

Karl Aiginger, Alois Guger

The ability to adapt: why it differs between the Scandinavian and Continental European Model

Abstract: Analysing the differences in economic performance of Europe relative to the US, but also relative to the fast growing Asian economies, many authors blame the high level of taxes and government expenditures, the degree of regulation, and the costs of welfare as the main reason for Europe's current underperformance. This hypothesis cannot explain the empirical fact that economic performance – which had been rather similar up to the nineties – diverges between European countries since the early or mid nineties. For this period the best performance is revealed for the extreme types, namely the liberal Anglo-Saxon model, and for the Scandinavian model. The first would be in line, the second contradicts to the hypothesis of “big government”. The worst performance is to be seen for the continental model, which produced low growth and high unemployment at least in the larger countries of this group. The Scandinavian countries were able to reform their institutions and incentives in a manner to succeed in the globalizing economy. They made their economies more flexible – in a managed and balanced strategy, after one or more periods of turmoil. They eliminated and reduced fiscal deficits and debts respectively. But most importantly the Scandinavian countries went for a strategy of excellence in innovation, education and technology diffusion. The same adaptability is not to be seen for the big countries in continental Europe.

JEL: A13, E60, H10, J50, P10

Keywords: Welfare models, corporatism, models of capitalism, big government, globalisation

Karl Aiginger
Austrian Institute of Economic Research WIFO
P.O. Box 91
A-1103 Vienna
Austria
Tel: +43 1 798 26 01-210
Fax: +43 1 798 93 86
Karl.Aiginger@wifo.ac.at
www.wifo.ac.at/Karl.Aiginger

Alois Guger
Austrian Institute of Economic Research WIFO
P.O. Box 91
A-1103 Vienna
Austria
Tel: +43 1 798 26 01-2647
Fax: +43 1 798 93 86
Alois.Guger@wifo.ac.at
www.wifo.ac.at/Alois.Guger

Karl Aiginger, Alois Guger

The ability to adapt: why it differs between the Scandinavian and Continental European Model

1. Differences in performance

It is well recognized today that European economic performance has deteriorated since the beginning of the nineties. This is the case whether we compare the performance relative to the past, relative to the performance in the US or relative to 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.

This article explores the differences across European models, to learn about the reasons of 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 better performing in the long run and struck by many crises up to the early nineties - since that time enjoys 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 globalizing economy in which higher “business flexibility” and “worker adaptability” (Reich, 1999) 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 to enable employees to respond flexible to changes and 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 (i) realized the extent of new challenges, since the burden of welfare, the prediction of upcoming problems as well as the experience of severe crises had made it crystal clear that the economies had to become more flexible and (ii) the institutions of the society cooperated with experts efficiently to develop a long-run strategy with a strong commitment to the welfare state, a consensus across the society and deep trust among all members. 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

