# EUROPEAN ECONOMIC AND SOCIAL MODELL

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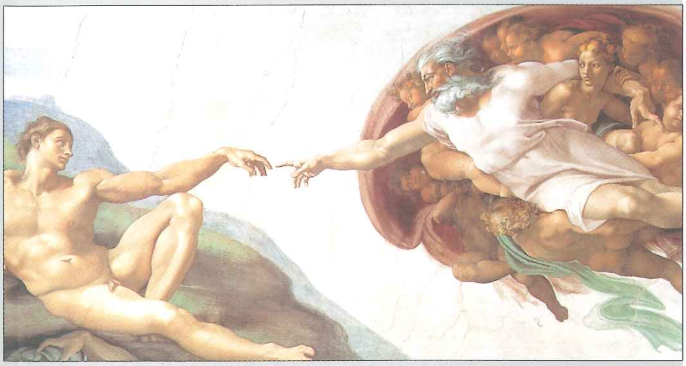

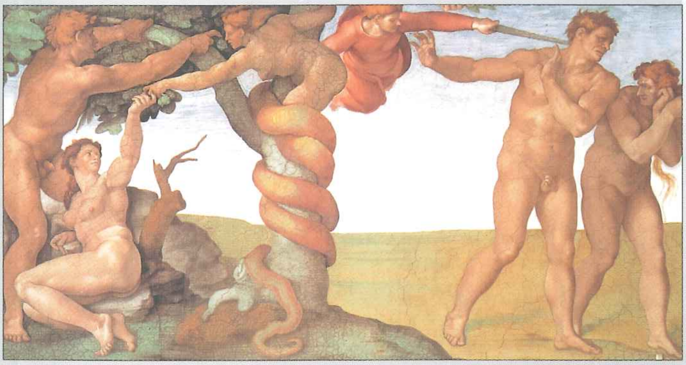

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# COMPETITION, INCOME DISTRIBUTION AND THE EUROPEAN SOCIAL MODEL

***Summary***

**1.** Competitive, free markets are supposed to deliver growth, employment and a fair distribution of income. In reality, markets are never free, but depend on the states and societies they are embedded in. Markets fail and the outcome of market processes is often considered unfair. To correct these deficiencies, states have always regulated markets. These regulatory systems are country-specific and constitute different "varieties of capitalism" which shift cost and risks between employers, employees, consumers and taxpayers.

**2.** Enterprises are the most important players in market systems. Their competitiveness and productivity depend not only on their own capacities to innovate and manage production but also on the regulatory framework which on the one hand limits their capacity to externalize costs and on the other hand offers opportunities to reduce costs or even to receive rents.

**3.** Integrating national economies offers new opportunities to rise productivity and lower costs. Transnational markets change the national distribution of income and expose people to new and foreign market failures and undesirable outcomes. The capacity of their own states to control and correct these are limited by their commitment to open markets and, within the European Union, even more so by the transfer of competencies to Brussels.

**4.** These problems become more salient with the integration of countries with very different levels of income. Poor countries that intend to catch up with rich countries often subsidize export production. In particular, differences between income measured at market exchange rates and purchasing power provide opportunities for an unequal exchange and strong incentives to relocate production.

**5.** The (negative) market integration and systems competition within Europe has forced enterprises to become more competitive and to cut costs without sufficiently regulating the macro-economic and distributive impact. European integration with its focus on stability and competition has therefore a potentially harmful effect on demand, employment and income distribution which hits different member states in different ways.

**6.** The European welfare states are also affected by the lop-sided integration of mar-

kets without supplementing positive integration. The competition of systems tends to endanger the national capacity to combine social security, financial solidity and successful employment policies. A European Social Model as a full blown alternative to national systems is still in its infancy. Although the EU-wide extension of any single national model would possibly be more effective than the present EU policy mix, it is hard to imagine that a common model will soon emerge given the wide range of distributional interests affected.

The dominant logic of European integration is permeated by the rhetoric of competition and competitiveness. The Lisbon strategy wants Europe to become "the world's most competitive knowledge-based economy". The whole integration process since the Rome treaties relies on the hope that stronger competition will increase welfare. Following that logic, Europe has reduced barriers to trade (customs duties, quota, subsidies, technical and fiscal barriers), and to the free movement of services, labor and capital. The following paper will analyze the basic logic and inherent conflicts of creating an European Social Model, discuss the meager real results within Europe and propose alternative policies to achieve more welfare and social justice.

