Inclusive Growth:
What Future for the European Social Model?[1]

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Abstract:

After a short introduction on the importance of "inclusive growth" from a German point of view, a brief sketch of a model follows explaining the trade-off between comparable productive capacity (CPC) and flexibility. After the monetary union, this trade-off sharpened for many EU member states whose CPC now falls below this line. To compensate for the lack of comparable productive capacities, flexibility measures would be necessary (e.g. downward wage flexibility, regional mobility) to an extent which is unrealistic or would erode social cohesion and democracy. What are the alternatives? Apart from macroeconomic measures (e g, strengthening control of banks or financial transactions and enhancing effective demand through investment into a European-wide infrastructure) not being subject of this intervention, the possible future role of the European Social Model could consist in implementing four strategies: First investive social transfers to stabilise weak member states; second protected flexibility, in particular internal functional flexibility; third investing in people, in particular to induce mobility chains (making transitions pay); and fourth efficient (European) labour market regulation for better utilising existing capacities and restraining inefficient forms of flexibility. Examples for each strategy are presented for illustration and stimulating the debate.

Inclusion has a high value. Only a couple of weeks ago the German government lost again a regional election in Low Saxony. Opinion polls presented as one possible explanation the results of a survey: "Would you prefer more growth or more equal opportunity?" 40 percent answered more growth, 48 percent more equal opportunity. Obviously, Germany has a problem of social inclusion, despite an apparent so-called 'Job Wunder'.

On a European level, however, the situation looks even worse: There is no job miracle lurking anywhere on the horizon, not even as a mirage, and inclusive growth bringing the economies of 27 member states closer together is far out of sight. Why is this so? Does it make sense to summon up again the European Social Model? Wouldn't it simply be better to first do the homework on creating better conditions for economic growth?

Why is it like this? Figure 1 presents a small model inspired by a recent paper of Frank Vandenbroucke (2012). The vertical axis represents a measurement for economic inclusion, which I call *'comparable productive capacity'*, modifying

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thereby the concept of ‘symmetry’ used by Vandenbroucke. The members of a monetary union must have a minimal amount of comparable productive capacity, that is: accumulated capital, a qualified workforce, material and immaterial infrastructure, reliable rule of law, an effective tax system and an incorruptible public administration. The horizontal axis is a measurement for economic flexibility, in other words the ability to cope with external shocks through flexible wages, variable employment contracts, regional mobility and inbuilt stabilisers.

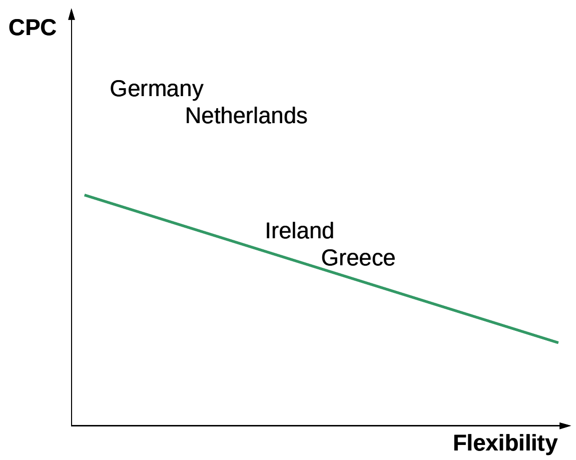

Fig. 1: The Trade-off between Comparable Productive Capacity (CPC) and Flexibility

There’s a trade-off between these two dimensions: A lack of comparable productive capacity has to be balanced out by increased flexibility, otherwise state debt or unemployment will rise. In order to illustrate this, the figure displays the potential situation of a few countries: Germany and the Netherlands lie above the line; Ireland and Greece are on the line, each presenting different trade-off constellations.

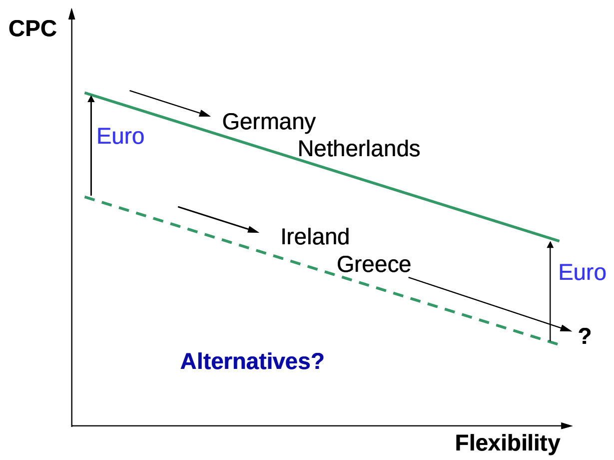

Fig. 2: The Impact of the Monetary Union on the CPC-Flexibility Trade-off

The introduction of the Euro has caused this line to move upwards, as Figure 2 shows. The demands for comparable productive capacity have grown due to increased competition and the loss of currency sovereignty. Although Germany and the Netherlands might now find themselves directly on the line, they already have moved downwards when it comes to more flexibility. Ireland and Greece are now both clearly below the line. Although measures for flexibilisation have already been introduced there, they would have to go much further than in Germany or the Netherlands compared to their productive capacity. This would be unacceptable for the majority of the population, in particular for workers. Democracy would become endangered and Europe could break apart.

