# The Strength and Weakness of the European Social Model

Padraig Flynn

WITHIN THE EUROPEAN UNION, THE German economy was the star performer for many years, achieving consistently high living standards and low levels of unemployment, particularly among young people. Structural features of the German political economy—its industrial relations, education and training systems, technology-transfer arrangements, and methods of providing finance for business—are widely admired. They are not all seen as transferable to other member states since they are built on particular institutional arrangements. Nevertheless, elements of the German system—for example, its apprenticeship and youth-labour-market arrangements—have inspired the systems of other member states.

In terms of macroeconomic policy, the strong economic integration in Europe and the deregulation and internationalisation of capital markets have led all EU member states to accept the German concept of low inflation as one of the keys to economic growth and prosperity.

Over the past few years, however, German unemployment has risen sharply. Now we are being encouraged by some to believe that the German economic model is close to collapse—notably under the weight of its highly developed system of social protection. In such views, nothing short of wholesale cutbacks in social provisions, the dismantling of its wider social arrangements, and the extensive deregulation of its markets will enable Germany to regain anything of its former glory.

*Social Affairs Commissioner, European Commission, Brussels, Belgium.*

This, in turn, has led some opponents of the "European social model" to claim that, if Europe's strongest economy can no longer afford an extensive social-welfare system, then Europe as a whole certainly cannot. They commonly argue for a shift toward more private, rather than public, provision.

Despite the frequency with which these arguments against Europe's extensive social-welfare system are made, there has been a dearth of serious supportive analysis or evidence. We need to ask some basic questions. First, has the German economy suffered any serious long-term deterioration in its performance or potential? Or is it facing difficult, but surmountable, short-run problems? Second, have exceptional circumstances—in particular, unification and the additional arrival of large numbers of refugees, ethnic German and others—been a significant factor leading to current difficulties? Or have they simply exacerbated an already existing problem? Third, are solutions to Germany's and Europe's employment difficulties to be found mainly in changes in our social policies? Or are they to be found more in changes to our economic policies?

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I argue here that Europe's problems—which are not to be easily dismissed—are not due to over-developed *social* policies, but rather to under-developed and fragmented *economic* policies. And it is the latter rather than the former that explains much of the different labour-market performances of the United States and Europe over the past two decades. There is some optimism, however, that the June 1997 Amsterdam Summit will spur employment policies in the EU. The political commitments and operational mechanisms agreed at Maastricht and Amsterdam will enable us to generate long-term growth and exploit the employment potential in the European economy.

## Reviewing Some Evidence

Assessing the state of Germany's economy, and to what extent its problems can be attributed to the plethora of social programmes, requires an examination of three key pieces of evidence: German unemployment, the impact of unification, and expenditures on social welfare. I shall deal with these in turn.

• *The Rise in German Unemployment.* Unemployment rates in Germany have averaged 2-3 percentage points below the EU average for the past 20 years—under 3% compared with the EU average of 5.5% in 1980, and under 5% compared with the EU average of 7.7% in 1990 (see Figure 1). Youth unemployment rates, in particular, have been between a third and a half of those in most other countries of the EU. At the time of unification, unemployment in West Germany had been falling steadily from its 1985 peak of over 7%, reaching a low of slightly over 4% by 1991.

The investment boom which followed unification was expected to maintain the employment momentum. This was short-lived, however, and the subsequent recession was severe, reversing the downward trend in unemployment. Small increases in 1992 were followed by larger increases, taking unemployment back to over 7% by 1996. Seasonal unemployment was particularly high in the winter of 1996.

Though the current level of unemployment in western Germany is high by German standards, it remains well below the levels currently experienced by France, or those of the UK in 1992 and 1993 when unemployment exceeded 10%.

• *The Economic Impact of Unification.* Unification would have involved far greater social and economic stress in the absence of the German system of social programmes. Indeed, while some of the economic decisions that were made at the time of unification have been subject to considerable criticism within Germany, it is difficult for outsiders, like myself, to envisage how unification could have been attempted without the German system of social solidarity.

