

Old Europe's Social Model – A Reason of Low Growth? The Case of Germany

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1. Old Europe - the three large continental countries Germany, France and Italy - has had a low average annual GDP growth rate since 1995 of 1.6 percent. It is half the US growth rate and 1 ½ percentage points less than in the UK. In the period 2000-2005, the growth rate of the three large continental countries is less than one third of that of the US. For Germany, Europe's largest economy, the growth rate for the period 1995-2005 is 1.4 per cent. The rate in the same period is similarly low for Italy with 1.1 percent; it is higher for France with 2.2 percent. All three countries have high unemployment rates (standardized rates 2004: Germany 9.2, France 9.6, Italy 8.0 percent). The topic is whether Old Europe's social model is one of the underlying reasons for the low growth rate.

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Table 1 Annual average GDP growth rates in the EU–25, 1991- 2005 ^a

	1991-1995	1995-2000	1991-2000	1991-2005 ^b	1995-2005	2000-2005
Continental						
3 large continentals ^c	1,5	2.3	1.9	1.6	1.6	0.9
of which Germany	1.5	2.0	1.8	1.4	1.4	0.7
4 small continentals ^d	2.0	3.3	2.7	2.2	2.2	1.2
2 Anglo-Saxon^e	2.6	3.6	3.2	3.0	3.1	2.5
of which UK	2.5	3.2	2.9	2.7	2.8	2.3
3 Nordics^f	1.7	3.5	2.7	2.4	2.7	1.9
3 Mediterraneans^g	1.7	4.0	3.0	3.0	3.5	3.0
10 New members		4.3			3.9	3.5
Memorandum item	3.1	4.1	3.7	3.3	3.3	2.6

^a Real GDP growth rates with prices and exchange rates of 1995. Growth rates do not reflect exchange rate changes. – ^b 2005: Eurostat forecast. – ^c Germany, France, Italy – ^d Austria and Benlux. – ^e UK and Ireland. – ^f Denmark, Finland and Sweden. – ^g Greece, Portugal and Spain.

Source: Eurostat Online

2. The hypothesis is that a goal conflict exists between social protection and economic growth (Figure 1). It can be argued that, for a low level of social protection, more social protection will increase the growth rate (Point A). At some point, however, the curve changes its property. For a high level of social protection, an increase in social protection will lower the growth rate (point B). It can be argued that the three major countries of “Old Europe” are on the falling branch of the bell- shaped curve.

