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THE EUROPEAN SOCIAL MODEL: IS THERE A THIRD WAY?

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Summary.

The search for a Third Way, intermediate between socialism and capitalism, began even before the birth of the Soviet Union, whose observed drawbacks encouraged a further search. There have been at least three alternative projects within this approach:

1. *Market Socialism, combining public ownership, market allocation and socialist values of high employment, growth and equality.* This was the target of many failed attempts at reforming the Soviet-type model, in the 1960s to the 1980s. Its best, though partial, embodiment is the Chinese economy circa 1980-2000.
2. *The New Labour paradigm of the late 1990s, accepting the dominant role of private ownership and enterprise, the primacy of domestic and global markets and budgetary discipline.* The model was a move in the right direction but it went too far in some respects, and not far enough in others. It was rejected by electors and its resurrection today would require a major overhaul.
3. *The European Social Model (ESM), emphasising the role of institutions as well as markets in resource allocation, with employment protection and a generous welfare state*. This model performed rather well in the 2000s but 1) its institutions and policies were never part of the *acquis communautaire* and its implementation was left to the discretion of member states; therefore it was significantly diluted by the European Enlargement to the Central Eastern European countries, that – with the exception of Slovenia and to some extent Estonia – adopted the

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hyper-liberal model fashionable at the time of their transition to capitalism in 1989-1991; 2) the increasing globalisation of labour, due not only to the more spectacular phenomena of de-localisation (caused by capital mobility) and labour migrations, but above all due to trade growth, has threatened employment, real wages and tax revenues in the more advanced countries such as those that had adopted the ESM; 3) even in those countries that did implement it fully, in spite of the stringencies of the Growth and Stability Pact, eventually the European Social Model was wrecked by the cuts in government expenditure adopted as a response to the global economic crisis of 2008-2010 and to generalised concerns about the sustainability of government debt.

In this paper I will review these three alternative Third Ways, concentrating on the ESM. My conclusion is that the European Social Model is still a viable and sustainable alternative, but only after the consolidation of public finances, subject to the constraints of global competition, and as an alternative to competing uses of public resources.

1. Market Socialism

Market Socialism was expected to combine public ownership, market allocation and socialist values of high employment, growth and equality. This system is often identified with the Oskar Lange model (1936, 1937), wrongly because this was only a de-centralised procedure for constructing a hypothetical central plan by simulating the market; that model retained all the drawbacks of central planning: the lack of enterprise managers' incentives and discipline, and of inter-temporal co-ordination. Market Socialism was the target of many reform attempts in Central Eastern Europe (first in Yugoslavia since the late 1950s, then throughout the area, most notably in Hungary since the late 1960s), which never came to fruition mostly because of persistent, endemic repressed inflation (shortages); as well as political limits to the growth of the private sector and to relaxing the state monopoly of foreign trade.

With the collapse of Soviet-type socialism the opportunity to explore this kind of Third Way in Central Eastern Europe came to an end, although a combination of dominant state ownership and some limited market process was introduced in Belarus and Uzbekistan, which remained politically authoritarian. In Belarus today lip service to a "socially-oriented market economy with state regulation" is simply a smokescreen to disguise the continued maintenance of a communist political monopoly and of a command economy – without full central planning but with dominant state ownership and enterprise. Putin's Russia has moved in some ways towards the same system, with re-étatisation of natural resources, banking and strategic sectors – aviation, aerospace, shipbuilding, car production as well as military production - and forms of "managed" democracy.

Stiglitz (1995), taking a particularly sombre view of market efficiency, argued that market socialism was a hopeless task, for it combined the drawbacks of both markets and socialism. Others regarded market socialism as an oxymoron. Vaclav Klaus (Vienna, January 1991) declared that "The Third Way is the fastest route to the Third World". Proposals such as that of John Roemer (1994), for a universal but non-transferable life interest in domestic capital assets, in place of public ownership, became obsolete since their realisation was unthinkable starting from a capitalist society.