At the time of unification, differences between West and East German living standards were very large. The income gap has now been substantially reduced. By 1995, wages in eastern Germany had risen to over 70% of western levels. Households' living standards (in terms of purchasing power) had increased to 85% of those in western Germany. Part of the improvement in living standards in eastern Germany has been due to improvements in manufacturing productivity. In 1991, manufacturing productivity in the East stood at only 20% of western German levels—by 1995, this figure had risen to over 50%. But subsequent productivity improvements have been slow, and the East remains heavily dependent on transfer payments from the West to sustain even modest growth in living standards. Each year, beginning in 1991, western Germany has made net *annual* transfers to the East of roughly DM 150 billion. Such transfers amount to only 4.5% of western German GDP, but currently account for over 40% of eastern German GDP.

German trade unions negotiated substantial nominal wage increases in the early 1990s—5% in 1990, 6% in 1991 and 6% in 1992. Workers demanded these increases partly in response to a range of tax increases implemented to help finance the transfers to the East. Companies agreed to these increases because profits had been steadily increasing, a trend that was expected to continue. The Bundesbank then raised interest rates in order to slow the overheating economy. By 1993, the economy had been pushed into recession with output in western Germany falling by nearly 2%. Wage inflation declined sharply but interest rates were reduced only slowly. Meanwhile, the German recession—engineered by a monetary contraction and the resulting high interest rates—spread to other member states participating in the Exchange Rate Mechanism (ERM). The widespread slowdown in economic growth was compounded by the effects of member states simultaneously imposing tight fiscal policies in an effort to meet Maastricht's fiscal conditions.

**FIGURE 1**
**European, West German, and US Unemployment Rates**

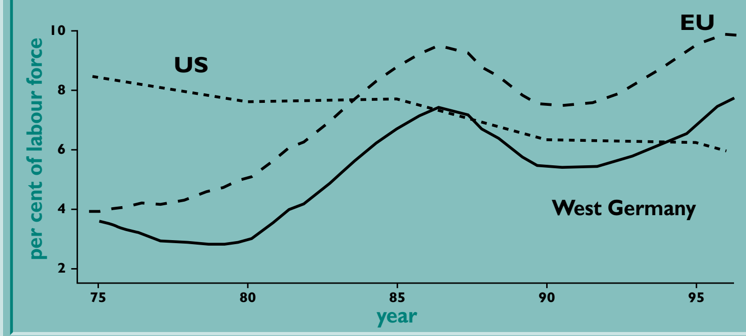
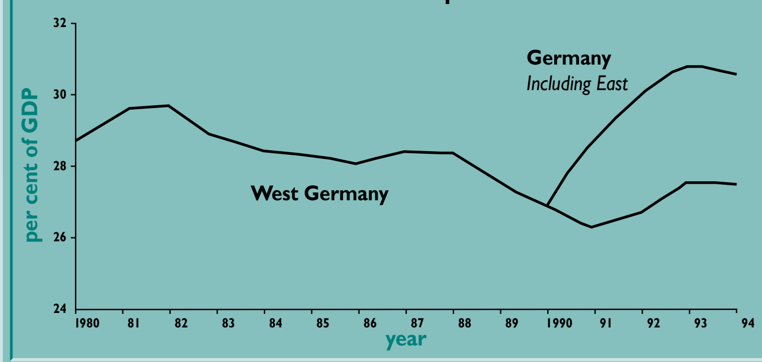



**FIGURE 2**
**Social-Welfare Expenditure**




• *Trends in Social-Welfare Expenditure*. The argument that the increase in unemployment after 1991 was somehow the consequence of increased expenditure on social welfare, and that this has been making the German economy progressively less competitive, is not supported by the facts. From 1980 to 1990, the scale of social expenditure in West Germany actually declined, from 29% of GDP to 27% of GDP (see Figure 2). Yet, referring back to Figure 1, it is clear that unemployment in West Germany actually increased from 1980 to 1990. This would suggest—if anything—the opposite relationship between unemployment and social-welfare expenditures.

The increase in German social expenditure—to over 30% of GDP today—was primarily the result of unification. This was necessary in order to cover the direct costs of additional transfer payments to the East, and to finance the cost of the increasing in unemployment in the West. The unemployment, however, was not *caused* by the social expenditures; it was the result of the recessions engineered by central banks who successfully fought inflation. Similar increases in unemployment were evident in all such countries.

