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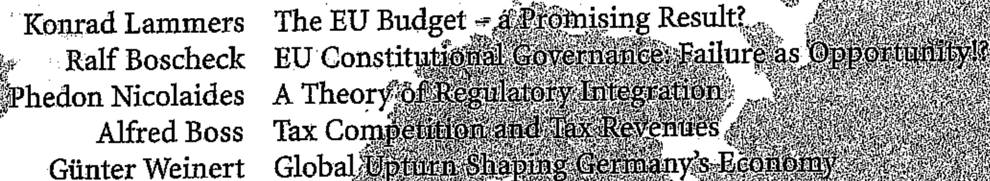

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1 · 2006

Karl Aiginger* and Alois Guger**

# The Ability to Adapt: Why It Differs between the Scandinavian and Continental European Models

It is well recognised today that European economic performance has deteriorated since the beginning of the 1990s. This is the case whether we compare the performance with that of the past, with that of the USA or that of the fast growing economies in China or India. Growth has also been disappointingly low and unemployment high compared to the expectations raised by the European integration and enlargement project. Many authors blame the high level of taxes and government expenditures, the degree of regulation, and the costs of welfare ("big government hypothesis") in Europe as the main reason for European underperformance.

## Differences in Performance

This article explores the differences across European models in order to learn about the reasons for underperformance and about successful strategies to keep European countries competitive in the world economy. We largely follow the standard definition of model types, specifically distinguishing between a Scandinavian version, a continental version and an Anglo-Saxon version of the European model. We add a Mediterranean model and a catching-up model for the new member countries but focus on the differences among the three "main models". The Scandinavian group – while not performing better in the long run and struck by many crises up to the early 1990s – since that time has enjoyed higher growth, high employment, decreasing unemployment and finally a budget surplus. We try to find out how these countries specifically adapted their economies to the new challenges of the globalising economy in which higher "business flexibility" and "worker adaptability" is needed: for firms it should be easier to establish new businesses by abolishing unnecessary rules and easing access to capital markets for small and medium-sized firms;[1] for workers this means that employees are enabled to respond flexibly to changes and to take advantage of new opportunities, such as high-quality education and first-class schools, housing, transportation and affordable child care.

A tentative hypothesis is that the Scandinavian countries realised the extent of new challenges, since the burden of welfare, the prediction of upcoming

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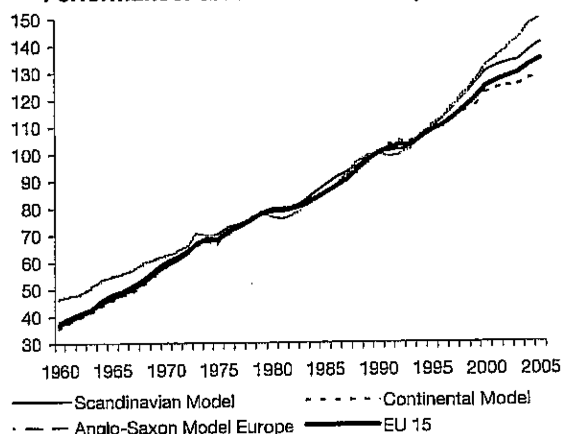
[1] Extended by a "secondary" capital market where loans are easily securitised and where there is better income protection in the case of bankruptcy.

Figure 1
**Performance: Growth of Real GDP; 1990=100**




Source: Eurostat (AMECO); as to sub-aggregates weighted average over countries; EU 15 reported.

problems as well as the experience of severe crises had made it crystal clear that the economies had to become more flexible and that the institutions of Scandinavian society cooperated with experts efficiently to develop a long-run strategy with a strong commitment to the welfare state, a consensus across society and deep trust among all members of society. The necessity to increase flexibility may have been lower in liberal countries – though these countries made some moves in similar directions. Their problem has not been macro-economic underperformance – low growth and high unemployment – but high and rising inequality and poverty. However, for "liberal" countries the evidence in Europe is limited to two countries (United Kingdom and Ireland) with very different economic policies, histories and growth experiences over the past decades. The necessity for change was underestimated in the continental countries where institutions did not cooperate to face the new challenges. The difference in the adaptability of the three main European models has some similarity to the well-known Calmfors-Drifill[2] hypothesis that countries with a medium degree of centralisation did worst in wage bargaining, compared to countries with centralised bargaining processes on the one hand and to decentralised bargaining at the firm level on the other hand. Of course the arguments relate to different issues and have different drivers, but common ground is that a medium position may not always be the best.

The paper is structured as follows. First, we briefly repeat the common characteristics of the European model and which model types we choose to distinguish. We prefer to speak of a model of European society or a socio-economic model, since the models and reforms relate not only to social issues, but also to regulation, incentives and the innovation system. We then compare the performances of different types of models, first by examining the dynamics of GDP, productivity and employment and then investigating a wider set of indicators.[3] This is followed by a description of the differences between the Scandinavian countries and the continental countries in three policy areas: size of government and dynamics of social expenditures, regulation and improving incentives on the labour market and, finally and most important, the level and dynamics of investment into the long-run drivers of economic growth. Finally, the differences are summarised between the old European welfare model and the reformed model, elements of which are emerging in many European countries, most of them Scandinavian, and to a much lesser extent in the big continental countries. The new European model certainly differs from the old European welfare state model but also from the US model.

### Model(s) of European Society

There has been no agreement on a common definition of the European model. We prefer to define the European socio-economic model in terms of the responsibility of society for the welfare of the individual. Labour and product markets are regulated, with regulation (partly) shaped by the social partners. Income differences between rich and poor are limited by taxes and transfers.[4] These three basic characteristics – responsibility, regulation, redistribution – reflect the fact that the European model is more than just a social model in the narrow sense. Indeed, it also influences production, employment and productivity, and thus growth and competitiveness as well as all the other objectives of economic policy. Furthermore, the European model influences social relationships, cultural institutions and behaviour, learning, and the creation and diffusion of knowledge. We therefore prefer to speak of a European socio-economic model rather than merely a social model.

