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Competitiveness, Welfare State and Labor Market in Open Economics

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Competitiveness, Welfare State and Labor Markets in Open Economies

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The overall theme of the Sapporo Sessions is “Social Governance in the Global Era — Beyond the 20th Century’s Social Democracy”. It suggests a negative relationship between the transition into the “Global Era” and the traditional values, goals and strategies of Social Democracy. Similarly, the title of my own paper seems to imply that the central aspirations of 20th century Social Democracy, full employment and social security, might be incompatible with the requirements of competitiveness in open economies.

In my view, these assumptions appear overly pessimistic. It is indeed true that social democratic aspirations must now be pursued in an economic environment that differs radically from that of the postwar decades in which these aspirations were first translated into effective strategies and implemented in the specific laws and institutions of particular nation states. It is also true that the present environment is less favorable for Social Democracy, and that the capacity of nation states to realize domestic political preferences without much concern for external conditions and constraints has been drastically reduced.

As a consequence, social-democratic policy legacies and institutions may have become ineffective or even counterproductive in many countries. But that does not mean that the aspirations of full employment and social security have become unattainable and should be abandoned. What is surely necessary, however, is a re-examination of social-democratic strategies and, in many countries, fundamental institutional and policy reforms that take account of, and respond to, the much greater vulnerability of national economies and societies, and the greatly reduced action space of national governments in the new international environment. This re-examination of social-democratic strategies must be a painful exercise everywhere. There is all the more reason, therefore, to consider the solutions adopted by countries that seem to have succeeded in defending social-democratic aspirations in the “Global Era”.

Given my almost total ignorance of conditions and policy successes and failures in East Asia, my present paper will primarily focus on Europe and the Anglo-Saxon countries. I will begin with a brief review of the status quo before the onset of internationalization, followed by an equally brief account of subsequent changes and by an extended discussion of the impact of European integration. I will then turn to the implications of the globalization or Europeanization of product and capital markets for employment in the exposed and the sheltered sectors of First-World economies, and I will finally discuss the fiscal viability of present welfare-state solutions under conditions of high international capital mobility. The conclusion will show that some of these solutions have become internationally robust, whereas others remain critically vulnerable.

1 The Postwar Decades: Divergence under the Regime of Embedded Liberalism

In order to understand what has changed, one needs to remind oneself of the conditions against which one is comparing the present state of affairs. In Europe, and for social democrats and unions in particular, that standard of comparison is explicitly or implicitly the "golden age" of the welfare state and of the social market economy and as it had developed after the "Great Transformation" of the 1930 and 1940s (Polanyi 1957) and reached its peak just before the onset of the first oil-price crises in the early 1970s. From the present perspective, it is clear that emergence of this golden age was owed to the breakdown of the international economy in the Great Depression as well as to the fact that — in contrast to 1920s — its gradual re-integration under the "benevolent hegemony" of the United States was governed by the Bretton-Woods regime of "embedded liberalism" (Ruggie 1982).

Initially, this meant that governments could control the extent to which national economies would become exposed to international competition. While most (but by no means all — e.g., Australia and New Zealand) advanced industrial countries agreed to liberalize markets for industrial products, boundary controls remained largely in place in the markets for agricultural products, for services and for capital. Moreover, international currency markets were controlled by the Bretton-Woods regime of fixed but adjustable exchange rates — under which short-term imbalances were buffered by IMF loans, whereas sustained changes in international competitiveness could still be corrected through agreed-upon adjustments of exchange rates. Hence advanced industrial countries could benefit from the steady expansion of world trade in industrial goods, but remained free to organize their domestic political economies according to preferences defined in national political processes.

As it turned out, these preferences — which were also shaped by existing institutional legacies (Ferrera 2003) — differed considerably among countries which, in the early postwar decades, were predominantly governed by social democratic, christian-democratic or liberal political parties (Esping-Anderson 1990). At the most fundamental level, these differences concern (1) the dividing line between insurance and caring functions which the state is supposed to provide and those which individuals or families are supposed to provide for themselves, and (2) the way in which the functions for which the state assumes responsibility are to be financed — either from general tax revenues or through work-based “social contributions”.

- In the “liberal” model, which prevailed in the Anglo-Saxon countries, state functions are generally limited to providing universalistic and tax financed basic income security and health care. At the same time, full-employment economic policies were explicitly designed to ensure that average workers would be able to make private provisions for income maintenance in times of need (Rhodes 2000; Schwartz 2000).
- By contrast, in the “christian-democratic” model prevailing in Continental European countries, the state also assumes responsibility for providing status-maintaining social insurance that is meant to approximate the income from work in cases of unemployment, sickness, disability and old age. These transfers as well as health care are generally financed through wage-based contributions from employers and workers.
- Going beyond that level, finally, the “social-democratic” welfare state in the Scandinavian countries has also come to provide universal social services of high quality to families with small children, to the sick, the handicapped, and the aged. These services are generally financed from tax revenues (and some user charges), whereas social insurance transfers are either financed by wage-based social contributions (in Sweden) or from general tax revenue (Denmark).

Not all highly developed industrial countries fit into this simple classification of welfare-state models. This is not only true of the United States, but also of Switzerland, whose welfare state arrangements combine features of the “liberal” and the “christian-democratic” model (Bonoli and March 2000), and it is of course true of Japan which, though sharing some of the characteristics of the liberal model, had developed some highly unique solutions (Manow 2001). Nevertheless, what is important here is that during the early postwar decades and under the regime of embedded liberalism, all of these different models of the welfare state were able to achieve their politically consented purposes of social protection, and — with the possible exception of the United Kingdom (Rhodes 2000) all were economically viable. Behind controlled economic borders, they were able to achieve a level of domestic investment that ensured economic growth and full employment at rising wages, and all were able to raise the revenues for financing their chosen mix of public services and transfers. Moreover, instead of converging to a single model of the modern welfare state, the dynamics of path dependent development under conditions of increasing affluence tended to drive national models further apart and to increase the variance of institutional solutions among OECD countries (Ferrera 2000).

2 Boundary Control Lost Again

Now however, a quarter-century later, conditions have changed radically: mass unemployment has returned as a major problem in most countries, and welfare state institutions have come under siege in all of the advanced industrial countries. So what has happened?

One important reason is of course *demographic change*: With increasing affluence and changing cultural orientations, families have become less stable, and the number of children per family has declined significantly, while medical progress helped to increase average life expectations dramatically. As a consequence, the costs of pension systems and health care are rising, and the younger cohorts that have to pay for them are shrinking. While differences among OECD countries remain significant, the trends are the same and severe financial strains are felt or anticipated everywhere (Bonoli 2003; Schludi 2003). If that were all, however, one should expect that national policy makers would be able to deal creatively and legitimately with the more intense distributive conflicts caused by the "graying" of their societies.

What makes the search for effective solutions much more difficult, however, is the fact that during the same quarter-century, nation states have lost much or most of their former capacity to shape domestic political economies according to preferences defined in national political processes.[1] The oft-told story began with the breakdown of the Bretton-Woods system of fixed exchange rates, and the expansion of offshore capital markets during the oil price crises of the 1970s; and it was driven onward in the early 1980s by the impact of extremely high dollar interest rates on countries that had become heavily indebted during the preceding crisis — whose effect was exacerbated by the influence of a neoliberal "Washington Consensus" on IMF and World Bank policies. In the same spirit, the liberalization of product and capital markets was advanced by successive rounds of GATT negotiations and by the Single-Market program in Europe. In the 1990s, finally, the territorial domain of the capitalist world market was greatly extended by the inclusion of "Second-World" economies after the end of the Cold War, while a series of currency crises demonstrated the vulnerability of national economies to volatile international capital markets — and reinforced European efforts to create a Monetary Union.