## *1. The logic and justice of markets*

Traditional, i.e. neoclassical or (neo-)liberal economic theory is founded on a very simple basic model which quasi axiomatically guarantees that free markets maximize welfare. Its core component is the model of exchange between two market participants with given resources (goods and/or production factors) and preferences. When these two agree to exchange a certain amount of resources against another set of resources, they do so *per definitionem* because they both expect to benefit from it. Their welfare, calculated as the sum of resources weighted by the preference given to each of them, will increase. Otherwise, an exchange would never take place in the first place. The market outcome is also just and fair because it is both voluntary and in the interest of both sides.

By assembling millions of these basic building blocks one arrives at general equilibrium models of national economies. Here it is assumed that, given the right prices including wages and interest rates, all markets clear and all members of the market economy maximize their welfare. Unemployment is voluntary and reflects a preference for leisure against income. Intervention by governments tends to distort prices and to lead to less just and suboptimal outcomes. In particular, competition in free markets ensures that neither wages nor profits can be "too" high or low as either other suppliers of capital or labor would enter the markets with high prices/returns or some would leave those markets with low prices and returns. In the "final" equilibrium, profits and wages would be equalized at the marginal productivity of capital and labor.

Competition, ideally perfect competition, lies behind the equilibrium. Prices are determined by supply and demand. On both sides, producers and consumers compete among each other. High prices induce new producers to enter the market and drive away consumers with less income and/or lower preferences for that good. Lower prices reduce supply by bankrupting less productive suppliers but increase demand. Adding new producers and consumers to a market by enlarging a common market will increase the welfare of most participants. The larger choice of resources and preferences allows new equilibria at higher levels of welfare.

When enterprises cut costs by processes such as restructuring, investing in labor-saving technologies, firing workers, then competition will ensure that lower costs are translated into lower prices thus increasing the real income of all consumers. The consumers will spend the additional income by demanding more of the now cheaper product or other goods and services whose supply will offer new jobs for the workers who were displaced by the original cost cutting. In the end, productivity will increase and allow higher consumption. It is basically that logic which the forecasts of higher growth for the Single Market by reports such as the Checchini report are based on. Similarly, liberal economists expect from the implementation of a European market of services more jobs and output.

## *2. Market failures and undesired outcomes*

Unfortunately, this wonderful world, the best of all possible worlds according to the liberal credo, does not exist in reality. Already the core element of free and fair exchange neglects crucial conditions. Before it can happen property rights must be established and protected. The model does also not care about the usually huge discrepancies in the original endowment of those involved in an exchange. To give a simple example: When in a desert one side owns the only source of water and the other side just its labor force, the exchange of water against labor will increase the welfare of both sides; but as the worker depends on the water with his life the price could be virtually set unilaterally by the owner of the source. In the logic of the market this simply reflects the preference structure of the worker. Very likely the situation and the outcome will hardly be considered as fair and just. People then tend to ask for correcting measures, usually by public policies.

Furthermore, in the sad reality, markets often fail. Such market failures which also require state intervention abound in economic theory and real life experience: asymmetrical information crowding out good products ("the market for lemons"), averse selection in risk markets, monopolies and oligopolies, externalities, social costs and public goods are all examples. Over time, most societies have developed a wide range of public policies to correct market outcomes and market failures considered unjust or suboptimal. They provide goods that markets do not deliver, they protect consumers, assure a minimum of competition where suppliers are few and/or collusive, and generally regulate markets. The total set of these public policies and the market and enterprise structures that co-develop in that policy framework constitute specific national varieties of capitalism (Albert 1992, Hall&Soskice 2001).

In particular, public policies might be needed to make sure that the productivity gains enterprises achieve under the pressure of competition will be translated into higher output, demand and consumption. Cost cuts could also result in higher savings by those who benefited either as consumers or as more profitable suppliers. If those savings are not invested in real capital because of lacking demand they might simply drive up asset prices and the resulting equilibrium is accompanied by higher unemployment. Fordism with its mixture of national Keynesianism and regulated global currency and capital markets has achieved a virtuous circle of productivity growth and full employment by keeping real interest rates below growth rates. (Schulmeister 1998, Stockhammer 2005)

Ideally, competition should be the great equalizer of incomes. Wherever there were high incomes deriving from exceptionally profitable activities, new suppliers of those goods or services would enter the market and drive down prices. Why are there still income discrepancies? The simple answer is: because markets do not work perfectly. There are natural monopolies that create rents. For instance, in a traditional, largely agricultural economy, land has different fertility that allows for differential rents, and the owners of land with natural resources such as oil earn rents, too. In modern economies, invention creates temporary monopolies whose lifetime is prolonged by patent protection. There are also sectors and activities which are characterized by increasing returns of scale and network effects which form huge barriers to entry for other potential suppliers.

