Panel 1

Competing Social Models in the Global Economy

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Comparing social models: changing fads

Which social model is likely to be most competitive in a globalized economy with free flows of goods, services, capital and people across borders? That question has been hotly debated for some time, and the answers to it have varied a lot over the years. Indeed, the perceptions of which social model is most successful seems to be highly subject to fads and heavily influenced by the most recent economic performance of various countries. In my own country in the 1980s, business leaders and policy makers were looking for so-called blond Japanese managerial types to run our businesses: if we could only foster entrepreneurs who could import Japanese business practices to our Scandinavian environment, and if our policy makers could only imitate the apparently very sophisticated and successful Japanese industrial policies, we should be able to replicate the strong performance of the Japanese economy – or so many people thought. Then enthusiasm for Japan evaporated with the bursting of the enormous Japanese real estate bubble in 1989–1990 which has left the country in the quagmire of economic stagnation for more than two decades now.

As the world gave up Japan as a role model for economic development, the good economic performance of the American economy during the 1990s led many observers to argue that the US economic and social model was highly fit for an era of intensifying global economic competition. But after the bursting of the dot.com stock market bubble in 2000 and the meltdown of the US financial system in 2008, it has become somewhat harder to believe in the strength of the *laissez-faire* oriented US model.

In Europe there was a lot of focus on the booming Dutch economy during the 1990s. Policy makers from other countries were flocking to the Netherlands to study the secrets of the so-called Dutch Miracle, hoping to be able to reproduce the miracle at home. But at the turn of the millennium the Dutch economy had become strongly overheated, so the economy was already starting to turn down when it was hit by the global recession of 2001. The Dutch economy had to struggle for several years to recover from this bust.

In their never-ending quest for miracles, international observers now turned their eyes on Ireland, a country which for a long time had produced truly spectacular rates of economic growth. Unfortunately the Irish growth model ended up relying on a credit-driven real estate bubble which was no less spectacular, and we all know how the Irish story ended.

For a while during the last decade, Denmark also enjoyed some popularity for our so-called flexicurity model of the labour market. The flexicurity model seemed to combine a low level of unemployment with a high degree of equality and social protection. But regrettably, we Danes repeated the mistake of the Dutch and allowed our economy to overheat in the run-up to the financial crisis, and so we were more vulnerable when the crisis struck. With the sluggish performance of the Danish economy in the aftermath of the crisis, we are no longer so interesting to foreign observers.

Instead, the revitalization of the German economy has created a renewed interest in the German economic and social model, often referred to as the social market economy. The rehabilitation of Germany as an economic role model is remarkable, considering that the German economy was widely believed to be quite weak only a few years ago.

The point of these observations is that international perceptions of the strengths and weaknesses of different social models appear to be highly dependent on the ups and downs of the business cycle. For a long time, the structural weaknesses and underlying imbalances in an economy can be hidden by an economic

boom, but they suddenly stand out clearly when the business cycle takes a serious downturn. In retrospect it always seems easy to see the flaws of an economic and social model that has suffered a set-back, but diagnosing its vulnerabilities ahead of time is usually a lot more difficult. Think of the recent financial crisis: by now we economists have come up with a lot of good explanations why it occurred, but very few of us saw the crisis coming. This should make us humble when we try to identify the most competitive social models.

What do we mean by a 'competitive' social model?

Why are scholars, policy makers and journalists so keen to study alternative social and economic models? Obviously because they hope to learn some economic and social engineering that can be used to improve their own societies. However, a trivial though very important point is that policies and social structures that seem to work well in one country are often very difficult if not impossible to replicate in other countries. National economic and social policies are developed in a local context conditioned by the country's historical and cultural traditions and specific deep-rooted institutions. Moreover, policies are often complementary: the success of a specific policy may depend on whether other supporting policies are in place.

But although one country's successful policies are often difficult to transplant to other countries, it is still interesting to discuss which economic and social policies are likely to be most competitive in today's globalized economy. For this purpose I must explain what I mean by the 'competitiveness' of a social model. An individual business manager might say that a national economic and social environment is 'competitive' if it allows his or her business to survive and grow in the global market place, provided he or she is no less competent than the average manager of competing foreign firms. From a broader social perspective it is less obvious how one should define and measure the competitiveness of a social model. Any definition will be somewhat subjective, since it involves ideas about the good society about which opinions are bound to differ.

