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CHAPTER 7

TOWARDS A NEW EUROPEAN MODEL OF A REFORMED WELFARE STATE: AN ALTERNATIVE TO THE UNITED STATES MODEL[266]

The better performance of the United States relative to western Europe in terms of output and productivity growth since the 1990s is now an accepted fact. This chapter views this from a longer-term perspective, and suggests that a more comprehensive comparison between the United States and western Europe, that includes social and environmental indicators, income distribution, social welfare and health care, may present a different picture than if per capita gross domestic product (GDP) alone is considered. Many analysts, in seeking to explain the differences in economic performance since the early 1990s, blame high welfare costs, rigid labour market rules and higher environmental standards for western Europe's poor performance. This would imply that western Europe has been trading off faster economic growth against the objective to achieve ambitious social and environmental goals. Surprisingly, however, the best performing European countries over the past 10 to 15 years in terms of overall economic performance have been three Nordic states (Denmark, Finland, Sweden) that have comprehensive welfare systems and a high degree of environmental awareness. All three suffered severe structural and cyclical crises in the 1980s and 1990s, but over the past 10 to 15 years they have been performing better than the larger European economies, and have been matching the United States in their dynamic performance. This chapter analyses whether the post-crisis reforms undertaken in these three countries have followed the United States model or whether they provide a new European model of a reformed welfare state.

7.1 Introduction

The better economic performance of the United States relative to western Europe since the early 1990s is an accepted fact. This chapter attempts to put this into perspective, first, by showing that while the United States forged ahead in terms of output and productivity, this was not the case in terms of per capita GDP; secondly, its better performance occurred following decades of catching up by western Europe in terms of productivity; and thirdly, a more comprehensive comparison than one of per capita income alone, covering welfare – that includes income distribution, environmental conservation, social and health coverage, and the comprehensive nature of its social welfare system in general – reveals a better performance by western Europe.

Many analysts blame precisely these higher welfare and environmental standards, along with inflexible labour markets, for western Europe's poorer performance.[267] If this were true, countries with lower social costs, unrestricted labour markets and lower environmental quality should have performed better. Surprisingly, the best performing European countries have been three Nordic welfare States, which have high taxes, a proactive innovation policy and comprehensive labour market

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[267] This has been termed the "Paris consensus" by some authors (K. Aiginger, *Labour Market Reforms and Economic Growth – The European Experience in the Nineties*, WIFO Working Paper, No. 232 (Vienna), September 2004; A. Guger, M. Marterbauer and E. Walterskirchen, "Stagnation policy versus growth strategies", paper presented at the conference in honour of Josef Steindl (Vienna), 2003), as such analyses are often found in OECD (Paris) publications. The term "Paris consensus" draws on the term "Washington consensus" for developing countries, which described strategies promoted by the IMF and World Bank.

institutions. Earlier, all of them had suffered severe crises, which may have been partially the consequence of rigidities, overspending and wage increases that were higher than productivity. But more recently, these "top 3" countries have been performing better than the European average and quite similar to the United States. This chapter examines whether these countries changed their economic model to follow more closely that of the United States or whether they are on the verge of developing a new European model that combines comprehensive coverage of risks (high share of union members and high share of workers covered by collective wage agreements) with a high degree of efficiency and modern technology.

The chapter begins by comparing economic performance, followed in section 7.2 by extending the comparison to a broader set of goals. Section 7.3 analyses the economic dynamics of western Europe and the United States since the 1990s, and speculates as to whether the higher growth in output, productivity and employment in the United States will extend into the next decade. Section 7.4 investigates whether the differences in welfare costs and labour market regulations between the United States and western Europe, which are often used to explain the lower European dynamics, also determine which western European countries performed better and worse during the 1990s. Section 7.5 uses the structure and policy strategies of the three most successful European countries (termed the top 3) to sketch a new European model, in which social and environmental responsibility is combined with rapid innovation and a high degree of efficiency of production. Section 7.6 presents a summary.

7.2 Differences in performance between the United States and western Europe

(i) Growth of output and productivity

Economic growth, as measured by real GDP, grew somewhat faster in western Europe than in the United States over much of the post-Second World War period, including the 1980s. However, since 1990 the United States has been outperforming western Europe: it was less affected by the business downturn of 1993, achieved higher growth during the second half of the decade, and proved more resistant to the most recent crisis of 2001-2003. For the period 1990 to 2003, the difference in economic growth between the EU-15 and the United States amounted to 1 per cent per annum and 14 per cent cumulative.

In the United States, GDP per capita has been some 40 per cent higher than the average level for the EU-15 in 2002, a gap that has remained broadly unchanged over the past decades (table 7.2.1). When comparing GDP per person employed, the gap between the United States and the EU-15 reduces to 30 per cent in 2002. The difference in levels of GDP per hour worked is much smaller, amounting to only 9 per cent. The large difference in levels of GDP per capita in 2002 reflects therefore in the main the combined effect of the higher United States employment rate, i.e. the larger proportion of persons aged 15-64 that are employed (some 80 per cent compared to 67 per cent in the EU-15 in 2002) and the larger number of hours worked per person per annum (shorter annual leave and longer weekly working hours).

In general, GDP per hour worked is considered to be the best measure of overall productivity in the economy, although reliable (and internationally comparable) time series on hours worked are difficult to obtain. GDP per person employed is used as an indicator of economic efficiency in case there are no reliable statistics on hours worked available. Per capita GDP is more relevant for measuring the average income of the population and, related to that, the potential to consume.

