Is It Possible to Preserve the European Social Model?

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Introduction

The process of economic and political consolidation in Europe is now well advanced. The European Union (EU) operates as a single market for goods, services, labor and increasingly for capital, and political borders have been moving from the constituent states to the outer rim of the EU. When present enlargement plans are completed, the borderless European state will cover most of historical Europe.

From its inception, the long process of building the Union had a clear political objective: to consolidate permanently peace in Europe. Suffering two of the bloodiest wars in history made this the overriding aim. With the passage of time, and especially after the fall of communism, a second priority emerged for the EU: to create an economic power that can compete with the US for world leadership by serving as a counterbalance to the growing weight of the US economy.

Not everyone embraces this second priority. For some EU politicians and thinkers, the overriding aim should be to establish a model of liberal democracy that combines economic efficiency and social cohesion to produce growing prosperity. The balanced and inclusive society that results should serve as a model for the rest of the world. If the US economy remains larger than that of the EU, this should not be cause for worry as long as the EU maintains a reasonable level of prosperity together with a high degree of cohesion. Jacques Delors makes the case for such

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This paper is a summary of a forthcoming book entitled "Quo Vadis Europe? Why is it persistently underperforming the US?"

a Union: "Europeans should attempt to create a grand liberal democracy which combines competition, as an element of fostering economic growth; cooperation, as an instrument of building political consensus; and solidarity, as a factor for achieving a more integrated union and deeper social cohesion." The clearest manifestation of the social cohesion and inclusiveness described here is the so-called European social model: the complex of unemployment and social protection programs intended to provide for the welfare of EU workers and citizens.

While the social objective may in many ways define the EU, it is equally clear that that the second objective is being pursued as well. The creation of the euro as a reserve currency that can compete with the dollar is one manifestation. The eventual formation of an EU federation or confederation of states, closer to the present federal political system of the US, is also being pursued with growing conviction. The decision to enlarge the Union to include twelve new members and probably more in the future is another.

One of the long-term objectives underlying the European Convention debate and its project of a European Constitution was to make a modest step towards deepening political union before embarking on the ambitious process of enlargement. Unfortunately, the member states have been unable to agree yet on a new constitution because, at each decision point for the new constitution, each has sought a formulation that would maximize its political standing in the governing Council and the Parliament. This is especially important now that unanimous decision-making will be slowly disappearing for most important issues. The small countries are already overrepresented but want a stronger relative weight in decision-making; the medium-sized countries want to have a voting weight similar that of the large ones; and the largest states want to achieve, among themselves, a combined large majority for all future decisions.

The expansion of the EU eastward also has a political objective. The EU needs to establish a stable zone of peace and security further away from its eastern frontiers. This will make it easier for new EU member states to make a more rapid transition to full democracy and capitalism. But although enlargement will increase the economic and political weight of the EU in the world, economic decision-making will be rendered far more complex; average income differentials among EU citizens will be increased; and budgetary transfers to the less developed members or regions of the present 15 will need to be reduced.

The social and economic objectives presented here — preservation of a European identity embodied in the EU social model, and economic competition with the US — are not separate policy challenges or alternative courses of action. Given the present demographic trends, the social model cannot be preserved in the future without faster growth and to achieve the latter, important reforms are necessary. The critical questions for the EU are whether the reforms required to accelerate growth are compatible with full preservation of the social model and, if the model must change, it is possible to make necessary reforms while preserving its main attributes.