As a consequence, international capitalism became progressively liberated from the beneficial constraints which nation states had once been able to define and enforce under the regime of "embedded liberalism". Capital now moves freely and instantly around the globe in search for differences in post-tax rates of return, and exchange rates among independent currencies are largely determined by speculative capital flows. In the liberalized markets for industrial goods, competition among high-cost countries in the "First World" has greatly intensified. Low-cost producers in former "Second-World" and "Third-World" economies in Asia and Eastern Europe have become major players in world markets for industrial products; and even in the expanding markets for information services, outsourcing to low-cost countries like India, Bulgaria or Russia is becoming widespread. As a consequence, national fiscal, tax and regulatory policies are tightly constrained by capital mobility and increased competition in product markets; industrial employment is shrinking, and employment in information, financial and business services tends to stagnate or, at any rate, is not increasing fast enough to compensate for job losses in industry.

[1] The following sections draw heavily on comparative research reported in Scharpf and Schmidt 2000a, 2000b, and in Huber and Stephens 2001.

3 European Economic Integration as an Extreme Case

If this is true of all advanced industrial countries, it is also true that European welfare states are facing much tougher economic challenges and much harder legal constraints as a consequence of the much greater integration of product and capital markets, the more extensive reach of liberalization rules, and of the Monetary Union.

3.1 Negative Integration and Liberalization

When the European Union adopted its Internal Market program in the mid-1980s, “negative integration”, i.e., the removal of national barriers to the free movement of goods, services and capital (Scharpf 1999), was pushed far beyond the requirements adopted in GATT and WTO negotiations. The program did not merely abolish all remaining tariff barriers and quantitative restrictions in the internal market for industrial and agricultural products, but also set out to eliminate the non-tariff barriers to free trade that had their origin in nationally differing regulations of product qualities and production processes. At the same time, European rules ensuring undistorted competition have imposed rigid legal constraints on the ability of member states to subsidize depressed regions and branches of industry or to aid individual firms.

Moreover, the rules creating the Internal Market, as interpreted by the European Commission and the European Court of Justice, have required the liberalization and deregulation — and typically privatization — of services and public utilities which previously had been protected against market competition by public ownership or as highly regulated private monopolies or cartels. As a consequence, telecommunications, postal services and television, air, rail and road transport, along with banking and insurance have been transformed into competitive markets, and the same transformation is required in energy production and distribution and in urban public transport. In other fields, like health care, social insurance and social services, the potential impact of European competition law on national welfare-state institutions is not yet fully manifest (Leibfried and Pierson 2000; Ferrera 2003) — but its anticipation is already shaping and constraining national policy choices (Scharpf 2003).

For consumers, the liberalization, deregulation and privatization of service branches and utilities have been positive in some cases (think of telecommunications), ambivalent in others and quite negative in some (think of railroads in the United Kingdom, the Netherlands or Germany). By contrast, the impact on employment, wages and working conditions has generally been negative in practically all branches affected (Héritier and Schmidt 2000). What matters more, however, is that these momentous policy choices are no longer left to national political processes but are largely determined by the syllogisms of legal interpretation in a multi-level system in which the application of European law by the Commission and the Court takes absolute precedence over all national law — constitutional or statutory — and all national policies (Scharpf 1999).

3.2 The Monetary Union

With the creation of the European Monetary Union, national governments have delegated control over monetary policy and exchange rate policy to a European Central Bank whose independence from political influence is more securely institutionalized than that of any national central bank, including the American Federal Reserve and the German Bundesbank. Again, this has beneficial effects — for tourists, business travelers and mobile consumers, who need to carry only a single currency and can easily compare prices, as well as for enterprises whose location choices, investment plans and export strategies can no longer be upset by unexpected fluctuations of exchange rates among European currencies. As a much bigger currency, moreover, the Euro is less vulnerable to speculative attacks than was true of the currencies of EMU member states, including Germany. At the same time, the Euro-Zone as a whole is much less dependent on imports and exports, and thus less affected by exchange-rate fluctuations, than was true of its member economies.

What remains problematic, however, is the macro-economic coordination between monetary and fiscal policy. By all accounts, the Euro-Zone is not what economists would consider an “optimal currency area”. Its member economies differ considerably in their state of economic development, and their business cycles are by no means synchronized. Moreover, equalizing mechanisms are weak as labor mobility between booming and depressed regions is very low, and fiscal transfers from high to low-growth regions are practically non-existent. As a consequence, the monetary policy of the European Central Bank, which must be oriented to average economic conditions in the Euro-Zone, will be too loose for high-growth countries and too restrictive for countries afflicted with economic stagnation or recession. Worse yet, as inflation rates also differ significantly, uniform ECB interest rates will translate into lower or even negative real interest rates in countries with above-average price increases, whereas growth in low-inflation economies will be inhibited by much higher real interest rates (Enderlein 2002).

In other words: Under the conditions prevailing in the Euro-Zone, ECB monetary policy is bound to be “wrong” for some countries, contributing to accelerating inflation in booming economies, and further depressing economies that are struggling against recession. Under these conditions, the burden of fitting macro-economic management to the conditions of individual economies is shifted entirely to the instruments government fiscal policy. Ideally, national fiscal policy would have to be more restrictive in booming economies than it would need to be under a “correct” monetary regime, and it would have to be exceedingly expansive in countries trying to cope with stagnation or recession. Unfortunately, however, the latter strategy is constrained by the deficit rules of the European Stability Pact which, adopted at German insistence, is meant to punish countries whose deficits rise in a recession, whereas it does nothing to restrain fiscal policies in booming economies.

3.3 Constraints on European Re-Regulation

In short, in creating the Internal Market, and even more so in joining the Monetary Union, European welfare states have accepted legal constraints which have eliminated many of the policy options they were formerly able to use in managing their national economies — and which independent nation states are still able to use even though globalization has also exposed them to the vicissitudes of international capital markets and to the economic pressures of intensified international competition. Some of the regulatory functions which were lost at the national level, it is true, are being recreated at the level of the European Union. However, as in the case of monetary policy, one-size-fits-all European solutions are rarely optimal for each member state, given the large structural differences among them.

Moreover, and much more important here: The European law of "negative integration" and liberalization, which removed national barriers to trade and established market competition in formerly protected sectors, was largely defined and expanded through "supranational" enforcement strategies of the Commission and the Court that were based on sparsely worded clauses in the Treaties. By contrast, European re-regulation (or "positive integration") depends on legislation that must be adopted in the "joint-decision" mode on the initiative of the Commission and with the agreement of national governments (voting unanimously or by qualified majority in the Council) and of the European Parliament. Given very high consensus requirements, such legislative initiatives are easily blocked or watered down by conflicts of interest and politically salient preferences among the member states (Scharpf 1999; 2001).

Such conflicts may have their roots in differences in economic development: Regulations appropriate for rich Denmark or the Netherlands may simply not be affordable in Portugal or Greece, let alone in the Central and Eastern European accession states that will soon have a voice in EU legislation. This has an effect on the stringency of European regulations of environmental standards, of work safety and of employment conditions. Nevertheless, the minimum standards that were in fact adopted are still quite useful since they at least mitigate the pressures of regulatory competition which would otherwise undermine national regulations of production processes (Falkner et al. 2002). In the field of taxation, however, European efforts to harmonize taxes on mobile capital have so far come to nothing. One reason is that some small countries are actually able to gain revenues and to increase employment trough tax competition, whereas big countries could not retaliate in kind without incurring very large revenue losses. A second and equally important reason is the fact that capital mobility is not limited to the territory of the European Union, and that low-tax member states with considerable employment in the financial services fear the competition of other "tax havens" that would not be bound by EU regulations (Genschel 2002).