Politics protects many rent sources, too. It guarantees property rights of land and natural resources, grants patents, and regulates access to markets, for instance by limiting the supply of professionals such as physicians, lawyers or pharmacies. The ownership of properties and assets which are unequally distributed in the first place causes income flows as returns on these assets that are unequal, too. Politics also protects workers resulting in higher wages (at least in kind such as health and safety, working time limits, etc.) because in free markets the unorganized workers are usually weaker than the big enterprises that employ them. Competition would lead to a specific market failure in the shape of too many accidents, low life expectancy and other consequences that are not only undesirable, but also undermine the sustainability of the national economy. Obviously, the resulting average real wages cannot be higher than average productivity.

According to the logic of markets, income reflects productivity. People earn more because they are more productive. But productivity differentials can result from different causes. As mentioned above, in traditional agriculture, they predominantly resulted from different fertility. Today, in many cases, they result from different capital endowments. Earlier investment in new technology, machines and new processes has led to higher productivity. Public policies boost productivity, too, by investing in education, research and infrastructure and by generally providing public goods such as security and peace that otherwise must be substituted by costly private supply. These productivity gains can be distributed between the state (taxes), labor and capital, between the latter according to marginal productivity.

### *3. The competitiveness of enterprises*

It is important to look at issues like productivity, competitiveness and distribution from the perspective of private businesses as the logic of business permeates the whole debate about competitiveness on all levels including national economies and Europe. An enterprise uses various inputs such as private and public goods and services, and labor and capital in order to produce specific goods and/or services. Its value added is the difference between value of inputs (except labor and capital) and output. Its productivity is the value added per unit of production factor used, most often regarding labor input, i.e. per employee or hour worked. An enterprise is competitive when it can sell its products in the market for a price which at least covers the cost of all inputs plus a profit.

The value added and thus productivity depends on the prices of input and output. The capacity to get cheaper inputs and to sell the output at higher prices increases productivity. But productivity gains can result from different processes which have very different broader repercussions. National economic policy and the EU therefore regulate enterprise behavior in order to minimize certain harmful processes. The main factors determining productivity are:

- **Physical productivity** is the positive core of productivity. It rises when the output can be produced with less input thanks to better technology or clever management.
- **Monopolies** allow to charge higher prices and thus increase value added and productivity. Enterprises can achieve this by buying competitors, cartel agreements or state protection. These are zero-sum games with clients such as consumers or other enterprises which use their output as input. The EU and national policies try to constrain this behavior. However, when enterprises exploit the lack or lagging behind of potential competitors by, for instance, offering innovative products they enjoy a (temporary) monopoly which basically is a positive feature. Actually, enterprises and whole economies can increase welfare best by continuous innovation.
- **Better quality** is a similarly positive factor of higher productivity as it allows to sell a product at a premium. It usually might require a constant upgrading of product qualities and processes and a rapid adjustment to new demands and fashions in order to stay ahead of competitors which will try to achieve similar levels of quality.
- **Lower cost of inputs** is obviously very helpful for the enterprise and raises its productivity. If the lower cost reflect certain real advantages such as location or agglomeration benefits (which might reduce transportation costs) they are hardly harmful. If, however, they result from market power which simply reduces the income suppliers can earn such as forcing workers to accept lower wages (in various forms including longer working time, less rights etc.) they basically redistribute income between enterprises in a zero-sum game without increasing total national income.
- **Externalization of costs** is a specific form of that zero-sum game. When enterprises can exploit nature (the environment) or workers by activities such as polluting water and air or endangering the health and safety of workers at no direct cost they increase productivity and gain a competitive advantage over competitors that take care of sustainability.

Bad quality which is not immediately perceived by buyers can also considered as an externalization of costs at the expense of the consumer. Shoddy products cost less to produce and can possibly be sold at similar prices as good ones when information about product quality is asymmetric.

Of course, enterprises try to use all of the above processes to increase their value added and thus profits. The less they are able to rely on innovation and quality the more they have to rely on low cost. Public policy should try to steer enterprises towards the positive-sum games of innovation, quality and increasing physical productivity which increase the total welfare of the economy while constraining zero-sum games of redistribution between enterprises and/or private business on the one side and labor and the state on the other. Unfortunately, public authorities often try to support enterprises by less healthy means in order to, among other goals, save jobs. They give direct monetary subsidies or tax reductions or free or cheap access to public goods and services which are specifically designed to serve a target business such as a road or rail link. Or they limit competition by establishing barriers to entry and thus enable them to charge above-market prices and gain rent income. Conversely, enterprises use to complain that high costs such as taxes, fees, regulatory burden, wages, or other inputs undermine their competitiveness.

