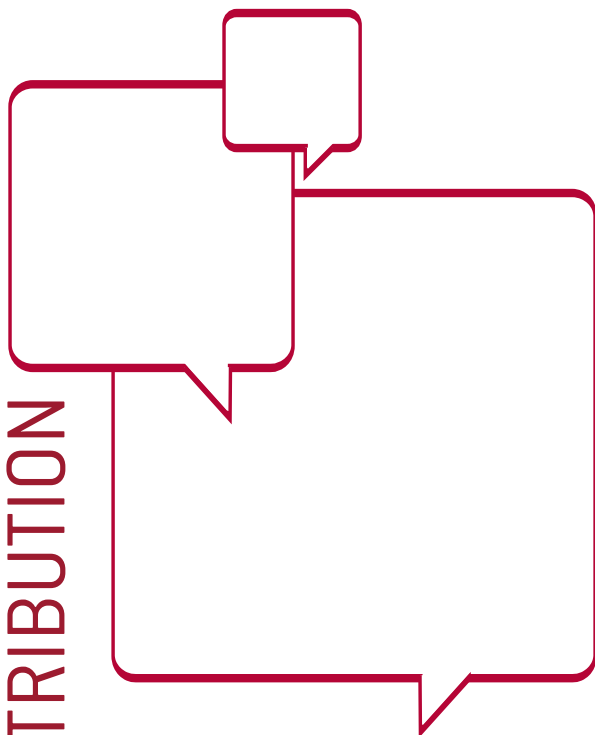


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GLOBALISATION AND THE REFORM OF EUROPEAN SOCIAL MODELS

ANDRÉ SAPIR



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INTRODUCTION

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

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

In this paper I attempt to make three points.

First, the global economy of the twenty-first century is characterised by rapid changes which create both threats and opportunities. The biggest challenge for the European economy is to become sufficiently flexible so as to avail of the opportunities and surmount the threats. This requires, above all, reforming labour market and social policies. Failing to do so would not only prevent Europe from the opportunity of globalisation but could even jeopardise two of its crucial policies – the Single Market and monetary union – which could in fact facilitate Europe's ability to meet the challenge of globalisation, but only if labour market and social policies are adequately reformed.

Second, the notion of "European social model" is misleading. There are in reality different European social models, with different features and different performance in terms of efficiency and equity. Models that are not efficient are not sustainable and must be reformed. The combined GDP of countries with inefficient models accounts for two-thirds of the entire EU and 90 per cent of the eurozone.

Third, in the EU system of economic governance, certain policies are decided at the national level, others at the EU level. Labour market and social policy reforms are a matter for the Member States alone, not for the European Union. Nonetheless, there are some benefits in

¹ This paper has been prepared for a presentation to the European Union's Finance Ministers and Central Bank Governors at the ECOFIN informal meeting in Manchester under the British Presidency of the EU, on 9 September 2005. It will provide the basis for a Bruegel Policy Brief scheduled for publication in October 2005.

² Sapir *et al.* (2003).