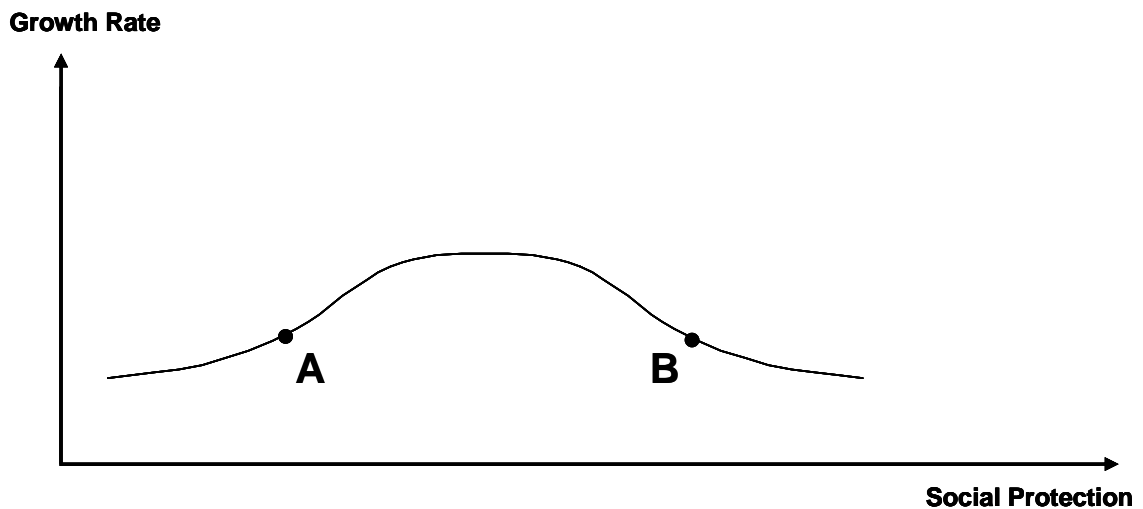


Figure 1 Goal Relation between growth and social protection

3. Such a hypothesis is consistent with empirical observations on the relationship between growth and inequality for a multitude of countries of the world. According to the Kuznets curve (1955), the curve for the growth rate and inequality follows an *inverted u* over longer periods. Low-income countries tend to have high growth rates and high inequality. High-income countries have lower growth and more equality. The Kuznets curve represents an empirical regularity (Barro 2000). However, we do not have a “causal” relationship between inequality and the growth rate. Adding the Gini coefficients to his equations, suggests a zero overall relationship between (the unexplained part of) the growth rate and the Gini coefficient in a 146 number sample (Barro 2000, Figure 1). If a distinction between low-income¹ and high-income countries is made, the growth rate is in a positive relation to inequality (the Gini coefficient) in low-income countries, i.e. more inequality (a higher Gini coefficient) reduces the unexplained part of the growth rate. In high income countries, the unexplained part of the growth rate increases with a higher Gini coefficient, i.e. more inequality reduces the unexplained part of the growth rate (Ibid, Figure 2).

4. My topic is not the relationship between distribution (or social equity) and growth but on social protection and growth. Both terms are not identical. Whereas distribution can be measured by the Gini coefficient, social protection does not only include income transfers from public systems, for instance in unemployment insurance, public pension systems or social welfare payments. It also includes legal entitlements such as lay-off constraints and legal stipulations in favor of collective wage contracts. Moreover, legal rules such as the rules for co-determination or the constitutional requirement of the similarity of living conditions in Germany’s federal states form part of social protection. These forms of social protection do not directly show up in the government’s budget and do not necessarily cause transfers

5. As with other empirical relationships such as the Philips curve or NAIRU, the curve on social protection and growth depends on institutional conditions. The institutional set-up defines the incentives for the decisions of households and firms. It is therefore necessary to take into account different institutional arrangements in Europe. I modify Sapir’s typology (2004), which is, however, not on growth and social protection, but on efficiency and equity.

¹ For developing countries see Hirschman’s “tunnel effect” (1973) according to which there is a high tolerance for growing inequalities in the early stages of development and growth. This tolerance erodes through time if the low income groups fail to benefit from the growth process.

Even though this typology may be questioned², it reminds us that institutional conditions differ and that in this paper we are only dealing with the Continentals.

Table 2 : Taxonomy of European Countries ^a

GDP Growth Rates	Equity	
	High	Low
Low	Continentals (Growth rate 1.6)	Mediterraneans (Growth rate 3.0)
High	Nordics (Growth rate 2.7)	Anglo-Saxons (Growth rate 3.1), New EU Members (Growth rate 3.9)

^a Average GDP growth rate 1995-2005.

6. Let us look at the incentive structure for growth that is affected by social protection and let us discuss which mechanisms can be at the root of a negative interdependence between social protection and growth. I will use Germany as an example to study this question and I will distinguish different areas relevant for growth.

Labor

A set of mechanisms of social protection relate to labor as a determinant of economic growth. They play a role in leaving labor idle. If ten percent of the labor force is unemployed, GDP is lower. With growing unemployment, the growth rate declines. Leaving labor idle may also imply less flexibility of the economic system and thus more difficulty in adjusting to economic shocks. It also affects the expenditures of the social security system and the public budget.

² It still has to be proven that a country like Sweden has a good performance in the very long run. First of all, it had a severe crisis in 1992. Second, an erosion process took place in the period 1970-1992. Third, it is still too early to tell whether the institutional changes undertaken in the 1990s will be sustainable. Finally, such high personal tax rates as in Sweden may not work in other countries.

- First, employment protection as one form of social protection can be expected to reduce the firms' demand for labor in the long-run. Lay-off restraints establish a negative shadow price for labor in the firms' intertemporal maximization framework if economic slumps, sectoral shocks and firm-specific disturbances are allowed for.

