they have limited capacity to tackle, understand and comply with complex regulations. Robert Baldwin in his report “Better Regulation. Is it better for business?” argues that fixed cost elements of regulatory compliance produce higher relative compliance costs for small firms. He cites the OECD report “Business views on red tape” that reveals that small firms (with 1–19 employees) incur more than three times higher regulatory costs per employee than medium firms (20–49 employees) and more than five times higher costs than large firms (50–500 employees).

The importance of the SMEs sector and regulatory improvements is now being addressed at the European level. The renaissance of the Better Regulation agenda and the current emphasis on SMEs is not a sudden love for improving the regulatory environment for businesses. Within the European Union there have been initiatives on Better Regulation and SMEs since the 1980s, but only now has a strong relationship been established between them.

The Competitiveness Council in its contribution for the Spring European Council 2006 invited the Commission among others to launch an exercise to measure the administrative costs associated with EU rules in specific areas and stressed the need to pay particular attention to SMEs. Moreover the Council invited the Commission and the member states to continue to cut red tape, in accordance with Better Regulation actions. According to the Council a “Think Small First” approach should be at both Community and national level.

(2) Look at the wider costs of regulation

Work on reducing administrative burdens, (based on the Dutch methodology of the Standard Cost Model), has come to dominate the better regulation agenda at the expense of a wider assessment of economic consequences of the existing and new legislation.

Better Regulation should be about more than just administrative burdens measurement. The dominance of the administrative cost is a fine example of the Emperor's new clothes phenomenon – it is in no individual's interest to point out that the approach is thread-bare.

Any assessment of cost for businesses should be designed in a fashion that meets the needs of different stakeholders and takes into account all cost that may arise. Better Regulation policy should focus on elimination of all kinds of regulatory costs. Only through a comprehensive approach to the issue of elimination of legislative burdens can the entire regulatory environment of business be improved.

(3) Reducing the regulatory burden on individuals

Interestingly the administrative burden approach has never been broadly discussed in the context of minimising the burdens upon citizens. The extreme diversity of administrative provisions within the European Union doesn't allow this problem to be tackled at the European level but is a matter for national actions.

A state as a producer or the supplier of a particular good or service to citizens imposes administrative burdens upon them. Reduction of those burdens should also take into account this group not because of the need to boost competitiveness but simply because of a desire to improve the quality of life – the avowed goal of governments.

(4) Harmonisation is not the only way

At their meeting in November 2005 and in preparation for the Lisbon Spring European Council 2006, the EU's Competitiveness Ministers found themselves discussing harmonisation as a means to better regulation. (This is important because this Council sets out the policy recommendations for the European Council in this area).

When the creation of a more competitive business environment and encouragement of private initiative through Better Regulation was discussed, some member states requested adding a reference to harmonisation as a crucial means to improve the quality of legislation for certain policy areas.

When harmonisation is discussed and seen as the main and most effective instrument for regulatory purposes, two points should be kept in mind.

Harmonisation should not always be seen as the only way to improve regulation.
In principle harmonisation is just one of the instruments of enhancing the regulatory environment. The choice of instruments should be decided on the basis of a broader analysis, which must show that harmonisation is more effective than introduction of some other instrument.

Malgosia Kaluzynska is Head of the Lisbon Strategy Unit,
Office of the Committee for European Integration, Poland.

CHAPTER 10

EU regulation - lightening the load

Paul Stephenson

The European Union is producing more new pieces of legislation than ever – around 4 a week on average – despite promising "a bonfire of regulation". Its insistence on "better" instead of less regulation has so far had precious little impact on business. There are several measures the EU and the UK must take to help stem the tide of damaging regulation and ensure businesses can remain competitive in an increasingly challenging global economic environment.

Back in 2004 there were high hopes for the new Commission, led by Jose Barroso, who was hailed as a liberal reformer. The new Enterprise Commissioner Gunter Verheugen said that "cutting red tape" would be his "personal trademark" and promised to repeal or simplify 1,500 pieces of existing EU legislation over three years. The headlines reported that Europe had started a "war on red tape." So far it seems the red tape is winning.

Everyone knows Europe faces slow growth, high unemployment and massive future demographic problems. But instead of pursuing any meaningful reduction in the burden of regulation on the economy, the EU is still tinkering around the edges. The emphasis has drifted towards redrafting laws rather than actually hacking back red tape.

Six months after the event we are still hearing about the Commission's headline-grabbing decision to withdraw 68 pending proposals for legislation in September last year. But a closer look at what was involved reveals that most of the 68 bills concerned were already obsolete, or had been pending for years. 27 of them, for example, were over five years old, and 22 concerned the association agreements signed with the ten new member countries, which all became defunct when they joined the EU in 2004. As *Le Figaro* wisely observed, the initiative was "largely cosmetic."

In October the Commission had another go. It announced that it would "repeal, codify, recast or modify" 220 pieces of legislation. Again, it sounded good, but it didn't stack up. Only 8 regulations will actually be repealed and not replaced. The rest are to be rewritten, as the Commission says, "without changing the substance of these provisions." Even the regulations which are to be ditched will have no economic impact – in the Commission's words they are "irrelevant or obsolete". For example one is an obscure 1960's directive on measuring the size of knots in bits of wood.

Despite the good intentions of President Barroso, the EU's production of new regulations is not going down, but is actually increasing at an alarming rate. Of the 22,000 pieces of legislation on the EU statute book, about 12,000 were introduced in the eight years between 1997 and 2005, compared to 10,000 during the forty years from 1957 to 1997.