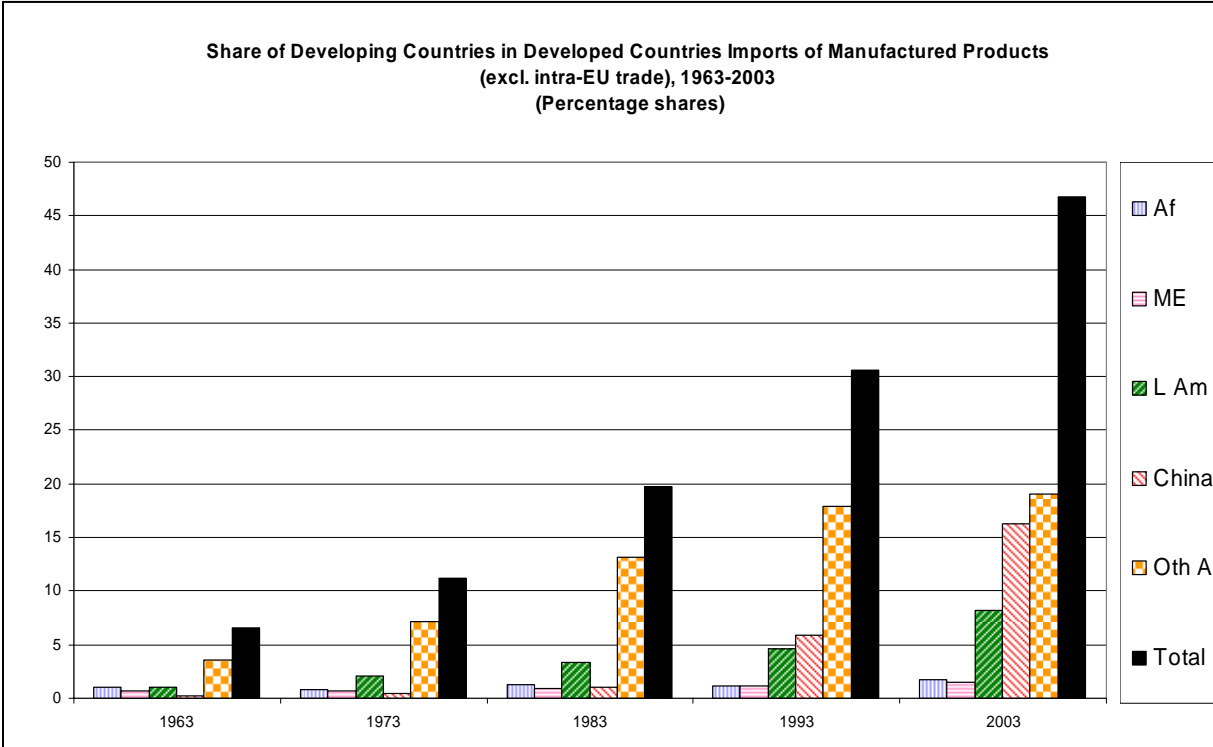
coordinating these reforms with other necessary reforms, especially for the countries in the eurozone which share a common currency. A two-handed strategy combining reforms at EU and national levels would be best. The Lisbon Agenda tried this but is rapidly failing. All EU efforts should now be geared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

CHALLENGES

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

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

Figure 1



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

The emergence of developing countries as major suppliers of products, both manufactures and services, which compete with European producers, has only just started. Over the coming decades, the trend is bound to accelerate as new suppliers join the fray. In particular, developing Asia (including China and India), which accounts for more than 50 per cent of world population but 25 per cent of world GDP (at PPP), is expected to continue growing steadily at more than 6 per cent per annum for at least one generation, drawing on vast resources of labour combined with increasingly sophisticated technological capability. Such a prospect is not only inevitable, but also desirable given the current distribution of world income, where the G-7 accounts for nearly 45 per cent of world GDP (at PPP) with barely 11 per cent of world population [the respective figures are 21 and 7 for the EU-25 and 21 and 5 for the US]. But emerging economies are not only producers and exporters; they are also consumers and importers. Indeed, the same six emerging economies which currently rank among the world's top ten exporters (China, Hong Kong, Korea, Mexico, Chinese Taipei and Singapore) are also among the top ten importers.

This rapid change in the global economy creates both opportunities and threats. It offers opportunities to those able to respond quickly and with the right technology and skills, but threatens those who adjust slowly and possess obsolete technology and skills. Moreover, the benefits associated with the opportunities take time to materialise since they require new investment, while the costs associated with the threats are incurred more rapidly since they derive from existing investment. But postponing inevitable changes is not a desirable option since it would only delay the benefits and increase the costs. The challenge to economic policy therefore is to conceive and implement, as soon as possible, economic and social reforms aimed at greater economic flexibility and better social protection. The goal must be to create a flexible environment capable of making the best use of the opportunity provided by the new economy and, thereby, of responding efficiently to the threat.

In Europe, the needed economic and social reforms concern above all labour market and social policies which were established in the 1950s and 1960s, when the economic environment was relatively stable and predictable. These policies have become increasingly dysfunctional in the more variable economic environment of the late twentieth and early twenty-first centuries. Instead of fostering the necessary adaptation and flexible responses to increasingly rapid changes, modern European welfare states, which had helped fuel economic and social progress during the '*trente glorieuses*' (the 30 years between 1945 and 1975 when Europe witnessed an unprecedented period of growth, stability and social cohesion), now often protect the status quo. And as James Heckman (the Nobel Prize winner) rightly states in his insightful analysis of Europe, "The opportunity cost of security and preservation of the status quo – whether it is the status quo technology, the status quo trading partner, or the status quo job – has risen greatly in recent times." (Heckman, 2002).