In differentiating between several versions of the European model it is standard practice since the work of Esping-Andersen[5] to distinguish between a

[2] L. Calmfors, J. Drifill: Bargaining structure, corporatism and macroeconomic performance, in: Economic policy, Vol. 3, No. 1, 1988, pp. 14-61.

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

[4] K. Aiginger, A. Guger: The European Social Model: from an alleged barrier to a competitive advantage, in: Journal of Progressive Politics, Vol. 4.3, Autumn 2005, pp. 40-47.

**Table1**
**Performance across Models: GDP and Employment**

| | 1960/ 1990 | 1990/ 2005 | GDP per capita at PPP 2005 | Employment rate 2005 | Unemployment rate 2005 |
|---|---|---|---|---|---|
| | Annual growth in % | | 1,000 € | | |
| Scandinavian Model | 3.3 | 2.3 | 29.0 | 74.2 | 5.6 |
| Denmark | 2.7 | 2.2 | 28.6 | 77.2 | 4.6 |
| Finland | 3.9 | 2.0 | 26.6 | 68.6 | 8.4 |
| Netherlands | 3.4 | 2.2 | 28.7 | 73.6 | 5.1 |
| Sweden | 2.9 | 2.0 | 27.0 | 73.7 | 6.8 |
| Norway | 3.9 | 3.2 | 34.7 | 77.7 | 4.0 |
| Continental Model | 3.5 | 1.7 | 25.2 | 66.2 | 8.9 |
| Germany | 3.2 | 1.7 | 25.0 | 70.0 | 9.5 |
| France | 3.8 | 1.9 | 25.9 | 63.8 | 9.6 |
| Italy | 3.9 | 1.3 | 23.7 | 62.0 | 7.7 |
| Belgium | 3.4 | 1.9 | 27.6 | 61.8 | 8.0 |
| Austria | 3.5 | 2.2 | 28.0 | 74.8 | 5.2 |
| Anglo-Saxon Model Europe | 2.6 | 2.7 | 27.8 | 71.9 | 4.6 |
| Ireland | 4.1 | 6.5 | 31.9 | 68.6 | 4.3 |
| United Kingdom | 2.5 | 2.4 | 27.6 | 72.1 | 4.6 |
| Mediterrean Model | 4.6 | 2.8 | 21.8 | 63.6 | 9.1 |
| Greece | 4.5 | 3.0 | 19.5 | 55.0 | 10.4 |
| Portugal | 4.8 | 2.1 | 17.5 | 70.5 | 7.4 |
| Spain | 4.6 | 2.9 | 23.1 | 64.1 | 9.2 |
| EU 15 | 3.4 | 2.0 | 25.3 | 67.2 | 7.9 |
| Japan | 6.1 | 1.3 | 26.3 | 77.2 | 4.5 |
| Catching-up Model | . | 2.5 | 15.7 | 61.2 | 7.5 |
| Czech Republic | . | 1.3 | 16.7 | 65.4 | 7.9 |
| Hungary | . | 3.9 | 14.5 | 56.2 | 7.0 |
| Anglo-Saxon Model Overseas | 3.6 | 3.1 | 35.0 | 72.9 | 5.2 |
| USA | 3.5 | 3.1 | 35.8 | 72.9 | 5.1 |
| Canada | 4.0 | 2.8 | 29.5 | 74.1 | 6.8 |
| Australia | 3.8 | 3.5 | 27.6 | 72.1 | 5.2 |
| New Zealand | 2.4 | 3.2 | 22.1 | 59.6 | 4.0 |
| Scandinavian Model without NL | 3.3 | 2.3 | 29.2 | 74.6 | 5.9 |
| Continental Model without IT plus NL | 3.4 | 1.6 | 23.3 | 61.2 | 8.3 |
| Mediterrean Model plus IT | 4.2 | 1.2 | 9.2 | 26.8 | 3.8 |
| Anglo-Saxon Model Total | 3.5 | 3.0 | 34.1 | 72.7 | 5.1 |

Source: Eurostat (AMECO); as to sub-aggregates weighted average over countries; EU 15 reported.

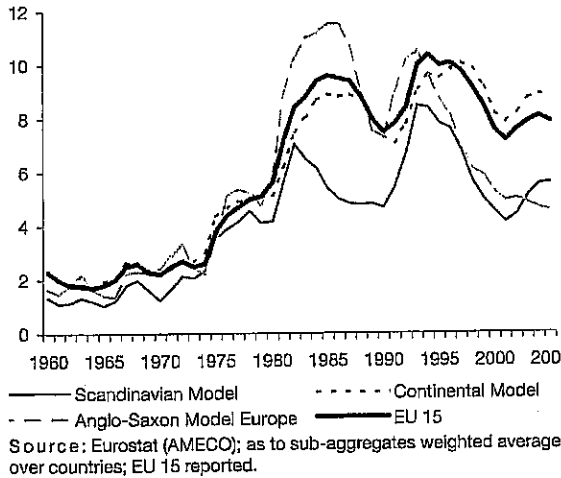
Scandinavian model (often called the Nordic model), a continental model (also known as the corporatist model and sometimes as the Rhineland model) and an Anglo-Saxon model (the liberal model). We may add a model where low levels of social expenditures are combined with supportive family networks. This is the case in southern European countries ("Mediterranean model"), where some characteristics of agrarian societies still prevail. A fifth model, not yet elaborated, may emerge for the new member countries of the European Union. Several social institutions were first founded after the transition; these countries are short of the financial means for a comprehensive welfare system and they are determined to catch up with the old member countries e.g. by attracting foreign direct investment. We will therefore call this fifth model the "catching-up model". Outside of Europe, the US model serves as the standard benchmark for an Anglo-Saxon model overseas. The USA is grouped together with Canada, Australia and New Zealand as the "Anglo-Saxon overseas model". Japan, as well as the other industrialised Asian economies, remains an outsider to this discussion.