How much regulation comes from the EU

The cost of these regulations for British business is enormous. Even Gordon Brown has admitted that "Approximately half of all new regulations that impact upon businesses in the UK originate in the EU". The Dutch government also says that over 50% of regulations have a "direct European origin", and calculates that the EU-related administrative burden on Dutch business is over 2 % of GDP.

However, research has shown that the actual burden imposed by EU regulation is far greater – since 1998, 77% *of the cost* of regulation on UK business has been driven by EU legislation. The total cost of these EU regulations to the UK's economy has been over £30 billion since 1998. Three of the EU regulations studied have cost business over £5 billion each since 1998. Indeed the EU is responsible for four of the five most costly regulations on UK businesses.

Even these figures are conservative – they are based on the UK's own Regulatory Impact Assessments, which tend to concentrate mainly on the direct costs of regulations. Estimates of the wider impact of regulation suggest the costs could be far higher.

Less regulation, not "better"

Part of the reason for the lack of progress on deregulation is the EU Commission's insistence that deregulation does not mean *less* regulation, but is about "better regulation". This has become the Commission's watchword over the last few years. It is argued that it will be beneficial for business if the EU simply redrafts and "codifies" its existing regulations – drawing together related directives and amalgamating them into one.

The Commission admits that 'de-regulation' is not its aim. Gunter Verheugen, the EU's Enterprise and Industry Commissioner stresses that his latest deregulatory drive "is not about less Europe, it is about better Europe." In a press release on deregulation the Commission insisted that, "Better regulation is not de-regulation."

This emphasis on "better regulation" allows the Commission to appear tough on regulation and generates positive headlines. However, the result is that existing costly regulations are not repealed, and they continue to damage the EU's competitiveness.

What is clearly needed is *less* regulation. Any meaningful deregulation will be controversial and will address the regulations which actually do impact on business.

As well as abandoning the insistence on "better" regulation, several other steps could be taken to stem the EU's current explosive growth of legislation:

Adopting a Dutch system of de-regulation

The EU could learn a lot from the Dutch system of de-regulation. The Netherlands is steadily conducting a proper economic audit of the whole body of existing legislation – both national and European – and has a target to reduce administrative costs by 25% by the end of 2006.

The Danish and Swedish governments have both proposed to implement a similar scheme with specific targets for reductions in administrative costs. The EU could create a unit like the US Regulator Oversight office to drive through such a programme.

Introducing compulsory impact assessments for EU regulation

Regulatory Impact Assessments (RIAs) at EU level should be made compulsory. The EU is not currently obliged to carry out proper Regulatory Impact Assessments before legislating. This means the vast majority of EU legislation goes through without being subjected to a proper economic impact assessment – either by the UK Government or the EU itself.

A study by the British Chambers of Commerce last year found that only 0.5% of EU regulations are subject to RIAs in the UK, and that only 0.2% of regulations were given impact assessments at EU level. Research has shown that large numbers of the impact assessments that were carried out were published after the regulation had already come into force. As well as their very limited coverage, and the fact that many are produced too late to be of use, the EU's impact assessments are also of very low quality.

Improving scrutiny of EU legislation at Westminster

Lastly, MPs at Westminster need far greater powers to raise the alarm about upcoming EU regulations at an early stage.

The current EU Scrutiny Committee is seriously underpowered to deal with the flood of EU legislation. On top of this, the Committee has no power to affect EU legislation in any meaningful way. A so-called 'scrutiny reserve' allows MPs to ask the

Government not to sign up to a proposal until it has been passed by the committee. However the Government makes a mockery of this system by exploiting a loophole which allows it to "override" the reserve, to avoid losing face in European Council meetings.

Use of this "override" is on the up – since figures were first collected in 2001 it has been used 346 times – i.e. to pass 346 pieces of key EU legislation without proper scrutiny in Parliament. 2005 saw one of the greatest ever uses of the override, despite the UK Government holding the EU Presidency (and therefore control of Council agendas) in the second half of the year. Any scrutiny that does happen often takes place after legislation has already been passed, meaning interest in EU affairs at Westminster is generally low.

The UK could learn a lot from the forward-looking Danish parliament, where a well-informed, well-attended EU scrutiny committee – the *Europaudvalget* – grills ministers every Friday and goes through the agenda for the following week's EU meetings. The minister must seek a mandate from the committee for his/her position, and report back to the committee after the meeting to prove he/she has kept within that mandate.

Serious reform of the Westminster scrutiny system could have a real impact on the flow of damaging regulation from the EU, by allowing UK MPs a bigger say in what is decided behind closed doors in Brussels. Reforming its own system of parliamentary control of EU legislation is something the UK can pursue independently, without needing to wait for the approval of other EU member states.

A big bang

These initiatives, while helping to stem the current explosive growth of EU legislation, are technocratic solutions. Any meaningful deregulation drive will involve a controversial effort to axe from the EU statute book the regulations that actually impact on business, and an end to the fiddling around the edges we have seen over the past year. Only a 'big-bang' like this will suffice if the EU is serious about reducing the burden of regulation on the economy.

Paul Stephenson is a researcher at Open Europe focussing on regulation. His recent publications include *The Services Directive: Can Europe Deliver? (2006)*

openeurope
7 Tufton Street
London SW1P 3QN
Tel: +44 (0)207 197 2333
Fax: +44 (0)207 197 2307
email: info@openeurope.org.uk
www.openeurope.org.uk