Above all, however, high consensus requirements have inhibited the adoption of European welfare-state rules. To begin with, it should be noted that there was never any serious proposal to create a European welfare state — with unified institutions, standardized provisions and common revenue systems. In contrast to German unification, where the extension of the West German welfare state to Eastern Germany was primarily financed by West German contributions and taxes, solutions based on the premise of Europe-wide solidarity and redistribution were never on the European agenda (Leibfried and Pierson 1995; Scharpf 2003). Thus, the most that one might have hoped for was a harmonization of national welfare-state rules that would have reduced the pressures of regulatory and tax competition generated by the completion of the Internal Market. But even that is more than one should have expected.

Among the reasons are, again, differences in the ability to pay of rich and poor member states. But even though Sweden and Britain may be equally rich, they could never agree on harmonized European rules, and rightly so. There simply is no possibility of uniform rules that would fit the minimal British welfare state and the generous and extremely expensive Swedish welfare state at the same time, or that would be politically acceptable to voters who, in both countries, have based their life plans on the continuation of existing systems. The same would be true of attempts to harmonize the tax-financed national health systems in Britain and Scandinavia with Continental systems where health care is privately provided and financed by compulsory health insurance. In short, the European Union does not, and could not, attempt to harmonize the diverse welfare state systems of its member states because the broad consensus that would be necessary simply could not be reached (Scharpf 2003).

From a social-democratic perspective, this state of affairs must surely appear unfortunate. The European Union has effectively centralized all market-making functions, creating an Internal Market which guarantees the free mobility of all factors of production, undistorted competition, and free access of consumers to all goods and services produced within the territory of the Union. In order to achieve these purposes, it had to remove or inhibit the market-limiting and market-correcting powers of its member governments that could interfere with undistorted market competition even in areas that were previously exempted from the market. At the same time, however, attempts to recreate market-limiting and market-correcting governing functions at the level of the European Union, while reasonably successful for the regulation of product qualities (and quite successful for ensuring free competition), have been less effective for the regulation of production processes including conditions of employment, and are all but non-existent for the core functions of the welfare state, unemployment insurance, pensions, health care and social services.

3.4 Conclusions

Clearly, the situation of EU and EMU member states differs significantly from that of other advanced industrial countries. In a nutshell, these differences can be summarized as follows:

Independent countries retain control over monetary and exchange-rate policy which EMU member states have delegated to the European Central Bank. They are thus better able to influence exchange rates and to coordinate the macro-economic instruments of monetary and fiscal policy. At the same time, however, their currencies are more vulnerable to speculative attack, and their economies are more likely to suffer from exchange rate fluctuations.

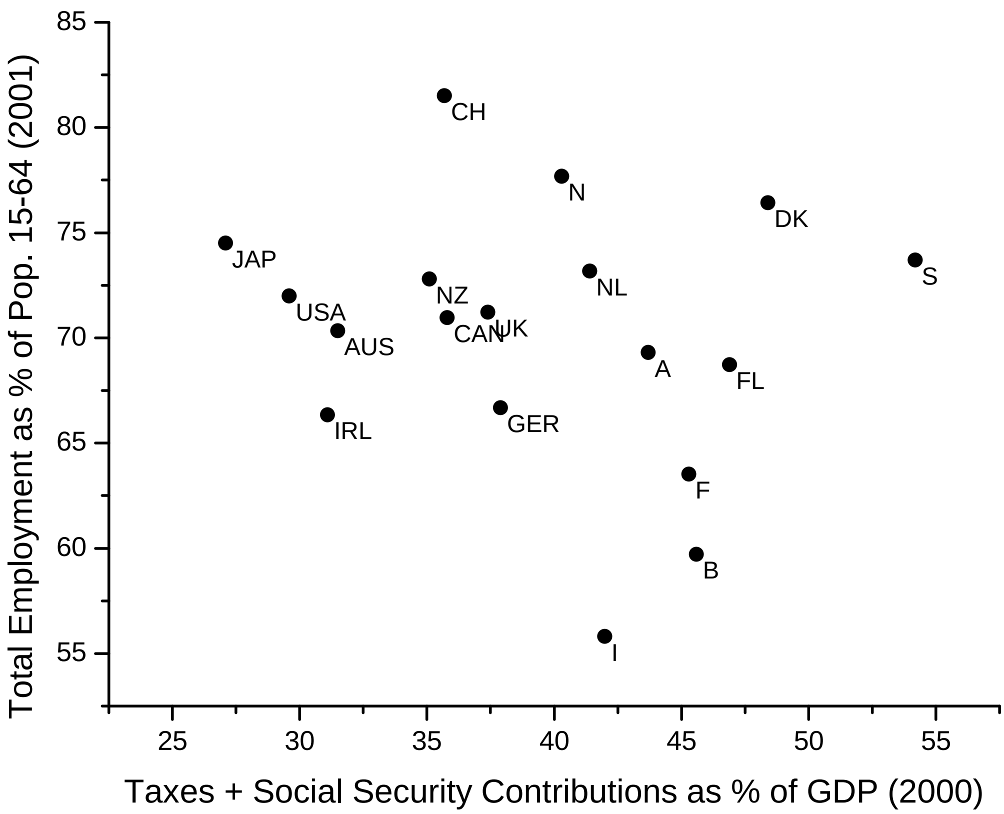
Compared to EU member states, independent countries have given up much less of their control over external economic relations, and practically none of their control over their national economies, to international authorities and to the free trade regime of the GATT and the WTO. At the same time, however, they also cannot benefit from the (albeit limited) success of the European Union in restraining regulatory competition among its members through re-regulation at the European level.

Beyond these differences in legal regimes, however, EU member states as well as independent countries are both subject to the economic constraints of an integrated world economy. International economic interdependence has reached an intensity that rules out autarchy as a viable option even for large economies like the European Union, the United States or Japan. Even more limited protectionist strategies in the markets for industrial goods and production-related services will provoke massive retaliation. At the same time, highly sensitive and volatile international capital markets will punish "unsound" fiscal policies as well as any market-correcting regulations and tax policies that are seen to reduce the post-tax rates of return on invested capital below the best available alternatives.

4 Implications for Employment

If this analysis is accepted, what are its implications for employment in open economies? In trying to answer these questions, it seems appropriate to employment rates (i.e., jobholders as a percentage of the working-age population), rather than unemployment rates , as a measure of success or failure. These differ remarkably among advanced industrial countries, ranging between more than 80 percent in Switzerland and merely 55 percent in neighboring Italy. Even more remarkable, n light of the present conventional wisdom, is the fact that that differences in employment do not correspond to equally large differences in total tax burdens (taxes and social security contributions as a percentage of GDP) — which in 2000 varied between more than 50 percent in Sweden and less than 30 per cent in the United States and Japan (Figure 1).