The Scandinavian model is the most comprehensive, with a high degree of emphasis on redistribution; social benefits are financed to a large extent by taxes. Institutions work closely together with the government, wage bargaining is centralised and trade unions are involved in the administration of unemployment insurance and training, and the model is characterised by an active labour market policy and high employment rates. The continental model emphasises employment as the basis of social transfers. Transfers are financed through the contributions of employers and employees. The social partners play an important role in industrial relations, and wage bargaining occurs less at the firm level but either at the industry level or at an even more centralised level. Redistribution and the inclusion of outsiders are not high on the agenda. The liberal model emphasises the responsibility of individuals for themselves, its labour market is not regulated and its competition policy is rather ambitious. Social transfers are smaller, more targeted and "means tested" than in the other models. Labour relations are decentralised, and bargaining takes place primarily at the firm level.

We include five countries in the Scandinavian group. The inclusion of the Netherlands is the most contentious choice, because the Dutch model is less ambitious, redistributes less and places less emphasis on gender equality (at least up to the 1990s). We pool five countries in the continental model – France, Germany and Italy, which are the three big continental countries, plus Belgium and Austria, two high-growth countries with top positions in per capita GDP. There is a certain amount of disagreement as to whether Italy fits better into this group or into the Mediterranean

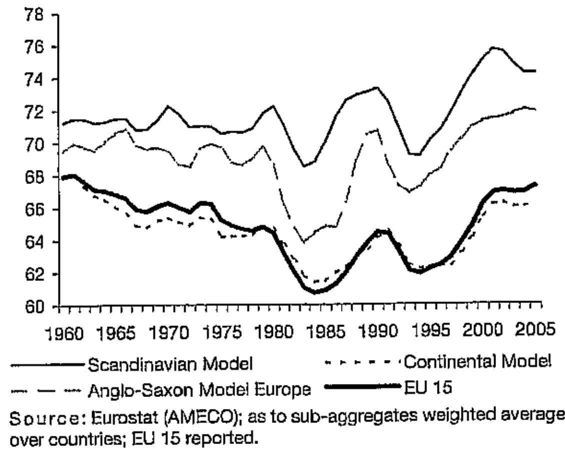
[5] G. Esping-Andersen: Three Worlds of Welfare Capitalism, Cambridge 1990, Polity Press.

Figure 2
Unemployment Rate




Source: Eurostat (AMECO); as to sub-aggregates weighted average over countries; EU 15 reported.

Figure 3
Employment Rate




Source: Eurostat (AMECO); as to sub-aggregates weighted average over countries; EU 15 reported.

group. We decided to delegate Italy to the continental group due to the economic importance of Northern Italy, and the Mediterranean model therefore comprises Spain, Portugal and Greece. The Anglo-Saxon model is championed in Europe by the United Kingdom. As far as the low degree of regulation and the social system are concerned, Ireland exhibits a certain degree of similarity to the United Kingdom, but policy interventions have been intense, as is typical of a catching-up country: high shares of inward FDI, low taxes for business, and a regional policy supporting small and medium-sized firms. In Europe, these strategies are now the paradigm for catching-up economies. Outside of Europe, we group Canada, the USA, New Zealand and Australia together, under the heading "Anglo-Saxon model overseas".

The results presented are robust whether we use a weighted or an unweighted average over the individual countries in building performance indicators for groups.[6] We decided to use weighted averages. The result is also robust if we change the members of the groups slightly, for example by shifting the Netherlands to the continental model and Italy to the Mediterranean model or integrate European and new European countries into an "Anglo-Saxon model total" (see the last four rows in Table 1).

### Economic Performance According to Type of Model

Table 1 shows that long-run economic growth had been very similar for the three main models (Scandinavian, continental, Anglo-Saxon), and that in the period 1960 to 1990 it was also rather similar in Europe to that in the USA. Performance in the nineties (1990/2005) diverged however. The Scandinavian group enjoyed a growth rate of 2.3% for these 15 years – despite a severe crisis in many countries in the early 1990s.[7] The growth rates of the countries associated with the continental model plummeted to 1.7%, due to low growth in Germany and Italy. France and Belgium came near to the average of the EU15 and Austria surpassed it, but none of them reached the level of dynamics attained by the Nordic group. The countries of the Anglo-Saxon model Europe enjoyed high growth – including the highest for a single country. However, this group consists in Europe of only two members with very different economic histories. Ireland is a late, and then very successful, catching-up story, while the UK rebounded from three decades of slow growth, in which it had lost its historical lead in per capita GDP. In highlighting the differences between successful and less successful strategies, we concentrate on the Scandinavian and the continental group, reporting the average of the EU15 and that of the Anglo-Saxon countries Europe as "benchmarks".

The differences in economic performance between the Nordic countries and the big continental economies are elaborated by Aiginger,[8] who uses a set of 12 indicators for the dynamics of output, productivity and employment, as well as for the level and changes in unemployment and fiscal balances to derive a more comprehensive "performance evaluation" of countries. Aside from the Irish growth experience, Sweden,

[6] With the exception of the Anglo-Saxon model Europe, where the United Kingdom dominates if we use weighted averages and Ireland dominates if we use unweighted averages.

[7] K. Aiginger, op. cit.; K. Aiginger, A. Guger, op. cit.