Second, increasing social protection in the lower segment of the labor market in a variety of forms (increasing the duration of unemployment benefits – *Arbeitslosengeld*- in the mid 1980s, increasing the replacement ratios in the 1970s in both forms of unemployment benefits - *Arbeitslosengeld* and *Arbeitslosenhilfe* - , improving social welfare benefits (measured as an increase in the number of recipients and expenditures)³ implies a high reservation wage. These arrangements are false incentives for the labor market. The low segment of the labor market dries up.

Other proposals, motivated by social protection, also affect the labor market. An explicit minimum wage truncates the lower part of the demand for labor curve if it is binding, for instance in low-income regions or for young people. The minimum wage in France is considered as one of the main factors explaining the high rate of 23 percent of youth unemployment (2005). Wage subsidies to bridge the gap between a desired wage and a low level of labor productivity will have an effect analogous to product subsidies.

Third, financing the social security systems through contributions based on the work contract has a similar effect for firms as a tax on labor (for the part that is financed by firms). Since the social security contributions have increased considerably since the 1970s⁴, the incentive for firms to shed labor has become stronger.

Fourth, a compressed wage structure can be interpreted as the result of an implicit minimum wage and redistribution. The net wage structure may be more compressed taking into account the rising contribution and tax burdens per individual. This leads to less effort.

Fifth, social protection can also be interpreted as the main reason for the institutional set-up of wage bargaining with the power given to the trade unions through a set of legal stipulations (Sec. 3 of para 4 *Tarifvertragsgesetz* and of para 77 *Betriebsverfassungsgesetz*). To protect the

³ On details see Siebert (2005), pp. 130-136.

⁴ From 26.5 (1970) to 41.7 percentage points in 2005, nearly 60 percent.

insiders discriminates the outsiders. The labor market has become less flexible and more labor has become idle.

Sixth, the trade union's drive for a 32- or 35- hour work week and for a pension at 60 may be interpreted as Continental Europe's choice for more leisure (Blanchard xxx). But it also can be understood as the unions' strategy to aggressively camouflage the effect of their wage policy and, together with unemployment schemes, to put the burden of unemployment on a third party, the state and the taxpayer, for instance in early retirement programs.

These six factors (and some others) imply that incentives are present in the economic system for firms to reduce labor. There are vicious circles in these arrangements that are self-reinforcing and can aggravate a negative development. They lead to less employment, for instance in jobs that pay into the social security system, then requiring to raise the contribution rates or tax financing for the social security systems. This, in turn, intensifies the wrong incentives.

Human Capital

Seventh, social protection is not only redistribution. It also includes the legal definition of entitlements, so that market allocations are substituted by bureaucratic or other allocation procedures. A crucial entitlement connected with social protection represents the right to study at a university if a high school diploma has been obtained. This entitlement has been interpreted as a right granted by the constitution. If this approach (which loses importance now) is applied, the students slots cannot be allocated through a competitive process. It requires a bureaucratic process as the ZVS (Central Agency for the Allocation of Student Slots, CAASS). The consequence is the administrative steering of the universities through the ministerial bureaucracy of the federal states.

Innovation

Eight, economic growth depends most prominently on accumulated stocks driving the growth process (physical and human capital, technological knowledge). Investment and innovation are important growth factors. The incentives to accumulate these stocks (and others such as experience) are influenced by social protection. Rewards like those for taking risk (determined ex ante and not evaluated ex post) and for being an entrepreneur play a role.

Social and Budget Policy

Ninth, Germany - as the two other large continental countries - spends a large part of its GDP for social absorption relative to the UK and the US (see Figure A.1 in the appendix). For instance, public expenditures for old-age pension insurance, health insurance and unemployment insurance in 2001 amounted to 20.8 percent of GDP in Germany instead of 11.9 percent in the US and 14.2 percent in the UK.⁵ The opportunity costs of the high level of social absorption become explicit in the contribution rates to social security and in high tax rates. The need to finance the social security systems through governmental transfers, using up 25 percent of the central government's budget, implies a high elasticity coefficient of transfers with respect to nominal GDP of 3.4 in the period 1998-2004. This then means that budget policy is at the mercy of social policy. In addition, institutional buffers between social policy and fiscal policy have all been demolished in order to be able to finance payments. Thus, fiscal policy is no longer independent from social policy. It has become nearly uncontrollable. Such a fiscal policy causes uncertainty for consumers and investors, and this uncertainty affects aggregate demand and capital formation, two important sources of economic growth. Opportunity cost also consist in a declining share of public investment in GDP.⁶

Tenth, this uncertainty from the budget can, together with high debt, eventually affect the stability of the euro. Then uncertainty arising from inflationary expectations would be an important factor negatively affecting growth.