EU Versus US Economic Performance

According to the official statistics of the EU and the OECD[1], during the 1960s and early 1970s, comparative growth of EU members and the US was broadly consistent with the conventional view that countries lagging in terms of labor productivity and GDP per capita will tend gradually to close the gap with countries at higher levels of performance in these areas. Starting at a level 30 percent below the US, over the full 40-year period average annual growth in GDP per capita in the EU has been 2.25 percent, compared to the US rate of 2.15 percent. However, EU progress began to slow in most member countries from the mid-1970s through the 1980s so that the growth rate of GDP per capita measured over a 30-year period has been roughly the same on both sides of the Atlantic. Finally, since the mid-1990s, the convergence process appears to have reversed. Trend GDP per capita is now growing slightly faster in the US than in the EU as a whole and clearly faster than in the largest EU member countries. From 1996 to 2002, US GDP per capita grew at an annual average of 2.3 percent while the EU grew at 2.0 percent. Only small and medium-sized EU countries with stagnant or slow growing populations outperformed the US during this period. This includes Ireland, Spain, Portugal and Greece, all starting from much lower initial levels of GDP per capita, as well as Sweden and Finland, which were starting from much higher levels. By contrast, the UK (2.2 percent),

1 The EU Economy 2001, 2002 and 2003 Review; The European Competitiveness Reports, 2001, 2002 and 2003 and the OECD "Sources of Economic Growth in OECD Countries" Report, 2003.

Italy (2 percent), France (1.9 percent) and Germany (1.6 percent) all had lower average growth rates of GDP per capita than the US.

This is occurring in a context in which US GDP, the total size of the economy, has outgrown the EU by an annual average of 0.7 percent for the last four decades and almost 0.9 percent for the last three. Over the period, US growth has been sufficient to maintain parity in GDP per capita while compensating for average annual population growth three times higher than that of the EU over the 40 year period (1.2 percent versus 0.4 percent).

According to the OECD, trend growth of GDP per capita (that is, eliminating cyclical variations[2]) has been increasing in the US from 2.1 percent in the period 1980-1990 to 2.3 percent from 1990-2000 and to 2.8 percent between 1996 and 2002. By contrast, EU trend growth of GDP per capita was 2.1 percent in the period 1980-1990; fell to 1.8 percent in the decade 1990-2000; and recovered to 2.2 percent between 1996 and 2002 — still below the average US growth rate. Considering that the level of GDP per capita in the EU remains about 30 percent below that in the US, these trends should be a major cause for concern among European policymakers. They underscore the urgent need to reform the micro- and macroeconomic policies of the EU in order to stimulate future growth.

Understanding the Widening US/EU Growth Gap

To understand the causes of this large gap in GDP per capita, it is useful to apply a standard growth accounting framework in which the contribution to growth is based on the accumulation of labor and capital, on one side, and the growth of labor productivity on the other. This analysis provides a rough breakdown of the US and EU GDP per capita gap as follows: two thirds of the gap is explained by lower labor utilization in the EU, of which roughly half is due to a lower employment rate and the other half to lower effective working hours per person employed. The remaining third can be attributed to lower labor productivity in the EU.

Turning first to labor utilization, the EU lags behind the US in both individual labor force participation and overall employment levels among

2 Using Hodrick-Prescott filters to remove low frequency variations from data series.

the working age population (ages 15 to 64). The gap in labor force participation is 7 percent, with the biggest gaps for women and older workers. The female participation rate is 10 percent higher in the US, and the older work participation rate is 11.5 percent higher in the US. The gap in the employment rate is 9 percent, with even larger differentials for these groups: for women, 11.5 percent, and for older workers, 13.5 percent. Since 1995, annual EU employment growth has been slightly faster than that of the US (1.2 percent versus 1.05 percent) while annual hours worked have fallen in comparison to the US (-0.5 percent versus -0.1 percent). The levels of average annual effective working time per person employed are much lower in the EU: 211 hours less (12 percent) per year than in the US (European Competitiveness Report, 2001).

The second most important explanatory factor is labor productivity, which is also worrying for the EU. Using GDP per person employed as the measure of productivity, the EU level is roughly 23 percent lower than that of the US. Measured as GDP per hour worked, it lags by around 10 percent. Although labour productivity has been growing on annual average slightly faster in the EU than in the US over the last three decades (1.7 percent versus 1.5 percent) since 1995, EU annual growth of labor productivity has lagged the US, both in terms of GDP per person employed (0.99 percent versus 2.16 percent) and GDP per hour worked (1.27 percent versus 1.86 percent). Moreover, in 2002 and 2003, the gap widened: tripling in terms of GDP per worker and doubling in terms of GDP per hour (Independent Group Report, 2003).