What are the alternatives? Macro-economic measures of course that have already partly been embraced, but not yet sufficiently implemented, for example: controlling the financial markets and banks or a European-wide investment programme in material infrastructure such as energy, transport, sewage, and information and communication technology. I'll leave that aside for now and instead ask: Which role could the European Social Model actually play? I can see four starting points which must be partly intertwined (Figure 3).

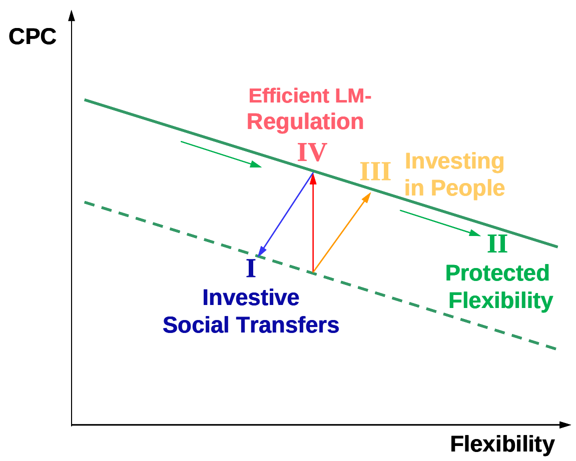

Fig. 3: Possible ESM-Strategies to mitigate or to cope with sharpened CPC-Flexibility trade-off

First, *investive social transfers* could push the trade-off line downwards, hence relieving member states below the line from taking recourse to further flexibility measures.

Second, the demands for greater productive capacities could be compensated for or supplemented by *protected flexibility*.

Third, the productive capacities could be improved by *investing in people*; this would also simultaneously raise the capacity of flexibility.

Fourth, productive capacities could be raised by establishing a real European labour market through *efficient labour market regulation* which better utilises existing capacities and reduces inefficient flexibility at the same time.

I. *Investive social transfers* between the EU member states are nothing new. The European Social Fund, the ESF, is one example. I'm talking about *investive* social transfers from the strong to weak member states with low productive capacities because the legitimacy of permanent social transfers is always problematic. With this in mind, it is no secret that ESF resources could be more effectively implemented. However, the role of this fund could be extended on two accounts, in particular in *institution building* related to (un-)employment insurance and modern employment services. Recent research shows that generous unemployment benefits during the first six to nine months should be regarded not as a 'passive', but rather as an 'active' investment in the search for jobs. Unemployed people with decent income support find more productive *and* more sustainable jobs than unemployed without such support. Research even shows that jobless people covered by unemployment insurance remain healthier and more self-confident than jobless people without unemployment insurance. So, there is a strong case for the ESF to support the set-up of effective unemployment insurance in the many member states in which such a system does not yet exist. Apart from the benefits for many unemployed, this would raise the member states' capacity of automatic stabilisers and redistribution to balance out discrepancies in regional living standards.

Second, there are good reasons to establish at least a rudimentary system of European Unemployment Insurance. In the short term, this would enable transfers to member states whose unemployment rates exceed a certain threshold. Above all, such transfers would serve as a stabiliser which sustains regional purchasing power and reduces the brain drain of skilled workers.

Third, these transfers could also be applied conditionally, for example for education purposes or 'youth guarantees'. Wage cost subsidies for companies recruiting additional workers from the pool of unemployed should also be considered. Nikolas Kaldor (1936), an intellectual contemporary of Lord Keynes, pointed out long ago: If employment cannot be boosted through devaluating the currency, then temporary wage cost subsidies can be used as a functional equivalent.

II. A paradigmatic example for *protected flexibility* is short-time work allowance to maintain employment in recessions through temporarily reducing working hours and compensating the temporary loss of income by unemployment insurance. This instrument allows workers to accept some wage flexibility in exchange for job security, and employers to accept some fixed wage-costs in exchange for workers' loyalties and skills. The state plays the role of moderator, co-financer, and insurer of conditionality, in particular through employment services having built-up trust relationships with employers. During the last recession, this instrument was successfully implemented in many member states, especially in Germany. The German example also shows a number of other effective possibilities for protected flexibility which can be negotiated by the social partners on the level of industrial branches or firms, in particular working time accounts and wage corridors (Schmid 2012a, 2012b).