Steering mechanisms of the economy

⁵ 19.5 percent in France, 21.5 percent in Italy.

⁶ Public investment in GDP declined from 4.8 percent (1970) to 1.4 percent (2004).

Eleventh, social protection also affects the governance of the economy, especially its implicit steering mechanism, in many ways. Subsidies in the product markets are overwhelmingly motivated by social considerations, for instance protecting the small family farmers and securing a sufficient income for them. It is not relevant for my argument that de facto most of these subsidies end up with well-to-do farmers (see reports on what the Royal family in the UK receives) and with agribusiness. Securing jobs in such sectors as coal and shipbuilding also played a role in motivating other important subsidies. Opportunity costs⁷ consist in that subsidies need additional taxation causing a deadweight loss. Agricultural subsidies that are paid by the consumer reduce the real wage. Subsidies also distort the sector structure, requiring a correction of over-expansion in the future (see East German construction sector).

Twelfth, subsidies prevent efficient solutions in the world economy, i.e. the exploitation of gains from trade. They distort comparative advantage and prevent market access to other countries whose positive development could have a stimulating feedback for growth in Europe. When taking into account the international dimension, a more systematic question is how equity and social protection can be defined in a globalized world. Can we define equity solely in terms of the nation state? Or do we have to take into account a larger spatial dimension such as the EU or the world economy?

Thirteenth, co-determination in the corporate governance of firms can be seen as an instrument of social protection. It gives workers or their unions a say in all major decisions of firms, redesigning the implicit contract between the factors of production and the allocation of benefits, costs and risks and thus redefining the nature of the firm. I argue that this institutional arrangement changes the incentive structure of decisions in firms and is favorable to marginal innovations in terms of products and technologies on a more or a less given technological trajectory, but is negative for technological leap-frogging.⁸

Managers tend to have a three-year contract. For renewal they need the support of the representatives of the employees, including the trade unions, in the supervisory council. Therefore, they are not free in their management decisions. They will anticipate the demands of the trade unions.

⁷ Subsidies in 2004 amounted to 6.6 percent of GDP according to the broad definition of the Kiel Institute of World Economics.

⁸ See *The German Economy*, Chap.14.

Fourteenth, social protection is the motivation for some regulations on the product markets that restrict the maneuvering space of economic agents. Examples are legal stipulations for the closing hours of stores, the regulation of the housing market and price regulation of pharmaceuticals.⁹ Such restrictions reduce the space for economic solutions. They stand in conflict with the love for freedom; they restrain competition.

Fifteenth, social protection also plays a major role in Germany's organization of the state in fiscal federalism. The state is not organized as a competitive federalism but as a distributive federalism. The constitutional requirement of the similarity in living conditions in Article xxx has led to revenue and burden sharing in which the federal state can rely to some extent on funds coming from elsewhere. It goes hand in hand with the role of the Bundesrat in federal legislation.

Sixteenth, social protection was at the root of the 1: 1 mentality in Germany's unification. The idea that equality of outcome is a guiding principle was at the heart of wage policy for the unified Germany. There is no doubt that this orientation of wage policy led to high unemployment in Eastern Germany.

Political economy

Seventeenth, social protection may be considered as the political economy price to be paid to get a positive answer to the question whether market results are acceptable. However, if the acceptable result will affect the fundamentals of the economy negatively, the solutions will not be sustainable. The economic mechanism will force people and politics to adjust. If not, there is erosion (Olson 19xx). To use a picture from Hicks¹⁰, economic processes are hammering in the basement.

Changing conditions for Europe's social model in the global economy

Eighteenth, it is important to recognize that the Germany's steering mechanism has been severely changed since the 1960s. These changes have different facets, for instance integrating the environment into the social market economy and to introduce more democracy into decision making. Whereas these aspects do not represent expressions of social protection, some of the changes can be summarized under the heading of social protection.¹¹ Many of

⁹ Many product market regulations are motivated by other aspects than social protection.