Looking at developments over time, Europe has been catching up with the United States in terms of GDP per person employed and per hour worked: in terms of GDP per person employed, the difference was 28 per cent in 1980, narrowing to 20 per cent in 1995, and in terms of GDP per hour worked it narrowed from 21 to 5 per cent over the same period. Since 1995, the differences have again become wider, by about 10 percentage points for GDP per person employed and 4 percentage points for GDP per hour worked (chart 7.2.1). The reason why United States productivity has been able to forge ahead after decades of European catching up has been widely discussed; there are at least three explanations: (i) the

TABLE 7.2.1

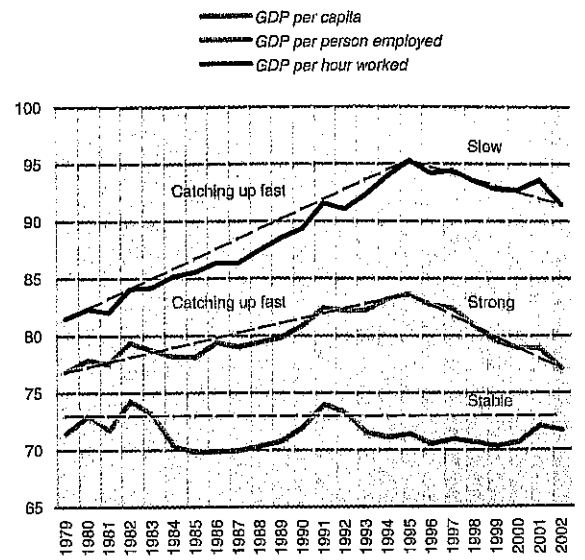
Differences in GDP per capita, GDP per person employed and GDP per hour worked between the EU-15 and the United States, 1980, 1990, 1995 and 2002

	GDP per capita			*GDP per person employed*			*GDP per hour worked*		
	EU-15	*United States*	*United States/ EU-15*	*EU-15*	*United States*	*United States/ EU-15*	*EU-15*	*United States*	*United States/ EU-15*
	(Thousand euros)			*(Thousand euros)*			*(Euros)*		
1980	16.30	22.31	1.37	39.84	51.16	1.28	23.00	27.93	1.21
1990	20.08	27.88	1.39	47.43	58.66	1.24	28.82	32.25	1.12
1995	21.30	29.81	1.40	52.52	62.79	1.20	32.53	34.13	1.05
2002	24.43	34.08	1.40	56.26	72.94	1.30	35.52	38.83	1.09

Source: WIFO calculations, based on data from the Groningen Growth and Development Centre.

CHART 7.2.1

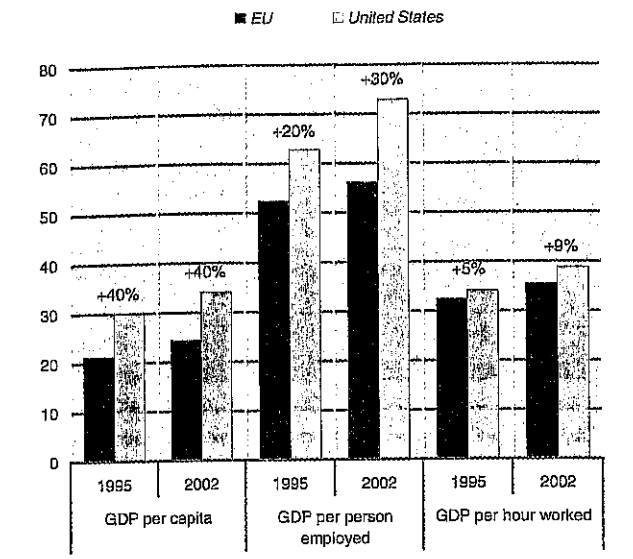
European catching up in GDP per capita, GDP per person employed and GDP per hour worked (United States=100), 1979-2002



Source: WIFO calculations, based on data from Groningen Growth and Development Centre.

CHART 7.2.2

United States ahead of Europe on three indicators, 1995 and 2002



Source: WIFO calculations, based on data from Groningen Growth and Development Centre.

earlier adoption of information and communications technologies (ICT) by the United States;[268] (ii) insufficient European investment in R&D and human capital;[269] and (iii) rather restrictive monetary and fiscal policies in Europe.[270] In terms of GDP per capita the gap has not widened; the United States has been leading since the early twentieth century, and the difference increased only slightly between 1990 and 2002. Some researchers have considered this good news, but the difference of 40 per cent is still extremely large (chart 7.2.2).[271]

(ii) Other welfare components

Broader comparisons of welfare include evaluations of: (i) employment and unemployment; (ii) income distribution, either investigating the spread between rich and poor or measuring poverty rates; (iii) the comprehensiveness of social and health care coverage; and (iv) environmental conservation and prudent use of resources. This implies that a more broadly defined welfare concept embraces considerations of not only employment and income distribution, but also the comprehensiveness of the social safety net and environmental conservation.[272] Extended even farther, concepts of welfare could also include life expectancy, democracy, security, cultural goals, the rule of law and all aspects of human development (chart 7.2.3). The broader the set of goals to be evaluated, the more difficult it is to measure them, and the more difficult it is to determine the relative weights of the individual objectives and make a general assessment.

Until the mid-1970s, the employment rate for the working-age population was higher in western Europe than in the United States (e.g. in 1960 the employment rate was 70 per cent in western Europe, as compared to 66 per cent in the United States). However, by 1980 the employment rate in the United States had overtaken that

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[268] R. Gordon, "Two centuries of economic growth: Europe chasing the American frontier", paper prepared for the Economic History Workshop, Northwestern University (Chicago), October 2002; D. Jorgenson and K. Stiroh, "U.S. economic growth in the new millennium", *Brookings Papers on Economic Activity*, 1 (Washington, D.C.), 2000; K. Aiginger and M. Landesmann, *Competitive Economic Performance: The European View*, WIFO Working Paper, No. 179 (Vienna), June 2002.