In many ways, enterprises can be used to redistribute income between different groups within a society. When enterprises are subsidized tax payers suffer while employers, employees and/or consumers gain. When markets are protected, consumers suffer while employers and/or employees gain. In communist planned economies, for instance, employees benefited primarily since enterprises required little work and offered a large range of social services. There was no pressure to increase productivity or quality (no consumer protection), budgetary constraints were soft and environmental and other regulation minimal. The transition to a market economy required massive labor shedding and new regulation.

When enterprises in market economies are regulated to prevent externalization or to enforce corporate social responsibility such as offering jobs to the handicapped or training to the young or retirement benefits, then tax payers and/or the public at large benefit at the expense of employers, sometimes employees and/or consumers. It is often relatively pointless to opt for one way or the other as burdens will be forwarded according to market power. When the competitive situation allows it, higher costs (including wages) are turned into higher prices to protect profits. When the large groups of consumers and tax payers overlap as usual, they might try to burden enterprises with taxes or regulations but will pay for it via higher prices.

### *4. International competition and the domestic distribution of income*

All the above aspects of markets and competition can also be observed in a multicountry economy such as the European and the world economy. But when markets cross national borders, various new phenomena appear that have been analyzed by economic theories notably the theory of international trade. In particular transnational markets are characterized by different national currencies which introduce exchange rates into the transnational markets. and by the competition between different regulatory and public policy systems which are largely responsible for the domestic level and distribution of income (as shown above).

The core concept of international trade theory goes back to Ricardo. Different levels of physical productivity in different national economies allow a better specialization according to comparative advantage that increases the overall productivity and welfare in all participating economies even when one economy is more productive in all industries. Within each economy, competition drives the less productive suppliers out of business but creates new demand for the more productive ones. Of course, overall productivity can only increase when the production factors can shift between different sectors/uses. The distribution of these productivity gains depends on the exchange rate. The country that accepts the weaker terms of trade gets higher employment and vice versa. Overall employment remains only stable when total demand increases. However, these gains might be reversed when productivity differences between economies disappear in the course of economic development (Samuelson 2004).

According to theory (Heckscher-Ohlin, Stolper-Samuelson), the specialization of different countries depends on their factor endowments. Countries with abundant labor will specialize in labor-intensive production while countries with abundant capital will specialize in capital-intensive production. Free trade and even more free movement of production factors such as labor and capital should equalize factor earnings, i.e. increase wages in labor-abundant economies and profits in capital-abundant ones. Similarly, the income of skilled and less skilled labor should change according to its changing scarcity. In reality, income levels have largely remained huge. During the decades of liberalization and globalization the income gap between rich and poor countries has hardly shrunk - the success of some, mostly Asian, countries notwithstanding. Capital has not moved massively from rich to poor countries. Labor would probably have moved to a much greater extent but has been hindered to do so. Many of the above mentioned market imperfections such as monopoly rents, increasing returns and agglomeration effects have played in favor of rich countries.

Income distribution has worsened not only in rich countries where it was to be expected according to trade theory but also in most poor countries (Milberg 2004). The effect can also be seen within the EU where the share of wages has declined and regional discrepancies have increased. Economic integration favors consumers at the expense of producers. But the overall effect depends on the shift of the production factors set free into new uses that provide new income and new goods and services that are effectively in demand.

Within the framework of classical trade theory, the notion of international competitiveness of nation does not make sense. It is, as Krugman pointed out, a "dangerous obsession" (Krugman 1996). Economies are always competitive, they just specialize in different activities. But already modern strategic trade theory acknowledges that with oligopolistic competition state intervention can enhance the welfare of a national economy at the expense of another. But most politicians and media go further and tend to consider a national economy as a huge enterprise whose competitiveness is determined in the same way as mentioned above (section 3) in the case of an enterprise within a national economy.

This might even make sense in the case of a very small economy where one big enterprise accounts for the bulk of employment and income like, for instance, the national oil company in Kuwait. In such a case, the national income is largely determined by the terms of trade of the output of that enterprise against all the imports. But in a diversified and relatively large economy certain recipes to increase national competitiveness do not make sense. Generally, the lowering of wages or taxes to reduce the local costs simply subsidizes exports and transfers welfare abroad. It could be justified in the case of a trade deficit, but even in that case it would make more sense to devalue the national currency. In the case of a trade surplus (as in Germany today) it would increase that surplus and, as a rule, lead to an appreciation of the currency which counteracts the cost cutting.

