

Erkki Liikanen: A European social model – an asset or a liability?

Remarks by Mr Erkki Liikanen, Governor of the Bank of Finland, at the World Political Forum (founded by Mr Mikhail Gorbachev), Budapest, 27 November 2007.

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1. Introduction

To begin with, there is no such thing as the Single European Social Model. Owing to historical reasons and differences in local circumstances, social models differ considerably across Europe.

Nevertheless, there are broadly-shared, characteristically European values, such as solidarity and social cohesion. There is also the recognition that market forces can sometimes result in outcomes that are not in keeping with these values. Consequently, a vast majority of Europeans share the conviction that the state should promote equality of opportunity and come to the assistance of those most in need.

Some argue that, while laudable, these European values are no longer compatible with the harsh realities of the modern world – a world that is characterized by ever intensifying competition brought on by globalization. Indeed, we can find examples in Europe that show how some features of a traditional welfare state have acted as a drag on economic growth.

So, is the distinctly European combination of social values and economic policies a thing of the past, a promise that can no longer be fulfilled? Or is it possible to reconcile it with the forces of globalization without stifling economic dynamism? In short: can a European social model continue to be an asset or has it become a liability?

These are questions I will try to address in the remainder of my remarks.

2. Characteristics of the Nordic model

In recent years, the strengths and weaknesses of different European social models have received increasing attention as all European countries have sought to find ways to cope with the challenges brought on by globalization.

Much of the attention has focused on a perceived tradeoff between equality and efficiency. As exceptions to the rule that these should be conflicting goals, the Nordic countries have often been mentioned. The Nordic model has attracted considerable interest because it seems to have been able to combine – also in the past decade – a high level of social protection and egalitarian income distribution with high economic dynamism.¹

So, does the Nordic model really offer a way to reconcile the European ideals with the demands of the global economy? To answer this question, we need to look more closely at the Nordic experience.

Actually, the Nordic economies are quite different from each other – both in terms of their resource endowment, as well as their industrial structure. Moreover, the Nordic countries' labour market and welfare policies are not uniform.

¹ See, for example, Sapir, André (2005); "Globalization and the Reform of European Social Models", Bruegel Policy Brief, Issue 2005/1. Sapir divided the EU-15 countries into four groups based on their efficiency and equity: the Mediterranean model (low equity and low efficiency); the Continental model (high equity and low efficiency); the Anglo-Saxon model (low equity and high efficiency); and the Nordic model (high equity and high efficiency). In reality, the groupings are far from being homogenous. Sapir included in his Nordic model Denmark, Finland, Sweden and the Netherlands. The two non-EU Nordic countries, i.e., Norway and Iceland, also fit the description of the Nordic model.

At the same time, the countries share some characteristic features that constitute the essence of the Nordic Model. These include: a large government sector, high tax rates, generous social protection and highly compressed wage structures.

The standard economics text books teach us that such features generally distort incentives for efficient resource allocation.

This notwithstanding, during the past decade the Nordic (EU) countries have achieved higher growth rates than the advanced European countries on average. Moreover, the Nordics have been able to achieve high employment combined with macroeconomic stability.

Does this mean that the economics textbooks are wrong and that incentives and markets do not really matter that much? The answer is a resounding no.

In fact, the strong macroeconomic performance in the Nordic countries owes a lot to policies that are well in line with recommendations of mainstream economics.²

- **Openness to competition.** Substantial product market deregulation has helped underpin economic growth in the Nordic countries. This deregulation took place earlier than in most other European countries and the level of product market regulation in the Nordics is low by European standards. There have been reforms to enhance competition also by addressing rigidities of the labour markets, although such reforms have been more gradual and subtle.
- **Sound macroeconomic policies.** Public finances in the Nordics are in better shape than in most other European countries. Disciplined fiscal policy has contributed to an environment in which consumers and businesses can plan for a longer term. Sound monetary policies have also been instrumental in supporting growth, even though their role in explaining the relative performance of the Nordics is limited since stability-oriented monetary policies have become increasingly widespread.
- **Strong and transparent institutional framework.** An institutional environment in which contracts can be enforced and property rights can be established promotes economic growth. Increasingly, all European countries share such an institutional environment. However, what sets apart the Nordic countries is the transparency and integrity of their public sector, as evidenced by the fact that these countries consistently score well in surveys that measure the degree of public sector corruption.³

Part of the strong economic performance in the Nordic countries can also be attributed to luck – both bad and good.