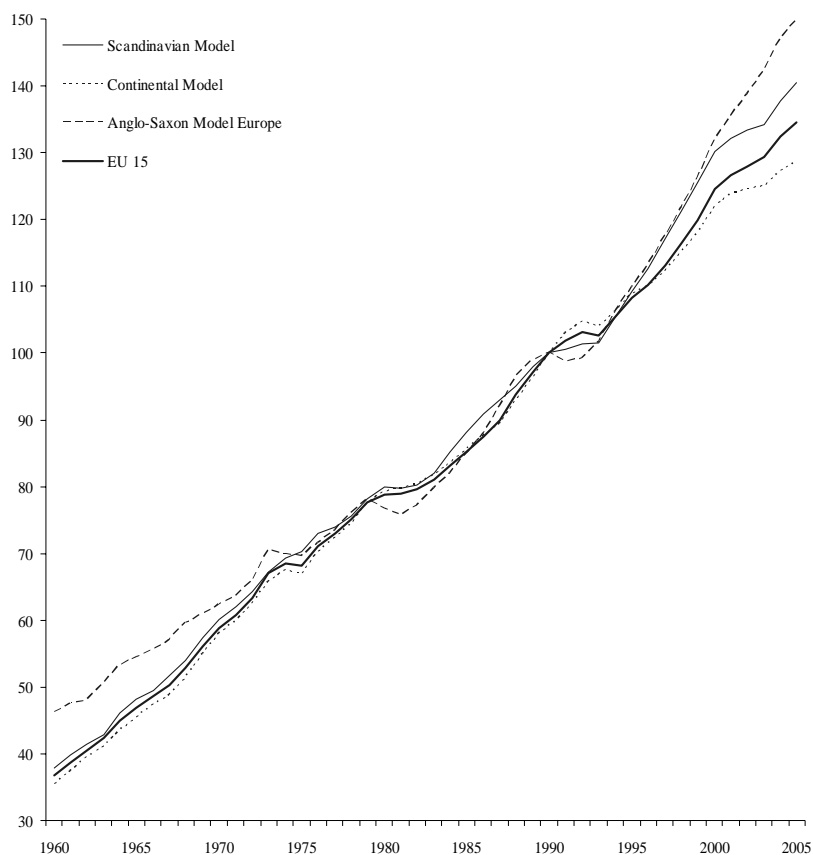
(United Kingdom and Ireland) with very different economic policy, history and growth experience over the past decades. The necessity for change was underestimated in the continental countries where institutions did not cooperate to face the new challenges. The difference in the adaptability of the three main European Models has some similarity to the well-known Calmfors-Drifill² hypothesis that countries with a medium degree of centralization did worst in wage bargaining, relative to countries with centralized bargaining processes on the one hand and to decentralized bargaining at the firm level, on the other hand. Of course the arguments relate to different issues and have different drivers, common ground is that a medium position may not always be the best.

The paper is structured as follows. In the next section we shortly 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. Section 3 compares 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 (following Aiginger, 2004).³ The next three sections describe differences between the Scandinavian countries and the Continental countries in three policy areas: size of government and dynamics of social expenditures (Section 4), regulation and improving incentives on the labour market (Section 5) and finally and most important the level and dynamics of investment into the long-run drivers of economic growth (Section 6). Section 7 summarises differences between the old European welfare model and the reformed model, elements of which are emerging in many European countries, most of them in Scandinavian countries, far less in the big continental countries. The new European model certainly differs from the old, European welfare state model but also from the US model. Section 8 summarises.

2. 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 responsibility of the society for the welfare of 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 (see Aiginger - Guger⁴). 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 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 about a European Socio-Economic Model rather than merely a social model.

Figure 1: Performance: Growth of real GDP; 1990=100



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

In differentiating between several versions of the European model it is standard practise since Esping-Andersen (1990) to distinguish between a 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 still some characteristics of an agrarian society prevail. A fifth model, not yet elaborated, may emerge for the new member countries of the European Union. Several social institutions have been founded after the transition only; they 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.

Table 1: 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
Mediterranean 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
Mediterranean 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

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

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. Social partners play an important role in industrial relations, and wage bargaining occurs less on the firm level but either on the branch level or even more centralised. 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 than in the other models, more targeted and “means tested”. Labour relations are decentralised, and bargaining takes place primarily at the firm level.