Table 2
**National Finances and Social Expenditures**

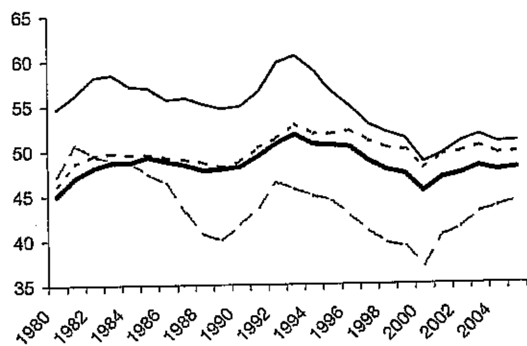
| | Public revenues | | | Public expenditures | | | Budget deficit | | | Total social expenditures | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1990 | 2000 | 2005 | 1990 | 2000 | 2005 | 1990 | 2000 | 2005 | 1990 | 2003 |
| | in % of GDP | | | | | | | | | | |
| Scandinavian Model | 51.5 | 54.2 | 53.3 | 52.8 | 48.6 | 50.8 | -1.0 | 5.6 | 2.5 | 29.7 | 29.5 |
| Denmark | 54.7 | 56.5 | 58.0 | 55.9 | 53.3 | 54.4 | -1.3 | 3.2 | 3.5 | 28.2 | 30.9 |
| Finland | 53.5 | 55.9 | 53.5 | 48.1 | 48.8 | 51.7 | 5.4 | 7.1 | 1.8 | 25.1 | 26.9 |
| Netherlands | 47.4 | 45.6 | 46.4 | 52.5 | 43.4 | 48.2 | -5.1 | 2.1 | -1.8 | 31.1 | 28.1 |
| Sweden | . | 62.4 | 58.2 | . | 57.4 | 57.1 | 0.0 | 5.0 | 1.2 | 33.1 | 33.5 |
| Norway | 56.2 | 58.2 | 56.8 | 54.0 | 42.6 | 43.6 | 2.2 | 15.6 | 13.3 | 26.2 | 27.7 |
| Continental Model | 44.3 | 47.8 | 46.1 | 48.8 | 47.9 | 49.6 | -4.5 | -0.1 | -3.5 | 25.9 | 29.5 |
| Germany | 42.1 | 46.4 | 43.1 | 44.1 | 45.1 | 46.9 | -2.0 | 1.3 | -3.8 | 25.4 | 30.2 |
| France | 47.7 | 50.4 | 50.6 | 49.8 | 51.8 | 53.9 | -2.1 | -1.4 | -3.2 | 27.4 | 30.9 |
| Italy | 42.6 | 46.2 | 44.9 | 54.3 | 47.0 | 49.2 | -11.8 | -0.8 | -4.3 | 24.7 | 26.4 |
| Belgium | 45.5 | 49.1 | 49.0 | 52.2 | 49.1 | 49.2 | -6.7 | 0.0 | -0.1 | 26.4 | 29.7 |
| Austria | 49.7 | 49.8 | 47.6 | 52.0 | 51.4 | 49.6 | -2.4 | -1.6 | -2.0 | 26.2 | 29.5 |
| Anglo-Saxon Model Europe | 40.0 | 40.8 | 41.0 | 41.7 | 37.0 | 44.2 | -1.7 | 3.8 | -3.2 | 22.6 | 26.1 |
| Ireland | 40.0 | 35.9 | 34.9 | 42.8 | 31.5 | 35.3 | -2.8 | 4.4 | -0.4 | 18.4 | 16.5 |
| United Kingdom | 40.0 | 41.2 | 41.4 | 41.6 | 37.4 | 44.8 | -1.6 | 3.8 | -3.4 | 22.9 | 26.7 |
| EU 15 | 42.7 | 46.2 | 45.1 | 48.2 | 45.3 | 47.8 | -4.6 | 0.9 | -2.7 | 25.4 | 28.3 |

Source: Eurostat (AMECO; ESSOSS); as to sub-aggregates weighted average over countries; EU 15 reported.

Finland and Denmark have been the best performers and were therefore designated by Aiginger as the "top countries".[9] Germany, Italy and France are the worst performing countries, and specifically for France a comprehensive evaluation reveals a worse performance than a comparison based on economic growth alone.[10]

In trying to find out the differences in the reaction of economic policy between the Scandinavian countries and the continental countries, we investigate the role of government, of labour markets and investment in the long-run growth determinants.

**Figure 4**
**Government Expenditures as a Percentage of GDP**




Scandinavian Model · Continental Model · Anglo-Saxon Model Europe · EU 15

Source: Eurostat (AMECO); as to sub-aggregates weighted average over countries; EU 15 reported.

## The Role of Government, Fiscal Deficits and Social Expenditures

The Scandinavian countries traditionally have a larger government sector and higher social expenditures than the continental economies, also in relation to the European average. Both indicators are lower for Anglo-Saxon European countries (and still lower in Mediterranean countries and in the Anglo-Saxon model overseas). In the last 15 years there has been a significant convergence between the models for expenditure rates but not for taxes. The difference in the share of public revenues, which was seven percentage points higher in the Scandinavian countries than in

[8] K. Aiginger, op. cit. The strong performance of Sweden, Finland and Denmark is based upon three pillars. First, these countries contained private and public costs in order to restore profitability and fiscal prudence. Secondly, they improved incentives by fine-tuning their welfare systems and deregulating part-time work and product markets. And thirdly, they significantly increased investment in future growth. In contrast, the large continental economies (France, Germany and Italy) underperformed in terms of investment in growth drivers, refrained from labour market reform and ran into persistent fiscal deficits.

[9] K. Aiginger, op. cit.

[10] K. Aiginger: Insufficient investment into future growth: the forgotten cause of low growth in Germany, in: Christoph Hausen, Marc Resinek, Nicolin Schürmann, Michael H. Stierle (eds.): Determinants of Growth and Business Cycles: Theory, Empirical Evidence and Policy Implications, INFER Annual Conference 2003, INFER Research Edition Vol. 9.