¹⁰ He applied it to autonomous investment.

¹¹ Compare the concept of social change.

these changes in the 1970s were undertaken under the implicit assumption that the high productivity growth of a catching-up economy of the 1950s and 1960s were continuing. All these factors can lead to an erosion process if we follow Mancur Olson () or to stagnation in the paradigm of Alwin Hansen.¹²

Nineteenth, Germany's given institutional incentives and the changes in its institutional conditions have become more relevant with changing conditions in a globalized world. The progress of developing countries in exporting manufactured exports¹³ makes the conflict between growth and social protection harder, shifting the curve in Figure 1 downward. Moreover, locational competition for foreign direct investment has become more relevant (Siebert 2006xxx). Observations indicate the economy has become less robust and that shocks have a stronger impact, for instance unemployment after a recession lasts much longer (Sachverständigenrat xxx). This indicates that a higher speed in structural and institutional change is needed in order to exploit the gains from trade. This requirement would arise even if institutional conditions would not have been made more rigid due to increased social protection. All the more are speedy changes needed when systems have been made more rigid.

Changing conditions for Europe's social model in the future: ageing

Twentieth, the immanent ageing of the German population means that existing institutional arrangements, influenced by the idea of social protection, are put to an additional test: the test of sustainability. The governmental pay-as-you-go system emanates from the idea of social protection. Redistribution mixes with risk spreading in insurance coverage.

A simple test for these systems is: why should a governmental system provide an income in old age if people live five years longer? The more crucial test is: How high will the burden of social protection be for the economy in the future? One of the available measures is implicit debt, defined by the claims on the system. Implicit debt is now calculated at 240 percent of German GDP. Moreover, ageing will start processes such as the decline in the labor force (and consequently a negative growth rate under ceteris paribus conditions) that are not yet

¹² On Hansen's stagnation thesis see Higgins ().

¹³ See the increase in their share in developed countries' imports from about 6 percent (1963) to about 45 percent in 2003, (Sapir 2005, Figure 2).

included in the actual figures of implicit debt.¹⁴ Aging will also shift the goal conflict curve in Figure 1 downward.

7. Economic growth depends on many other factors than social protection, most prominently on accumulated stocks driving the growth process (physical and human capital, labor supply, technological knowledge, spatial structure). Although social protection affects the incentives for the accumulation of these stocks, there are additional patterns or “economic laws” governing and influencing the accumulation of stocks, for instance technological innovation cycles, processes of catching up and business cycles. These factors are relevant for growth independently from social protection. Moreover, international settings such as regional integrations and the WTO have their impact on growth. Furthermore, other growth factors such as the preparedness to accept technological (or economic) risks and the social evaluation of the role of the entrepreneur play a role. Whereas the rewards for taking risk and the standing of entrepreneurs may be affected by concepts of social protection, technophobia may have other roots than social protection.

All these factors may play a role. However, from the arguments presented my conclusion is that we do have a goal conflict between social protection and economic growth in a country like Germany.¹⁵

8. Empirically, we do not know the properties of the curve of goal conflict. The curve may be a wide band. Moreover, we may have more information on specific aspects. Thus, unemployment may be seen as an empirically valid function of employment protection legislation. Or employment is found to be a declining function of the total tax and contribution burden (Scharpf 2000, Figure 1).

¹⁴ In the European Union of 15, the GDP growth rate will fall from 2.2 percent in the period 2004-2010 to 1.8 percent in 2011-2030 and to 1.3 in 2031-2500 according to a forecast of the EU Commission (Feb., 2006) .

¹⁵ I had a discussion on this point with Paul de Grauwe on the occasion with of the 50th anniversary of Johns Hopkins in Bologna in 2005. He negates that a goal conflict consists and (believes together with others) that the issue is only to find more intelligent incentives with which the same level of social protection can be maintained.

9. Cross-country panel studies have traditionally been used to study the question at issue. It seems to me that for the European economies such studies with data for a given moment of time (or a given period) do not seem too promising, taking into account the different institutional conditions that become apparent in Table 2. The institutional heterogeneity of European countries and the difference in conditions for economic growth are simply too large.