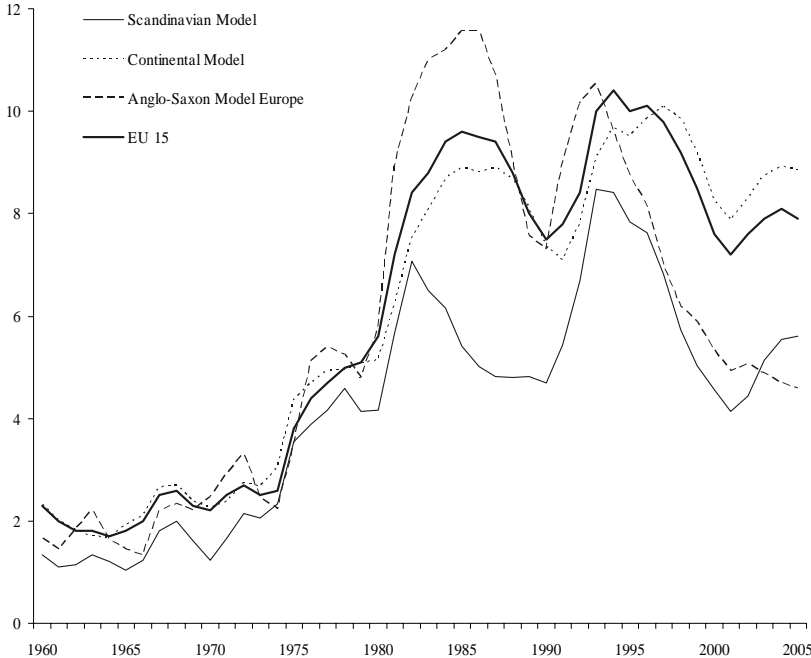
We include five countries in the Scandinavian group. The inclusion of the Netherlands is the most contentious choice, because the Dutch model is less ambitious, redistributes less and places less emphasis on gender equality (at least up to the nineties). We pool five countries in the Continental Model - 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 group. We decide to delegated Italy to the Continental group due to the economic importance of Northern Italy, 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 first whether we use weighted or unweighted average over the individual countries in building performance indicators for groups.⁵ We decided to use weighted averages. The result is also robust if we change the members of the groups slightly, for example shifting Netherlands to the continental Model and Italy to the Southern Model or integrate European and new European countries into an “Anglo-Saxon Model Total” (see last four rows in Table 1).