The distribution of income between tax payers, consumers, employers and employees which has been analyzed above (sections 3 and 4) changes in a multi-national economy in so far as certain groups or parts of them will be foreigners. In an open economy prices might be given by the price of imports and enterprises cannot shift higher costs upon the consumers who would buy cheaper imports. When capital is highly mobile, it becomes difficult to retain capital within the domestic economy at rates of return below the global average or, simply, below the rate offered by any other feasible investment opportunity. Similarly, labor will migrate to the best paid jobs and thus prevent that wages decrease below a certain level, at least for scarce skills whose wage differences compensate the costs of migration.

## *5. Subsidizing exports and the competitiveness of nations*

European integration has thus reduced the options of national governments to support their enterprises. They can no longer protect domestic markets by custom tariffs, quota or technical and fiscal barriers. Such a protection would have allowed domestic enterprises to make a higher profit in the home market due to the possibility of higher prices and, by cross-subsidization, charge lower prices in foreign markets (dumping). Logically, the EU treaties forbid direct subsidies without authorization by Brussels, too. Such subsidies would have allowed to underbid foreign suppliers on both markets, the home market and foreign markets. In the first case, domestic consumers would subsidize the export production, in the second case domestic tax payers. Welfare would be eventually shifted from domestic tax payers or consumers to foreign consumers. Of course, when international competition is less fierce, enterprises might use the direct or indirect subsidies not to lower prices but to increase profits and wages. In that case, the welfare gains would be shifted not to foreign consumers but to domestic producers. In the case of environmental or labor legislation, less regulation allowing enterprises to externalize costs would also lead to a competitive advantage in comparison to more regulated foreign enterprises. Deregulation would shift costs from enterprises to those harmed by pollution or health and safety risks. In order to avoid a race to the bottom, the EU has set minimum standards.

With these ways of protection and subsidization closed, enterprises start looking for other cost advantages. As the local cost of most tradable inputs will be equal to them and their competitors because prices of tradables tend to be equalized throughout the European and even global market, the enterprises will focus their demands for lower input costs on lower taxes and lower wages. National governments might cut corporate taxes. As enterprises still benefit from public goods and services (protection of property rights, judicial system, police, infrastructure) they will be de facto subsidized. Tax competition might lead to a race to the bottom regarding corporate taxes. In a similar way, low wages might not suffice to cover the real reproduction cost of workers. When working poor have to be subsidized by public transfers such as housing benefits or negative income tax in order to survive or have a somewhat decent living standard, these payments actually subsidize production. In many poor countries, workers in the export sector survive because of intra-family income pooling, usually in peasant families.

National competitiveness is often seen as the capacity to export based on such subsidization. It primarily means price competitiveness due to low costs. This is indeed a dangerous obsession which justifies shifting welfare abroad or to capital owners exposed to international competition at the expense of domestic tax payers or workers. A true measure and sensible definition of international competitiveness would focus on the capacity of a country (or the EU) to increase continuously the real per capita income of the citizens (not only foreign investors!) while maintaining balanced external accounts in the long term (which does not exclude longer periods of deficits and surpluses). Actually, real per-capita income should be understood in a large sense including leisure time. A country might chose to translate productivity gains due to technological progress and/or international trade not only into higher output, monetary income and consumption but also into more leisure in the form of a shorter working time, longer holidays, or earlier retirement. The capacity to afford that luxury without endangering the external position also indicates competitiveness.

Using that definition, many often cited threats to competitiveness will turn out to be fake dangers. A given share of the government in GDP or a given level of social spending is not *per se* endangering international competitiveness. It is a societal choice regarding the form of provision of certain goods and services. The fact that they are paid by taxes or social security contributions rather than bought by private insurance or from private businesses does not impair the competitiveness. To the contrary, an efficient and broad supply of public goods and services (research, education, security, social peace etc.) will obviously improve the outlook for growth and competitiveness.

However, moving activities from the non-market, non-monetary sphere of households or subsistence farming into the formal economy rises the official GDP. Historically, it was a major source of growth, the base of the "dream of eternal prosperity" (Lutz

1984). Even in highly advanced economies, increasing the labor market participation of women and the marketization of household activities like cleaning, cooking and child care is still a major source of growth and differences in the extent of that shift can explain to some extent differences in growth between OECD countries (Freeman/Schettkat 2005). Conversely, shifting economic activities into the shadow economy will lower official growth. In both cases, the real wealth of nations in terms of goods and services supplied might not change by much although marketized activities will possibly be more professional and thus productive.

In the end, growth in terms of measured output depends on the physical productivity and the numbers of hours worked. Fiddling with prices will affect monetary productivity by shifting costs from one part of the economy to another. But it does not enhance national welfare or "competitiveness" except through terms-of-trade effects in international trade. Physical productivity per hour worked will probably decline when ever more (and usually less productive) people enter the labor force and are employed even at low wages though average productivity per person increases. Continental welfare states tended to prefer to forego these potential gains by pricing the less productive workers out of their jobs, by keeping household activities less marketized and by the benign neglect of the growth of the shadow economy.