10. The beef of the story is whether changes in the institutional conditions of social protection in Germany show an impact on the GDP growth rate and whether this impact can be isolated from other growth determinants. .

As a first step we need a social protection index for the three large continental countries over a longer period, say since 1960. This index would be a composite index including employment protection (lay-off constraints), rigidity of the labor market, the social budget in percent of GDP, government spending in percent of GDP and structural aspects of government spending such as the transfers from the public budget to the social security systems.¹⁶ The values for these sub-indices for 1970 (or 1960) are set equal to one.

The weights could be

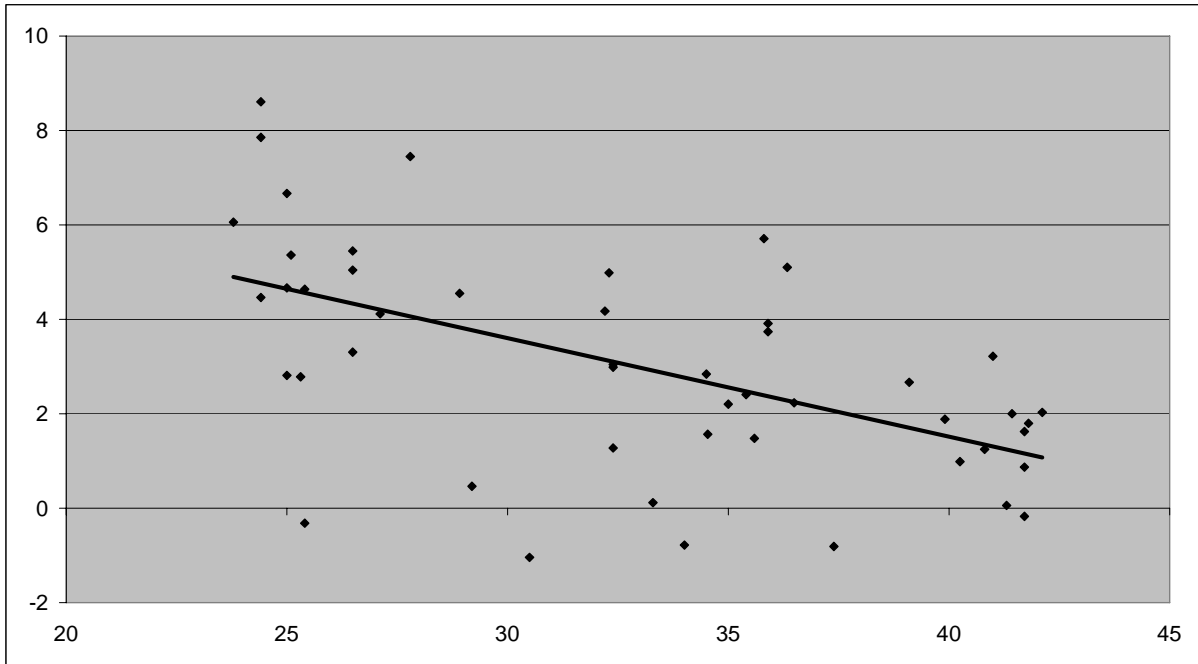
- 0.5 for the labor market characteristics (employment protection, lay-off constraints, minimum wage, lower segment of the labor market and the rigidity of the labor market).¹⁷
- 0.5 for the social budget in percent of GDP.¹⁸

11. I had hoped to be able to at least construct such an index. A preliminary attempt has been to look at Germany's GDP growth rate (vertical axis) and contributions rates to social security (horizontal axis).¹⁹

¹⁶ 1960: 10,51 percent in GDP for unconsolidated expenditures; 2003: 22,35 percent in GDP (See Figure A.2)

¹⁷ One could use the OECD Employment Protection Index which stood at 2.6 in the late 1990s for Germany. One can argue that in 1960, it was not as low as in the US in the late 1990s, namely 0.7. A range between 1.0 and 1.3 for 1960 seems plausible.