Nevertheless, I would argue that a country's economic and social model is 'competitive' if it allows its citizens to share the benefits from globalization in an equitable manner. There are several aspects to this definition. First, there are net benefits to be shared: globalization is not a zero-sum game. This may seem trivial to this audience, but the public debate often leaves the impression that if some countries benefit from globalization, others are bound to lose. This is of course wrong: globalization allows all countries to benefit from trade and specialization.

Second, my definition of competitiveness acknowledges that while a country as a whole will gain from participation in the international division of labour, globalization certainly has the potential to create losers as well as winners within the country. After all, international trade and capital flows often induce changes in the relative prices of goods, capital and labour, and these relative price changes imply a redistribution of market incomes. The Portuguese consumers of textiles imported from China or India will benefit from cheaper goods, but the competition from abroad may mean that Portuguese textile workers must either take a real wage cut or face unemployment. The challenge for policy makers is to carry out economic and social policies ensuring that all citizens receive a fair share of the gains from globalization. In my example, this may mean that the government should help the Portuguese textile workers to upgrade their skills and/or help them find employment in other sectors. More generally, a competitive social model is one that avoids the counterproductive social conflict and low social mobility that often comes with a highly unequal distribution of income.

A third requirement implicit in my definition is that a competitive social model should enable the country's average living standard to grow at a rate that is at least comparable to the trend growth rate of other countries at a similar level of development. I realize that this requirement may be challenged by raising the philosophical question whether economic growth in rich countries actually makes their citizens happier. However, just as people tend to become frustrated if they see their income lag behind that of their fellow citizens within the country, they also tend to become dissatisfied if they see their living standard fall relative to that of citizens in similar countries with whom it is natural to compare themselves. Hence it does not seem unreasonable to say that a country has a competitiveness problem if it experiences a subnormal economic growth rate for an extended period.

Are the economic and social models found in Europe 'competitive' in the sense I have described? In discussing this issue, it may be useful to take a brief look

at the Chinese and American social models since competition from these countries is often seen as a threat to the European welfare states.

The Chinese model

Any attempt to characterize the Chinese social model is inherently problematic since today's Chinese society is a vast and complex organism displaying many contradictions and paradoxes. Although the strategic industries are controlled by the allegedly Communist state, many parts of the Chinese economy look like a ruthless version of 19th-century Klondyke capitalism.

Arthur Kroeber (2008) has argued that China's bureaucratic culture is what distinguishes the country from much of the rest of the developing world. According to Kroeber, China's 'bureaucratic authoritarianism' builds on a long historical tradition of governing the country through a loyal and relatively competent civil service. Despite the many stories about corruption, Kroeber argues that China's economic success stems to a large degree from the country's skillful bureaucracy.

China has been good at combining an abundance of cheap labour with Western technology to mass produce manufactures for the world market. It follows from what I have already said about the benefits of international trade that Europe and other parts of the advanced world should welcome the entrance of countries like China and India in the global economy. Adapting to the new patterns of world trade may require some restructuring of the European economy, but European consumers undoubtedly benefit from the cheap goods imported from Asia.

Yet there is at least one aspect of the Chinese economic model which may be problematic for the rest of the world. China saves an abnormally high share of its national income, leading to a massive capital export that is reflected in large current account deficits in many other countries, the United States being the prime example. If the Chinese surplus capital were systematically channeled into high-yielding productive investment in other countries, it would be all to the good. But unfortunately historical and recent experience shows that large and persistent current account deficits often lead to the accumulation of unsustainable piles of private and public debt which end up triggering a financial crisis and/or a sovereign debt crisis. Of course, it takes two to tango, so the Chinese are not the only ones to blame for the current account imbalances which rose to unsustainable levels in the run-up to the recent financial crisis and which are now building up again. Irresponsible macro policies and regulatory failures in the advanced economies are the other side of this problematic coin. Still, if we are to reduce the global imbalances that threaten the future stability of the world economy, the big Chinese savings surplus must come down.