3. Economic performance according to type of model

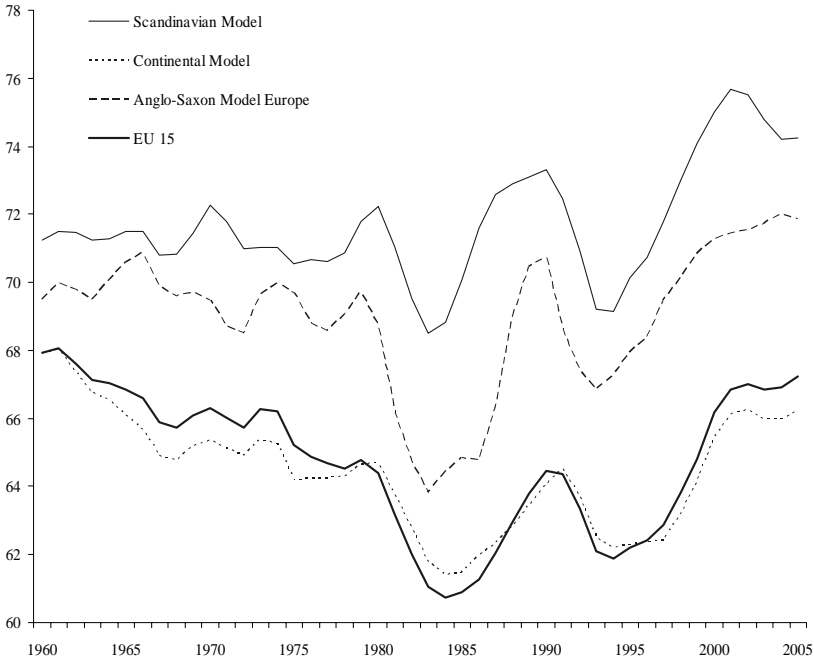
Figure 2: Unemployment rate



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

Table 1 shows that long-run economic growth had been very similar for the three main models (Scandinavian, Continental, Anglo-Saxon), in the period 1960 to 1990 it had also rather been similar in Europe relative to the US. Performance in the nineties (1990/2005) however diverged. The Scandinavian group enjoyed a growth rate of 2.3 % for these 15 years – despite of a severe crisis in many countries in the early nineties (Aiginger, 2004 and Aiginger - Guger, 2005). 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; Austria surpassed the average of EU-15, but all did not reach the level of dynamics attained by the Nordic group. The countries of the Anglo-Saxon model Europe enjoyed high growth – in fact the highest. This group consists in Europe however of two members only with a very different economic history. Ireland is a late and then very successful catching up story, while UK rebounded from three decades of slow growth, in which it had lost its historical lead in per capita GDP. In highlighting differences between successful and less successful strategies, we concentrate on the Scandinavian and the Continental group, reporting the average of EU-15 and that of the Anglo-Saxon countries Europe as “benchmarks”.

Figure 3: Employment rate



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

The differences in economic performance between the Nordic countries and the big continental economies are elaborated in Aiginger (2004), who uses a set of 12 indicators on the dynamics of output, productivity and employment, as well as on the level and changes of unemployment and fiscal balances to derive a more comprehensive “performance evaluation” of countries. Aside from the Irish growth experience, Sweden, Finland, and Denmark have been the best performers and were therefore designated by Aiginger (2004) as the

“top countries”.⁶ Germany, Italy and France are the least performing countries, specifically for France a comprehensive evaluation reveals a worse performance, than a comparison based on economic growth alone.⁷

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

4. The role of government, fiscal deficits and social expenditures

The Scandinavian countries have traditionally 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). For the last 15 years there is a significant convergence between the models for expenditure rates but not for taxes. The difference in the share of public revenues, which had been seven percentage points higher in the Scandinavian countries as compared to the continental countries in 1990 did not change, but the difference in public expenditures which had been 4 percentage points is now about 1 % 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 have now 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 countries⁸.

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

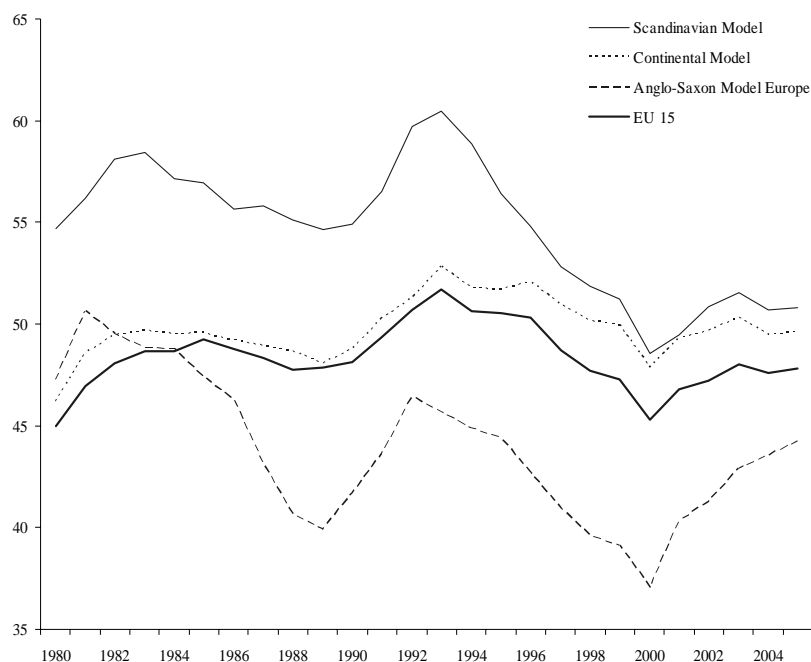
S: Eurostat (AMECO);

As to sub-aggregates weighted average over countries; EU 15 reported.