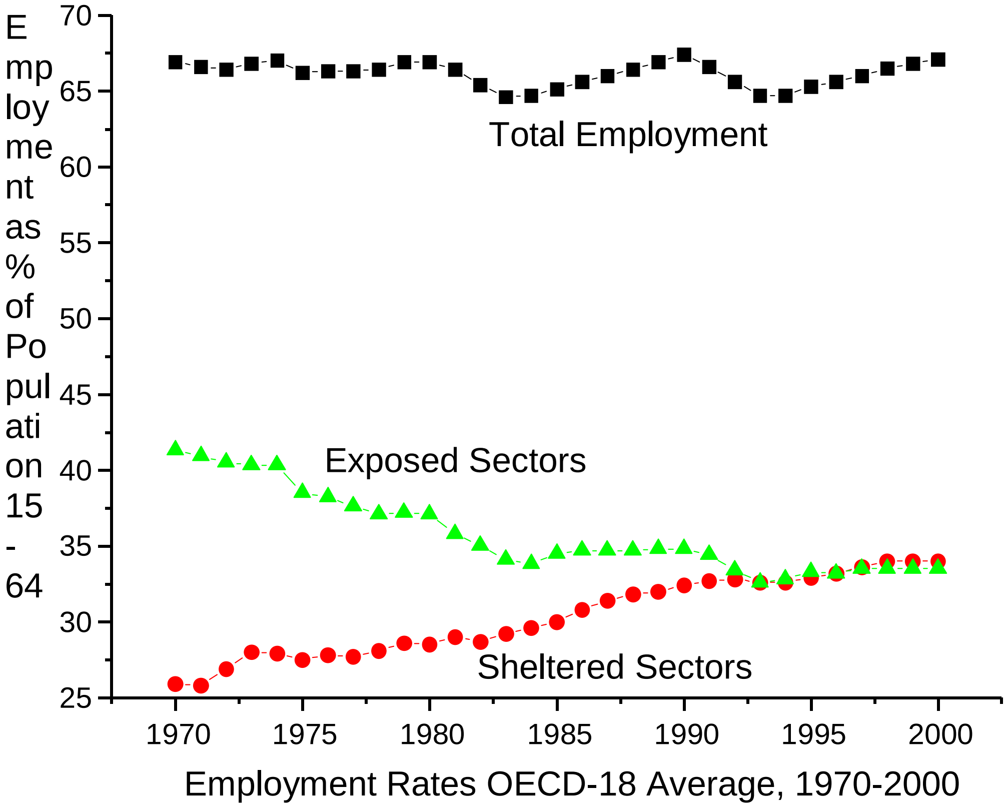
Figure 1: Total Employment Rates and Total Tax Burdens (2000/2001)
Sources: OECD Labour Force Statistics and OECD Revenue Statistics



As the Figure shows, employment rates are relatively high in low-tax “liberal” welfare states and very high in high-tax “social-democratic” welfare states, whereas the Continental European countries with intermediate tax burdens tend to have relatively low or very low levels of employment.

In trying to explain these differences, it is useful to distinguish between employment in the internationally exposed and the sheltered sectors of the economy. Under present conditions, the former include not only agriculture, raw-material producing and manufacturing industries, but also a wide range of service branches like transport and communication or financial and business services, including marketing, applied research and development (i.e., ISIC branches 1-5 plus 7 and 8 in the (former) classification of the OECD Labour Force Statistics). The latter can be broadly described as including public and private services that are locally provided and locally consumed (ISIC 6 and 9). Looking at the present distribution in the average of the 18 most advanced OECD countries, both sectors have about equal weight. Over the last three decades, however, average employment rates in the exposed sectors have declined considerably. If total employment rates have nevertheless remained more or less constant, this was due to a corresponding rise of employment rates in the sheltered sectors (Figure 2).

Figure 2: Average OECD-18 employment rates 1970-2000



4.1 Exposed Sectors

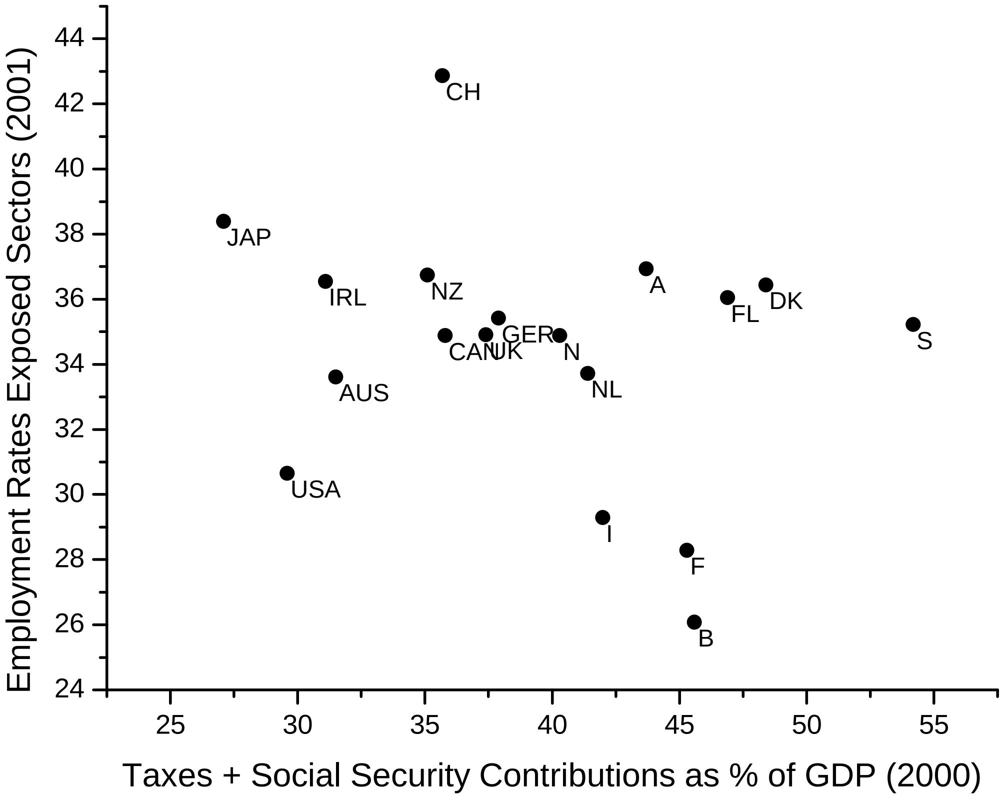
The increasing globalization/Europeanization of economic interactions affects employment in the advanced industrial countries through greater capital mobility and through more intense competition in product markets. The former has contributed to the rise of shareholder-value orientations even in countries where firms in the past could depend on "patient capital" (Yamamura and Streeck 2003). Hence when profits are declining, workers are laid off more readily and more quickly than before. This effect can be observed in all capital-intensive firms, regardless of their operation in the exposed or sheltered sectors of the economy (Streeck and Höpner 2003; Höpner 2003).

By contrast, increased international competition in product markets would affect only the exposed sectors. There, employment rates in agriculture and manufacturing industries have steadily declined in all advanced countries over the last three decades, while employment in production-related services did generally increase. But since the rise of these services was to a considerable extent a consequence of the outsourcing strategies of large industrial firms that were driven by hoped-for gains in productivity, job losses in manufacturing were not fully compensated.

In the literature, the overall decline of exposed-sector employment in advanced industrial countries is generally explained as a consequence of labor productivity rising faster than the demand for goods and services — a development that was facilitated by rapid technical progress whose utilization was propelled by more intense competition and by the liberalization of transport, communications and financial services in First-World economies. To what extent net employment losses are also a consequence of firms shifting production, and outsourcing services, to Second and Third-World countries is still a controversial issue. There is of course no question that manufacturing jobs have been transferred to low-wage economies in large numbers, but given the positive trade balances between high-wage countries and the rest of the world, it seems possible that these job losses were compensated by the positive employment effects of rising demand for high-quality consumer and investment goods and for production-related services.