The high household savings rate in China seems to have deep historical and cultural roots, but in part it may also reflect the absence of a well-developed public social safety network. Despite its allegedly communist foundations, the Chinese government has not managed to establish welfare programs securing sufficient public support for the elderly, the sick, the disabled and the unemployed. Hence Chinese households must undertake large precautionary savings for a rainy day. Establishing such public welfare programs would not only seem to be in the interest of the ordinary Chinese citizen; it would also help to bring down the large Chinese savings surplus, thereby contributing to a much needed rebalancing of the world economy.

In summary, copying the Chinese economic and social model or just parts of it seems neither possible nor desirable. On the contrary, China and the rest of the world would probably benefit if the Chinese imported some of the European welfare state practices.

The US model

Before turning to Europe, let me also offer a few remarks on the *laissez-faire* oriented American economic and social model. As I mentioned, many observers saw the dynamism of the US economy during the 1990s as proof of the superiority of the American model. Subsequent events have exposed some less flattering aspects of the US economic system. The American model is now in trouble, struggling to recover from a devastating financial crisis and with a sovereign debt crisis looming in the horizon. Yet history shows that one should not underestimate America's ability to reinvent itself. The strength of the US economy is its capacity to innovate, and perhaps that capacity will serve as a basis for a new era of prosperity once the current debt problems have been overcome.

However, as I see it, a major weakness of the American economic and social system is its inability to halt the long-lasting trend towards greater inequality in the distribution of income and wealth. Former IMF chief economist Raghuram Rajan (2010) argues that the irresponsible loosening of credit conditions in the run-up to the financial crisis was due in large part to pressure from politicians who were looking for a quick and easy fix to the problem of stagnating or falling real incomes for the poorer segments of the US population. Rajan points out that the US educational system has failed to upgrade the skills of a large part of the American work force to the requirements of an advanced knowledge-based economy. Hence many American workers face falling real wages and poor employment opportunities. For them the American Dream is increasingly unlikely to ever come true. Yet politicians insisted that even people who could not afford it should be granted credit to buy their own home. We all know how this subprime story ended.

Of course there were many other forces at work in the build-up to the crisis, but Rajan's story reminds us that large and growing inequalities may threaten the stability of an economic and social model. Rajan believes that the US government needs to spend more money on improving its educational system and on active labour market policies to reverse the trend towards growing inequality. Other observers argue that the American government should spend more on infrastructure investment and on environmental protection. All of this will require more public revenue, just as it is hard to see how America can solve its public debt problem without raising additional tax revenue. From an outsider's perspective, this should not be difficult. The US tax level is relatively low by international standards, and if the country were to return to the far from punitive level of income taxation prevailing during the Clinton era, a large part of the fiscal gap would be closed. Further, the United States is the only OECD country that does not have a value added tax; it does not have a carbon tax and its gasoline tax is way below any reasonable estimate of the external cost associated with fossil fuel consumption.

Yet the current majority of the US Congress seems determined to avoid any kind of tax increase, even if it takes the form of closing obvious loopholes in the tax code. But let us not be too pessimistic. As Winston Churchill once said, you can always rely on the Americans doing the right thing, once they have exhausted all other possibilities.

European welfare state models

The US economic and social model is sometimes held out as an example of the so-called residual model of the welfare state. In its pure version, a residual welfare state is characterized by a relatively small public sector, a limited degree of redistribution of income via the public budget and welfare programs which are systematically means-tested and targeted towards low-income groups.

The continental European welfare states come in different varieties, but scholars often group them into two broad categories, although no individual country falls squarely into any of these two categories. One category is referred to as the 'universal' model because it offers various social security transfers and key social services such as education, health care, child care and care for the elderly to all resident citizens regardless of their labour market status. This model involves a large public sector and a high degree of redistribution financed by general tax revenues. It is based on the philosophy that people in social need should be supported by the public sector regardless of the ability of their families to support them. The Nordic countries are usually seen as coming close to this way of organizing a welfare state.