- As for the bad luck, it can be argued that the sharp economic downturns experienced by the Nordics in the early 1990s were a blessing in disguise. This is because they gave impetus to structural reforms and disciplined macroeconomic policies that ushered in a strong recovery from the recessions.
- As for the good luck, e.g. Finland and Sweden have been lucky to have been in the vanguard of the mobile phone technology during its explosive growth phase.

² For a more comprehensive assessment of the strengths and weaknesses of the "Scandinavian Model", see e.g. Chapter 4 in the EEAG Report on the European Economy 2007, prepared by the European Economic Advisory Group at CESifo.

³ For instance, Denmark and Finland shared the top ranking, and all the Nordic model countries were in the top ten, in Transparency International's 2007 Corruption Perception Index that looks at perceptions of public sector corruption in 180 countries and territories. See: http://www.transparency.org/policy_research/surveys_indices/cpi/2007.

3. Digging deeper – the importance of education and openness to change and new ideas

So, good policies, sound institutions and some luck go far in explaining the strong performance of the Nordic countries. However, by digging a bit deeper, we can see also other common features that have played a crucially important role. These include: emphasis on education and openness to change and new ideas.

The Nordic countries share a long-tradition of emphasising the importance of education. Nowadays, the share of the working age population with upper-secondary education, as well as tertiary education, is considerably higher in the Nordic countries than in the other EU countries on average. Moreover, the participation rates for non-formal job-related continuing education and training are exceptionally high in the Nordic countries.⁴

The Nordic economies have benefited from a well-educated labour force. The skilled labour force has contributed to a rapid diffusion of information and communication technologies, thus contributing to favourable productivity developments. Moreover, human capital accumulation, together with high spending on Research and Development, has fostered innovation.

Another characteristic strength of the Nordic countries has been their general willingness and ability to adapt to changing circumstances. Undoubtedly, this partly reflects their relatively small size, but it seems that education has in several ways smoothed the process of adjustment.

- First, a well-educated electorate has underpinned political systems which have been able to produce pragmatic policies that have helped in adapting to a rapidly changing world. According to the Economist Intelligence Unit's democracy index, the Nordic countries (plus the Netherlands, which is often considered a Nordic model country) are the most democratic countries in the world.⁵
- Second, education has enabled these countries to tap into the full pool of human potential and has contributed to the absence of rigid social classes. Reflecting this, the Nordic countries are among the most mobile societies in term of intergenerational income mobility.⁶ The Finnish experience with comprehensive school reform suggests that ensuring a sound basic education for the entire population promotes social mobility by creating an equality of opportunity.⁷ A society with a well-educated labour force will also be able to adjust to a changing environment.

Finally, in this "information age", we need to recognize the crucial role of information. Information technology, e.g., as measured by the degree of "wiredness" and density of mobile phones, helps in global competition. However, even more important is the free competition of ideas and ideologies. Here relevant metrics include the freedom of the press

⁴ See e.g., OECD (2007), *Education at a Glance*, Paris.

⁵ See *The world in 2007*, The Economist Intelligence Unit's index of democracy. http://www.economist.com/media/pdf/DEMOCRACY_INDEX_2007_v3.pdf.

⁶ See e.g., *Generational Income Mobility in North America and Europe*, edited by Miles Corak, Cambridge University Press, November 2004.

⁷ Pekkarinen, T., Uusitalo, R. and Pekkala, S. (2006), "Education Policy and Intergenerational Income Mobility: Evidence from the Finnish Comprehensive School Reform, The Institute for Study of Labor (IZA) Discussion Paper No. 2204.

or newspaper circulation per capita – both measures that place the Nordic model countries near the top in global rankings.⁸

I would like to say a few more words about free competition of ideas and ideologies. It seems that this aspect of society is nowadays often ignored when discussing determinants of economic growth. Perhaps the recent spectacular rise of some emerging market economies that are, at best, flawed democracies, has led some observers to downplay the importance of freedom in ensuring the long-term prosperity of societies.