In the present context, however, it is more important to note that employment levels in the exposed sectors differ greatly among advanced industrial countries and that, again, these differences are not systematically related to differences in total tax burdens (Figure 3). Thus, high-tax Denmark and intermediate-tax countries like Austria, Norway or Germany have actually more jobs in the exposed sectors than low-tax countries like the United States or Australia. In other words: Large welfare states and high tax burdens will not necessarily undermine international competitiveness, and public-sector retrenchment is not necessarily a recipe for greater success in international markets.

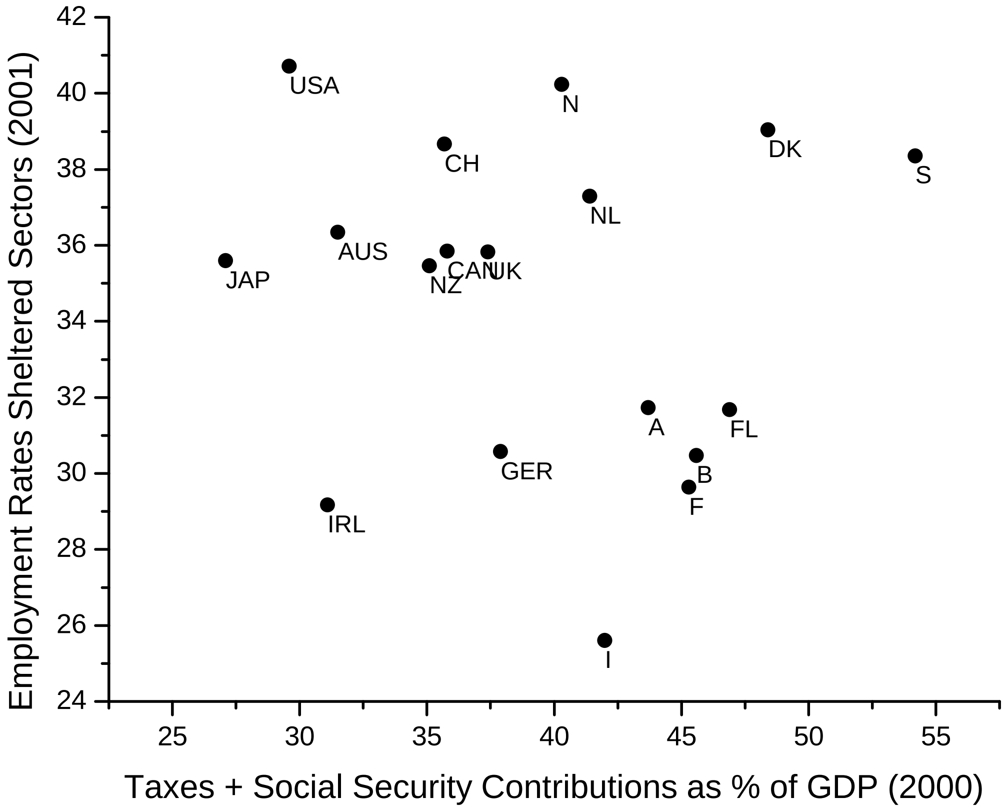
Figure 3: Employment Rates in Exposed Sectors and Total Tax Burdens



4.2 Sheltered Sectors

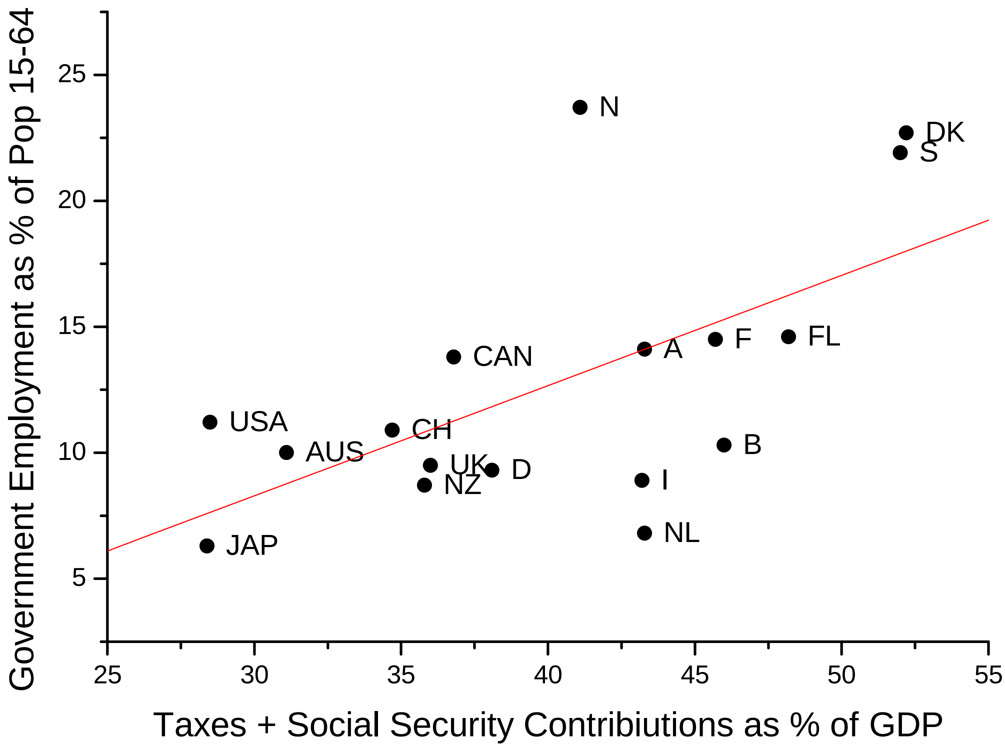
Given present levels of liberalization, the domain of sheltered sectors has shrunk to where only services that are locally provided and locally consumed can be thought to exempt from international competition. This domain, which roughly corresponds to ISIC classifications 6 and 7, covers a heterogeneous variety of services, including the large blocks of education, health care and social services, personal, household and repair services, recreation and tourism, hotels and restaurants, as well as wholesale and retail trade. Some of them (think of health care and education) are characterized by very high skill requirements and high wages, whereas other (think of services in households or restaurants) tend to be provided by low-skilled and low-paid workers.

Figure 4: Employment Rates in Sheltered Sectors and Total Tax Burdens



Again, advanced welfare states differ greatly in their employment rates, ranging from more than 40 percent in the United States and Norway to 25 percent in Italy, and again there is no linear relationship between differences in employment and differences in tax total burdens: High or very high levels of sheltered-sector employment are achieved in countries with very low, very high or intermediate tax burdens. It should be noted moreover, that the intermediate tax burdens of Continental welfare states (if we disregard the Netherlands, whose employment statistics include an exceptionally large share of part-time jobs) are associated with low or very levels of sheltered-sector employment (Figure 4). The lack of statistical association becomes less surprising, however, if we consider the fact that sheltered sector services may either be financed and provided by the public sector, or may be publicly financed and privately provided, or may depend entirely on private provision and privately financed demand. Unfortunately, we have no comparative OECD statistics distinguishing between publicly and privately financed jobs. There is, however, a clearly negative association between total tax burdens and the totality of "business employment" (not shown here). Since we already know that exposed-sector employment is not affected, the negative impact must occur in the sheltered sector. Conversely, there is also the expected positive association with public-sector employment (Figure 5).