Further examples are hedging income risks during further training or retraining by providing education vouchers; or hedging income risks during leaves for parenting, taking care of sick family members or for sabbaticals. Non-standard employment is becoming increasingly standard. It would therefore be a distinct task of the European Social Model to further develop *and* maintain mutual standards of social protection for life-course transitions that are of common value in Europe, such as the right to return from a part-time job into an equivalent full-time job. Often the legal framework for such protection is already available, but effective implementation is hampered by lack of procedural securities and control. The Open Method of Coordination could enhance efficient implementation by encouraging member states to establish binding procedures and control measures according to their administrative culture, for instance work inspectors, legally endorsed collective agreements or administrative agreements like the covenants in the Netherlands or regional employment pacts in many member states (Bekker 2013, Schmid 2008, 2012b).

Final examples are wage insurance for workers who have to change into lower paid jobs as a result of diminished productive capacities, and targeted in-work-subsidies for workers whose income capacity is temporarily restricted through unpaid care obligations, in particular single parents.

III. *Investing in people* is central if Europe wants to remain competitive. The issue is not just about preventing skill shortage due to our ageing society for example; the issue is above all about combating a central cause of rising inequality. Across the whole union, the employment rate for the highly qualified is 83 percent; the employment rate for low-qualified workers is only 53 percent. This makes a difference of 30 percentage points. It should become an objective of the European Social Model to narrow this gap.

The costs of not investing in skills are enormous: It hampers not only the creation of new jobs but also innovation and thereby competitiveness. One of the many studies on growth and skills finds that 50 additional points on the PISA scale induce 0.6 percentage points more growth. This makes 30 percent more income measured after forty years. But it is not just about investing in high formal education. As the current unemployment situation among highly educated young adults in some countries shows, it is also about caring for a good balance of simple, professional and high qualifications. Europe needs not only academics but also engineers, skilled craft workers and competent labourers.

As we cannot wait until the education system has produced the new skills for new growth, it would be an essential component of the future European Social Model to strengthen the links between the education system and the labour market over the whole life course. Easy transitions between education and work or the combination of both should not only be possible after secondary or tertiary education, but also for the rest of one's whole adult working life. This would not only improve the horizontal and vertical mobility, but also induce mobility chains that would altogether raise the capacity of flexibility. Why is it still exceptional if not impossible that a nurse becomes step by step a professional doctor? Education or training should not stop at a certain age. Recent research shows a clear positive correlation between training participation and labour force participation of elderly people, even after controlling for other factors. And the link between labour market and the education system exists even beyond retirement: knowledge goods need knowledgeable people.

IV. Productive capacities and flexibility could be enhanced by establishing a real European labour market through *efficient labour market regulation*. The basic orientation must be to diminish inefficient flexibility by better utilising existing capacities. This may sound like squaring the circle. But plausible examples exist. Recent research shows that excessive use of fixed-term contracts, including temp-agency work, hampers innovation and productivity. So, some restriction of fixed-term contracts would enhance and not erode productive capacities in the long-term. One way to do this would be setting the right economic incentives, for instance internalisation of risks, in other words risk-related contributions to social security and training funds. Fighting inefficient flexibility would also support life-course planning of young adults who are most hit by non-standard and often precarious forms of employment.

Another example is EU-wide recognition of qualifications which would improve mobility, especially in areas threatened by skill deficits. A directive for a European Professional Card is already in the making. However, this should not lead to an erosion of quality standards in order to guarantee a sustainable rise in productive capacities. We may not, just to name an example, praise dual vocational training and education as a successful tool against youth unemployment and jeopardise the merits of this qualification at the same time.

A highly contested example is the suggestion to regulate a Europe-wide minimum wage. Of course, this target cannot be met by a unifying minimum wage, which would be an economic hara-kiri. It would however be sensible to establish common rules, for example to set the minimum wage on a national level <u>and</u> to monitor the impact through the Open Method of Coordination in close cooperation with Social Partners. One rule could be that the minimum wage should not be lower than a certain relation to national average wages respectively, e g fifty percent. Member states may then make annual adjustments according to their individual experiences. Joint European monitoring of minimum wages would not only avoid cut-throat competition by wage dumping. It would also stimulate investments in quality work and increase the domestic purchasing power of strong economies, thereby enhancing the export chances for weaker countries. By regarding unit wage cost trends of the last decade, it is understandable that many people gained the impression that Germany has been playing some beggar-thy-neighbour policy by having insufficient minimum wages and expanding rapidly the low-wage sector.

To summarise: The best of a European Social Model could still be on the way. But this little glimmer of hope might soon become extinct if Europe does not succeed in controlling the financial markets and getting the weak economies on a path of inclusive growth. In turn, only *institution building* striving for a *European* Social Model as suggested here (certainly still open for the debate) and in other recent publications (e.g., Vandenbroucke 2012) as well as more binding coordination of social policies (e.g., Bekker 2013) would support and ensure *sustainability* of this growth.

Selected Literature

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