During the past 25 years Europe has not remained idle. Indeed recognition of the need to improve Europe's economic performance in the face of globalisation has driven much of EU economic policy during the past two decades. In the mid-1980s, the Single Market Programme was explicitly conceived as a means to inject fresh dynamism into the European economy and adjust to the new economic environment. At the same time, the EU became an important sponsor of R&D activities aimed at meeting the challenges of globalisation and technological change, first with ESPRIT (launched in 1983) then with the Framework Programme for Research and Technological Development (launched in 1984). Monetary

union, by fostering both macroeconomic stability and the Single Market ('One Market, One Money'), can also be seen as part of Europe's response to the challenge of globalisation.

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

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

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

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

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

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

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

Dysfunctional labour market and social policies are not only a threat to globalisation and the Single Market, but also endanger the currency union. Any European country is bound to suffer from structural changes, be they caused by enlargement, globalisation or technological progress, if its markets are inflexible and do not allow the necessary transfer of resources across firms, sectors or regions. For members of the eurozone, market-led flexibility is even more important since they share a common monetary policy which precludes the use of the exchange rate as an instrument of flexibility – albeit very inadequate for responding to structural changes. The lack of appropriate market mechanisms is bound to lead to attempts to use fiscal policy as a temporary remedy. However, such attempts are bound not only to conflict with the fiscal rules of the currency union (the Stability and Growth Pact) but could even threaten its survival if it led to unsustainable fiscal positions (in violation of the SGP) or if respect of the SGP led to public discontent towards the currency union itself, as was recently observed in several eurozone countries.

A few days after the No votes in the French and Dutch referendums, Martin Wolf (2005) wrote a piece in the *Financial Times* entitled “Crushing reality of eurozone”, which concluded that: “The struggle for the constitutional treaty is over. The battle for a successful currency union has begun.” His point being that poor economic performance of the eurozone was one of the principal reasons for the No votes and that monetary union may not survive a prolonged period of economic difficulty. Although the demise of the eurozone, or the exit of some its members, is certainly not as close as some proclaim, the fact of the matter is that discussion about the possible break up of the currency union will continue to surface from time to time as long as its members remain plagued by inflexible markets – especially labour markets – that prevent them from making the necessary economic adjustments.

FOUR EUROPEAN SOCIAL MODELS

There are so many differences among national welfare state systems that the very notions of “European model” or “Social Europe” are rather dubious. I prefer to use the now familiar grouping of national systems into four different social policy models in order to examine the relative performance of each model along a number of dimensions. The four models cover four different geographical areas.

Nordic countries (Denmark, Finland and Sweden, plus the Netherlands) feature the highest levels of social protection expenditures and universal welfare provision. There is extensive fiscal intervention in labour markets based on a variety of “active” policy instruments. Strong labour unions ensure highly compressed wage structures. *Anglo-Saxon countries* (Ireland and

the United Kingdom) feature relatively large social assistance of the last resort. Cash transfers are primarily oriented to people in working age. Activation measures are important as well as schemes conditioning access to benefits to regular employment. On the labour market side, this model is characterized by a mixture of weak unions, comparatively wide and increasing wage dispersion and relatively high incidence of low-pay employment. *Continental countries* (Austria, Belgium, France, Germany and Luxembourg) rely extensively on insurance-based, non-employment benefits and old-age pensions. Although their membership is on the decline, unions remain strong as regulations extend the coverage of collective bargaining to non-union situations. Finally, *Mediterranean countries* (Greece, Italy, Portugal and Spain), concentrate their social spending on old-age pensions and allow for a high segmentation of entitlements and status. Their social welfare systems typically draw on employment protection and early retirement provisions to exempt segments of the working age population from participation in the labour market. The wage structure is, at least in the formal sector, covered by collective bargaining and strongly compressed.³