The collapse of Soviet-type systems in 1989-91 did not prove conclusively the impossibility of market socialism, nor did it turn such an impossibility into a plausible conjecture. The project to construct market socialism as a Third Way survived in countries such as China, where it was enshrined in the 1993 Constitution, and Vietnam‟s "renewal" or "*doi moi*". Except that in the early 2000s, following privatization of state assets and the demise of Township and Village Enterprises (officially part of the "non-state" sector but still public though locally controlled), China's private sector became dominant. But there is still a major, glaring departure of the Chinese economy from a market system, i.e. the gross under-valuation of the *renmimbi*, directly decided by the Central Bank of China regardless of market balance – indeed at the expense of massive global imbalances. This is a conspicuous residual of central planning in spite of China's WTO membership, which should never have been agreed by its trading partners without prior liberalization of its capital markets.

2. The New Labour paradigm of the late 1990s

In 1997-98 the European Union went through a conspicuous, unscheduled and unexpected process of political convergence. By the end of 1998 thirteen out of the fifteen EU member countries (not Ireland and Spain) had social-democratic or left-wing coalition governments; social-democrats also held a dominant position in the European Parliament. Although the electoral dominance of social democracy ended immediately in the European Parliament and was gradually reversed in the following decade, temporarily the discussion of a "New" Third Way gained practical relevance, especially in the larger countries (see Nuti, 1999).

The most comprehensive theoretical reflection on the new Third Way is Anthony Giddens (1998), while the most developed political manifesto is the joint proposal by Blair and Schroeder (1999) issued on the eve of the European elections of 10-13 June 1999, at which social democrats were resoundingly defeated. An intermediate system between neo-liberal capitalism and old-fashioned socialism, the new project was committed to traditional socialist values of community, equality and participation, but differed from similar previous attempts in three major respects: 1) the acceptance of the primacy and desirability of markets, fully recognising their global nature in the modern world; 2) the rejection of public ownership and public enterprise, supporting private entrepreneurship and continued privatisation; and, above all, 3) affordability, i.e. fiscal discipline and monetary restraint, rejecting inflationary expansion and public deficit and debt. Social-democratic policies were to be implemented using market instruments instead of direct controls and the management of state enterprises. "*The market is part of the social organisation we desire,* not just a necessary means which we reluctantly admit that we need, and need to master" (Karlsson 1999). The end of the commitment to public ownership and public enterprise (e.g. the repeal of the fundamental Clause IV of the old British Labour Party Constitution) did not just remove nationalisation from the new agenda. It also included a commitment to continued privatisation of state assets and to competition, with state regulation taking the form of setting the rules of the game instead of direct interference in resource allocation. More state assets per year were privatised by Lionel Jospin in France in 1997-98 (25bn ECU in under two years) than by Margaret Thatcher (135bn ECU at 1998 prices in 17 years); large scale privatisations followed throughout social-democratic Europe in the following decade.

Undoubtedly these developments went in the right directions for a socialist economy to be efficient and sustainable. Some encouraging practical developments could be discerned, especially at the European level, through the prospect of co-ordination of national fiscal policies, co-ordination between fiscal and monetary policies, and the re-launching of tripartite social pacts to raise and stabilise employment. But these moves were not developed and consolidated. The new Third Way model was never fully developed intellectually while, in implementing policy, its proponents went sometimes too far, sometimes not far enough.

In some ways the New Third Way was wrong-footed by neo-liberalism, by adopting neo-liberal principles of privatisation and de-regulation precisely at a time when former neo-liberals had moved away towards more critical positions. Damaging ways in which social-democratic governments overshot when implementing liberal policies include: 1) Over-commitment to production of wealth versus redistribution; 2) Over-commitment to social mobility versus redistribution; 3) Over-commitment to reducing the scope of pay-as-you go (PAYG) pensions in favour of funded systems; 4) New Labour's acquiescence in de-mutualisation of financial institutions in the UK; 5) Over-commitment to central bank independence; 6) Over-commitment to employment policies based on wage restraint and labour mobility/flexibility; 7) identifying market globalisation with passive acceptance of the rules of the game as defined by the most untrammelled private sector enthusiasts.

In other cases, incarnations of the new project did not go far enough, retaining for instance: 1) Moves to shorten the working week without lowering wages; 2) Proposals to lower the pension age in Germany, in spite of significant ageing of the population; 3) Proposals to use excess ECB reserves to finance public investment; and – especially in the UK - 4) The neglect of liberty and civil rights, and 5) involvement in imperialistic conflicts as a US ally.