## There are Still Strengths

Whatever problems Germany may have, dwelling on them risks ignoring some of Germany's strengths, and there are some significant ones to keep in mind.

• *Competitiveness*. Contrary to some arguments presented in the popular press, the German economy does not have a fundamental competitiveness problem, any more than does the European Union as a whole. Germany has stable real unit labour costs—this means that productivity gains are keeping pace with increases in real wages. In terms of cost competitiveness, the economy is in the same position as it was at the beginning of the period of exchange-rate stability following the Louvre Accord in the mid-1980s.

Over the past decade, Germany's manufacturing sector has experienced some deterioration in its cost competitiveness. But this deterioration has not appeared to affect Germany's performance in world trade. This is commonly attributed to any cost disadvantage being offset by the quality advantage that German industry retains, reflecting its high level of investment, its strengths in niche markets, and its capacity to innovate.

• *Investment*. By historic standards, investment rates in the European Union are relatively low, although they are higher than in the United States. Germany, however, has continued to invest at an above-average rate of 21% relative to GDP (compared with an EU average of 19%).

Due to its high rates of investment in plant and equipment, the German economy is structurally very strong. Germany also has high levels of human-resource skills, notably at the middle and lower ends of the labour market. These differences are being perpetuated by new entrants into education and the workforce; 95% of 16-18 year-olds and 55% of 19-21 year-olds are participating in education.

• *Low Labour-Force Participation*. Despite western Germany's relatively low unemployment rate, Germany does have a low *employment* rate. This is commonly attributed to the existence of the generous social-safety net which allegedly creates disincentives to work. But it is important to keep in mind that low employment rates are entirely consistent with low unemployment rates, so long as labour-force participation rates are also low. Low labour-force participation is indeed a long-standing feature of the German labour market, partly reflecting low, although rising, levels of female activity. This is related to cultural factors, including the existence of part-day schooling, and the fact that a very high proportion of people under 25 are in education or training and thus have little or no labour-force attachment (though they presumably will have when their training is completed).

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Moreover, and most significantly, when the employment rates of different European countries are corrected for the extent of part-time working—that is, when the employment rates are expressed in terms of full-time equivalents—the gap is significantly reduced. For example, the gap in employment rates between Germany and the UK is reduced from 6 to 2 percentage points. Furthermore, when workers under 25 years of age are excluded from the comparisons, the difference between these two countries' employment rates falls to under 1 percentage point.

### Europe's Main Problem

The debate over German unemployment has led some commentators to question the competitiveness of Europe as a whole. In fact, Europe is competitive on any criteria that makes economic sense. We have low and stable inflation—a little over 2%—that has created a positive and predictable environment for business. We have steady productivity growth of 2% per year—considerably faster than in the US, steadily narrowing the real income gap between us. Our businesses have declining unit labour costs, and are experiencing the highest levels of profitability in 35 years.

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Europe's problem is not that our economies are weak, or even that our budgets are fundamentally unbalanced—3 or 4 years of economic growth, in the range of 3%, should balance our public budgets. The basic problem in Europe is that our competitive success—reflected especially in our productivity performance—has not been matched by the necessary economic policy management to ensure that our potential resources are fully employed.

Europe's persistent unemployment is not the consequence of over-developed social policies, although many should, and are being, reformed. It is instead the result of under-developed and fragmented economic policies, as well as insufficient investment in human resources. The very success of Europe's Single Market—which has allowed the trade among its members to double over the past 20 years—has highlighted the growing problems arising from having economic policies based on the old concept of fragmented national markets rather than on the reality of the Single European Market.

This is reflected in the different fates of Europe and the US during and after the major recessions of the 1970s and the early 1990s. In the US, the policy guidelines and instruments of countervailing action exist in order to respond to prolonged recessions or booms. The US central monetary authority, the Federal Reserve, is obliged to pursue both full employment and price stability. And the Fed appears to have used its influence with increasing effectiveness in both respects.

In contrast, Europe has lacked such a framework. We have had 14 separate currencies and only a loose commitment to economic policy co-ordination. The result? The US has recovered rapidly after each recession, Europe has not. Without the means to manage common action, European recovery has been slow. And each recession has left a legacy of high, and increasingly structural, unemployment.