The causality between democracy and prosperity may run both ways. However, a well-functioning democracy becomes even more vital to economic growth as a country becomes more prosperous. This is because the richer countries need to rely primarily on "smart growth", that is, increasing total factor productivity through innovation and technological change, while the poorer ones can grow robustly for long periods merely by imitating more advanced countries and adding more inputs of labor and capital.⁹

So, going back to the Nordic model: what are the lessons to be drawn from the Nordic experience? Clearly, we see the importance of sound macroeconomic policies and structural reforms that promote competition. An even more fundamental lesson is the central role of high-quality public institutions, in particular the schooling system, in supporting both economic growth and a democracy that is open to new ideas and change.

4. Challenges for Europe

How should these lessons be applied to some of the most pressing challenges that are common to all European countries? I will look at two challenges that are of vital importance: globalization and population ageing. The responses to these challenges will have an important bearing on the future of European social models.

Globalization & rapid technological change

The end of the cold war ushered in the current rapid phase of globalization. More than any other individual, our host and the founder of the World Political Forum, Mikhail Gorbachev, deserves credit for ending the Cold War.

Globalization has underpinned an exceptionally long, strong and broad-based economic expansion. The strong growth in emerging market and developing countries is finally reducing the number of people living in extreme poverty, and the gap between average incomes of developing and developed countries is narrowing. These are most welcome developments.

Also Europe has benefited greatly from robust global growth. At the same time, the forces of globalization pose difficult challenges for the European social models.

Globalization and more rapid changes in technology are separate but closely related phenomena. Globalization reduces barriers and implies restructuring and relocation of economic activities to take advantage of new technologies and comparative advantages.

⁸ For data on press freedom, see: Reporters without Borders, Annual Worldwide Press Freedom Index 2007. http://www.rsf.org/article.php3?id_article=24025, and for data on newspaper circulation per capita, see: NationMaster.com (original source UNESCO Institute for Statistics) http://www.nationmaster.com/graph/med_new_cir_percap-media-newspaper-circulation-per-capita.

⁹ For an interesting discussion of determinants of growth in countries at different levels of development, see Baumol, W.J., Litan, R.E. and Schramm, C.J. (2007) "Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity", Yale University Press, or Eichengreen, Barry and Leblang, David (2006) "Democracy and globalization", NBER Working Paper 12450.

This implies accelerated change and a less predictable operating environment. In such an environment, stability-oriented macroeconomic policies are particularly essential as they reduce the overall uncertainty faced by consumers and companies alike and thus allow them to see signs of change and make well-informed plans for a longer term.

Globalization and technological innovation threaten the status quo and raise calls for protectionism. Such calls must be resisted. Shielding companies from competition undermines their long-term viability. Thus the long-term success of European companies calls for more, not less, competition. Also, protectionism will not stop technological innovation. History teaches us that a luddite refusal to accept technological advances is not a viable option.

Having said this, we must recognize and tackle the difficult problems associated with globalization. Two problems stand out. First, globalization brings with it painful economic dislocation, and many people lose their jobs. Second, technological advances tend to lead to higher dispersion of income.

Governments can and should play an active role in easing the pain of dislocation. Social safety nets are needed to cushion economic dislocation in a rapidly changing world. However, they must not support unviable structures and practices. Instead, the safety nets should be designed in a way that encourages people to adapt and seek new challenges.

Also, a higher dispersion of income should not be allowed to become so entrenched that it erodes the equality of opportunity. Here, tax policies need to play a role in levelling the playing field. However, above all, the equality of opportunity must be ensured through access to education.

Let me say a few more words about education.

Europe has a rich and long tradition in science and innovation. Indeed, Europe is the birthplace of scientific inquiry. And, it is fitting that some of the most influential scientists of the 20th century, John von Neumann and Leó Szilárd, men whose contributions ushered in the computer and nuclear age, hailed originally from our host city Budapest.