Another archetypical European social model is the Bismarckian or labour-market based welfare state. In this system you earn your right to social security benefits by participating in the labour market. Hence benefits are tied to social security contributions, and needy individuals with little or no attachment to the labour market are supposed to be supported by their families. Families are also given a key role in the production and financing of child care and care for the elderly. Since social security benefits may well be high, the public sector is not necessarily small in a labour-market based welfare state, if you include social security contributions in your measure of public revenue, but the degree of income redistribution is less than in a universal welfare state. Germany is often quoted as an example of a Bismarckian welfare state.

In practice countries do of course mix elements from the various theoretical welfare state models. For example, in Germany needy citizens are entitled to some amount of unemployment benefit and social assistance benefit even if the benefits are not matched by prior contributions. As another example, although the Danish pension system offers a universal flat public retirement benefit on a pay-as-you go basis, an

important second pillar of the system consists of the occupational fully funded pension schemes based on contributions from employers and employees. In this way the Danish pension system combines elements of the universal and the labour-market based model of the welfare state.

Some years ago when the ongoing process of globalization caught the attention of social scientists, it was quite common to argue that the growing international mobility of capital and labour would gradually force the European welfare states in the direction of the residual Anglo-Saxon welfare state model. The idea was that countries with a high level of taxation and redistribution would induce capital and high-income earners to flee the country while attracting low-income earners relying on public transfers. In this way the public finances would be systematically eroded, ultimately forbidding an ambitious welfare state policy.

There was also a widespread belief that a welfare state of the Bismarckian type would be more robust to globalization than the universal welfare state because the Bismarckian model involves less redistribution. Yet the experience of recent decades is that the Nordic countries have performed relatively well in economic terms and that globalization has not forced them to dismantle the key elements of their welfare states. In the final part of this talk I will offer a few observations on the likely reasons for the relatively good performance of the Nordic model.

The Nordic model: strengths and vulnerabilities

How is it possible for the Nordic countries to maintain such high levels of taxation and redistribution without seriously undermining the economic incentives to work, save and invest? One simple reason is that the Nordic governments have managed to keep the bases for their income and consumption taxes quite broad by international standards. This helps to keep marginal tax rates down. Moreover, the Nordic so-called dual income tax combines progressive taxation of labour income with a low flat tax rate on capital income, thereby reducing the incentive for capital flight.

The expenditure side of the Nordic welfare state budgets also helps to broaden the tax base by encouraging female labour force participation. Given the generous public provision of day care and care for the elderly and the sick, women have been freed from many of their traditional duties in the home and have found more time to participate in the formal labour market where the income they create are part of the tax base. To a large extent the production of public welfare services involves paying women to carry out the same kind of work which they previously performed for free at home.

Some critics have argued that the high rates of employment in the Nordic countries simply reflect an overexpansion of the public sector. According to this view the Nordic countries have managed to keep unemployment low only by offering an increasing number of low-productive public sector jobs to pick up the growing slack in the private demand for low-skilled labour. This is the so-called 'Scandinavian trick': instead of paying out unemployment benefits, the Nordic governments offer the unemployed a public sector salary along with a desk from which they can carry out their low-productive work.

I do not deny that you can find examples of low-productive public sector activity in Scandinavia, as elsewhere. But I don't think the theory of the Scandinavian trick provides the main explanation why the Scandinavian countries have managed to keep unemployment relatively low even among the unskilled. The fact is that public sector employees in the Nordic countries tend to be relatively well educated. In Denmark, with which I am most familiar, the average public sector worker has a higher level of education than the average private sector worker.

I rather like to think that the relatively low unemployment rates in Scandinavia are to a large extent a payoff from the Scandinavian labour market policies. The Danish so-called flexicurity model is often mentioned in this context. The flexicurity model combines liberal rules for hiring and firing with relatively generous unemployment benefits and an active labour market policy. The active labour market policy in turn combines generous public spending on adult education and training with tough demands on recipients of unemployment benefits to search actively for work even if that involves crossing geographical or occupational boundaries.

The flexicurity model is often portrayed as an implicit social contract between employers, employees and the state. Employers benefit from the liberal hiring and firing rules. Employees and their trade union representatives accept a low degree of formal job protec-

tion because the state offers a decent level of unemployment compensation and helps people to qualify for a new job by offering additional education and training, if necessary.