Table 3
**Social Expenditures in Detail**

| | Total social expenditures | | Sickness and health care | | Disability | | Old age | | Survivors | | Family/ Children | | Unemploy-ment | | Housing and social exclu-sion n.e.c. | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1990 | 2003 | 1990 | 2003 | 1990 | 2003 | 1990 | 2003 | 1990 | 2003 | 1990 | 2003 | 1990 | 2003 | 1990 | 2003 |
| Scandinavian Model | 29.7 | 29.5 | 7.5 | 8.0 | 4.1 | 3.8 | 8.9 | 9.9 | 1.0 | 0.8 | 2.5 | 2.6 | 2.5 | 1.9 | 1.2 | 1.4 |
| Denmark | 28.2 | 30.9 | 5.5 | 6.1 | 2.7 | 4.0 | 10.0 | 11.1 | 0.0 | 0.0 | 3.2 | 4.0 | 4.2 | 2.9 | 1.6 | 1.7 |
| Finland | 25.1 | 26.9 | 6.9 | 6.5 | 3.8 | 3.5 | 7.2 | 8.7 | 1.0 | 1.0 | 3.3 | 3.0 | 1.5 | 2.6 | 0.6 | 0.9 |
| Netherlands | 31.1 | 28.1 | 8.4 | 8.2 | 4.9 | 2.9 | 9.5 | 9.2 | 1.6 | 1.4 | 1.7 | 1.3 | 2.5 | 1.6 | 1.2 | 1.6 |
| Sweden | 33.1 | 33.5 | . | 8.5 | . | 4.6 | . | 12.2 | . | 0.7 | . | 3.1 | . | 1.9 | . | 1.3 |
| Norway | 26.2 | 27.7 | 7.7 | 9.4 | 4.1 | 4.8 | 7.7 | 7.7 | 0.4 | 0.3 | 2.8 | 3.2 | 1.8 | 0.9 | 1.1 | 0.9 |
| Continental Model | 25.9 | 29.5 | 7.3 | 7.9 | 1.7 | 1.9 | 10.3 | 11.8 | 1.4 | 1.5 | 2.0 | 2.4 | 1.6 | 2.0 | 0.8 | 0.7 |
| Germany | 25.4 | 30.2 | 7.8 | 8.1 | 1.5 | 2.3 | 10.6 | 12.0 | 0.6 | 0.4 | 1.9 | 3.1 | 1.5 | 2.5 | 0.7 | 0.7 |
| France | 27.4 | 30.9 | 7.4 | 8.9 | 1.7 | 1.4 | 9.4 | 10.6 | 1.7 | 2.0 | 2.7 | 2.6 | 2.3 | 2.3 | 1.0 | 1.3 |
| Italy | 24.7 | 26.4 | 6.6 | 6.5 | 1.7 | 1.6 | 11.2 | 13.1 | 2.4 | 2.6 | 1.0 | 1.0 | 0.6 | 0.5 | . | 0.1 |
| Belgium | 26.4 | 29.7 | 6.6 | 7.6 | 1.9 | 1.9 | 7.6 | 9.7 | 2.9 | 2.9 | 2.3 | 2.2 | 3.4 | 3.5 | 0.5 | 0.5 |
| Austria | 26.2 | 29.5 | 6.6 | 7.1 | 2.3 | 2.4 | 11.7 | 13.4 | 0.6 | 0.4 | 2.6 | 3.1 | 1.2 | 1.7 | 0.4 | 0.5 |
| Anglo-Saxon Model Europe | 22.6 | 26.1 | 5.3 | 7.6 | 1.9 | 2.3 | 8.7 | 10.2 | 0.9 | 0.9 | 2.0 | 1.8 | 1.4 | 0.7 | 1.5 | 1.7 |
| Ireland | 18.4 | 16.5 | 6.0 | 6.6 | 0.8 | 0.8 | 4.2 | 2.9 | 1.2 | 0.8 | 2.0 | 2.5 | 2.6 | 1.3 | 0.9 | 0.9 |
| United Kingdom | 22.9 | 26.7 | 5.3 | 7.7 | 2.0 | 2.4 | 9.0 | 10.7 | 0.9 | 0.9 | 2.0 | 1.8 | 1.3 | 0.7 | 1.5 | 1.7 |
| EU 15 | 25.4 | 28.3 | 6.8 | 7.7 | 2.0 | 2.1 | 9.8 | 11.1 | 1.3 | 1.3 | 1.9 | 2.2 | 1.8 | 1.8 | 0.8 | 1.0 |

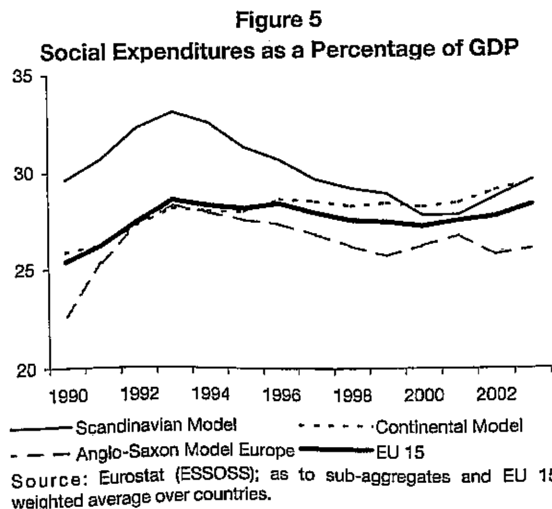
Source: Eurostat (ESOSS); as to sub-aggregates weighted average over countries; EU 15 reported.

the continental countries in 1990, did not change but the difference in public expenditures, which had been four percentage points, is now about one percentage point. The most dramatic change happened for budget deficits. The fiscal deficit reached a record of 5% of GDP in the Scandinavian countries in 1993 and these countries now have a surplus of 2.5% in 2005. The countries of the continental models, specifically Germany and France, had low deficits in 1990 but all three major countries are running deficits above 3% and the group average reaches 3.5%. This gives a six point difference to the Scandinavian countries.[11]

This fiscal prudence is part of the new strategy implemented by the Scandinavian countries, which had not been known for budgetary discipline before.[12] They tried to get rid of their structural deficits by imposing limits in the expenditures, but tax cuts were not high on the agenda. The traditional sensibility of Scandinavian countries not to impose too high taxes on business (while taxing energy consumption and

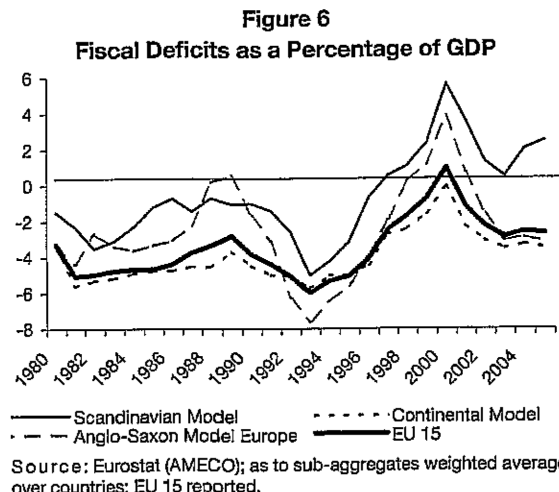
[11] The group averages are to some extent misleading due to the large deficit of Italy in 1990, and the high surplus of Norway. The surplus in 2005 was 0.4% for the Scandinavian countries without Norway (and 2% if we also exclude the Netherlands).