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

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

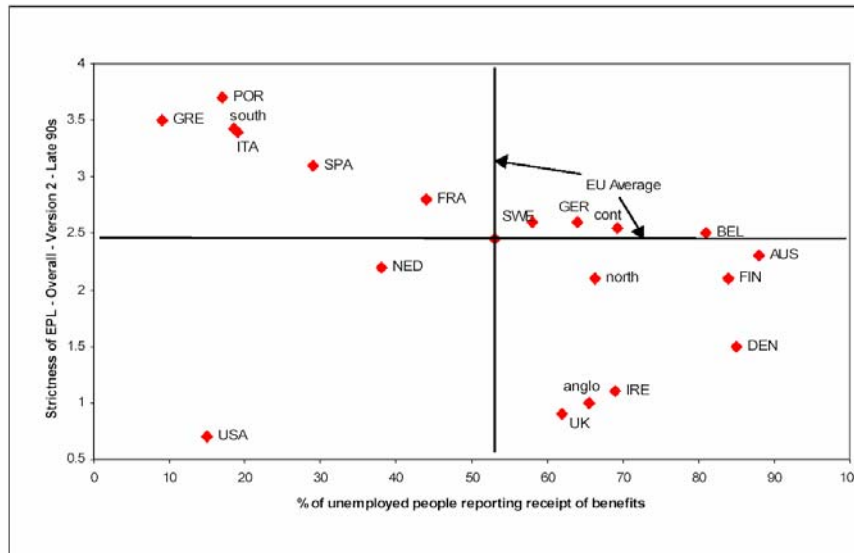
Regarding the *reduction of income inequality and poverty*, he finds that the extent of redistribution effected via taxes and transfers is highest in Nordic countries (with 42% reduction of inequality) and lowest in Mediterranean countries (35% reduction), with Anglo-Saxon and continental countries in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

Protection against uninsurable labour market risk can be provided either by employment protection legislation (EPL), which protects workers against firing, or by unemployment benefits (UB). The differences between these two systems are clear: EPL protects those who already have a job and does not impose any tax burden, whereas UB provide insurance to the population at large and are typically financed by a tax on those who work. Thus insiders, those with a stable and regular job, typically prefer EPL to UB. Since EPL and UB are two instruments designed to achieve a similar purpose, there is a clear trade-off between them. Having a generous unemployment insurance system reduces the need for firing restrictions, and vice versa. This trade-off is indeed well visible over the cross-section of European countries shown in Figure 2. It is clear that the EU Member States have chosen very different

³ This familiar grouping now used by many economists based on earlier political sociology work by Esping-Anderson (1990) which partitions welfare systems into three regimes: a liberal regime (encompassing Anglo-Saxon countries); a conservative regime (encompassing continental and Mediterranean countries); and a social democratic regime (encompassing Nordic countries).

points in the trade-off between the two main instruments to protect individuals against unemployment

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



Source: Boeri (2002)

The four European social policy models behave very differently. The Mediterranean model is characterised by very strict employment protection regulations and a rather low coverage of unemployment benefits. On the opposite side, the Nordic model provides unemployment benefits which are both generous and comprehensive, but the strictness of their EPL is quite low. The continental model also provides generous unemployment benefits, but its EPL is stricter. Finally, the Anglo-Saxon model provides comparatively less protection than the others, with far lower EPL strictness but as much unemployment insurance as the continental and Nordic models. However the European Anglo-Saxon model is still very different from its America cousin. Both feature considerably extremely low EPL but the US model is unique in that it also provides very little unemployment insurance. Altogether, therefore, it is appropriate to contrast the “American model”, which offers little insurance against labour market risk and the “European model”, which provides far more insurance.

One should, however, be careful in trying to rank different models in terms of the amount of insurance they provide. In particular the alleged superiority of the “European model” vis-à-vis the “American model” partly reflects a different mix between social and market protection between the two sides of the Atlantic (or between the two sides of the Channel, if one compares the Anglo-Saxon and the other European models). The “European model”, with its stricter EPL and more generous UB, generally provides more *social insurance* than its American counterpart. On the other hand, the American and European Anglo-Saxon models provide more *labour market insurance*, than other European models, as witnessed by their lower incidence of long term unemployment.