The overall result is that the US has roughly 9 more people employed for every 100 persons of working age than the EU. They work about 211 more hours per year and enjoy 10 percent higher productivity per hour worked. For instance, if the employment rate of the EU were to match that of the US, it would imply creating around 16 million more new jobs. Even more troubling is that these gaps appear to be widening (European Economy, 2001).

Nevertheless, the factors that determine labor productivity — capital deepening (the capital-labor ratio) and total factor productivity (TFP, a residual factor) —have actually been growing faster in the EU than in the US, on average over the thirty year period. Capital deepening is defined as the average percentage contribution of capital to labor productivity growth or, alternatively, the substitution of capital for labor. The EU growth rate has been much higher than the US over the 30-year period: 0.7 percent versus only 0.32 percent. However, in the last eight years, that trend has reversed as well, with the US (at 1.7 percent) moving ahead of the EU (1.4 percent). Overall, capital deepening levels continue to be around 7 percent higher in the US, despite taking into consideration the fact that substitution of capital for labor in the EU has been quite high while in the US it has been very low.

Average growth of total factor productivity (TFP) in the EU has slightly outpaced the US over the last 40 years (1.25 percent versus 1.075 percent). Again, however, in the period 1995-2002, the trend has reversed, with the US average annual growth rate of 1.5 percent eclipsing the EU at 0.5 percent. Consequently, the US Total Factor Productivity level remains still roughly 12 percent higher than that in the EU. TFP growth is an increasingly important net contributor to labor productivity and increasing it should be a major priority for the EU in the years to come. While TFP is a residual in growth accounting terms, the factors underlying it — innovation, R&D and entrepreneurship — are recognized contributors to growth, and it is important to pursue policies aimed at supporting them (Independent Group Report, 2003).

It is also important to understand the causes underlying this different economic performance. Part of lower labor utilization reflects shorter, and declining, working hours in Europe. This may reflect a European social preference for leisure over work and income, but that conclusion is a topic of debate. Blanchard (2004) argues that in the EU improvements in labor productivity were used to increase leisure rather than income, while the US did the opposite. Prescott (2003) argues that the reduction of working hours was not a matter of social preference but a rational reaction by employees to the higher marginal income tax rates prevalent in the EU. When the EU and US tax rates were similar in the 1970s, hours worked per employed person were roughly equal in both economies. When the EU tax rates started to outpace the US, the EU labor supply started to shrink and today is almost 50 percent lower in terms of hours worked than that of the US.

The remainder of the deficiency in EU labor utilization reflects much lower participation and employment rates, as well as much higher unemployment. These are not matters of social preference, reflecting important structural rigidities that should be a matter of great concern for EU policymakers. Therefore, while demographics have been the most important factor in explaining the US-EU gap for many years, in the last eight years lagging productivity has become an increasingly important factor.

Implications for the Future

Looking to the medium to longer term, there is no indication of a reversal in the widening gap between US and EU economic performance. According to forecasts by the OECD, the IMF and the European Commission, the US should grow at a higher rate than the EU for the next ten years, with an average differential growth rate per annum of around 1 percent. This annual extra point of growth in GDP will be enough to compensate for higher population growth in the US and cause the US advantage in GDP per capita to widen even further in this period.

Given these trends, the very ambitious target set at the Lisbon Summit in 2000 for the EU to become the "most dynamic economy in the world" by 2010 is already totally out of reach. This is clear even if agreed reform targets were to be implemented in the very short-term, which does not appear likely. The long-term future looks even more complicated for the EU than for the US.

The demand for pensions, health and long-term care by a rapidly aging population is going to claim a much higher share of GDP in the EU than in the US, and it will be a very serious challenge for the sustainability of EU public finances. The elderly dependency ratio (the number of people aged 60 and over divided by the number aged 15 to 59) is 35 percent in the EU today and 25 percent in the US, while by 2050 it is expected to be 70 percent in the EU versus only 35 percent in the US. The EU median age of 39 years (35.6 years in the US) is expected to rise to 48.5 years 2050, as against only 41.3 years in the US. In the EU, the percentage of people over 60 is expected to go up from 21.7 percent today to 35.6 percent in 2050, whereas in the US the increase is assumed to rise only from 16.1 percent to 26.9 percent (United Nations Population Division, 2003).