This description paints a rather harmonious picture of the flexicurity model. I do believe there is some truth in this vision. However, Danish economic research suggests that government training programs for the unemployed are not in themselves very effective in getting the unemployed back to work. On the other hand, a lot of research indicates that the tough demands on the unemployed to either find a job or to enroll in an active labour market program provides a strong incentive for many people to find work *before* they are recruited for some program activity in which they are not interested. In other words, the strict requirement that the unemployed be active in one way or the other seems to be an important reason for the success of the flexicurity model.

The flexicurity model does seem to facilitate reallocation of labour towards more productive uses. At least it is a fact that the rate of labour turnover in the Danish labour market is high, and the incidence of long-term unemployment is low by international standards. More generally, it appears that the extensive social safety nets and the active labour market policies of the Nordic countries have helped to ensure popular acceptance of the economic restructuring that comes with globalization. The Nordic countries have a long tradition of supporting free trade and have been good at adapting to the recent changes in the international division of labour.

However, the Nordic welfare state is based on a high level of taxation and extensive public intervention in many important aspects of life. The broad acceptance of this social model may be due to the fact that the Nordic countries have small and homogeneous populations. Historically these countries have therefore been able to foster a degree of solidarity and trust among citizens which may be difficult to replicate in larger and more diverse societies.

The Nordics do not have any historical experience with immigration on a significant scale, and that may be one reason why populist political parties with an anti-immigration platform have recently gained ground in the Nordic countries. But apart from the cultural aspects, there is also an economic challenge here: a large fraction of recent immigrants to Scandinavia come from backgrounds with no tradition of female labour force participation and with low education levels that are hard to square with the high wages paid for low-skilled labour in Scandinavia. Hence these groups are hard to integrate into the Nordic labour markets. The problem is that maintaining a high employment rate is key to the fiscal viability of the Nordic social model.

More broadly, increasing international factor mobility does pose significant challenges to the universal model of the welfare state where all residents are entitled to transfers and public services regardless of whether they have contributed to public revenue or not. Population ageing will also put growing pressure on the Nordic public finances, and dealing with this challenge in countries where the level of taxation is already very high will not be easy. Yet I take comfort in the fact that the Nordic countries have so far been quite good at implementing politically difficult economic and social reforms without throwing the welfare state baby out with the bathwater.

References

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Panel

The Chief Economics Commentator of *The Times,* **Anatole Kaletsky** chaired the first panel and began by describing how capitalism has evolved historically in response to new situations. As a reaction to the current crisis, a new model of capitalism may emerge with a new system of checks and balances between the market and the state where each exerts a disciplining force on the other. Europe, in his opinion, is well placed to lead the thinking for this new form of capitalism.

The first panel statement came from the Bavarian Finance Minister, **Georg Fahrenschon,** who outlined the basic principles of the social market economy. (1) Fair competition: supply and demand should be determined by prices and markets, not by government intervention. This encourages companies to improve their competitiveness. (2) Social equilibrium: a social market economy combines economic efficiency with social responsibility. It was

Germany's social safety net that helped it cushion the effects of the last crisis. Still, too much redistribution is detrimental to economic incentives. This right balance must be found. (3) Subsidiarity: the focus is on the individual; the state sets the ground rules, pursuing an 'active and activating economic policy'. In the last crisis, economic stimulus and stabilisation programmes were necessary, but they "must not mutate into permanent measures". (4) Self-responsibility: everyone must bear responsibility for their own action. Risk and responsibility are inseparable, for individual as well as for institutions. (5) Subsidiarity: 'long-term development instead of short-term success, enduring values instead of quick profits' should be the guiding principle of all businesses. One reason Germany quickly overcame the crisis was the sustainable practices of its many small and medium-sized businesses. These principles of the social market economy can be adopted by other countries and adapted to their individual requirements.