Figure 5: Public-Sector Employment Rates and Total Tax Burdens (1998)



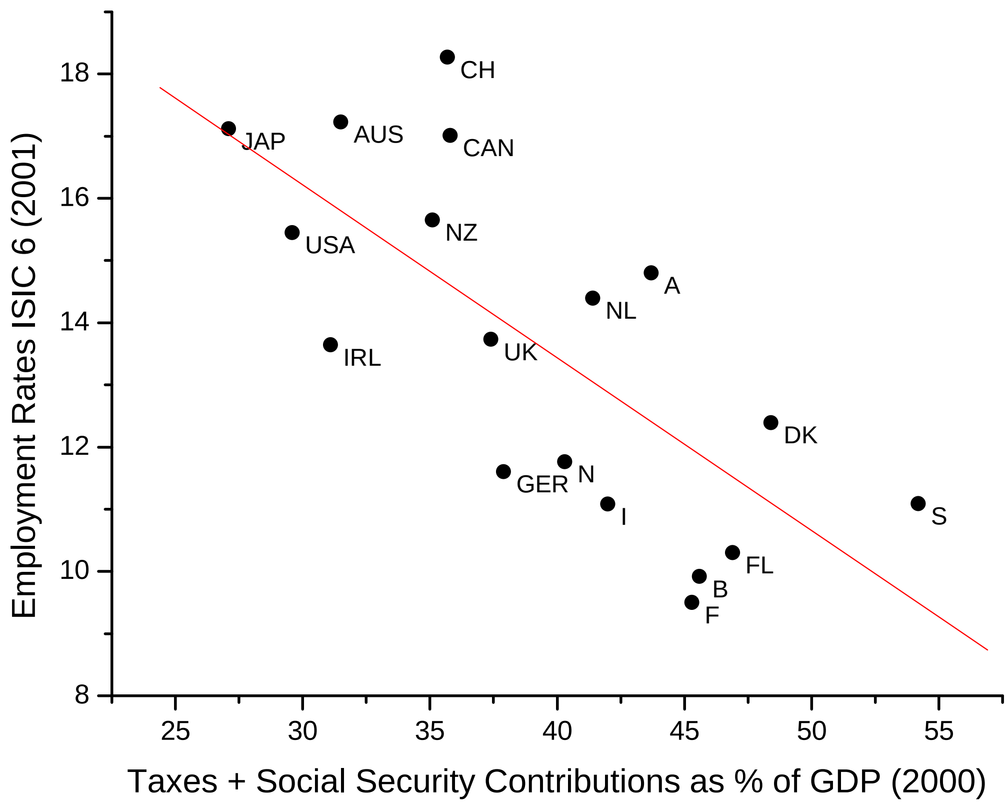
On a second look, however, this association does not seem to be very strong and it would almost disappear if the Scandinavian countries were removed from the plot. This pattern corresponds with the structural differences between the three types of welfare states discussed above: "Social-democratic" welfare states in the Scandinavian countries have high levels of sheltered-sector employment because they use their high levels of taxation to finance of publicly provided services. These reduce the demand for private services, whose costs are also increased by high taxes and egalitarian wages. By contrast, “liberal” welfare states achieve high levels of sheltered-sector employment in the private sector, since low tax burdens and high inequality of incomes allow private demand to expand while low non-wage labor costs combined with relatively high wage differentials have facilitated the supply of low-cost private services.

By comparison, Continental European welfare states seem to have the worst of both worlds: Even though their total tax burdens are much higher, they are used to finance social transfers, rather than public services. Thus Belgium, the Netherlands, Italy or Germany, have public-sector employment rates that are even lower than those of the United States — and less than half as high as those of Denmark, Sweden or Norway. At the same time, however, their employment rates in private services are also lower than they should be, given their intermediate tax burdens.

In the available OECD statistics, this can be shown by focusing on employment rates in ISIC 6 (now ISIC G+H) which includes restaurants, hotels, wholesale and retail trade and varieties of repair work — i.e., sheltered-sector services which are almost everywhere privately provided and privately financed (Figure 6). In this segment, there is indeed a fairly strong negative association between employment rates and tax burdens. It is not perfect, however ($R^2 = 0.51$), and with the exception of Austria and the Netherlands, the Continental welfare states are located well below the regression line. This is largely explained by the specific vulnerability of the services in question to the characteristic tax mix of Continental welfare states (Scharpf 2000, 75-82).

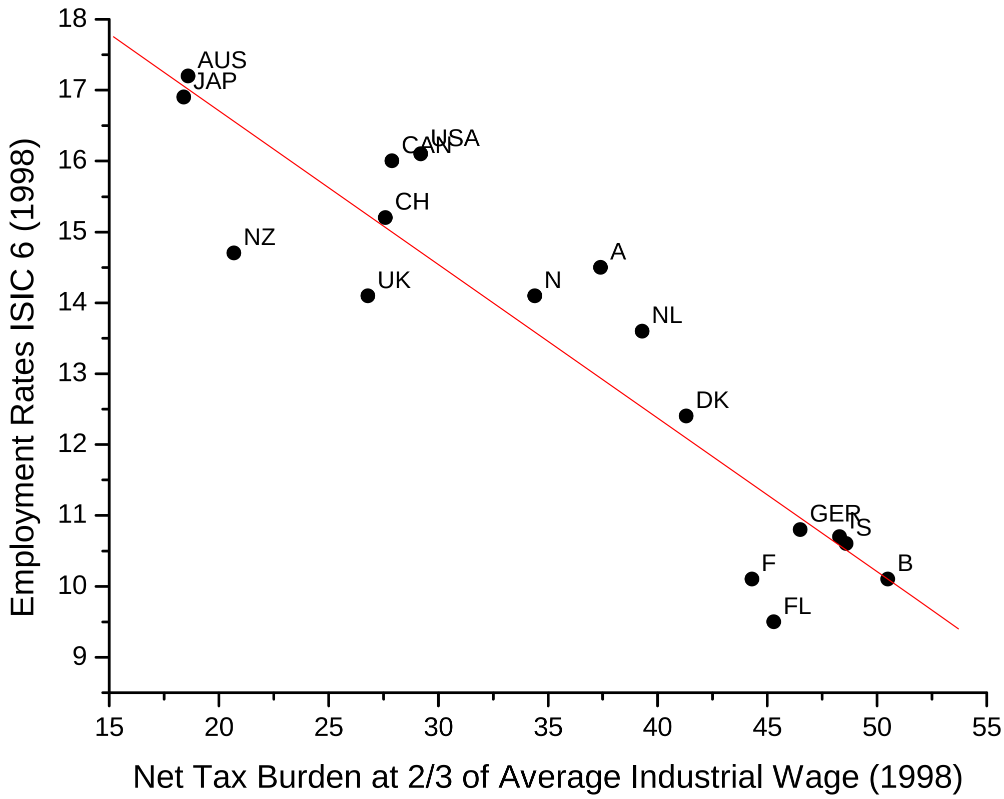
Most of the jobs in ISIC-6 branches have relatively low productivity, relatively low skill requirements, and relatively low market wages. As a consequence, they are not much affected by progressive income taxes, which generally are only due on incomes above a basic exemption. By contrast, social security contributions, from which Continental welfare states derive most of their revenue, are generally in the form of a flat tax on wages, imposed without a basic exemption but only up to a limit, and thus regressive in their incidence. In Germany, for instance, they presently amount to more than 42 percent of gross wages.