Figure 5
**Social Expenditures as a Percentage of GDP**




Source: Eurostat (ESSOSS); as to sub-aggregates and EU 15 weighted average over countries.

Figure 6
**Fiscal Deficits as a Percentage of GDP**




Source: Eurostat (AMECO); as to sub-aggregates weighted average over countries; EU 15 reported.

**Table 4**
**Product and Labour Market Regulation**

| | Product market regulation | | Labour market regulation | | | |
|---|---|---|---|---|---|---|
| | | | All contracts | | Temporary contracts | |
| | 1998 | 2003 | 1990 | 2003 | 1990 | 2003 |
| Scandinavian Model | 1.9 | 1.3 | 2.8 | 2.3 | 3.0 | 1.7 |
| Denmark | 1.4 | 1.1 | 2.3 | 1.8 | 3.1 | 1.4 |
| Finland | 2.1 | 1.3 | 2.3 | 2.1 | 1.9 | 1.9 |
| Netherlands | 1.8 | 1.4 | 2.7 | 2.3 | 2.4 | 1.2 |
| Sweden | 1.8 | 1.1 | 3.5 | 2.6 | 4.1 | 1.6 |
| Norway | 2.4 | 1.4 | 2.9 | 2.6 | 3.5 | 2.9 |
| Continental Model | 2.2 | 1.5 | 3.1 | 2.6 | 3.9 | 2.4 |
| Germany | 1.8 | 1.3 | 3.2 | 2.5 | 3.8 | 1.8 |
| France | 2.4 | 1.6 | 2.7 | 2.9 | 3.1 | 3.6 |
| Italy | 2.7 | 1.8 | 3.6 | 2.4 | 5.4 | 2.1 |
| Belgium | 1.9 | 1.4 | 3.2 | 2.5 | 4.6 | 2.6 |
| Austria | 1.8 | 1.3 | 2.2 | 2.2 | 1.5 | 1.5 |
| Anglo-Saxon Model Europe | 1.1 | 0.9 | 0.6 | 1.1 | 0.3 | 0.4 |
| Ireland | 1.4 | 1.0 | 0.9 | 1.3 | 0.3 | 0.6 |
| United Kingdom | 1.1 | 0.9 | 0.6 | 1.1 | 0.3 | 0.4 |
| EU 15 | 1.9 | 1.4 | 2.8 | 2.4 | 3.0 | 2.0 |

Source: OECD (ECO/CPE/WP1(2004)9/ANN3); index between 0 (unregulated) and 6 (regulated).

property) was maintained and strengthened. The final success of the fiscal policy came however, as growth rebounded.[13]

The share of social expenditures had been 29.7 % in the Scandinavian countries in 1990, which was four percentage points higher than in the continental countries. It peaked at 33 % in the Nordic countries due to the deep recession in 1993. The percentage came down to 29.5 in 2003, about the same level as in the continental countries, in which social expenditures increased from 26% to 29.5%.[14] Germany and France have now higher public expenditure shares than the Scandinavian average. One of the reasons is that unemployment benefits expenditures are increasing in the continental countries and decreasing in the Scandinavian ones; other major factors are stronger increases in contributions for old age pensions in continental Europe.

### Labour Market Institutions and Changing Incentives

Regulation of both product and labour markets is higher in continental Europe. The difference had existed for a long time but became more pronounced since the 1990s. The empirical data were collected by the OECD and are partly qualitative assessments; they are scaled from 0 (no regulation) to 6 (highly regulated) and exist for product market regulation between 1998 and 2003 and for labour market regulation between 1990 and 2003 (Table 4).

In 1998, the Scandinavian countries had product markets as regulated as on European average, now they are as deregulated as in the Anglo-Saxon countries at least in Denmark and in Sweden. The countries of the continental model started and ended with a marginally higher regulated product market, with Italy and France lagging Germany and Austria as far as product market deregulation is concerned. The Mediterranean countries have more regulated product markets (Table 4).

As far as labour markets are concerned Scandinavian countries have traditionally somewhat less regulated labour markets and have kept this position. Specifically Denmark and Finland have now considerably less regulated labour markets than France, Germany and Belgium. An interesting feature is that the Scandinavian countries did not change the regulations for regular contracts (they are marginally more regulated than those of the continental model countries), but for temporary contracts. Specifically Sweden, Denmark and the Netherlands cancelled most administrative limits for temporary contracts (while providing *pro rata* benefits to them), and temporary contracts are now much less regulated than in countries of the continental model (with the exception of Germany and Austria). Regulation is stricter for all contracts in the countries of the Mediterranean model.[15]

The very high trade union density has not changed in Scandinavia in general, with a rate of 59% and rates above 75% in Sweden and Denmark. Col-

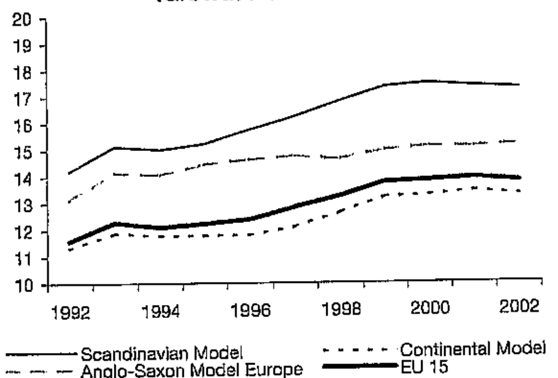
[12] Alesina and Ardagna define episodes of loose fiscal policies for OECD countries between 1960 and 1994. Finland and Sweden lead the table with ten loose periods, Norway and Denmark have five and six respectively, while the average amounts to three per country. Cf. A. Alesina, S. Ardagna: Tales of fiscal adjustment, in: Economic Policy, Vol. 13, No.27, October 1998.