Martin Wolf, Chief Economics Commentator of the *Financial Times,* stressed that the differences among the various economic models – Anglo-Saxon, Social Market, Nordic, Southern European or Asian – should not be exaggerated. The UK economy, for example, conforms less to the Anglo-Saxon model; it is much more like continental Europe, 'in all the bad ways'. In terms of the share of public spending in GDP, Britain is very solidly in the European pack, the United States is approaching the Europeans and France is ahead of most Nordic countries. In terms of borrowing, however, the Anglo-Saxon countries are far in the lead, which does, on the other hand, contribute to the dynamism of German export markets. There is also no real difference among the models with regard to long-term performance. Also when looking at what happened in the crisis, "GDP and unemployment performance in the crisis is not model-specific". In terms of GDP, the US economy was the most resilient in the crisis and Britain performed miserably. In terms of unemployment, it doubled in the United States and productivity soared. "Britain had a very modest unemployment increase despite a GDP catastrophe", which implies that it has a very continental labour market. "The United States is out there on its own with a properly functioning labour market", and it may benefit from this in the long run. All this calls into question the existence of an Anglo-Saxon economic model.

Michael Hüther, Director of the Cologne Institute for Economic Research, listed some of the factors that helped the German labour market overcome the crisis so successfully: the moderate wage policies in the late 1990s, the recent labour market reforms, and the short-time working subsidisation scheme, all of which helped stabilise employment in Germany and put firms in a position to step up production quickly. He went on to comment that despite the converging trends brought about by globalisation and system competition, "key areas of economic activity … follow very strong national patterns and structures". However, a country's institutional arrangements are only sustainable if they are sufficiently flexible and responsive.

Neo Boon Siong, Nanyang Business School in Singapore, provided the Asian perspective on the panel topic. His government has always regarded economic growth as the key to solving social problems. After stagnant growth during the crisis, Singapore has returned to high-level growth, largely due to its flexible response to changes in the world economy. Given its small size, the country is dependent on its human capital. It is highly connected to the rest of the world and has created a business-friendly environment. The financial reserves it had built up helped it overcome the crisis. During the crisis, labour was subsidised for the first time and unemployment did not exceed 4 percent. The government also guaranteed a portion of bank loans in the crisis without intervening in banks' market decisions. Finally, Singapore's social safety net is constructed in such a way that the work ethic is not eroded.

In the discussion, **Elmar Brok,** Member of the European Parliament, pointed out that important decisions need to be made at the *European level* in three areas: (1) stricter control of national budgets, (2) a more effective stability programme and (3) improving the competitiveness of the EU countries.

Barbara Judge, Chairwoman of the UK Atomic Energy Authority, raised the question of the extent to which the female labour participation rates are a success factor of the Nordic economies, especially in the light of shrinking work forces. Anders Borg agreed that this is a factor and stressed the structural reforms in Sweden that have given women incentives to enter the labour market: eliminating family taxation, almost cost-free child care, an autonomous pension system that encourages working and a cost-effective health-care system.

Hans-Werner Sinn wondered whether Sweden's success was because it turned away from the Scandinavian model, and also why the government sector is so large in the Nordic countries. Is this not a form of hidden unemployment? Anders Borg argued that Sweden has not abandoned the model but has reformed it, keeping its core values: high labour market participation rates, limited income inequality, gender equality and openness. The reforms have placed an emphasis on welfare services, which are more efficient than economic transfers. Peter Birch Sørensen addressed the problem of the 'Scandinavian trick' of a large public sector to maintain a high level of employment. Many public sector employees are women working in the area of social services, performing tasks that were once unpaid. Theoretically, this work could be privatised and receive a government subsidy, thus reducing public-sector and increasing private-sector employment. The effect would be the same.

Michael Fabricius, Managing Director of Fabricius Vermögensverwaltung GmbH, expressed the concern that self-reliance is being weakened in Europe and that too much responsibility is being transferred to the state. He asked how Sweden managed to get the balance right between government responsibility and leaving room for entrepreneurship. Anders Borg replied that Sweden's competitiveness is ranked fairly high although the country is weak in entrepreneurship. His government has tried to improve the situation of ownership by lowering taxation. "Ownership is one of the key links to entrepreneurship" and it is a mistake to tax it too much.

Neo Boon Siong cautioned that competiveness should not be looked at in terms of Europe alone to the neglect of the dynamism of the market economy that is developing in Asia. Since the private sector behaves globally, it is necessary to view the competiveness of European companies and countries in the light of the global environment.