Figure 6: Private Sector Services in ISIC 6 and Total Tax Burdens (2000/2001)



At the upper end of the labor market, where productivity and wages are high, these non-wage labor costs may be absorbed by workers and negative effects on the demand for services and hence on employment may thus be avoided. At the lower end, however, net incomes cannot fall below the reservation wage that is defined by unemployment benefits and, ultimately, social assistance. Hence most of the tax burden must be borne by the employer and will be reflected in the price of the product. At the same time, low-wage and low-skill private services are likely to be highly price sensitive, being vulnerable to substitution by self-help and do-it-yourself activities or by work in the "unofficial economy" (Gershuny 1978). In short: high social security contributions are likely to price them out of the market — an effect that is avoided if social expenditures are primarily financed from general tax revenues, as is the case not only in "liberal" welfare states but also in Denmark and Norway (but not in Sweden). This effect is demonstrated by the following diagram (Figure 7).

Figure 7: ISIC-6 Employment and Tax Burdens on Low-Wage Jobs (1998)



Here, employment rates in ISIC-6 branches is related to the net burden of taxes and social-security contributions on (single) workers receiving two-thirds of average industrial wages. The statistical association is extremely close ($R^2 = 0.85$) which suggests that tax burdens are indeed a major determinant of low-wage service employment. It is also important to note significant differences among Continental welfare states — all of which depend on revenues from social security contributions for financing the welfare state. In contrast to Belgium, France, Germany and Italy, however, it seems that Austria and the Netherlands have achieved a targeted reduction of the tax burden on low-wage jobs — and are benefiting from significantly higher employment rates in sheltered-sector private services as a consequence.

4.3 Conclusion

So where does that leave us in our assessment of the employment perspectives of advanced welfare states in the open economy?

In the exposed sectors of advanced industrial economies, employment rates differ considerably, but these differences are not statistically associated with either the size of the welfare state or with the size of total tax burdens. It is reasonable to expect moreover, that the general decline of industrial employment in First-World countries that has been characteristic of the last three decades will continue, and may yet accelerate. The intensity of international competition is bound to increase, as technical progress and the rising capacity of information and communications systems will provide new opportunities for productivity-increasing and cost-reducing innovations in production processes, and as rising levels of education and world-wide technology transfer will allow low-cost producers in Second and Third-World countries to compete in the world markets for technically advanced high-quality products and production-related services.

In the process, to be sure, wages in present low-cost economies will also rise and new markets will expand as workers will become more affluent consumers — just as has been true of Japan, Taiwan and South Korea in the past. Nevertheless, the transition period may be long and old industrial countries will have to go through painful processes of restructuring and downsizing as manufacturing jobs will continue to decline and production-related service employment may also shrink under the dual pressures of productivity increases and of outsourcing. In short, there is little hope that present employment deficits could be overcome by the renewed expansion of industrial production and production-related services.

It should be understood, however, that even if the exposed sectors can no longer be relied upon to solve present employment problems, advanced industrial economies continue to depend on their international competitiveness as the main source of national wealth. It also goes without saying, that the overall employment performance of a country is affected by the more rapid or slower loss of jobs in industry and production-related services. Thus, nothing that has been said should be taken as an argument against government policies supporting basic and applied research, industrial development and innovation, or against firms making use of all available technical and organizational opportunities for shortening the "time to market" of product innovations and for increasing the efficiency of production processes. By the same token, governments also have reason to avoid policies that might reduce the capacity of industrial producers to innovate and to adjust to volatile international markets — and the same is true for the policies of labor unions.

But when all is said and done, it is still true that high levels of employment depend on jobs in the sheltered sectors where services are locally provided and consumed. Here, we again have significant differences in employment rates, but in contrast to the exposed sectors, these differences are in fact systematically related to the size of the welfare state and to the structural differences between the three welfare-state models discussed above. However, these relationships are not linear.

In purely quantitative terms, sheltered-sector employment rates are high in the low-tax "liberal" welfare states as well as in the high tax "social-democratic" welfare states. However, in the latter group of countries most of these jobs are in the public sector, financed from general tax revenues (and some user charges), whereas similar services in the "liberal" welfare states are primarily provided by private firms and non-profit organizations, and financed by their clients, either directly or through private insurance. By contrast, sheltered-sector employment in the Continental welfare states is generally quite low. The reason is that their relatively expensive welfare state provides generous transfers but few publicly financed services while their predominant mode of financing through social security contributions increases the price of labor and prevents the expansion of private services.

The conclusion is, therefore, that employment in First-World countries is indeed affected by the international pressures and constraints facing open economies. Nevertheless, many of these countries have been able to compensate for job losses in the internationally exposed sectors of the economy through job growth in the sheltered sectors. Contrary to the conventional wisdom of liberal economists and politicians, employment success seems to be unrelated to the *size* of the welfare state, whereas the way in which it is achieved is greatly affected by the *type* of welfare state. In general, low-tax "liberal" welfare states as well as high-tax social-democratic welfare states are doing well in terms of employment rates. In Continental welfare states, by contrast, the typical structures of welfare spending and finance have become a major impediment to employment growth.

5 The Fiscal Viability of Advanced Welfare States in the Open Economy

Quite apart from any international economic pressures or constraints, therefore, welfare-state reforms are essential if Continental European countries are to overcome their endemic employment deficits. From what was shown above, it follows that such reforms could move either in the “social-democratic” direction of increasing publicly financed services or in the “liberal” direction of facilitating the expansion of service employment in the private sector. The first option would require considerably higher tax revenues, whereas the second would depend on a significant lowering of total tax burdens — which could not be achieved without a painful retrenchment of welfare-state functions and benefit levels. Quite obviously, either one of these solutions could only be adopted against massive political opposition.

But even if present *levels* of tax burdens and benefits remained unchanged, the analysis presented here has shown that a limited move in the “liberal” direction, that would increase employment in private-sector services, could be achieved through changes in the characteristic *tax structure* of Continental welfare states.

Table 1: Taxes and Social Security Contributions as % of GDP (2000)
Source: OECD Revenue Statistics 1965-2001

	Total Revenues	Income and Profits	Social Security
Australia	31.5	18.0	0
Canada	35,8	17.5	5.1
New Zealand	35,1	20.8	0
United Kingdom	37,4	14.6	6.1
United States	29,6	15.1	6.9
Austria	43,7	12.4	14.9
Belgium	45,6	17.9	14.1
France	45,3	11.3	16.4
Germany	37,9	11.4	14.8
Italy	42,0	13.9	11.9
Netherlands	41,4	10.4	16.1
Denmark	48,8	28,7	2,2
Finland	46,9	20,0	12,0
Norway	40,3	16,4	9,0
Sweden	54,2	23,4	15,2

As the table shows, Continental welfare states rely heavily on social security contributions, whereas these play a very limited role, or none at all, in the revenue mix of “liberal” welfare states. By contrast, and in spite of their lower total tax burdens, revenues collected from taxes on incomes and profits are significantly higher in “liberal" countries than in Continental countries (with the exception of Belgium), and much higher in Scandinavian countries (except for oil-rich Norway). In principle, therefore, it would be possible to shift a considerable part of the costs of Continental welfare states from social security contributions to income taxes without raising the overall tax burden. Since it has been shown that non-wage labor costs have a strong negative impact on private-sector services, whereas income taxes have no such effect, this shift would create additional jobs — and it would be particularly effective in creating employment opportunities for low-skill groups if the reduction of non-wage labor costs were targeted on the low-wage sector.