[269] K. Aiginger, "The three tier strategy followed by successful European countries in the 1990s", *International Review of Applied Economics*, Vol. 18, No. 4, 2004, pp. 399-422.

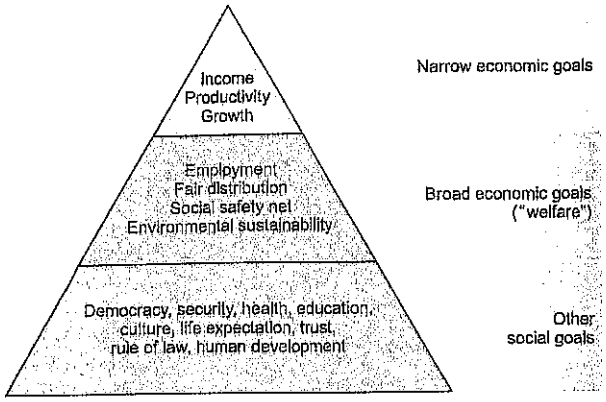
[270] S. Schulmeister, *Die unterschiedliche Wachstumsdynamik in den USA und Deutschland in den neunziger Jahren*, WIFO Working Paper, No. 134 (Vienna), 2000.

[271] The large difference in income per capita versus the relatively low difference in GDP per hour worked led Gordon to question how Europe could be so productive yet so poor. R. Gordon, "Two centuries of economic growth: ...", op. cit., p. 2.

[272] This is not to overlook the fact that certain other economic variables are also closely monitored, such as inflation, budgetary stability and the trade balance. However, these are not goals, but rather instruments or constraints, which have the potential to become important obstacles for raising welfare if they are out of balance. If inflation is in the two-digit range, it will sooner or later dampen economic growth and endanger employment. However, a zero rate of inflation is not an economic end (and negative rates even less so). Trade deficits are unimportant if they are compensated by investment flows; they may signal the loss of competitiveness if they increase without these compensatory flows. Budget deficits may help stabilize income and employment in the short run (anti-cyclical spending) or in the long run (if they boost research and infrastructure), but they may endanger growth if they are the result of excessive spending on items that do not help improve the production potential.

CHART 7.2.3

Hierarchy of European economic and social goals



Source: K. Alginger, "The economic agenda: a view from Europe", *Review of International Economics*, Vol. 12, Issue 2 (Special Issue: Economic Agenda for the 21st Century), May 2004.

of western Europe, and continued to increase at a faster rate, to reach almost 80 per cent in 2002 compared with western Europe where it was 67 per cent (table 7.2.2). A detailed analysis of the changes in these trends is beyond the scope of this paper. However, one reason is that faster growing economies need more employees. Another is that, at the lower end of the wage spectrum, United States labour became comparatively cheap, thereby increasing the rate of employment growth in the United States. The United States created 78 million new jobs between 1960 and 2000, while western Europe created 42 million. However, employment creation in more recent years has accelerated in western Europe: between 1995 and 2002, western Europe created 12 million jobs; and even during the last three years of slow growth (2001-2003) employment increased, in contrast to other periods of sluggish growth, although many of the jobs were part-time. In 2002, the unemployment rate was 5.8 per cent in the United States, broadly unchanged from 1995. In contrast, in western Europe, the unemployment rate fell from 10.1 per cent in 1995 to 7.6 per cent in 2002 (table 7.2.2).

The social safety net is considerably more generous in western Europe. Net public spending on welfare is about 16 per cent in the United States and 24 per cent in western Europe (table 7.2.3). Most Europeans have government-funded or obligatory health insurance, pensions are higher, retirement can be taken earlier and governments' contributions to pensions are higher. Unemployment payments are higher in relation to income (replacement rate), they are paid for a longer period of time and the fall-back payments (social assistance) are relatively high and practically unlimited in time.

Income is less evenly distributed in the United States. The top 20 per cent earn 45 per cent of total income and the bottom 20 per cent earn 4.8 per cent, which results in an inequality ratio of 9.4. In western Europe, the corresponding numbers (using an unweighted average for the member countries) are 38.5 per cent for the top 20 per cent and 8.3 per cent for the bottom 20 per cent, resulting in a ratio of 4.7 (table 7.2.3). The lowest ratio in western Europe is 3.2 for Austria, followed closely by the Scandinavian countries and Belgium; Portugal is the only country where the inequality ratio is closer to that of the United States. As for poverty ratios, which can be calculated absolutely or relatively, by both measures the United States has higher rates. Income distribution is becoming increasingly uneven in many countries, but much more so in the United States. However, contrary to common expectations – suggested by the increasing inequality of incomes – the poverty rate has not been rising in the United States when viewed over a long period: it dropped from 22 per cent in 1960 to a historic low of 11.1 per cent in 1973; it later increased to 15.2 per cent in 1983, following a shift in economic policy by the Reagan Administration and a rise in unemployment, but declined again during the 1990s to 11.3 per cent, and it has been increasing only slightly since the most recent recession (12.5 per cent in 2003).[273] The reason for the relatively low level of poverty, despite increasing income inequality, is the relatively high employment rate.

There are social indicators that indicate a worse performance of the United States model (or greater downside risks in American society). For example, the number of homeless, the illiteracy rate, the proportion of the population in prison,[274] the homicide rate, the relative prevalence of drugs and guns, racial discrimination and the discrepancies in living standards between the slums and suburbs are higher in the United States. On the other hand, data on mobility reveal that expectations of upward mobility are greater in the United States, although the difference in actual mobility between the United States and western Europe is far lower than is commonly believed.[275] The number of immigrants in the United States is also larger than in the EU-15.