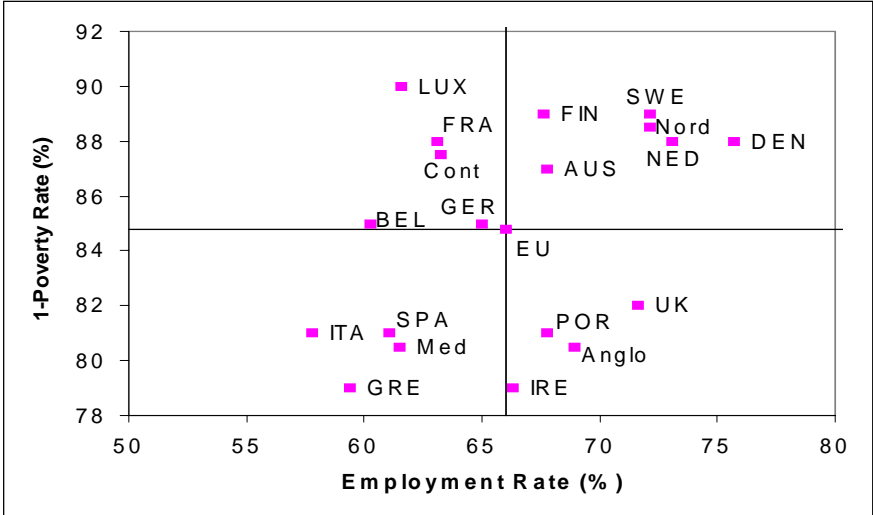
Rewards to labour market participation vary a great deal across the four European social models. Employment rates are far higher in Nordic and Anglo-Saxon countries (respectively 72% and 69% in 2004) than in continental and Mediterranean countries (respectively 63% and

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

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

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

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



All Nordic and Anglo-Saxon countries rank above average in terms of overall employment rate, whereas most continental (with the exception of Austria) and Mediterranean (with the exception of Portugal) countries rank below average. Comparing figures 2 and 3 indicates a strong connection between the employment rate generated by a social system and the instrument it uses to protect workers from the vagaries of the labour market. The stricter the employment protection legislation of a model, the lower its employment rate.⁴ By contrast, the generosity of unemployment only plays a secondary role.⁵ This means that protecting jobs with employment legislation is definitely detrimental to employment, whereas protecting workers with unemployment insurance is potentially useful for employment.

⁴ The correlation coefficient between the overall employment rate and the EPL index for 14 EU countries and the US is -0.63.

⁵ Once the strictness of the EPL is taken into account, adding the UB has no impact on variations in the overall employment rates across models or even countries. A regression of the overall employment rate on EPL and UB for 14 EU countries and the US produces a significantly negative coefficient for EPL and a coefficient not significantly different from zero for UB. This implies that EPL is the key explanation of employment rates.

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

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

Table 1
The Four European Models: A Typology

| | | | |
|--------|-------------|---------------|-------------|
| | | EFFICIENCY | |
| | | <i>Low</i> | <i>High</i> |
| EQUITY | <i>High</i> | Continental | Nordic |
| | <i>Low</i> | Mediterranean | Anglo-Saxon |

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

⁶ The correlation coefficient between the index of poverty and the measure of educational attainment for 14 EU countries is -0.76.

⁷ Once educational attainment is taken into account, adding the income redistribution has no impact on variations in the risk of poverty across models or even countries. A regression of the index of poverty risk on educational attainment and income redistribution for 14 EU countries produces a very significantly negative coefficient for education and a coefficient not significantly different from zero for redistribution. This implies that educational attainment is the key factor driving poverty risk in the EU.

⁸ Figure 3 indicates that the four country groupings are far from homogenous. In particular, Austria seems to be more Nordic than continental, and Portugal more Anglo-Saxon than Mediterranean. Nonetheless, I will retain the country groupings as defined so far.