This fiscal prudence is part of the new strategy implemented by the Scandinavian countries, which have not been known for budgetary discipline before.⁹ They tried to get rid of their structural deficits, by imposing limits in the

expenditures, 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 property) was maintained and strengthened. The final success of the fiscal policy came however, as growth rebounded.¹⁰

Figure 4: Government expenditure as percentage of GDP



S: Eurostat (AMECO);

As to sub-aggregates weighted average over countries; EU 15 reported.

Table 3: Social expenditures in detail

	Total social expenditures		Sickness and health care		Disability		Old age		Survivors		Family/Children		Unemployment		Housing and social exclusion	
	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

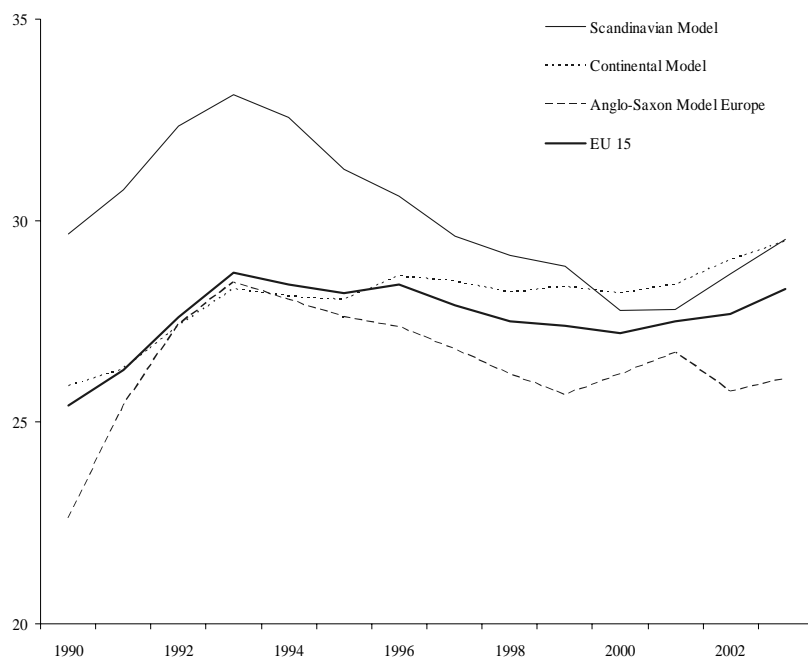
S: Eurostat (ESSOSS);

As to sub-aggregates weighted average over countries; EU 15 reported.

The share of social expenditures had been 29.7 % in the Scandinavian countries in 1990, this 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 is now 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 %¹¹. Germany and France have now higher public expenditure shares than in the Scandinavian average. One of the reasons is that unemployment benefits expenditures are increasing in the continental countries and decreasing in the Scandinavian, other major factors are stronger increases of contributions for old age pensions in continental Europe.