## *6. Regional income discrepancies and catching up*

International competition has become the more threatening the more poor countries have joined the game. In a playing field that has been increasingly leveled by the abolishment of barriers to trade, capital movements and labor migration, countries with abundant low-wage labor attract more and more labor-intensive production or send migrants to high-wage countries who compete there with domestic workers. This general feature of globalization has become particularly salient within the EU with its super-level playing field after the accession of poor countries, first Ireland, Greece, Portugal and Spain and, in 2004, the eight post-communist new member states of East-Central Europe. Further enlargements by even poorer countries like Bulgaria, Romania and Turkey threaten to exacerbate these problems.

The income discrepancies depend much on the way they are measured. Measured by purchasing power standards, the differences between rich and poor countries shrink: measured at market exchange rates, they look much bigger. The difference between these two yardsticks results from large differences between the price levels in poor and rich countries. While price differences of tradable goods are relatively low, they are high for non-tradables such as services or housing. The difference has substantial economic implications. Foreign investors can hire local labor for wages which are minimal measured at exchange rates but which still allow the workers more or less adequate living standards thanks to their much higher local purchasing power. Conversely, migrant, in particular commuting, workers can earn wages in rich countries whose purchasing power in their home countries is enormous. More generally, this exchange rate deviation leads to low purchasing power of poor countries regarding imports from rich countries and to an unequal exchange between rich and poor countries.

The best way out of that situation would be the rapid growth of the poorer member states' economies until their per-capita income and wages have reached more or less the level of the EU average. The necessary catching-up process has two aspects:

- **Nominal catching up** by the real appreciation of the exchange rate due either to the nominal appreciation of the poor country's currency or by higher inflation within the poor country than in the EU. This process carries huge risks if it proceeds faster than the real productivity growth of the poorer economy. As one could see in the case of East Germany, sudden nominal convergence will completely ruin local enterprises which are no longer able to compete against imports from much more productive economies with only slightly higher wage costs.
- **Real productivity growth** and the catching-up with the productivity levels of richer countries is therefore paramount. It involves a continuous up-grading of human and physical capital, investment in new technologies, structural change and modernization. One way to achieve that is by attracting foreign direct investment (FDI) although this is by no means a necessary condition (Mencinger 2003, Nunnenkamp 2004). Early adoption of regulations protecting the environment and labor might slow down catching-up while offering long-term benefits.

The most successful countries in this regard have been the East Asian economies Japan, Korea, Taiwan while Ireland has been the only apparent success story within the EU. The Asian tigers relied on protected export promotion, managed credit allocation and various other state interventions which ensured high levels of profits in the export industry which was used to further up-grade and modernize production. In the contrary, the Celtic Tiger (Ireland) relied on tax breaks and EU-sponsored public goods (infrastructure, vocational training of the labor force) to attract FDI at a high price: Today approximately 20% of the Irish GDP are transferred to foreign investors. The high productivity of foreign subsidiaries in Ireland is largely due to transfer pricing which shifts profits from subsidiaries in high-tax countries to Ireland.

Both tiger models rely on subsidizing export promotion to trigger and accelerate growth. The East Asian economies used the rising productivity in agriculture to produce cheap food which allowed workers to survive on very low wages. They kept their currencies slightly undervalued which kept wages low in international comparison even when their domestic purchasing power increased. Industrialization started with light industries such as textile and clothing. The subsidized enterprises used the rents they accrued indirectly from agriculture not to enrich the owners but to modernize production and to invest in import-substituting production in upstream industries such as textile machinery. Ireland subsidized foreign investors using EU funds and taking away other countries corporate tax revenues in a predatory way. In the end, both types of tigers achieved almost full employment which led to increasing wages and rising domestic prices in general. However, income distribution has been much more equal in the Asian tigers than in the Celtic one.

Can the new member states of East Central Europe become post-communist tigers? The obstacles are big. The East Asian policy mix is not compatible with the *acquis communautaire*. The Irish model is compatible but a hard act to follow as it depended on many special factors and required enormous amounts of FDI. The post-communist economies have no large internal rents they can use to subsidize export production. Their agricultures could certainly have fed workers cheaply. But the Common Agricultural Policy will put and end to this option and, anyway, the expectations of their population are already or will soon be exceeding the frugal standards of rural Poland, let alone rural China. Their welfare states are already highly developed and burdened with the big numbers of workers shed from former state-owned industries. Still, for some time, the new member states will be a source of comparatively cheap labor albeit one rapidly becoming more expensive thanks to real appreciation of their still existing national currencies. (Ehrke 2004)

The problems arise during the adjustment period when emerging or would-be tigers dump their exports on the world, that is mainly the rich countries' markets. Although they shift welfare to their clients and/or investors they might ruin many jobs in rich countries. In the end, most tigers will start to consume at rich countries' levels, too. But, meanwhile, the adjustment pressures build up. Some of these pressures are widely exaggerated. Much less outsourcing can be proven by official statistics than anecdotal evidence and media hype suggest. Employers benefit from these exaggerations to blackmail employees and states to lower wages and taxes and thus counter-subsidize their own production.