Today only three EU governments belong to the social-democratic tradition: Greece, Spain and Portugal, none of them in good economic and/or political health. A possible re-vamping of this model will require emphasis on participation at all levels, genuine restoration of co-operative and mutual values and institutions, and a continued commitment to pacifism and to equality of opportunities, possibly by pursuing the notion of a basic income or citizen income.

3. The European Social Model

Most social and labour market policies are not part of the obligations of EU membership. Yet official EU documents and economic literature on types of capitalism refer to the *European Social Model (ESM)*:

"*The European social model, characterised in particular by systems that offer a high level of social protection, by the importance of social dialogue and by services of general interest covering activities vital for social cohesion, is today based, beyond the diversity of the Member States' social systems, on a common core of values*" (European Council, 2000, para. 11, p.4).

The European Social Model is also known as the *European model of social dialogue.* The label of *co-ordinated market economies (CMEs)* has also been used. These expressions are virtually inter-changeable, in that *co-ordination* takes the form of a *dialogue* leading to a *social pact*, and welfare provisions are an integral part of such a pact; thus the choice of label is not even a matter of emphasis, but simply of focus.

The European Social Model is a controversial subject. Some deny that it ever existed. Other contrast it with the American Model, but debate where the UK should be placed. Some argue that there is not one but three or four European models. The ESM has been praised for positive aspects of European economic performance, such as social cohesion and the non inflationary composition of conflicts, and blamed for the alleged lower ability to compete in the global economy and to create employment and growth. The model is claimed to be in a crisis, to be on the wane or to have collapsed. I believe that the European Social Model is one, recognisable in spite of European diversity, it is alive and well, and has considerable merit.

3.1 ESM and US models compared

Hall and Soskice (2001) and Freeman (2005) compare the ESM or European model of social dialogue or Coordinated Market Economy (CME) with the American model. Freeman argues that in some respects the two economies are like "two peas in the same pod": advanced capitalist systems, abiding by the rule of law, protecting private property, guaranteeing freedom of association and enterprise, with various degrees of social safety and welfare systems, combining "institutional regulations and markets to determine economic outcomes." The difference is in the weights they place on institutions versus markets, not the qualitative differences that divided capitalism from communist state planning" (Freeman 2005).

The US economy, in its idealised form, conforms to the neoclassical theory of markets "where the Invisible Hand of exit and entry determines outcomes".

Trade Union membership has declined to a low level and wages and employment have become largely market-driven. Firms' employment policy and wages policy do not have to be negotiated with employees, who can take it or leave it. Product markets are little regulated and firms can enter and exit easily. Employment is the primary form of social protection, including access to health care.

The EU "relies more on the non-market institutions of 'voice', particularly in the labour market". The EU requires dialogue between social partners at company level, through Works Councils (EC 94/45/EC), at sectoral and inter-professional level through Sectoral and Social Dialogue Committees, at the aggregate level through the Standing Employment Committee, and Advisory Committees (e.g. on social security); and so on. Wages are determined by collective bargaining between federations of employees and employers, applying also to firms that are not party to it. Firms entry and closure, and employee lay-offs, face greater administrative obstacles. The welfare state requires higher taxes.

Table 1. Measured Differences between US and EU Models of Capitalism

	US	EU
Aggregate Measures		
Economic Freedom Index (Fraser Inst.)	90	82
Tax/GDP ratio	32	42
Goods Market		
Days required to form business	7	64
Product market regulations (OECD)	1.0	1.4
Administrative regulations (OECD)	1.1	1.5
Economic regulations (OECD)	1.3	2.0
Labour Market		
Employment Protection Legislation Index	0.7	2.4
Unionisation [lower in the US]	<	
Collective bargaining coverage per cent	14	76

(From Freeman, 2005)

Both the EU and US models partake of the advantages of market economies and are viable systems. "Some theories, such as the Coase (1960) analysis of property rights and efficient bargaining predict that a social dialogue system will work as well as a competitive market driven model" (Freeman 2005). This conclusion is strengthened by game theory (the prisoners' dilemma): an inter-temporal social pact between employees and employers representatives, monitored and guaranteed by the government with fiscal incentives and penalties, can deliver wage restraint today in exchange for price restraint and higher investment and growth tomorrow. In addition, ESM redistribution provisions can alleviate the distributive impact of globalisation (e.g. the *European Globalisation Adjustment Fund* 2007-13).