Figure 5: Social expenditures as a percentage of GDP

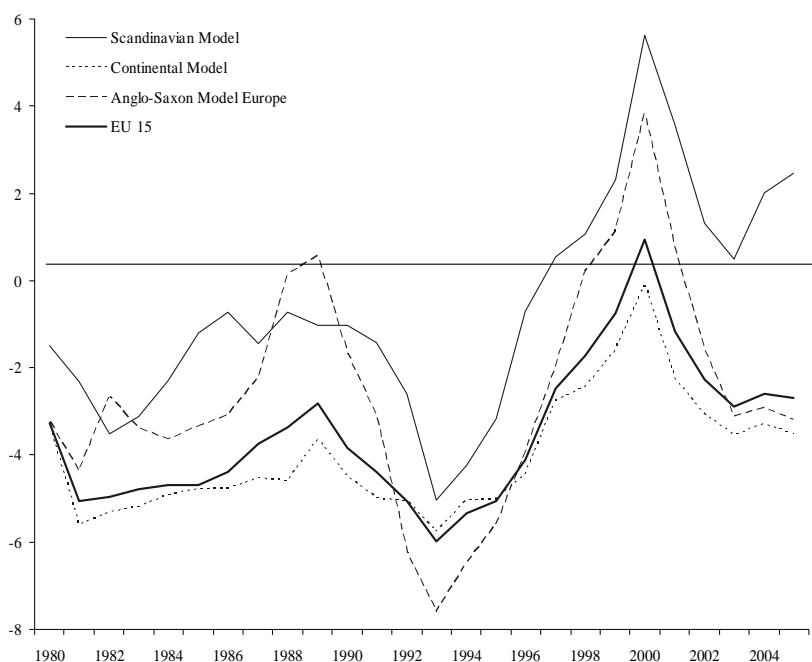


S: Eurostat (ESSOSS);
As to sub-aggregates and EU 15 weighted average over countries.

5. Labour market institutions and changing incentives

Regulation of product as well as of labour markets is higher in continental Europe. The difference existed over a long time but became more pronounced since the nineties. The empirical data were collected by 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).

Figure 6: Fiscal deficits as a percentage of GDP



S: Eurostat (AMECO);

As to sub-aggregates weighted average over countries; EU 15 reported.

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 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.¹²

Table 4: Product and labour market regulation

	Product market regulation		Labour market regulation			
	1998	2003	All contracts		Temporary contracts	
			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

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

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. Collective agreements cover 82 % of employees in the Scandinavian countries, and the trend is on the rise, and they cover at least 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 as to make the markets more flexible but also to help people to find new jobs by offering genuine and even personalized assistance and re-qualification. Active labour market policy, 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. In case of not fulfilling the obligations or refusing to accept jobs, the benefit duration period and the benefit level will be reduced. Part time jobs 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, decentralization of institutions, complementary private agencies) are summarized 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.¹³

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 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 % 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.

6. 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 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 %, in the Continental countries future investment used to be lower and increased in the nineties 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 would not put Netherlands into the Scandinavian group. Sweden, Finland and Denmark are countries fulfilling the Lisbon goal of a 3 % research expenditures rate (ranking on place 1, 2, 4 in the share of R&D in GDP in Europe). Future investment in EU 15 is 13.8 % in the US 16.1 %; thus the Scandinavian countries surpass the US in these investments which decide about long-run growth.

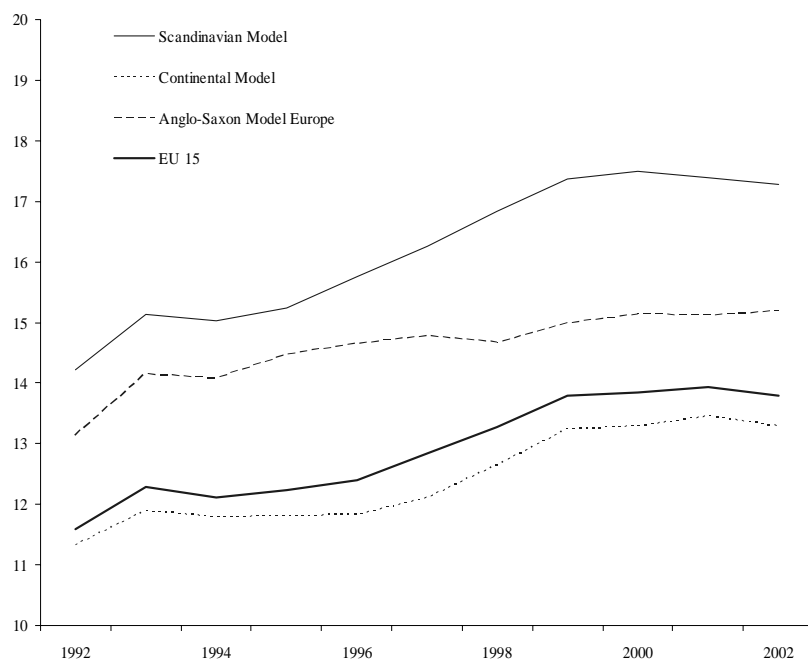
The continental countries have not raised their R&D ratio, have average expenditures on education, are moderate in the PISA ratings and under invest in ICT.