## *7. Systems competition, crisis and welfare state reform within Europe*

It is against this background of global and inter-EU low-wage competition that the member states of the EU compete among each other and try to cope with the adjustment pressures stemming from that competition and other secular changes such as demography, new technologies and changing societal patterns. The proven ways of the different European welfare models (Esping-Andersen 1990) and their corresponding varieties of capitalism are threatened by the European integration. As we have seen above, states have intervened to a large extent to protect the privileged positions of their enterprises and workers. They have created the competitive advantages to ensure higher productivity and incomes. Free trade and factor movements, in particular in the EU, threaten the efficiency and viability of many state interventions in national markets. The reassertion of markets could lead to the reemergence of market failures and politically or socially undesired market outcomes on the European scale.

In macro-economic terms, this has already become obvious. Growth has slowed, unemployment increased, and the income distribution has worsened (see table below). In particular within the Euroland, there is no macro-economic management that coordinates monetary, fiscal and incomes policies in a way that promotes growth and employment. Its main beneficial effect has been the promotion of convergence between the poorer periphery (Greece, Spain, Portugal) and the richer core (Germany, France). This has been achieved through lower interest rates in the periphery which continued to be lower in real terms due to higher inflation, while the center continues to suffer from comparatively high real interest rates which dampen growth and inflation further. (Bofinger 2003)

**Growth, unemployment and wage share in the EU 1961–2004**

| | 1961–1970 | 1971–1980 | 1981–1990 | 1991–2000 | 2001–2005 |
|---|---|---|---|---|---|
| Growth (in %) | 4.8 | 3.0 | 2.4 | 2.1 | 1.6 |
| Unemployment (in %) | 2.0 | 3.8 | 8.5 | 9.4 | 7.8 |
| Wage share (in % of GDP) | 72.3 | 73.9 | 72.1 | 69.2 | 68.4 |

*Quelle:* European Economy 4/2004.

Meanwhile, some periphery countries have lost their price competitiveness, in particular against Germany, as unit labor costs are diverging (falling in Germany while rising in the periphery including Italy). There is no institutional arrangement except the almost defunct Cologne process to take care of these potentially harmful developments. Of course, the markets will eventually correct these imbalances but probably at a price people will not be willing to pay.

The same discontent is likely to arise regarding micro-economic failures. As the systems competition in the common market weakens the traditional ways states used to intervene and correct market failures or outcomes people will ask for new common policies. As Sinn has shown with some basic models, systems competition is likely to undermine the tax base, and to weaken regulation in particular regarding labor, the environment and consumer protection (Sinn 2003). Although real markets usually are different from these models which assume perfect competition, certain production functions and other ideal conditions, the basic logic works at least in some sectors. The EU has in many ways tried to replace national by European regulation but, for good reasons, it has been largely stood away from the core policies of the welfare states. At the same time, the basic patterns of income distribution and redistribution which make up the national social models are under severe stress due to the depth of integration achieved within Europe.

Some member states and models have fared better than others. The most fundamental differences result from the different capacity to manage structural employment change in the wake of integration. Virtually all countries have experienced deindustrialization and the slimming of their enterprises in the face of increased competition. But some like the Scandinavians or Great Britain managed to shift the surplus labor from the exposed private sector into new activities, be they in the less exposed private sector (usually services) or the public sector. (Klodt 2004; Scharpf 2005)

International competition as such does not require fundamental changes in the welfare state systems. Free trade increases the welfare of nations. Europe benefits from the fact that it can acquire the same amount of goods and services with less labor or more cheaply. Therefore, consumption does not have to be curtailed to achieve an external equilibrium. The demographic change needs to be accommodated but it can be done in various ways ranging from higher contributions (which do not necessarily mean net income losses when productivity and incomes grow faster the contribution rates) to later retirement or capital funded systems which, however, cannot guarantee high real old age incomes.