This aging trend will be reflected in a rapid increase in public expenditure. Total EU expenditures for public pensions and health care now stand at about 17 percent of GDP versus 10.3 percent in the US; that is, a difference of nearly 7 percent. By 2050, EU public expenditure in these two areas is expected to rise to 24 percent of GDP versus 14 percent in the US. An increase of 7 percent of GDP will be a huge challenge for the sustainability of EU public finances, while for the US an increase of 4 percent of GDP is more manageable. The challenge is even greater for the EU if the present levels of tax revenue and debt are taken into account. Today average levels are roughly 47 percent and 70 percent of GDP respectively, while they stand at only 30 percent and 50 percent in the US. An attempt to increase the EU tax burden by this amount will be politically unacceptable. Meanwhile the OECD estimates the EU debt to GDP ratio could double to 140 percent of GDP by 2050 unless reform of pension and health systems is pursued. In the US the debt ratio is expected to rise only to 80 percent of GDP by 2050.[3]

Relying on immigration to offset the rapidly aging population in the EU appears much more difficult than in the US. Given high rates of unemployment, European citizens seem much less willing to increase immigration than in the US. In the period 1990-2000 the US absorbed 12 million new immigrants versus only 6 million in the EU, and the US has already absorbed 40 million Hispanic immigrants. Over the period 2000-2050, the United Nations forecasts 55 million immigrants to the US versus only 21 million to the EU. EU enlargement toward Central and Eastern Europe is not going to help much because the fertility rate and population growth of the potential new member countries are even lower than in the present 15 EU members. A society with a rapidly aging population will be less entrepreneurial, less innovative and less able to provide for future EU growth and a continuing high standard of living. Furthermore, since it is likely that most new EU immigrants will come from Africa and Asia, the region will face the additional challenge of integrating their different religious and cultural traditions into Europe's dominant Christian society (United Nations Population Division, 2003).

Given all these trends, the obvious conclusion is that unless the EU implements very radical structural reforms in the near future, its economy will continue to lag that of the United States for years to come. Without reforms ranging from political structure and decision-making, to reform of product markets, labor regulations, agricultural policy, pensions, health care systems and immigration policies, the EU will not be competitive in an increasingly global environment. Furthermore, and more importantly, the EU's ability to maintain its present welfare state and its standards of living will be called into question.

3 The "Working Group on Ageing Populations, European Economy 2001; The "Fiscal Implications of Ageing" report by the OECD, 2001; The UN Population Division Report, 2003, and The CSIS report on "The Global Retirement Crisis", 2002)

The EU Social Model Versus The US Model

Although the US economy has outperformed the EU economy in a number of areas over the last 40 years, maintaining its substantial overall economic advantage and showing a higher degree of efficiency, there has been a widespread consensus among economists, sociologists and citizens at large that the so-called "EU social model" offers a better trade-off of equality and efficiency than the US model (Okun, 1975). A more equal and inclusive EU society is a much more attractive society in which to live.

Data from the Luxembourg Income Study (LIS) and by Smeeding (2002) demonstrate the differences between the EU and the US social models in terms of inequality. For instance, in 1999 income inequality as measured by the Gini coefficient was 0.37 in the US while that of the EU was only 0.27. The ratio of the income of the richest 10 percent of the population to that of the lowest 10 percent was 5.6 times greater in the US and only 3.5 times greater in the EU. The percentage of population in relative poverty (with disposable income less than 50 percent of the median disposable income) was 17 percent in the US and 9 percent in the EU. The percentage of children living in relative poverty was of 21.9 percent in the US and 10 percent in the EU. Inequality measures in both economies have been on an upward trend in the last few years, but they are increasing much faster in the US due to the impact of the US financial "bubble," the widespread use of stock options to remunerate top executives and the recent US income tax reductions.