⁹ Denmark is a prime example of a Nordic country with an efficient and equitable model. It has the highest employment rate (75%) and one of lowest poverty indexes (12%) in the EU-15. In the opposite corner, Italy is a

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

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

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

In conclusion, there is a strong case for reforming European labour market and social policies, especially in continental and Mediterranean countries. There are two overriding reasons for focusing on these two groups of countries. First, in many of them the welfare state system has become highly inefficient. By relying on strict employment protection laws at a time of rapid change when old jobs and practices are no longer warranted, it discourages adaptation to change and preserves the status quo. The system therefore reduces overall employment and raises unemployment. For a long time “median voters” were largely spared from growing unemployment, the burden falling mainly on the young and the immigrants,¹¹ while older workers exited the labour market through generous early retirement schemes. Today, however, the political equilibrium has changed. Median voters are no more insulated from the ever-growing pressure of globalisation and also realise that the combination of population ageing and low employment rates jeopardises their future pension benefits. The second reason for focusing on the continental and Mediterranean countries is simple arithmetic. The combined GDP of the nine continental and Mediterranean countries accounts for two-thirds that of the entire EU-25 and 90 per cent that of the 12-member eurozone. The economic and

good example of a Mediterranean country with an inefficient and inequitable model. It has the lowest employment rate (58%) and one of the worst poverty indexes (19%).

¹⁰ The United Kingdom is epitomic of the Anglo-Saxon model. It has a high employment rate (72%) and a high poverty index (18%). France and Germany are two representative examples of the continental model, with a low employment rate (63 and 65% respectively) and a low poverty index (12 and 15% respectively).

¹¹ Sapir (2001) shows that the unemployment rate among immigrants is about twice the overall unemployment rate in many European countries. In continental countries, where the youth unemployment rate is around 20 per cent, the unemployment rate among young workers from immigrant families reaches more than 30 per cent.

social health of these countries is therefore of paramount importance for the smooth functioning of the entire European Union and of the eurozone.

POLICIES

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

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

What Role for Coordination?

Before trying to answer this question, it is probably useful to recall the allocation of economic responsibilities within the EU system of multi-level governance. The chart below, taken from Pisani-Ferry and von Hagen (2002) but originally suggested by Tommaso Padoa-Schioppa, provides a highly schematic but very clear picture of EU economic governance. In the microeconomic sphere, labour market regulation is decided at national level, whereas the EU level deals with product and capital markets regulation. In the macroeconomic sphere, the Member States are responsible for fiscal policy, but monetary policy is managed by the European Central Bank (ECB) for countries belonging to the eurozone.

**Table 2
Assignment of Economic Policies in the EU System**

| | | | |
|--------|--------------|--------------------------|---------------------------------------|
| | | LEVEL | |
| | | <i>National</i> | <i>Union</i> |
| POLICY | <i>Micro</i> | Labour market regulation | Product and capital market regulation |
| | <i>Macro</i> | Fiscal policy | Monetary policy |

This schematic presentation of the assignment of economic policies in the EU system suggests that the question about the potential role of Europe in the process of reforming national labour

market and social policies raises first of all several questions about coordination: (1) is there a case for coordinating labour market reforms among EU countries?; (2) is there a case for coordinating labour market reforms with reforms of product and capital market regulation at EU level?; and (3) for countries in the eurozone, is there a case for coordinating structural reform and macroeconomic policy?

Coordinating labour market reforms?

With the Amsterdam Treaty, the Member States have committed themselves to coordinate their employment policies, on which they retain sole competence, at EU level. Based on the forthcoming treaty, the EU established at the 1997 Luxembourg Jobs Summit the European Employment Strategy (EES), a set of non-binding employment guidelines designed to govern the reform of national laws, policies and institutions in order to make them more employment-friendly. The EES includes a complex system of periodic reporting, indicators, and multilateral surveillance, as well as mechanisms for benchmarking, peer review and exchange of best practices. A classic form of new governance, the EES has been a model for similar systems which now are all denominated the “Open Method of Coordination” (OMC). The EES amounts to soft coordination in that the guidelines are nonbinding. The EES was recently revamped with a view to aligning it more closely to the Lisbon Strategy.

Like the Open Method of Coordination, the European Employment Strategy suffers from a major flaw. It is neither a very convincing benchmarking and peer review exercise nor does it represent effective method for changing the behaviour of national governments. As a tool for benchmarking and reviewing peers the OECD Jobs Strategy, launched in 1994, appears to be a far more effective than the EES for several reasons. First, the OECD Jobs Strategy rests on a much clearer analytical framework than the EES. This is because the former focuses on efficiency, whereas the latter tends to mix efficiency and equity considerations. Second, the OECD documents clearly separate the analytics and the politics as one would expect from a benchmarking and peer review exercise, while the EU reports tend to mix the two and be more bureaucratic and political. This is not surprising since the former are produced by the OECD Secretariat, whereas the Joint Employment Reports are co-authored by the Commission (the reviewer) and the Council (the peers). Third, if the goal is simply benchmarking and peer review, then the OECD is probably a better forum as it brings together not only the EU Member States but also other countries which may be useful comparators.