The core problem in Europe is unemployment which is only to a very limited extent due to the welfare state. There might be some people free riding and avoiding work in the official economy while at the same time receiving welfare benefits and/or working in the shadow economy. But the core problem is total demand and the matching of productivity requirements and wage levels. Redistribution through the welfare state does not solve the demand problem as taxes and contributions lower demand by more or less the same amount as the benefits paid out to recipients increase it. But only a decreasing share of people can satisfy the productivity requirements of enterprises which are subject to fierce competition and which shift their processes continuously up-market.

Beyond the necessary efforts to improve education and vocational training, societies must decide what they can and want to offer those less productive members of the active population. The more they can put into employment the better for growth and the viability of the welfare states. But there are limits by law and custom how much you can impute to the weaker members of society. These norms are closely related to perceptions of dignity and human and social rights which are increasingly defined also on the European level. But the fate of the European Constitutional Treaty shows how sensitive these issues are.

## *8. Towards a European Social Model?*

By creating transnational markets and regulating them, the EU interferes with the income distribution within and between member states. EU regulation and competitive pressures influence the translation of productivity gains into higher income or, alternatively, higher quality of life (environmental protection, more leisure, less pressure to take up unloved jobs). Competition within the Common market affects the primary distribution through its impact on prices, wages, and profits. To a lesser extent, the EU influences the secondary income distribution via taxation, public transfer payments such as pensions, unemployment benefits and welfare and the provision of social services to groups perceived as needy through its regulation of national fiscal policies and its competition policy which increasingly affects the provision of public services. (Dauderstädt 2004).

A European Social Model would have to fulfill the same core functions of regulating and correcting markets as national models do or have done. Given their present performance, either a Scandinavian or an Anglo-Saxon model would possibly be best. But it stretches imagination to assume that one, albeit successful, national model could simply be extended to the whole of Europe. Although one common variety of capitalism would probably work better than 25 competing ones the switch from one model to another implies a substantial redistribution of income between core constituencies. The European political system is by far not developed enough to produce a compromise and consensus on such a scale (Dauderstädt 2004). Still, some essential policies can be identified in order to get closer to a social Europe.

**European demand management:** With the European Monetary Union, the EU has taken on the responsibility for the monetary policy. At the same time, the EU has set limits to the national fiscal policy through the Growth and Stability Pact. There is virtually no exchange rate policy. The inflation target and the job description of the ECB and the Maastricht criteria, notably the 3% limit for new government debt, aim at stability rather than growth and employment. Member states can react to imbalances between savings and investment and to external shocks but by nominal wage policies which are extremely difficult to implement. The EU's economic policy should get a broader mandate and be empowered to lower interest rates more flexibly in times of slow growth even at the risk of a somewhat higher inflation rate. The EU should monitor general balances between savings and investment and allow higher deficit spending in situations where both enterprises and households have become net savers. Macro-economic policies should be better coordinated involving also the wage-setting social partners.

**Capital market regulation:** The EU should reconsider the liberalization of its capital account and possibly and partially re-regulate capital movements beyond the common market in order to become more independent in the implementation of its own macro-economic policies and to reduce pressure on its own enterprises to focus exclusively on shareholder value.

**European incomes policy**: Wages have suffered during the last decades (see table above) and are under constant pressure due to low-wage competition and continuous restructuring of enterprises. Enterprises have used often unrealistic threats of relocation and outsourcing to lower wages. Migrants have exerted additional pressure on already weak labor markets. The EU services directive wants to open Europe-wide labor markets under home-country regulation. All this will undermine demand and consumption further. Workers should receive decent wages according to host country standards regardless of their country of origin (as members of the European Parliament do). Many member states have minimum wage policies which could ensure this. They should be harmonized albeit maintaining different levels reflecting purchasing power and levels of general social and economic development.

**Tax harmonization**: Corporate taxes should be harmonized on the EU-level. They could be even collected by the EU as an additional or alternative source of financing the EU budget. A European corporate tax would also take care of the problems of taxing companies with subsidiaries in different member states and it would abolish incentives for tax avoidance through transfer pricing.

**EU budgetary spending:** The EU should shift its expenditures from policies that are either largely inefficient (regional policy) or harmful and socially unjust (Common

Agricultural Policy) to financing public investment in infrastructure, research and development, education.

What will happen if there is no European Social Model in the near future? Chances are that the French "Non" and the Dutch "Nee" are only the beginning of more national discontent towards European integration. If there is no viable consensus on a European regulation of market processes, national polities will intervene by their own means, and eventually undo some parts of the market integration and/or prevent further integration of, above all, factor markets. Conflicts between Brussels and national governments are to be expected which are likely to undermine the support for integration further. As further enlargement by mostly even poorer candidate countries are bound to exacerbate all these problems these accessions will face stiffer opposition and endanger one of the few successes of European integration: the transformation of a continent full of war and dictatorships into one of peaceful democracies.

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