[13] This proves that "even the most successful structural reform in Europe will not generate growth if the macroeconomic conditions are not right. Weakness in aggregate demand can ruin any economic party". M. N. Baily, J. F. Kirkegaard: Transforming the European Economy, Washington 2004, Institute for International Economics, p.18, available at http://bookstore.iie.com/merchant.mvc?Screen=PROD&Product_Code=353. Cf. also A. Sapir et al.: An Agenda for a Growing Europe, Oxford 2004, Oxford University Press; J. P. Fitoussi, F. K. Kostoris Padoa Schioppa: (eds.): Report on the State of the European Union, Vol. 1, Houndsmills 2005, Palgrave Macmillan.

[14] According to the latest published figures from the OECD, which reports only public expenditures, these are higher on average in relation to GDP in the continental countries than in the Scandinavian countries in the last published figures.

[15] K. Aiginger: Labour market reforms and economic growth - the European experience in the nineties, in: Journal of Economic Studies, Vol. 32, No. 6, 2005, pp. 540-573.

Figure 7
**Investment in the Future as a Percentage of GDP (Growth Determinants)**




Source: Eurostat; EITO; as to sub-aggregates weighted average over countries; EU 15 reported.

Table 5
**Investment in the Future (Growth Determinants)**

| | Investment in the future | | |
|---|---|---|---|
| | 1992 | 1995 | 2003 |
| | In % of GDP | | |
| Scandinavian Model | 14.2 | 15.2 | 17.3 |
| Denmark | 14.4 | 15.4 | 17.8 |
| Finland | 13.8 | 14.8 | 16.9 |
| Netherlands | 13.3 | 13.7 | 14.7 |
| Sweden | 15.6 | 17.7 | 21.1 |
| Norway | . | . | . |
| Continental Model | 11.3 | 11.8 | 13.3 |
| Germany | 11.8 | 11.8 | 13.4 |
| France | 12.3 | 13.2 | 14.2 |
| Italy | 8.9 | 9.9 | 11.3 |
| Belgium | 12.2 | 12.6 | 15.1 |
| Austria | 11.6 | 11.8 | 14.3 |
| Anglo-Saxon Model Europe | 13.1 | 14.5 | 15.2 |
| Ireland | 12.7 | 13.5 | 11.3 |
| United Kingdom | 13.2 | 14.5 | 15.5 |
| EU 15 | 11.6 | 12.2 | 13.8 |

Source: Eurostat, EITO; as to sub-aggregates weighted average over countries; EU-15 reported.

lective agreements cover 82% of employees in the Scandinavian countries, and the trend is on the rise, and they cover about as large a share of employees in the continental countries (the rate is stable at 80%). With the exception of Belgium, trade union density has declined in the continental countries since 1980; on average from more than one third to one quarter. This is to a large extent due to the rise in unemployment and structural changes in employment: the decline in big business manufacturing employment, on the one hand, and the increase in service production in firms of small and medium size on the other. Despite this decline in trade union density there was on average hardly any change in the coverage of collective agreements in these countries. In the United Kingdom, the coverage of collective bargaining plunged from 70% in 1980 to 40% in 1990 and 30% in 2000.

The labour market institutions were reformed to make the markets more flexible but also to help people find new jobs by offering genuine and even personalised assistance and re-qualification. Active labour market policy and lifelong education has a high and increasing priority in the Scandinavian countries. The obligations for the individuals were increased as far as sectoral and regional mobility is concerned. If they do not fulfil the obligations or refuse to accept jobs, the benefit duration period and the benefit level are reduced. Part-time jobs have increased, but the gender distribution is more equal in Scandinavian countries and the share of voluntary part-time – due to personal priorities – was increased. *Pro rata* benefits are associated with part-time, return to full time is possible, and switching from irregular contracts to regular contracts is favoured. These strategies and several innovative measures in individual countries (such as sabbaticals in Denmark, decentralisation of institutions, complementary private agencies) are summarised as strategies of "flexicurity" or "balanced and managed flexibility". Trust among institutions and individuals, and a high level of macroeconomic activity are favourable for such reforms.[16]

The difference between gross earnings and net earnings (tax wedge) is specifically important for the functioning of a labour market since employees supply labour if net earnings are high and firms demand labour if labour compensation is low. The tax wedge decreased in Scandinavian countries from 46.1% in 1979 to 45.4% in 1991 and to 43.2% in 2004, while it increased in continental countries from 42.4% to 47.2% to 48.6%. Thus a lower wedge in continental countries (by 4 percentage points) turned into a higher wedge of 5.4 percentage points in two decades (and from 1.8 to 5.4 since 1990). Scandinavian countries were very careful to prevent their high taxes from distorting the labour markets too much.

### Future Investments

While fiscal prudence has been a precondition for a long-run growth strategy and making the labour market more flexible in a balanced way is an important

[16] G. Tichy: Die 'Neue Unsicherheit' als Ursache der europäischen Wachstumsschwäche, in: Perspektiven der Wirtschaftspolitik, Vol. 6, No. 3, 2005, pp. 385-407.

second pillar of the success, the sufficient part of the strategy – and maybe the most important long-run difference between the Scandinavian and the continental economies – is the emphasis of the Nordic countries on technology, education and growth. According to growth theory, the medium-term growth rate of an advanced economy depends on R&D, human capital and the speed of diffusion of new technologies. Under the heading "future investment", we summarise expenditures on research, education, and information and communication technology (as a proxy for the diffusion of a new technology). In the Scandinavian countries future investment increased from 14.2% to 17.3%, while in the continental countries future investment used to be lower and increased in the 1990s only from 11.3% to 13.3%. Thus the Scandinavian countries increased their lead from three points to four points, and the difference would be more than 5 percentage points if we did not put the Netherlands into the Scandinavian group. Sweden, Finland and Denmark are countries fulfilling the Lisbon goal of a 3% research expenditures rate (ranking places 1, 2 and 4 in the share of R&D in GDP in Europe). Future investment in the EU15 is 13.8%, in the USA 16.1%; thus the Scandinavian countries surpass the USA in these investments which decide about long-run growth.

The continental countries have not raised their R&D ratio, have average expenditures on education, are moderate in the PISA ratings and underinvest in ICT.