Western Europe is far ahead of the United States in terms of environmental performance. The ratio of energy consumption to GDP is 73 per cent higher in the United States than in western Europe (United States: 0.26 Mtoe/GDP; western Europe: 0.15 Mtoe/GDP) and that of carbon dioxide emissions is 84 per cent higher (table 7.2.3). With respect to the cutting down of emissions, western Europe is at least trying to fulfil the targets of reducing greenhouse gases set by the Kyoto Protocol of the United Nations Framework Convention on Climate Change, while the United States is not even a signatory to that Protocol.

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[273] *Economic Report of the President*, 2004 (Washington, D.C.), transmitted to the United States Congress, February 2004.

[274] For every 100,000 people, 469 are in prison in the United States versus 65 in Europe.

[275] A. Alesina, E. Glaeser and B. Sacerdote, *Why Doesn't the US Have a European-style Welfare System?*, NBER Working Paper, No. w8524 (Cambridge, MA), October 2001.

TABLE 7.2.2

Employment and unemployment rates: EU-15 and the United States, 1980, 1990, 1995 and 2002

	Employment rate [a]			*Employment (million persons)*			*Working hours (per year and per person)*			*Unemployment rate* [b]		
	EU-15	*United States*	*United States/EU-15*	*EU-15*	*United States*	*United States/EU-15*	*EU-15*	*United States*	*United States/EU-15*	*EU-15*	*United States*	*United States/EU-15*
1980	64.5	71.0	1.10	145 160	99 303	0.68	1 732.5	1 831.4	1.06	5.6	7.1	1.27
1990	64.5	77.9	1.21	154 249	118 793	0.77	1 643.8	1 819.0	1.11	7.4	5.5	0.74
1995	62.7	78.6	1.25	150 721	124 900	0.83	1 612.0	1 839.9	1.14	10.1	5.6	0.55
2002	67.0	79.7	1.19	164 471	134 398	0.82	1 581.3	1 878.4	1.19	7.6	5.8	0.76

Source: WIFO calculations, based on data from the Groningen Growth and Development Centre.

[a] Persons employed in the 15-64 age group as a percentage of population in the same age group.

[b] As a per cent of the civil labour force.

TABLE 7.2.3

Broad indicators of economic welfare, 2002

	EU-15	*United States*	*Top 3 European countries* [a]	*Big 3 European countries* [b]
Employment rate (per cent)	67.00	79.70	73.30	64.30
Employment generation, 1990-2002 (millions)	10.30	19.60	-0.20	3.70
Unemployment rate (per cent)	7.60	5.80	6.20	8.60
Net social expenditures, public and private (per cent of GDP)	25.80	23.40	26.40	21.20
Net social expenditures, public (per cent of GDP)	24.00	16.40	24.30	18.70
Income distribution				
Share of top 20 per cent	38.50	45.20	34.90	38.70
Share of bottom 20 per cent	8.30	4.80	9.70	7.90
Ratio of top 20 per cent/bottom 20 per cent	4.70	9.40	3.60	4.90
Energy consumption (Mtoe/GDP)	0.15	0.26	0.16	0.14
Carbon dioxide (t/GDP)	0.31	0.57	0.27	0.29
Self-assessment of happiness (on a scale of 1 to 10)	7.05[c]	7.60	7.87	6.87
Self-assessment of life satisfaction (on a scale of 1 to 10)	6.81[c]	7.46	7.75	6.68
Health adjusted life expectancy at birth (years)	70.14	67.60	70.67	70.83
Persons sentenced to imprisonment per 100 000	65	469	..	..

Source: W. Adema, "Net social expenditure", 2nd edition, *Labour Market and Social Occasional Paper*, No. 52, OECD (Paris), August 2001; OECD, *Society at a Glance* (Paris), 2003; IMD, *World Competitiveness Yearbook*, 1999; International Energy Agency, *Total Primary Energy Supply* (Paris) 2003; R. Veenhoven, "Advances in understanding happiness", *Revue Quebecoise de Psychologie*, Vol. 18, 1997, pp. 29-74.

Note: Mtoe/GDP = million tonnes of oil equivalent per GDP; t/GDP = tonnes per GDP.

[a] Denmark, Finland and Sweden.

[b] France, Germany and Italy.

[c] The four largest EU countries only (France, Germany, Italy, United Kingdom).

Western Europeans have more leisure time. More specifically, there are 16 per cent fewer working hours per year (more vacations and fewer working hours per week), although the share of the population in work is lower in Europe by 13 percentage points. It is difficult to assess the extent to which the fewer hours worked are voluntary, and to what extent they are the by-products of the economic environment – such as the lack of full-time jobs, or jobs for middle-aged workers who have lost their jobs and have little chance of regaining employment. Gordon ventures the "wild guess that about one third of the difference represents voluntary chosen leisure and the remaining two thirds represent a lack of employment opportunities".[276]

How can we weigh these factors? There is no satisfactory method, and indeed there should be none, since an assessment of the success or failure of an economic and social system should be concerned with specific questions. One way of making an overall assessment by means of socio-economic research is to raise two internationally comparable questions: whether people are happy, and whether they are satisfied with their lives. This might seem somewhat primitive at first, but it is a serious line of research. It includes many tests for cultural bias, and displays careful sampling and wording. Results indicate that people are influenced by income, but the rankings ascribed to income and individuals' assessments of life satisfaction do not necessarily coincide. For both subjective indicators, Americans rank higher: the United States rating for "happiness" is 7.6 on a scale of 10 versus 7.1 for the four largest western European countries (France, Germany, Italy and the United Kingdom); for "life satisfaction", the United States rating is 7.5, while the corresponding value for the four largest western European countries is 6.8. Interestingly, differences within the United States are smaller than those within France and the United Kingdom.[277]

[276] R. Gordon, "Two centuries of economic growth: ...", op. cit., p. 10. Europeans worked longer hours than Americans during the 1945-1973 era of post-war reconstruction. "So passion for long vacations and short weekly hours of work is a recently acquired taste", while "Americans seem happy to be bribed to work long hours for premium overtime pay ... everyone wants his fair share of compulsory overtime". R. Gordon, ibid., p. 9.