Critics have alleged the superiority of the US system in terms of growth, job creation and employment. Goodin (2003) claims that CMEs [Co-ordinated Market Economies, i.e. the ESMs] "are naturally doomed to extinction", that the system is vulnerable and unstable. "LMEs [Liberal Market Economies] ultimately [will] prevail". The US outperformed the EU in the 1990s up to the mid-2000s. But some of the smaller EU social dialogue countries, like Ireland, Austria, the Netherlands and Denmark, had an exemplary performance in the same period, while the EU outperformed the US from the 1950s to the 1990s. Relative EU and US performance depends strictly on the periods selected. After the second World War labour productivity in the west of Europe was only half that of the US, whereas now it is not far below.

"Since the turn of the century, the euro zone has created more jobs than the United States" (*The Economist*, 27-1-2007). In the first half of 2007 Europe's growth rate had overtaken that of the United States. Income inequality is lower in the EU than in the US, also, and with better universal health care at lower cost in the EU than in the US. Comparative performance during the 2009-2010 crisis should not neglect that *the crisis itself originated in the United States and was caused by US institutions and policies. A major problem in system comparison is to what extent performance differences can be attributed to institutional differences* (Freeman 2005).

3,2 ESM dilution: rising costs and EU enlargement

In the last 10 years ESM has suffered some dilution, due to several factors including 1) the rising pension burden of an ageing population, 2) the rising cost of available health treatments, 3) opportunistic behaviour (moral hazard), 4) the parallel greater fiscal discipline of the Maastricht 1992 and the Amsterdam 1997 Treaties.

Another major factor diluting the ESM has been EU enlargement to the post-socialist countries of central eastern Europe (the Czech Republic, Hungary, Poland, Slovakia; Slovenia; Estonia, Latvia and Lithuania on 1-5-2004; Bulgaria and Romania on 1-1-2007). It has been argued (Vaughan-Whitehead, 2003) that EU enlargement has diluted the ESM model because of: 1) its non-affordability by new members averaging 40% of the older members' GDP *per capita,* 2) the lack of EU solidarity with new members, or 3) the cost of enlargement itself. But the impact of these factors has been exaggerated. The ESM has been diluted by EU accession of transition economies that had adopted a hyper-liberal socio-economic model. This has greatly diluted the ESM, both in the new EU average characteristics and – by imitation, competition and active promotion of hyper-liberalism – in some of the older EU members (see Giannetti and Nuti, 2007).

On the re-bound from the old system, transition countries gave shape to their systems at the peak of Reaganite and Thatcherite ideology. They were subject to the strong pressures of Bretton Woods institutions. Instances of hyper-liberalism abound: 1) An immediate unilateral opening of international trade, frequently revoked and therefore premature; 2) a much faster capital liberalisation than in the earlier experience of other European economies, which caused currency and financial crises such as those of the Czech Republic in 1993, and Russia in 1998 which affected other central European countries; 3) an unprecedented form of mass privatisation (everywhere except Hungary), a veritable experiment in social engineering of questionable effectiveness, which did not change governance mechanisms, nor access to investment funds and managerial resources; 4) a pension reform from a Pay as You Go to a capitalisation system which made a hidden form of public debt come to the surface while at least partly it could have remained buried; 5) particularly bland and non-progressive taxation of companies and households, as witnessed by the widespread "flat tax" and by the lack of a capital gains tax, with greater incidence of indirect taxes; 6) a central bank of exceptional independence and not subject to any control, and without any coordination with fiscal policy; 7) a particularly restrictive monetary policy, with real interest rates at usury levels, that contributed greatly to the deep and protracted recession that accompanied the transition, discouraging investment and unduly strengthening exchange rates; 8) a particularly flexible labour market (in spite of the occasional protection of employment in some crisis sectors), with weak Trades Unions and scarce diffusion of collective bargaining; 9) a lack of mechanisms for consultation and *concertation* between social partners and with the government; 10) in general, a dominant weight of markets with respect to institutional mechanisms.

In the end the transition economies embraced a hyper-liberal version of the market economy, very different from the European Social Model, converging instead with the US model of capitalism and beyond.