### Towards a New European Model

The Scandinavian countries have embarked on a strategy of fiscal prudence, and they are improving institutions and incentives without abandoning the principles of the welfare state. Specific elements of the political reforms in these Northern European countries might lead to a reformed European model which combines welfare with efficiency and adaptability to new challenges.

- The social system remains inclusive and tight, but social benefits are partly made dependent on the input of the individual and transfers become conditional to certain obligations; replacement rates are lower than they used to be in order to provide stronger incentives to work but are still high by international standards.
- The welfare system is more service oriented (care facilities for children, the aged and the handicapped) than transfer oriented, in order to increase equality and to increase female employment.
- Taxes are relatively high, but in line with expenditures, aiming at budget surpluses in the medium term, to cover future pensions and to repay current debt. The "quality" of public finances is monitored, and expenditures for education, innovation and lifelong learning have priority.
- Wages are high, but the position of the individual is not guaranteed, as business conditions vary. People losing their jobs get assistance and training (flexicurity). The public services are complemented by private agencies. Welfare-to-work elements have been introduced, the background philosophy being one of giving help without incriminating the unemployed of being idle and inactive.
- Part-time work and the adaptation of work to life-cycles are encouraged, not prevented. Social benefits are extended *pro rata* to part-time work, which is valued as a right of the individual and as an instrument of personal choice (managed and balanced flexibility), rather than a fate preventing gender equality.
- Technology policy and investment in the future are seen as a precondition for economic growth, competitiveness and the survival of the welfare state, they lead to more challenging and interesting work.[17]

Some of these reforms are similar to parallel reforms in the Anglo-Saxon model (e.g. welfare to work strategies), while others are very different.

- Environmental and social goals, as well as the equity of income distribution and the prevention of poverty remain high on the political agenda. Public institutions also provide the largest share of education and health care, which is open to all residents, of high quality and available at affordable conditions.
- Government and public institutions play a proactive role in promoting innovation, efficiency, structural change, higher qualifications and lifelong learning. This contradicts the approach that governments have just to deregulate the markets, and to expect – given markets are flexible – that innovation and growth will rebound automatically ("Paris consensus").
- Social partners (institutions representing employers and employees) negotiate wage formation, develop labour laws and co-determine economic policy in general. They monitor that flexibility is balanced and profits accruing from flexibility are shared.

[17] 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, E. Walterskirchen: Growth Policy in the Spirit of Steindl and Kalecki, WIFO Working Papers 240/2004, Vienna 2004.

- 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 ("fiscal rules") in periods of high demand. Firms are partly sheltered from high tax rates; there are high taxes on consumption and specifically on energy.

**Summary**

International organisations often blame the higher welfare costs and the stricter regulation of labour and product markets for the lack of dynamics in European economies ("big government hypothesis"). However, an assessment of performance differences across Europe reveals that the model type performing best since the 1990s is the Scandinavian model.[18] The Scandinavian countries traditionally have the highest share of government and social expenditures; they emphasise redistribution and social inclusion. Many of these countries have experienced periods of structural and cyclical crises, which appeared to confirm some of the bleak predictions for welfare states in general. Over the past ten years, however, they have been able to adjust their institutions and incentives better than the continental countries, where growth is lower and unemployment is higher. The underperformance of the continental countries holds specifically for the larger continental countries, while the smaller managed to come close to (Belgium) or surpass (Austria) the European average in growth and employment.

The Scandinavian countries applied a three-tier strategy of fiscal prudence, improving incentives on the labour market and boosting long-run growth, thereby combining welfare with higher efficiency. Government expenditures to GDP, which had been 6 percentage points higher in 1990 is now equal to that in the continental countries at about 50% of GDP, declining gradually in the first group and increasing in the second. Taxes (incl. other revenues) are still higher in the Scandinavian group and tax rates did not decline while they increased in the continental group. The fiscal balance is now 2.5% in surplus in the Scandinavian group, while the deficit in the continental countries is 3.5%. Surpluses were intended in the Scandinavian countries, high growth helped to achieve them and there was even space for a counter-cyclical fiscal policy over the past years without accruing a deficit. In the continental group the deficit was largely the consequence of low growth, not due to strategies to support demand or accelerate future investment in a low growth period. Social expenditures relative to GDP mirror the expenditure trend in general; they had been four percentage points higher in the Scandinavian countries in 1990 and they are now about the same in Scandinavian and continental countries.

Labour market regulation had always been slightly lower in the Scandinavian countries; specifically temporary contracts are now easier than in 1990. On the other hand replacement rates are high in Scandinavian countries and an active labour market policy fosters re-qualification and re-employment. Thus flexibility for the firms as well as security for the employees was intensified. This is about to become a role model called flexicurity. Trade union density is high and unchanged in the Scandinavian countries, while it decreased in continental countries and plummeted in the Anglo-Saxon countries. The reform agenda is strategic and consensual; trust has a high value in the Scandinavian countries.

The Scandinavian countries realised that high growth and best technology is necessary for the maintenance of a welfare state with high taxes. Investment in research, education and new technologies had been higher and increased faster than in the countries of the continental model. On average they invest 17.3% in these future areas as compared to 13.3% in the continental countries.

It is interesting to ask why the Scandinavian model is better able to cope with the challenges of globalisation and competition. One reason might be the experience of the crises which hit Denmark and the Netherlands in the eighties, and then Sweden and Finland in the early 1990s. The second reason might be that these countries realised that their model was an extreme case as far as government share, taxes, social inclusion and welfare goals were concerned and that they wanted fervently to keep their welfare model in principle, and therefore realised that they had to make changes and reforms at the margin and to improve incentives. A third reason could be that the coherence of the society is larger, trust is higher and policy is more strategic. The continental countries on the other hand did not feel the same pressure and underestimated the necessity for change. And the reforms – if they were made at all – were made in a more controversial, less strategic and less consensual way. Further research is still needed, however, to find the underlying causes for the differences in the adaptability of the Scandinavian and the continental model.

[18] Together with the United Kingdom and Ireland, which are part of the Anglo-Saxon model but had rather different and specific histories in the previous three decades.