[277] The research is based at Erasmus University in the Netherlands (see its website on this subject at: www.eur.nl/fsw/research/happiness, directed by R. Veenhoven). See also, R. Veenhoven, "Advances in understanding happiness", *Revue Quebecoise de Psychologie*, Vol. 18, 1997, pp. 29-74; G .Tichy, "Die Unzufriedenheit der Bürger mit den

TABLE 7.3.1

Growth dynamics of the EU-15 and the United States in the 1990s
(Average annual growth rates)

	Real GDP		GDP per person employed		Employment		GDP per hour worked	
	EU-15	United States	EU-15	United States	EU-15	United States	EU-15	United States
1991-1995	1.59	2.39	2.06	1.37	-0.46	1.01	2.45	1.14
1996-2000	2.65	4.04	1.22	2.40	1.41	1.60	1.42	1.97
2001-2002	1.29	1.27	0.41	1.58	0.87	-0.30	0.88	1.59
1996-2002	2.26	3.24	0.99	2.16	1.26	1.05	1.26	1.86
1991-2002	2.16	3.15	1.56	2.00	0.59	1.13	1.92	1.70

Source: WIFO calculations, based on data from the Groningen Growth and Development Centre.

7.3 Differences in dynamics between the EU-15 and the United States in the 1990s

This section examines the differences in growth of output, productivity and employment between the United States and western Europe. Between 1991 and 2002, output growth in western Europe was 2.2 per cent per annum – 1 percentage point less than in the United States, labour productivity expanded by 1.6 per cent in western Europe, compared to 2 per cent in the United States, and employment increased by 0.6 per cent in western Europe compared with 1.1 per cent in the United States (table 7.3.1). The amounts might seem small in per annum figures but cumulative growth of GDP was 26.5 per cent for western Europe and 40.7 per cent for the United States over this period. We summarize the main reasons for the differences,[278] and then attempt to assess what can be expected over the next decade.

Most international studies, and specifically those by the Organisation for Economic Co-operation and Development (OECD), the International Monetary Fund (IMF) and the European Commission, explicitly or implicitly blame high welfare costs and low labour market flexibility for western Europe's poor performance. While it is true that welfare costs are higher and west European labour as well as product markets are more regulated, there are some doubts as to whether these are the main reasons. First, differences in product markets and in labour market regulations narrowed considerably during the 1990s; secondly, there is a weak – if any – relationship between the degree of regulatory change during the 1990s and economic performance.[279]

It has been argued that macroeconomic policy (e.g. growth-supporting monetary policy, and demand stabilization through fiscal policy during troughs) is at least as important as regulatory changes.[280] The strongest and increasing difference between the United States and western Europe is, however, the dynamics of investment in future growth, such as in education, research and diffusion of new technologies (ICT and biotechnology). Aiginger uses 16 indicators to measure the investments of countries in these variables, including indicators of research input and output, education expenditures and educational attainment, as well as spending on ICT in both production and consumption (as a proxy for spending and the diffusion of new technologies). The astonishing result is that in 1990, the United States led in all 16 indicators, and by the end of the 1990s it was still leading in 14 of the 16 indicators. The EU-15 as a group is catching up in four of the indicators, and has surpassed the United States in two, while the difference is increasing for 11 indicators (and constant for one). In light of this evidence, it is therefore no surprise that growth rates have been higher in the United States since the 1990s.[281] Chart 7.3.1 allows comparing these drivers of future growth. Each value inside the unit circle indicates lower levels in western Europe relative to the United States

While stressing that investment in the future is the most important explanation for differences in growth performance, the importance of the other policy areas should not, however, be overlooked. There are several interactions, and causality runs in both directions: innovation supports growth and growth fosters innovation. Innovations are easier to implement if markets are less strictly regulated, and regulations can be abandoned if people who lose their jobs can find new ones easily.

Zielen der Wirtschaftspolitik, Zu den Erkenntnissen der, 'happiness-Forschung'", *Wirtschaft und Gesellschaft*, Vol. 30, No. 4, 2004 and "Die 'Neue Unsicherheit' als Ursache der europäischen Wachstumsschwäche", *Perspektiven der Wirtschaftspolitik*, Vol. 5, No. 4, 2004.

[278] K. Aiginger, "The three tier strategy ...", op. cit.

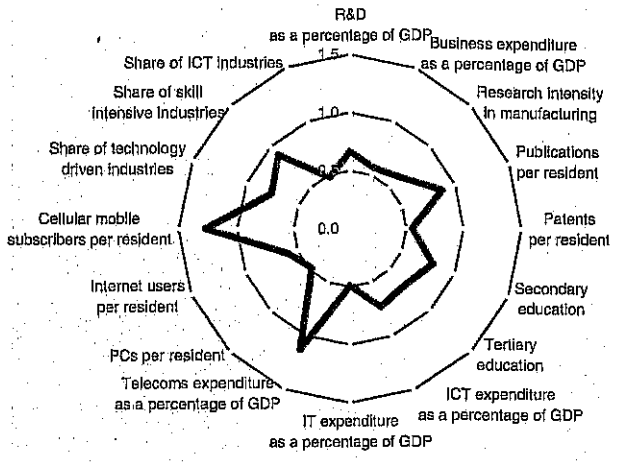
[279] K. Aiginger, "Economic agenda for the 21st century", *Review of International Economics*, Vol. 12, Issue 2, May 2004, pp. 187-206.