So far, so good for employment. But wouldn't a shift to higher taxes on incomes and profits violate the fiscal constraints imposed by international capital markets? There is no question that the investment decisions of capital owners and firms are highly sensitive to differences in post-tax rates of return, and that in anticipation or response to increasing capital mobility, OECD countries have significantly reduced statutory tax rates on business profits and capital interest over the last two decades (Ganghof 2000). So how could "liberal" welfare states, let alone the Scandinavian countries, maintain their high levels of revenue from taxes on income and profits under conditions of an open economy? The answer, in short, have been "tax-cuts-cum-base-broadening" strategies, but in implementing these, the two groups of countries have adopted significantly differing solutions (Ganghof 2003):

Given their lower revenue requirements and their greater tolerance for inequality, Anglo-Saxon "liberal" states generally reduced statutory tax rates on all forms of income to the level considered appropriate for the taxation of incomes from mobile capital. In order to maintain revenue levels, however, eliminating ubiquitous tax exemptions (i.e., "base broadening") was not enough; it was also necessary to reduce the progressivity of tax schedules to a point where they came to approximate a system of proportional "flat" taxes. As a consequence, "liberal" model remains viable in internationalized capital markets, but the revenue side of the tax system has more or less lost its former ability to reduce the inequality of market incomes.

In general, equality of incomes is not treated as a normatively significant aspiration in "liberal" political discourses, whereas poverty is considered a problem that is to be prevented by basic-income transfers. This creates a possible "unemployment trap" if the low market wages of the “working poor” fall below the level of social assistance for families with children. In response, “progressive” governments have introduced or expanded systems of “in-work-benefits” (resembling the “Earned Income Tax Credit” in the United States) which allow the combination of incomes from low-wage jobs with (degressive) social transfers. To the extent that these transfers are sufficiently generous, “liberal” welfare states will continue to have high levels of employment in the private sector without allowing the rise of extreme poverty and without jeopardizing economic and fiscal viability in globalized product and capital markets.

In the “social-democratic” welfare states of Scandinavian countries, by contrast, very high revenue requirements and egalitarian political preferences ruled out the “flat-tax” response to the competitive pressures of capital mobility. Being nevertheless aware of their new vulnerability after capital-market liberalization, these countries opted for “dual-income-tax” solutions in the late 1980s or early 1990s. Assuming that capital owners would respond to statutory tax rates, rather than to effective rates (which were never high in Scandinavia), Denmark was first in introducing a relatively low flat tax on all capital incomes, while at the same time eliminating most of its tax exemptions for certain types of investments. By contrast, taxes on personal incomes remained steeply progressive, and top rates continued to be very high. Given the interdependence, of their economies, Sweden, Norway and Finland did follow suit within a few years.

From a fiscal perspective, the dual income tax has been a success. Scandinavian countries continue to finance their expensive welfare states primarily from income taxes, and as a consequence of base broadening they are in fact collecting more revenue than before from taxes on capital incomes. Moreover, since their flat tax rates on capital incomes are somewhat lower than those of the “liberal” countries, the viability of Scandinavian welfare states in international capital markets is not in question for the time being. If there are problems, they are of a political, rather than economic, nature.

Moving to the dual income tax has greatly increased the visibility of (largely pre-existing) differences in the taxation of incomes from capital and incomes from labor. Given their anti-capitalist ideological tradition and their normative commitment to an egalitarian distribution of incomes, the new tax system was difficult to accept for social-democratic parties and unions in Scandinavia. In Denmark, political dissatisfaction was particularly strong, so that the dual-income tax system had to be modified after a few years, reducing the gap between nominal tax rates for capital and labor, and reintroducing less visible forms of tax relief for mobile capital. In Sweden, union protests and conflicts with the labor party contributed to the electoral defeat of the social democrats at the beginning of the 1990s, whereas acceptance in Norway and Finland was less of a problem. In any case, however, the move to the dual income tax has ensured the economic and fiscal the viability of expensive Scandinavian welfare states in the open economy. Instead, their future depends on the continuing willingness of voters to accept the very high taxes on personal incomes that are required for its finance.

For the Continental welfare states, the conditions of fiscal viability are less clear. In general, their low levels of revenue from taxes on income and profits are not a consequence of low statutory rates, but of a multitude of tax exemptions. Since it is politically difficult to eliminate these, the pressure of international competition on statutory rates for capital tends to reduce revenues even further. Hence if Continental countries should indeed try to shift welfare-state finances from social security contributions to income taxes, that would definitely require a substantial broadening of tax bases. If these political battles can be won, countries would still face the choice between the “Anglo-Saxon” solution of uniform and relatively low top rates for incomes from capital and labor combined with relatively flat tax schedules on the one hand, or the “Scandinavian” dual income tax on the other hand.

In technical and economic terms, both solutions may be equally feasible, but they differ in their distributive consequences. Given the fact that regressive social security contributions and regressive value-added taxes will continue to play a considerable role in the revenue systems of Continental welfare states, a solution that would make income taxes much less progressive is likely to render the tax system as a whole regressive as well. If this is considered politically unacceptable, Continental welfare states would also have to move toward dual-income-tax solutions which would maintain, and perhaps even increase, the progressive taxation of incomes from labor.

6 Conclusions

In the open economy, the policy choices of First World countries are constrained by increasing competition in product markets and by the increasing international mobility of real and financial capital. Both of these constraints are tighter and more binding for member states of the European Union and of the European Monetary Union, than they are for independent states.

International competition in product markets puts a premium on the capacity of economies to adopt product innovations and to increase the efficiency of production processes. In general, First World countries have been able to maintain their international competitiveness, but their employment rates in the exposed sectors of their economies have been declining.

On average, this decline has been compensated by the growth of employment in the sheltered sectors of the economy where locally provided services are locally consumed. Countries differ greatly, however, in the extent and in the type of this employment growth. These differences are largely explained by the characteristics of different types of welfare states:

In the minimal welfare state of "liberal" and mostly Anglo-Saxon countries, most service employment is in the private sector, and it is facilitated by low tax burdens, a relatively unequal distribution of incomes and high wage differentials. In the "social democratic" and very generous welfare states of Scandinavian countries, most service employment is in the public sector, and it is financed by very high tax burdens. In the Continental welfare states, whose post-war development has been shaped by conservative or "christian-democratic" political parties, employment in both public and private services is lower than one would expect in view of their intermediate tax burdens.

The explanation of this poor employment performance is found in the characteristic revenue mix of Continental welfare states, which rely more on wage-based social security contributions, and less on taxes on incomes and profits, than is true of either the Anglo-Saxon or the Scandinavian countries. It has been shown that this part of the tax burden has the most negative impact on employment in low-productivity, low-skill and low-wage jobs in the sheltered sectors. The obvious remedy would be a shift in welfare-state financing from social security contributions to income taxes.

The viability of welfare-state financing in international capital markets is constrained by capital mobility which rules out policies that would reduce post-tax rates of return below the going rate internationally (adjusted for expected changes of exchange rates). In Anglo-Saxon countries, with their relatively low revenue requirements, viability is achieved by lowering statutory top rates of taxes on all incomes to a level that is considered competitive internationally, and by flattening tax schedules generally. Scandinavian countries, with their much higher revenue requirements, have instead opted for a “dual income tax” in which capital incomes are taxed at an internationally viable flat rat, whereas personal incomes from labor and other sources continue to be taxed at progressive schedules with comparatively very high top rates. If Continental countries should indeed try to shift welfare finances from social security contributions to income taxes, they would have to face the same choice.

In short, the compatibility of high levels of employment and a viable welfare state with international competitiveness in open economies has been achieved for the minimal Anglo-Saxon welfare states as well as for the maximal Scandinavian welfare states, but it is as yet uncertain for Continental countries with low levels of employment in public services and revenue systems that impose very high non-wage labor costs on private-sector services. The reforms which would be necessary to increase employment levels will, in any case, be very difficult politically.

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