The only justification for the European Employment Strategy would be if it went beyond benchmarking and peer review *a la OECD* and contained either sticks or carrots capable of influencing the behaviour of national governments, but this is neither feasible nor desirable. The fact of the matter is that reforms of labour market and social policies need to be conceived and engineered by each Member State according to its own economic, social and political reality. To the extent that it clearly and solely focuses on benchmarking and exchange of best practices, coordination can be useful – although it is not clear that the EU process adds much, if anything, to the OECD process. Beyond that, coordination of labour market and social policies is probably an obstacle rather than a catalyst for reform because it tends to blur the responsibility between national and EU authorities. The danger may not be important for the authorities themselves, but it certainly is for the public which has become utterly confused about who is responsible for what with respect to labour market and social policies.

Claiming at the same time that Member States have sole competence over employment policies and that Europe has an Employment Strategy for “reforming labour markets” and “achieving full employment” as official EU documents do is a sure recipe for voters’ dissatisfaction with the European Union. As Andrew Moravcsik (2005) rightly observed the No votes in the French and Dutch referendums were above all a reaction of those fearful of unemployment, labour market reform, globalisation, privatisation and the consolidation of the welfare state. “This type of disaffection is the primary political problem for European governments today, since it is directed both against poor economic performance and against reform measures designed to improve it.” Surmounting this difficult political problem requires clear and strong political leadership by national governments. Placing responsibility where power lies is crucial for the well functioning of the EU system.

Coordinating labour market and product market reforms?

So far I have concentrated solely on labour market reforms. Yet it is well known that the structure of product and capital markets affects the performance of the labour market and vice versa that the structure of labour markets affects the performance of product and capital markets. Reforms of product and capital markets tend to increase the demand for labour and therefore facilitate reforms in the labour market. Equally, reforms of labour markets tend to facilitate the creation of new firms, thereby facilitating reforms in product and capital markets. Conversely, not reforming one set of markets hinders reforms in the other set.

The case for coordinating product and capital market reforms on one hand and labour market reforms on the other *within each EU country* appears strong therefore. But what about coordinating product and capital market reforms *at the EU level with national* labour market reforms, which would amount to coordinating labour market reforms *between EU countries*?

In principle one does not expect spillovers between countries as far as labour market (and national product market regulation) reform is concerned, each country reaping most of the effects of its own reform. However, the situation should be different in the EU because countries share a common good, namely the Single Market, which (like national product market regulation) also interacts with national labour markets. The better national labour markets operate the easier it is to reform the Single Market and vice versa.

There are two ways of solving the chicken-and-egg problem between product and capital market reforms at the EU level on one hand, and reforms in national labour markets on the other. One is to concentrate all energy on the EU level, secure product market and capital market liberalisation, and hope that this will eventually trigger labour market reforms through some TINA (“there is no alternative”) process. The other is to act simultaneously at the EU level, with product and capital market reforms, and at the national level, with labour market reforms. The advantage of the second solution is that it would, in principle, be more efficient and less painful as labour market reforms would benefit from product and capital market reforms, and vice versa.

The Lisbon Agenda can be viewed as an attempt to solve this “coordination failure” between EU and national reforms. Its main objective is to speed up productivity growth by removing barriers in product and markets (mostly at the EU level, through the Single Market Program), and to ensure that labour is used more efficiently by reforming labour markets and social policies (at national level). The twin tracks of EU and national level actions are central to the

Lisbon process.

Unfortunately Lisbon has not delivered.

Coordinating structural reforms and macroeconomic policy?

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

Countries belonging to the eurozone share not only the Single Market. They also share a common currency and therefore a common interest rate which is set by the ECB with respect to the average inflation rate of the eurozone. To the extent, therefore, that structural reforms in one country affect the average inflation rate of the eurozone, there is a case for coordinating structural reforms since they affect the common interest rate.