[280] K. Aiginger, "The three tier strategy ...", op. cit.

[281] Some of the advantages of investment into future components of growth were already evident in previous decades, when Europe grew faster than the United States. There are two explanations as to why insufficient investments in Europe did not hamper growth earlier: first of all, per capita GDP as well as productivity were initially much lower in Europe, so that the higher levels of European growth included an element of catching up; secondly, it is argued that the European system of innovation may have been particularly apt during periods of imitation and diffusion, while the United States system of innovation is better adapted to periods marked by the emergence of new general-purpose technologies such as ICT. K. Aiginger and M. Landesmann, "Competitive economic performance, ...", op. cit.

CHART 7.3.1

Indicators of future growth potential: EU-15 versus the United States



Source: WIFO calculations, based on Eurostat NewCronos Database; European Information Technology Observatory (EITO).

Note: Values inside the unit circle indicate that levels in the EU-15 are below the United States levels for the corresponding indicator. Data refer to last year available for the period 1999-2001.

Economists need to be cautious when judging whether the United States lead will be extended into the next decade, given that in 1990 neither the accelerated growth of the United States had been forecast nor the demise of the Japanese economy. If present trends were to continue, the following developments could reasonably be expected to occur:

- The differences in macroeconomic policy will probably become narrower, given that the deficit in the United States is now higher than in western Europe. Thus fiscal policy in the United States will have to become more restrictive. It is difficult to predict whether a more growth-oriented monetary policy will compensate for this;
- Western Europe is reforming its welfare systems and is increasingly cost conscious: several countries have started to tackle the pension problem, welfare costs have been reduced in most western European countries without dismantling the core elements of the welfare state , and unfavourable incentive structures are being changed;
- Western Europe still has an advantage in the technology diffusion phase: the European system of innovation, with its reliance on skilled labour and small-scale innovation, seems to be more competitive during the diffusion phase of a new technology, and step-by-step improvement in quality is one of western Europe's core capabilities;
- EU enlargement, the shaping of new institutions, liberalization and the consequences of the Single Market will favour growth and competitiveness in the long run. Some of these policies may have resulted in short-term costs associated with structural change and declining employment, but the growth effect of European integration should eventually become evident, and then accelerate as a result of rapid growth in the accession countries;
- Higher levels of research and a high degree of efficiency in the United States persist. Even if certain European countries are catching up and differences in some of the growth drivers are diminishing, there continue to be differences in the levels of most of these determinants, reflecting differences in quantitative inputs as well as efficiency;
- The industry structure should remain more favourable in the United States, where the share of technology-intensive and ICT industries is higher. The share of labour-intensive industries is declining, but is still higher in western Europe. However, western Europe is likely to maintain its advantage in medium-skilled industries and in upgrading the quality of existing structures;[262]
- Taxes, welfare and the regulatory burden are lower in the United States. The creation of new firms is easier, venture capital is more abundant, and more cheap labour is available, due to the open labour market as well as high rates of legal and illegal immigration;
- The long-term impact of increased expenditures on security will probably be a burden for the United States. Expenditure on war and security can initially boost demand and stabilize growth, but a long-standing preoccupation with security is likely to create a heavy financial burden and may divert financial resources from more profitable projects (and from areas higher in the priority of the more developed countries: health, education and equity).

Summing up, the difference between United States and western European rates of growth may decline, since the risk of a widening trade deficit and the costs of war and security could prove to be a burden for the United States. Nevertheless, a higher growth rate for the United States in the medium term is forecast.

7.4 Differences among western European countries

Differences in dynamics among western European countries have become larger in the 1990s. Cross-county comparisons of such differences can be used to learn about the determinants of growth in the 1990s.

[262] K. Aiginger, "Europe's position in quality competition", background report for *The European Competitiveness Report 2000*, European Commission (Brussels), 2000.

TABLE 7.4.1

Performance of top 3 and big 3 European countries relative to the EU-15 and the United States

	Top 3 European countries [a]	*Big 3 European countries* [b]	*EU-15*	*United States*
Real growth of GDP				
Growth, 1993-2002	2.9	1.6	2.1	3.2
Acceleration [c]	1.2	-1.0	-0.5	-0.2
Macro productivity growth				
Growth, 1993-2002	2.4	1.2	1.4	1.6
Acceleration [c]	0.5	-0.8	-0.6	–
Employment rate				
Average, 1993-2002	70.8	61.9	64.4	79.7
Absolute change, 1993-2002	1.2	2.0	3.0	3.7
Unemployment rate				
Average, 1993-2002	8.7	9.9	9.2	5.2
Absolute change, 1993-2002	-2.5	0.3	-1.0	-1.6
Inflation rate				
Average, 1993-2002	1.8	2.2	2.4	2.5
Absolute change, 1993-2002	-0.3	-1.9	-2.1	-1.4
Budget deficit as a per cent of GDP [d]				
2002	-2.3	3.0	2.0	3.2
Absolute change, 1993-2002	-5.0	-3.7	-3.9	-2.7
Public debt as a per cent of GDP				
2002	46.8	75.7	62.7	61.0
Absolute change, 1993-2002	-9.9	12.3	3.7	-13.8
Taxes as a per cent of GDP				
2002	56.6	47.0	45.5	31.6
Absolute change, 1993-2002	-4.5	1.0	-0.1	0.6
GDP per capita at PPP 2002				
Thousand euros	25.3	24.5	23.9	33.5

Source: WIFO calculations, based on the annual macroeconomic database of the European Commission's Directorate General for Economic and Financial Affairs (AMECO) (DG ECFIN).