Today, unfortunately, the consensus in favor of the EU social model is diminishing and there is a growing perception that this model may be unsustainable in the long term. The major apparent challenge confronting the EU system, and the US system for that matter, is globalization. As summarized in the so-called "Transatlantic Consensus" by Andre Sapir (2000), economists agree that the greater technical progress and competition associated with globalization is shifting demand away from unskilled workers towards skilled workers, resulting in higher wage inequality in the US and higher unemployment in the EU.

In the US, where markets operate more efficiently, globalization generates more wealth but also more income inequality, through wage differentiation and labor adjustment. The result has been fierce opposition of organized labor to globalization. In Europe, where the welfare state is more generous and product and factor markets are less flexible and efficient, globalization has also generated additional wealth but with less income inequality and adjustment than in the US. Instead EU wage and labor adjustments have come via an increase in the unemployment rate, felt mainly by "outsiders" such as the young, women and immigrants and not by "insiders", the unionized and protected employed. Accordingly, European organized labor has voiced much less opposition to globalization than in the US.

The judgment to be made is whether having more people employed, even if some are the "working poor," produces greater equality than having more people unemployed, although with generous unemployment insurance. The conclusion, based on the inequality indexes discussed above, is that the EU model is preferred.

Anthony Atkinson (1999) and others have challenged this Transatlantic Consensus. According to the dissenting view, it is necessary to move from a simple skilled/unskilled dichotomy of the labor force to a more realistic assumption that there is a continuum of earnings capacity: not only have unskilled workers lost relative to the median, but the median worker has lost relative to high earners. The Transatlantic Consensus does not explain the tilt in the upper part of the income distribution. In this alternative view, the principal force driving the EU and US models is not the challenge of globalization or the faster rate of technical progress, but a shift in social conventions and preferences of the median voter. Since the main cause is social in origin rather than trade and technology, there is greater scope for political leadership to reverse the trend toward larger inequality, using redistributive policies.

EU versus US Social Preferences

Another basic issue to be considered is whether the definition of equality differs across the Atlantic. The US is a country of immigrants seeking opportunity, with more flexible economic institutions and greater opportunity to climb the social ladder. The traditional notion of equality in the US system is mostly "equality of opportunity" in the form of equal access to education and health care. Given the social perception that this equality ex-ante has been achieved, even if only partially, there is little compassion for those unable to exploit their individual opportunities, except for the physically or mentally disabled. In the EU, an older, more stratified society, with fewer opportunities for social promotion, a less flexible economy and where full equality of opportunity is more difficult to achieve, there seems to be a preference for "equality of outcomes". Therefore, redistributive policies are also applied ex-post, helping those who are not capable of finding employment or who have not been able to adapt to globalization and technological change.

Whether these distinctions are fully valid or not, apparently, the majority of European citizens tend to prefer a more generous welfare state paid for by a more progressive tax system and to make a trade-off of more leisure against more income. By contrast, most US citizens seem to prefer more efficiency to more equality and more income to more leisure. This is the reason why Atkinson suggests that, in both the EU and US systems, the government could reduce the increasing inequality gap by means of increasing redistributive policies. It is thus a question of developing policies that can counteract the negative effects of diverging social preferences.

In fact, the issue is much more complex that different definitions of equality. Labor market regulations and social policies can serve two distinct purposes. First, they may counteract market failures, thereby increasing economic efficiency. Examples include unemployment insurance, which permits unemployed workers to sustain consumption in the face of a job loss, and health and safety regulations. On efficiency grounds, both are clearly desirable.