The paradox is that most commentators never cease telling us that we should learn from the US with its flexible labour markets. On the contrary, I believe that we can learn much more from the US in terms of economic policy management than in terms of labour-market policies and social-policy design. The former has enabled the US to maintain a high level of employment. The latter has led, directly or indirectly, to costly social problems that Europe has more successfully avoided—something that Robert Reich, for one, had always been willing to acknowledge when he was the US Secretary of Labour.

## Amsterdam and Maastricht: The New Opportunity

Europe now has the opportunity to escape its own policy "traps"—to emulate the positive aspects of US employment performance while maintaining the inherent strength of the European social model. The recent Amsterdam Summit in June of 1997—wrongly played down by some—was a watershed in this process of European policy-making. The new European Treaty has put employment "centre stage", alongside the other criterion of success—price stability. It has created an opportunity to shape the long-term growth and employment potentials of the European economy.

Two phrases from the Treaty tell it all. First, "Member states ... shall regard employment as a matter of common concern and shall co-ordinate their action." Second, "The objective of a high level of employment shall be taken into consideration in the formulation and implementation of Community policies and activities." The identification of employment as "a matter of common concern" reflects awareness of the interdependence of the EU's member states. If one country, in an attempt to stimulate output in its own economy, resorts to a competitive devaluation, distortionary industrial subsidies, or a weakening of labour standards, this will adversely affect job prospects in all other member states.

The aim of the Treaty goes further than just stopping bad behaviour; it aims to promote a positive-sum game in economic and social policy from which all EU members will benefit. Amsterdam, with Maastricht, gives us the tools and policy guidelines we need to ensure the long-run growth and development of employment in the European economies.

Two political consequences follow. First, full monetary union, scheduled to go ahead in January 1999, can no longer be seen as some kind of "optional extra". It is the necessary counterpart to the emergence of an increasingly integrated European economy, in which national economic policies lose much of their force if exercised alone. Second, monetary union, though necessary, is not sufficient. Our objective must be full economic and monetary union, with effective and positive co-operation and co-ordination of national policies and objectives, including employment policy.

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## Still Room for Reform

Though weaknesses in economic policy have been the root cause of Europe's unemployment, it is the inadequacies in our social-protection and labour-market systems that have often been responsible for the serious problem of *long-term* unemployment. Too little emphasis on *employability* policies—such as low-wage employment subsidies—and too much emphasis on unemployment insurance and other income-maintenance schemes—both of which introduce serious disincentives to working—has weakened our capacity to adjust.

We need to modernise not only our economic policies, but also our labour-market policies and social-protection systems. But reform and modernisation do not mean wholesale deregulation. Contrary to the rhetoric, deregulated labour markets do not produce higher levels of employment than well-regulated ones. They tend to reduce standards. They widen the income spread between richer and poorer members of the workforce. They reduce overall levels of productivity-enhancing investment in people and capital.

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Well-regulated labour markets are as essential to long-run economic success as are well-regulated product or financial markets. They enable entrepreneurs to create jobs, just as much as they enable workers to equip themselves for changing demands for skills. They also help to create the essential precondition for economic and social well-being: a skilled, flexible, secure, and mobile workforce.

To achieve this, the regulatory framework cannot remain static in a changing world. We must reconcile the flexibility which firms need with the security which workers require. This is the key to bringing our success as productive economies and societies into the new century. In the new, more fluid, labour market, the need for security will not diminish. But its purpose and its form needs to change in order to serve, and help create, a more dynamic labour market and economy.

An important part of this emerging economy must be a stronger focus on social-protection systems, employability, and access to skills. And, just as important, labour law, and the collective arrangements governing future working patterns, must offer recognition to new forms of working conditions and contractual arrangements.

We in Europe see economic and social policies as part of an integrated and comprehensive strategy for raising living standards for all. Actions must be pursued within a framework of supportive macroeconomic policies. They must be backed up, however, by institutional reforms, creating national labour-market institutions and social-protection systems that are "employment friendly".

That is the challenge facing Europe as it prepares for EMU. It is one for which all member states are politically prepared and committed. We have lacked the machinery to turn that potential into action. The necessary reforms are now being put in place, and they will enable us to put Europe onto the policy high-road leading in the direction of sustainable full employment. ◆