This tradition provides a solid foundation to build on. High-profile joint undertakings such as CERN can play an important role in pooling European resources to advance basic or fundamental research. Such endeavours can also spawn unexpected by-products. For instance, the World Wide Web came to being at CERN.

However, even more important than large European projects, is that we put in place conditions that allow and encourage private companies and public sectors to embrace new technologies. This means that we need to equip all European citizens with the skills that they need to cope with the rapidly changing world.

Population ageing requires increasing public sector efficiency

In general, large public sector employment tends to crowd out employment in the private sector, thus distorting the allocation of labour input in the economy.

Similarly, a large public sector can be a drag for productivity growth. Even though it is difficult to measure productivity in the public sector, in aggregate terms it appears to be lower than in the rest of the economy and in particular in the open sector, and grows more slowly.

The question of how to minimise these negative aspects of a large public sector, becomes all the more pressing with an ageing population. In Finland we face the most rapidly ageing population, so these are no longer hypothetical questions but a reality that policymakers must deal with today.

The demand for welfare and health services increases as the population grows older, and at the same time, the room for financing extra expenditure by higher taxation is limited because of an already high level of taxation and increasing tax competition.

How can we ensure that the public sector in general and welfare services in particular can adapt?

One way, the applicability of which varies from case to case, is to expose part of the public services to private competition. Another way is to focus on measuring performance of the public sector and put in place appropriate incentives to respond to change.

The public sector needs also to be more responsive to its "customers" needs. Too often bureaucracies forget that they ultimately exist for the benefit of their customers.

The customer-oriented approach is not only essential for ensuring efficient delivery of public services. But, perhaps more importantly, the public sector also needs to be responsive to customers' needs in order ensure its legitimacy and support of the electorate.

Public services need to provide a good match with the preferences of a median voter. Without such a match, the funding base of the public sector (taxes) will inevitably start to erode. This could lead to a vicious circle that would be difficult to reverse.

5. Conclusions

So, what is the answer to the question that I posed at the beginning, i.e., is the European Social model an asset or a liability? As is often the case in real life, the answer is: "it depends".

Namely, in a rapidly changing environment any static model is likely to become a liability. Indeed, economic systems are so complicated that no single policy prescription can ensure rapid and sustainable growth over the long run. Therefore, it would be helpful to shift the focus from copying particular "models" to analysing what structures are needed to support successful and adaptable approaches.

I have attempted to do so by examining the experience of the Nordic countries. This experience suggests that it is possible to combine economic dynamism with a system that is consistent with the core European values. The key lesson to be drawn from the apparent success of the Nordics is the importance to ensure that both the private sector and public policies are capable of adapting to changing circumstances.

To sustain a social system that is in keeping with the core European values, we need the following, mutually reinforcing three pillars:

- a competitive private sector exposed to free competition;
- sound and transparent institutions; and
- an efficient and responsive public sector.

There is no silver bullet. However, as I have argued, an active and open civil society plays a crucial role in keeping all these three pillars strong.

Going forward, European values of solidarity and social cohesion will be tested by centrifugal forces arising from globalization, rapid technological advances and population ageing. Nevertheless, they should continue to guide policy choices also in the future.

Ensuring that these values are truly reflected in European social models will require many painful decisions, and we must be mindful of the dangers of populism. This calls for a frank and honest political discourse that recognizes the benefits and downsides of globalization and other forces that shape the future. This, combined with a well-educated electorate, press freedom, and a culture of transparency provide a powerful antidote against populist policies.

I see some similarities between the current rapid phase of globalization and the European integration process triggered by the Treaty of Rome 50 years ago. Both imply changes in many old structures, both bring benefits. There are also differences: in the integration process, the benefits accrued automatically to EU countries, but globalization does not imply

such automaticity. The benefits of globalization are spread wider among the global community and European countries are not guaranteed winners.

To survive and thrive in the global competition, Europe needs to regain its self-confidence and be an open society. Europe must not be focused on preserving structures; it needs to embrace change in order to preserve its core values.