Second, social policies may try to redistribute income between different groups in society or to protect rents. While the imposition of a minimum wage can be justified as an efficiency measure to curb the power of "monopsonistic" employers, there is no doubt that, for many workers, it simply serves to redistribute income from the owners of physical and human capital towards low-skilled labor. Other regulations that seek mainly to redistribute income may reduce economic efficiency. For instance, labor standards and regulations frequently have the effect of decreasing the supply of labor. Examples are mandatory reduction of hours worked; overly generous unemployment insurance that encourages the unemployed to be choosier about the jobs they accept; or rigid employment security legislation which slows the rate of exit from obsolete industries and makes expanding firms reluctant to create new jobs. Some social policies achieve neither equality nor efficiency goals. The high costs associated with firing workers in many EU countries, originally intended to protect workers against unfair job separation, have ended up insulating "insiders" from the competitive pressure of unemployed "outsiders".

It is also the case that the objectives and mechanisms of social policy measures vary across the EU itself. The welfare systems of the continental European countries tend to be employment-related. They focus on employment of prime-age males, at the expense of the young and women, and offer generous pensions to former workers. By contrast, the Anglo-Saxon and Scandinavian welfare models offer benefits mainly on the basis of need. These models clearly reflect different social preferences.

Even within continental Europe, there exist very different mechanisms for protecting workers. Some countries provide high job security and offer low unemployment insurance, while others have the opposite. Those in the first group have done better at creating jobs than the second, but they face greater competitive pressure to change as integration deepens because of the difficulty to maintaining high firing costs. Within the EU, some harmonization of welfare systems could offer significant efficiency benefits by allowing higher labor mobility among member countries, but that is going to be almost impossible once the new Eastern candidates are full members. Harmonization makes sense only for countries at similar levels of development and with similar social preferences between efficiency and equality. Income disparities are already relatively high in the EU and will become even higher with enlargement (Bean, Bentolila, Bertola and Dolado, 1998).

Differing Views of EU Reform

Reducing persistent high levels of unemployment in most EU countries will require reduction of labor regulations and social policies that reduce efficiency, as soon as possible. The problem with the "European model" is that it has maintained both high labor market rigidity and a high level of social protection for many years, with no electoral pressure for change. This choice appears to represent a “political equilibrium” and shifting away from that equilibrium is not going to be easy. The only way to achieve change may be to wait for competition arising from enlargement and the budgetary demands of an aging population to demonstrate that the present system may not be sustainable in the medium term. That should force modification of the European social model but unfortunately reform is needed sooner rather than later. A new and workable trade-off between efficiency and equality is urgently needed. The example of the Nordic countries and the Netherlands shows that it is possible to achieve both without major sacrifices. What is needed is a larger consensus among employers, trade unions and governments on these societal reforms.

There are two different positions on the costs and benefits of the EU welfare state. Heckman (2003) is a good example of the conventional and majority view that the difference in economic performance between the US and EU can be explained by the disincentives of the EU's highly regulated welfare state. These disincentives distort resource allocation and impair efficiency. The consensus estimate is that 40 percent of each euro of taxation or regulatory expense represents a cost, or 'dead-weight burden' in economic terms, to the EU economy. These costs arise from distortions in economic activity induced not only by taxation but also by centralized collective bargaining, regulation of business entry, banking practices and employment protection.

Since the purpose of a welfare system is the social insurance it provides, the efficiency cost of taxation and regulation must be evaluated against the benefit of greater equity and security. But a closer look at how the system operates in many EU countries shows that income security and even wage gains for protected insiders come at the cost of job and income losses for outsiders who are only partially protected by the social insurance. Far from promoting universal equity and social justice, the protection afforded insiders comes at the cost of low employment growth, low productivity growth in the manufacturing sector and higher unit labor costs. The level of EU unemployment is mainly structural. It is symptomatic of deeper problems that require long term solutions while the politicians are focused on the short term. Incentives to innovate, to acquire skills and to take risks are thwarted by regulation, undermining the long-term competitive position of the EU and inhibiting investment in the technologies of the future. Moreover, the opportunity costs of preserving the status quo are increasing since the new global economy offers many new opportunities in technology and trade. Present trends portend a second-rate EU economy for the future.