[a] Denmark, Finland and Sweden.

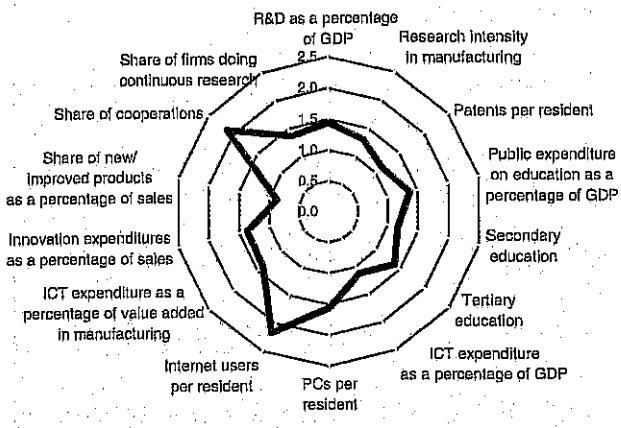
[b] France, Germany and Italy.

[c] Growth per annum 1993-2002 minus growth per annum 1983-1992.

[d] Negative value = surplus.

CHART 7.4.1

Indicators of future growth potential: top 3 European countries [a] versus 3 large European economies [b]



Source: WIFO calculations, based on Eurostat NewCronos Database; European Information Technology Observatory (EITO).

Note: Values inside the unit circle indicate that levels in the top 3 countries are below the levels of the corresponding indicator in the 3 large economies. Data refer to last year available for the period 1999-2001.

[a] Denmark, Finland and Sweden.

[b] France, Germany and Italy.

Specifically, if the high welfare costs were at the heart of the European problem of low dynamics, it could be expected that the worst performers should be countries with the most comprehensive welfare programmes and high taxes.

Denmark, Finland and Sweden can be ranked[283] as the three best performers in western Europe using indicators on growth of output, productivity and employment to measure "overall economic performance". The same conclusions have been reached in assessments of the competitiveness of western European countries by the International Institute of Management Development (IMD) and the World Economic Forum (WEF), and in studies by the OECD on countries' growth differences. These three countries are also welfare states of the Nordic type, which means they are characterized by ambitious social goals and a high degree of government involvement.

The strategy pursued by these successful countries has been called the three tier strategy.[284] First, they contained private and public costs in order to restore profitability and fiscal prudence. Second, they improved incentives by fine-tuning their welfare systems and liberalizing part-time work as well as product markets. And third, they significantly increased investment in future growth, surpassing that of the larger western European economies in research input and output, in education expenditures and quality, and in information technology. In contrast, the larger continental economies (France, Germany and Italy) underperformed in terms of investments in growth drivers (chart 7.4.1).

7.5 Towards a new European model: a tentative sketch of its features

The structures and policies of the most successful European countries are very different from those of the

[283] K. Aiginger, "The three tier strategy ...", op. cit. Ranking the countries according to the indicators in table 7.4.1 reveals Ireland as the top performing country, followed by Sweden, Denmark and Finland. While Ireland's is a remarkable story of catching up and finally forging ahead (in terms of a subset of indicators, but not in terms of income per head or wages per worker), we consider the other three as important examples of how mature and rich countries can continue to grow, and call them the "top 3 countries".

[284] K. Aiginger, "The three tier strategy ...", op. cit.

TABLE 7.5.1

Old model versus new European model of a reformed welfare state

Old model of European welfare	*New model of the leading three countries*[a]
	Welfare pillar
Security in existing jobs	Assistance in finding a new job
High replacement ratios	Incentives to accept new jobs (return to labour force)
Structural change in existing firms (often large firms)	Job creation in new firms, service, self-employment
Comprehensive health coverage, pensions, education	Coverage dependent on personal obligations
Regulation of labour and product markets	Flexibility as a strategy for firms and as a right for employees
Focus on stable, full-time jobs	Part-time work as individual choice (softened by some rules)
Early retirement	Encouraging employment of the elderly
	Policy pillar
Focus on price stability	Focus on growth and new technologies
Asymmetric fiscal policy (deficits)	Fiscal prudence (but flexible in crisis)
Incentives for physical investment	Incentives for research, education and new technologies
Subsidies for ailing firms (public ownership)	Industrial areas, university nexus
Industrial policy for large firms	Start-ups, venture capital, services
Local champions, permissive competition policy	Exploit current strengths (cluster and regional policy) and competition

Source: K. Aiginger, "The economic agenda: a view from Europe", *Review of International Economics*, Vol. 12, Issue 2 (Special Issue: Economic Agenda for the 21st Century), May 2004.

[a] Denmark, Finland, Sweden.