Table 5: Investment into the future (growth determinants)

Investment into the future			
	1992	1995	2002
	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

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

Figure 7: Investment into the future (growth determinants)



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

7. Towards a new European Model: a tentative sketch of its features

The Scandinavian countries embark 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 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. “Quality” of public finances is monitored, expenditures for education, innovation and life-long 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 into 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.¹⁴

Some of these reforms are similar to parallel reforms in the Anglo-Saxon Model (e.g. welfare to work strategies), other are very different such as:

- 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.
- 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.

6. 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 nineties is the Scandinavian model¹⁵. The Scandinavian countries have traditionally the highest share of government, social expenditures, they emphasise redistribution and social inclusion. Many of these countries 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 (Belgium) or surpass the European average growth (Austria) 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 did help 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 1990, 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 replacements 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 realized that high growth and best technology is necessary for the maintenance of a welfare state with high taxes. Investment into 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 % into 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 globalization and competition. One reason might be the experience of the crises, which hit Denmark and Netherlands in the eighties, and then Sweden and Finland in the early nineties. The second reason might be that these countries realized that their model was an extreme case as far as government share, taxes, social inclusion, welfare goals were concerned and that they wanted fervently to keep their welfare model in principle, and therefore realized 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 at the other side did not feel the same pressure and underestimated the necessity for change. And the reforms - if they were done - were made in a more controversial, less strategic and less consensual way. Further research is needed to find the underlying causes for the differences in the adaptability of the Scandinavian and the Continental Model.

¹ Extended by a “secondary” capital market where loans are easily securitised and a better income protection in the case of bankruptcy.

² L. Calmfors, J. Drifill (1988): Bargaining structure, corporatism and macroeconomic performance. *Economic policy*, S. 14-61.

³ K. Aiginger: The Three Tier Strategy Followed by Successful European Countries in the 1990s, in: *International Review of Applied Economics*, 18, 4 (2004), pp. 399-422.

⁴ K. Aiginger: 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.

⁵ 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.

⁶ K. Aiginger, The Three Tier Strategy Followed by Successful European Countries in the 1990s, in: *International Review of Applied Economics*, 18, 4 (2004), pp. 399-422. 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.

⁷ 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.

⁸ 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 has been 0.4 % for the Scandinavian countries without Norway (and 2 % if we also exclude the Netherlands).

⁹ 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. ..., A. Alesina, S. Ardagna: Tales of fiscal adjustment in *Economic Policy*, Vol. 20(27), October 1998.

¹⁰ 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 and J.F. Kirkegaard, *A Transformation of the European Economy* (Washington: Institute for International Economics, September 2004), p.18, available at http://bookstore.iie.com/merchant.mvc?Screen=PROD&Product_Code=353. See also Sapir et al., *An Agenda for a Growing Europe*; J.P. Fitoussi, F.K. Kostoris Padoa Schioppa, eds, *Report on the State of the European Union*, Vol. 1 (Houndsmills: Palgrave Macmillan, 2005).

¹¹ According to the OECD statistic which reports only public expenditures, these are higher in relation to GDP in the average of the continental countries than in the Scandinavian countries in the last published figures.

¹² K. Aiginger: Labour market reforms and economic growth - the European experience in the nineties, in: *Journal of Economic Studies*, Vol. 32 No. 6, pp. 540-573

¹³ G. Tichy, “Die 'Neue Unsicherheit' als Ursache der europäischen Wachstumsschwäche”, *Perspektiven der Wirtschaftspolitik*, 6, 3 (2005), pp. 385-407.

¹⁴ 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 (WIFO, Vienna, 2004).

¹⁵ Together with the United Kingdom and Ireland which are part of the Anglo-Saxon Model but had rather different and specific history in the three decades before.