¹⁸ One could use the ratio of the social budget to nominal GDP for the years 1960, 1970, 1980 etc from table 65* ???xxx Sachverständigenrat 2005/ 2006 and set the ratio of 1960 =1. The 0.5 could be broken down into: (0.3) government spending in percent of GDP, (0.1) and structural aspects of government spending such as the transfers from the public budget to the social security systems (0.1).



12. For policy purposes, we would need to calculate an index of adjustment needs. If we had a measure of the social protection index, we could indicate to what extent this index has to be reduced in order to get higher employment and more growth. We could also look at adjustment needs in specific areas. For instance, employment protection could be reduced until outsider discrimination is abolished. The adjustment need of an aging population can be measured by implicit debt in intergenerational accounts. Or it could be calculated for specific sectors of the social insurance system such as the health insurance or the pension insurance. The adjustment needs to the external challenge of globalization (including trade and locational competition) could be calculated by the productivity growth necessary to keep a

¹⁹ Unfortunately, the results are not satisfactory.

certain number of social security jobs. As this discussion shows, we are rather vague when it comes to adjustment needs.

Conclusions

13. This is research in progress. At this stage, I do not have an econometric answer to the question which property the curve between social protection and the GDP growth rate has. Thus, further research is needed.

However, we have three observations:

First, social protection has been extended considerably since the 1960s in Germany.

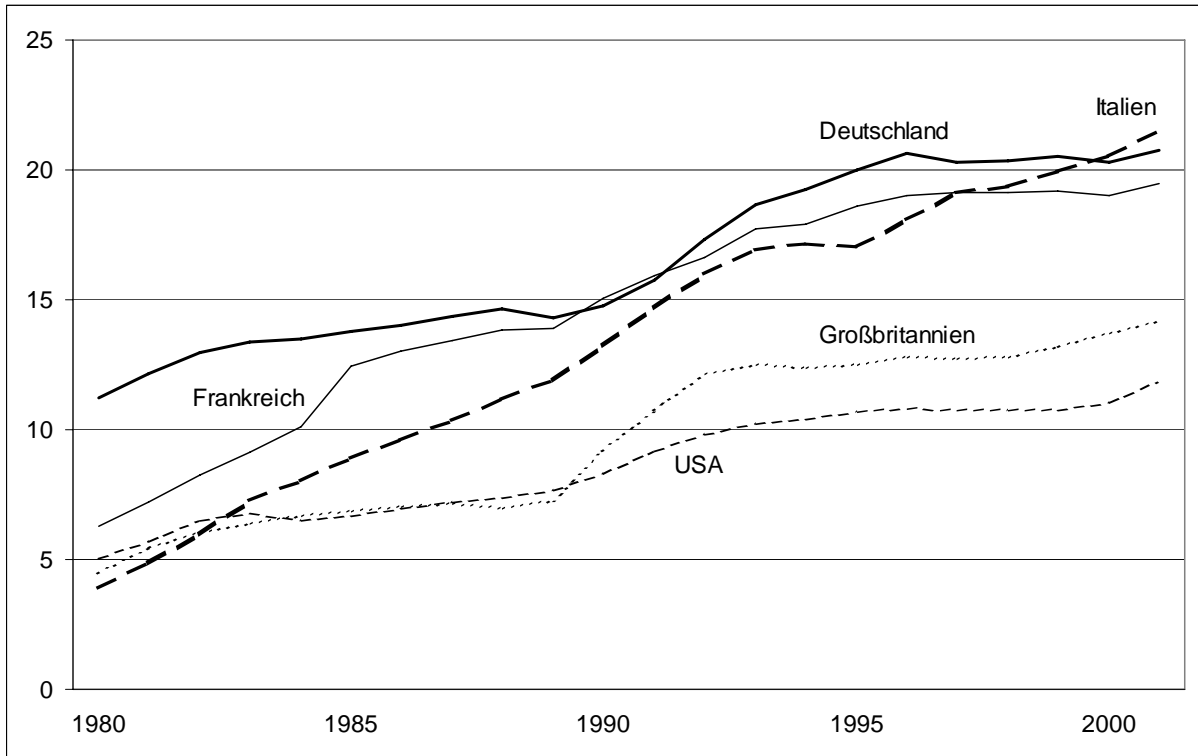
Second, there are many mechanisms and incentives that point to a higher unemployment rate and also to lower growth rates. It can be expected that this expansion has affected the fundamentals of the economy.