As Jean Pisani-Ferry (2005) argues, the case for coordination is especially important when it comes to implement reforms that are costly in the short term. Labour market reforms may increase unemployment before they lower it, because they create anxiety and lead firm to shed off redundant labour faster than they create new jobs. Product market reforms may also depress growth because incumbents immediately react to the loss of rents while entry only develops over time. This is why reform is easier when accompanied by monetary expansion (to offset its effects on aggregate demand) and fiscal relaxation (to also compensate the losers).

For understandable reasons the ECB is unwilling to engage in formal coordination with governments of the eurozone and to cut interest rates ahead of structural reforms. Members of the eurozone, therefore, need to act first and find a way to convince the ECB that they are serious about economic reform. The more credible the reform, the greater the likelihood of a move by the ECB. Coordinated structural reform by the main players of the eurozone would be a powerful signal to the ECB. It is also essential for the countries of the eurozone where progress with structural reforms has been particularly slow

What Role for EU Policies?

Europe cannot and should not have a strategy for reforming national labour market and social policies. It is up to each national government to devise and implement its own strategy.

Yet, a two-handed strategy combining product and capital market reform at the EU level with labour market and social policy reform at the national level would be superior to a strategy seeking to reform national labour market and social policies alone, especially for the countries of the eurozone.

The Lisbon Strategy was an attempt to implement this kind of two-handed approach, but the Lisbon method was simply too weak to deliver. Five years after its launch in 2000, it has delivered neither a major thrust towards completing the Single Market nor significant labour market reforms. This is not to deny that labour market reforms have taken place in Europe, but there is little evidence of a link between initial conditions and subsequent reform efforts during the past ten years, with some countries taking only modest measures despite a poor

starting point and others carrying out ambitious programs even though their initial conditions were already relatively favourable.¹² Moreover, there is no evidence of an acceleration of reforms during the second half of the period, after the launch of the Lisbon Strategy, on the contrary.

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

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

What should be done?

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

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

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

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

¹² Brandt, Burniaux and Duval (2005).

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

Third, the SMP naturally excluded the liberalisation of labour markets, since it falls within the competence of Member States. Yet without such reform and greater labour mobility within and across companies, the liberalisation of product markets was unlikely to trigger the reallocation of resources necessary to produce higher growth.

A major flaw with the SMP is that has not succeeded in opening up service markets which account for about 70 per cent of European economic activity and offer the greatest opportunities for employment growth. So far, therefore, the Single Market has not provided sufficient incentive to reform labour markets. At the same time, the absence of adequate reforms in labour markets has clearly deterred the creation of new activities in services and elsewhere.

At the moment, the creation of a single market for services, a crucial component of the Lisbon Agenda, remains uncertain at best. The rejection, in March 2005, by the European Council of the services directive tabled by the Commission in January 2004 has even led some observers to conclude that “a major and perhaps fatal blow was delivered to the Lisbon agenda” (Gros, 2005).

The lack of progress with the services directive is bad news for two reasons. First, it further postpones the long overdue completion of the single market for services, which holds huge promise not only for the creation of much-needed jobs in services but equally importantly for the competitiveness of the European manufacturing sector which is more and more intertwined with on the provision of modern and flexible services. Moreover, continued rigidities in services tend to discourage foreign direct investment as the effectiveness of business services is a key factor in the location of multinational enterprises.¹³

Second, as the discussion about the “Polish plumber” demonstrates the difficulty about the services directive points to a fundamental tension between the goals of creating a genuine Single Market among 27+ countries with vast economic and social disparities on one hand, and of preserving the “European social model” on the other. Those who argue against the services directive not only argue against the “freedom to provide services within the Community” enshrined in Article 49 of the EC Treaty and economic efficiency, but against reality. It is not the Single Market which threatens the “European social model”, but the inability to reform it, or more precisely some of its incarnations, in the face of rapid global changes. With or without the services directive, the rise of manufacturing in China and the exodus of back-office services to India are inevitable. With or without it, the addition of 12 new Member States with low incomes and close proximity to high-income countries is bound to affect the European services market either in the open or in the shadow. A genuine Single

¹³ Faini et al. (2004).

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

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

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

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

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

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

André Sapir is a Senior Fellow at Bruegel and a Professor of Economics at Université Libre de Bruxelles.

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