United States system as far as welfare and government involvement are concerned, as well as in their commitments to training and redistribution as goals of labour market policy. Their labour market policies offer a high degree of flexibility for firms (e.g. easy dismissals and low corporate taxes), but also provide security to individuals in helping them to find new jobs and upgrade their qualifications. This system could therefore be called "flexicurity", and it builds on the broader concept of "active labour market policies". These countries accord high priority to new technologies, efficiency of production and the competitiveness of firms (table 7.5.1). In contrast to the United States, they rely on proactive industrial policies, with government support for information technology, for agencies promoting research, for regional policies and for clusters. Although these countries suffered severe financial crises when many of the problems suspected of dampening growth in a highly developed welfare state surfaced (e.g. costs increased faster than productivity and government expenditures increased faster than taxes), they changed their course without, however, abandoning the principles of the welfare state and without giving up their environmental goals. We believe that the specific elements of the political reforms in the northern European countries suggest that there may be a new kind of reformed European model, which combines welfare and sustainability on the one hand with efficiency and economic incentives on the other.[285]

The new welfare state, as represented by the policy strategy in these leading European countries, is different from the old welfare state in the following ways:

- The social system remains inclusive and tight, but the social benefits may depend on the individual's inputs; they may be conditional on certain obligations; replacement rates are lower than they used to be (but still high by international standards) to provide better incentives to work;
- Taxes are relatively high, but in line with expenditures, and aim at positive balances to take care of future pensions or to repay current debt;
- Wages are high, but the individual's position is not guaranteed, as business conditions vary. However, assistance and training opportunities that are personalized, less bureaucratic and less centralized are offered to people who lose their jobs;
- Welfare-to-work elements have been introduced, usually on a decentralized – sometimes even private – basis; conditions differ according to the size and kind of problem, the background philosophy being one of giving help but without encouraging laziness;
- Part-time work and adaptation of work to life cycles is encouraged – not prevented – and social benefits are pro rata extended to part-time work, which becomes an individual right and a measure voluntarily taken to enforce, rather than prevent, gender equality;
- Technology policy and adoption of new technologies, rather than subsidizing old industries, are a

[285] For earlier suggestions along this line, see K. Aiginger, *The New European Model of the Reformed Welfare State*, European Forum Working Paper 2/2002, Stanford University, December 2002; K. Aiginger and M. Landesmann, op. cit.; K. Aiginger, "Economic agenda ..., op. cit.

precondition for the survival of the welfare state, and lead to more challenging and interesting work.[286]

The new European model differs from the United States model in the following ways:

- Even where welfare costs are streamlined and incentives improved, the welfare system offers comprehensive insurance against economic and social risks and a broad coverage of health risks;
- Environmental and social goals as well as equity of income distribution and prevention of poverty are high on the political agenda;
- Government and public institutions play a proactive role in promoting innovation, efficiency, structural change, higher qualifications and lifelong learning. Public institutions also provide the largest share of education and health care;
- Social partners (institutions comprising representatives of firms and employees) determine many elements of wage formation, and together they develop labour laws and institutions specifically and economic policy in general;
- Government is large and taxes are high, even if there are mechanisms to limit increases in spending and goals for achieving a sound fiscal policy in periods of increasing demand.

7.6 Summary

Income per capita in the United States is 40 per cent higher than in Europe and is unlikely to converge. Productivity is 30 per cent higher, although Europe had been catching up in GDP per person employed over a long period in the post-war years. However, in the past 10 years the United States has once again increased its lead. GDP per hour worked is the most favourable indicator of European performance, revealing a gap of less than 10 per cent, but again the difference has been increasing recently. Employment indicators show that the United States created 78 million jobs between 1990 and 2003, while Europe created 42 million. The employment rate in Europe, which up to the 1970s was higher, is now 13 percentage points lower than that of the United States (although the gap has recently narrowed slightly). Unemployment is higher in Europe, even excluding the significant number of people on disability or in early retirement schemes, which decreases open unemployment. There are fewer hours worked in Europe, partly voluntarily and partly due to the lack of full-time jobs. Leisure takes a higher priority in Europe.

International organizations (e.g. OECD and the EU Commission) often blame the higher welfare costs and stricter regulations of labour and product markets for the low dynamics in the European economies ("Paris consensus"). However, assessing performance differences in Europe reveals that the best performing countries (besides Ireland, which experienced a remarkable catching up) are three Nordic European welfare states: Denmark, Finland and Sweden. All three countries had suffered structural and cyclical crises, which appeared to confirm some of the bleak predictions for welfare states, but over the past 10 years they have been performing better than the other European countries, with a growth performance similar to that of the United States. At the same time, they are successfully trying to combine welfare with higher efficiency. This chapter has highlighted the main characteristics of these countries and their reforms, enabling the definition of a new European model of a reformed welfare state. It provides an alternative model to that of the United States in that it aims at achieving economic efficiency while maintaining the traditional European concerns for social welfare and environmental quality. The model thus combines security for citizens with efficiency and flexibility for firms, and may be considered as being in the tradition of Josef Steindl and Michal Kalecki.[287]

The fact that the three Nordic states performed well in the 1990s does not imply that welfare costs are irrelevant for performance. After suffering severe crises, these countries realized that costs needed to be cut and the fiscal balance stabilized, that incentives had to be implemented and institutions reformed. But, most importantly, they realized also that cost-cutting represents a short-term strategy which needs to be complemented by proactive policies to promote research, education and the diffusion of new technologies. This chapter has attempted to present the tentative hypothesis that a new European model is in the offing, with an emphasis on cost balancing, institutional flexibility and technology orientation. Even in the trough period, from 2001 to 2004, the budgets in all three countries have been balanced. The firms are more flexible with regard to the use of labour, and workers who are laid off are efficiently assisted in finding new jobs. Replacement ratios have been reduced and benefits are conditional upon job searches and training efforts. Thus the new European model of the reformed welfare state has three major elements: social and environmental responsibility, openness and technology promotion.

[286] Surprisingly, the policies pursued by the leading countries have many similarities with the economic policy recommendations of the Steindl-Kalecki tradition, as described in A. Guger, M. Marterbauer and E. Walterskirchen, op. cit.

[287] J. Steindl, *Maturity and Stagnation in American Capitalism* (Oxford, Blackwell, 1952); M. Kalecki, *Studies in the Theory of Business Cycles, 1933-1939* (New York, Augustus M. Kelley, 1966).