Third, the external change in the world economy puts additional pressure on the fundamentals of the economy, even with a given institutional arrangement. This pressure is even stronger with the expansion of social protection.

As a conclusion, we should expect a negative relationship between the expansion of social protection and the growth rate.

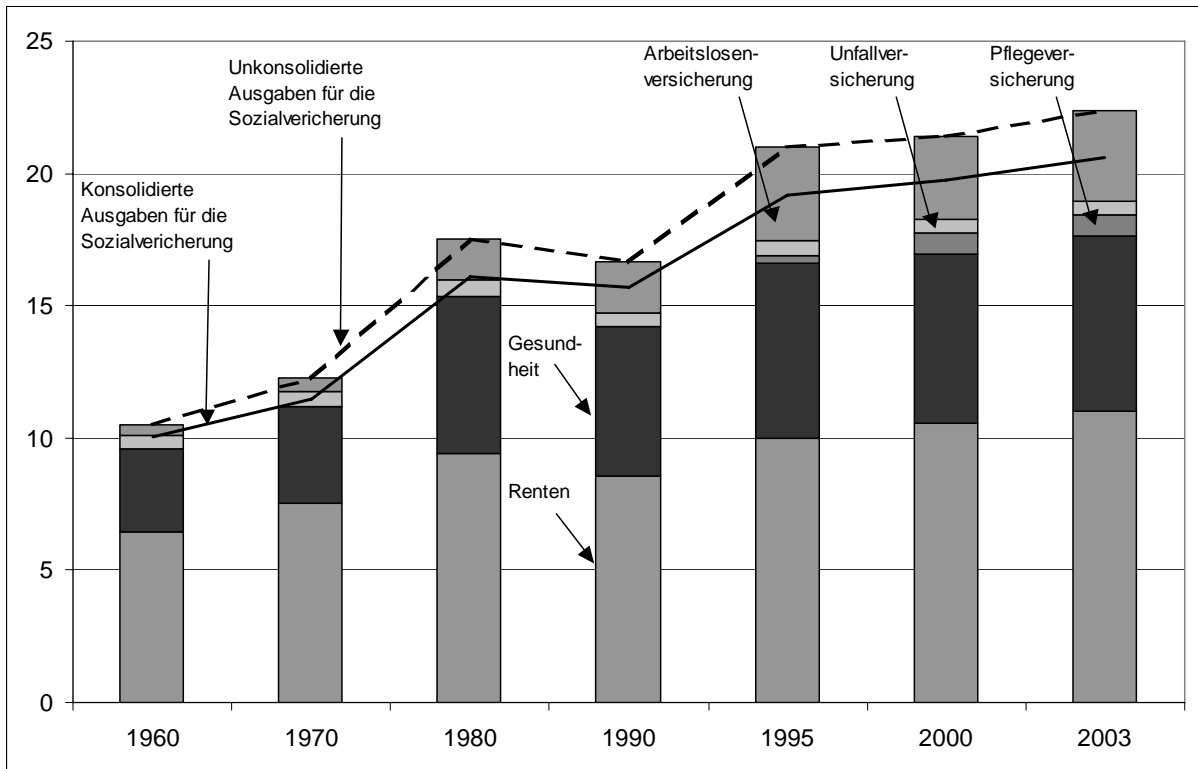
Appendix

Figure A.1 Public Expenditures for old-age, health and unemployment insurance



Source: OECD, Social Expenditure Database, see Siebert (2006), Figure 5.3.

Figure 2: Expenditures of the social system in percent of GDP, Germany 1960- 2003.



Source: Sachverständigenrat Annual Report. 2005, Table 65*, see Siebert 2006, Figure 5.2.

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²⁰ xxxxxNot yet read Net Social Expenditure, 2005 Edition More comprehensive measures of social support Willem Adema and Maxime LadaiqueOECD SOCIAL, EMPLOYMENT AND MIGRATION WORKING PAPERSNet Social Expenditure, 2005 Edition More comprehensive measures of social support Willem Adema and Maxime Ladaiquewww.oecd.org/els/workingpapers .
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