European authorities monitored the convergence of major monetary and fiscal parameters, and of market institutions. Thus EU candidates adopted EU competition policy; restrictions on state aid; improvements in state governance associated with implementation of the *acquis communautaire*. But the EU authorities did not require of the new members the convergence with those policies that add up to the social dialogue model that – though to different degrees and in a flexible and non-codified fashion – characterised the European model. Hanson (2006) utilises several indices: World Bank Ease of Doing Business, Kaufmann-World Bank measures of governance, Transparency International Corruption Indices, and the Srholec index placing a country on a scale between liberal market and strategic coordination. He finds *a significant partition between old and new members, which he attributes to entry negotiations neglecting the elements of a distinctive economic regime.*

Vaughan-Whitehead (2003) notes that: 1) The scope of collective bargaining in the new member countries is only of the order of 10-20 per cent of the labour force; 2) Social dialogue is practically non-existent in small-medium enterprises; 3) EU Directives on Works Councils, profit-sharing and other forms of workers' participation are not being implemented; 4) A large scale informal sector is totally unaffected by ESM policies. *The exceptions are Slovenia and, to some extent, Estonia.*

3.2 ESM dilution: Globalisation and the recent crisis

Another important factor of ESM dilution has been the weakening of labour bargaining power due the globalisation, which involved an increasing globalisation of labour markets, due not only to the more spectacular phenomena of de-localisation (caused by capital mobility) and of labour migrations, but above all to trade growth, which has already been mentioned. Labour markets globalization has threatened employment, real wages and tax revenues in the more advanced countries which had adopted the ESM. Competition in the global labour market is best illustrated by the growth of the export-weighted world labour force, of over 250% in 1980-2005, relatively to an un-weighted labour force growth of 70%. This is what in 1995-2005 lowered by 10 points the average share of labour income in GDP in advanced countries, from 65% to 55% (see IMF *World Economic Outlook,* June 2007). *The crux of the matter is that it is impossible to maintain current relative and often absolute standards of living in the more advanced countries while, at the same time, following policies of the free mobility of factors and free trade. Protectionism, and/or constraints on migrations and on capital mobility, would have to be introduced to support living standards and welfare states in the more advanced countries, at the expense of lower overall productivity and lower living standards and growth in the emerging countries.* This is the dilemma facing advanced countries, including all those adopting a European Social Model.

The stringencies of the Growth and Stability Pact had already forced a certain dilution of the ESM, but eventually the Model was wrecked by the cuts in government expenditure adopted as a response to the global economic crisis of 2008-2010 and to generalised concerns about the sustainability of government debt. In the European Union expenditure cuts have apparently reached a total of the order of €300bn, plus another €90bn in the UK in the October 2010 budget adopted by the new Coalition government.

At the same time, the provisions of the ESM, though diluted, have allowed the older EU members to fare better, during the recent crisis – in terms of social costs - than the less welfare-minded New Member States of Central Eastern Europe. This, of itself, is causing internal migratory strains on EU cohesion as central and east Europeans move to high welfare EU countries but bring neo-liberal wage and conditions flexibility with them, thus destroying the "voice" of the ESM in older member states. And the US model has also been transformed in the crisis, re-instating the state as a major actor, taking care of the welfare not just of workers but of shareholders, creditors and managers of bankrupt private financial institutions.

4. Conclusions

In conclusion:

- The European Social Model is alive and well;
- It has a distinctive identity in spite of cross-country diversity;
- It is not a superior model but it partakes fully of the advantages of a market economy and has specific merits in social protection and the composition of conflicts;
- It has been diluted in the last ten years as a result of various factors, including its rising costs, the adoption by nearly all transition economies of a hyper-liberal socio-economic model, the deterioration of labour's bargaining power caused by globalisation, the fiscal discipline imposed by the Maastricht and Amsterdam Treaties and, finally, the cost of expenditure cuts undertaken – rightly or wrongly, for lower government expenditure does not necessarily leads to a lower deficit – with the purpose of consolidating public finances.
- It appears to be still a viable and sustainable alternative, but only 1) after consolidation of public finances, or at any rate conditionally on the continued feasibility of such consolidation; 2) subject to the constraints of global competition, and 3) as an alternative to competing uses of public resources.

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