In contrast to this conventional view, there are other less pessimistic ones. Blanchard (2004) remains optimistic about achieving reform while maintaining the basic attributes of the EU welfare state. He sees pressure by the European Commission to reform goods and products markets, mainly in the utility and financial sectors, changing the environment for workers and eventually producing labor market reform. Protected firms can maintain employment protection but when their rents are decreased by product and market reforms, they can no longer afford it. This explains the strong correlation between highly regulated product and labor markets. As shown by Saint-Paul (2000) and Bertola and Boeri (2003), the reverse should be true when goods and products regulations are substantially reduced. Such a change will reduce the present rigidity of the labor markets. In any case, Blanchard is of the view that there is no need to move towards a full "US social model" in the labor markets. The experience of the Netherlands and the Nordic countries shows that reform is possible without decreasing social insurance: efficient social insurance is not so costly after all.

Agell (2003) also offers a more optimistic view about the possibility of a better balance of efficiency and equality in the EU's future. He points to the EU experience during the 1960s and early 1970s when Europe achieved much lower unemployment rates than the US with even more rigid labor markets than today. Further, when the UK deregulated its labour markets in the 1980s, it did not fare significantly better than the average European economy during the 1990s, showing that macro-economic events and their interaction with institutions play important roles as well. He offers no support for the commonly held view in the EU that equality is best served by a tax system with increasing marginal tax rates at the top of the income distribution. Such a system creates disincentives to work for high-skill individuals, creating inefficiency in the supply of labor. Rate cuts that increase the labor supply of high-wage individuals provide extra tax revenue that can be distributed to the low wage individuals.

Along similar lines, Atkinson (1999 b) argues that unemployment benefits should be of limited duration so as to impose active job search requirements, and should be subject to disqualification for persons who quit voluntarily, are dismissed because of misconduct, or reject reasonable job offers. Restrictions on free riders are essential to maintain a more efficient welfare state, because willingness to invest in public goods and to cooperate with the rules of the system depend on the belief that the systems are efficiently managed and will punish those who free-ride on the cooperation of others. Experiments show that without these conditions, cooperation may eventually break down.

Additionally, Agell disputes the present conventional view that globalization is going to undermine present labor regulations in the EU. He argues that because globalization tends to increase the risk of unemployment, which tends to increase voter demand for social insurance, it will yield a new "political equilibrium" that could be associated with more or less income redistribution, given that the competing pressures of globalization and demand for social protection may balance out.

Conclusion

The preceding economic comparisons clearly demonstrate the urgency with which reform of product markets and social and labour policies must be pursued in the European Union in order to achieve greater efficiency and lower social costs. Without reform, the EU will continue to lag the US economically and the pressures of international competition and an aging population will put the EU social model and its "political equilibrium" under increasing strain.

The solution has two parts. Reforms in product and services markets should be accelerated to increase competition among incumbent firms and make them more conscious of the high cost of the labor and social protection they provide. On the side of social policy, the EU welfare state should be reformed with emphasis on addressing market failures, pursuing redistribution to those in genuine need, and providing incentives to seek employment for those left out of the labor market, while eliminating policies and programs that add unnecessary costs and create disincentives to efficiency. The solution is not to replicate the US model, which has many shortcomings in equity terms, but to make the EU social model more efficient and less costly without sacrificing its major benefits.

Governments know what must be done, as the issues involved have by now been well researched and experienced. A more recent, serious and comprehensive analysis of EU weaknesses and a set of reasonable policy recommendations to increase EU efficiency and to preserve its social model was presented by a group of European economists, chaired by André Sapir, in the Independent High Level Group Report (2003) commissioned by the President of the European Commission. Unfortunately, the response by Member States has been rather negative.

The main cause of this response is that most of the major member countries are going through a period of very slow growth and governments find it difficult to embark on long-term policy reforms that will reduce their electoral support in the near term. Although greater competitiveness is essential to preserve the EU social model, experience shows that EU governments remain very short-term oriented and unwilling to take the risk of reform. Commissioner Fritz Bolkestein summarized the situation well: "Member States are strong on rhetoric and weak on actions. There is much poetry but precious little motion."

The proposed new EU Constitution, which will introduce majority voting for most EU decisions, could accelerate achievement of the Lisbon strategic goals if there is a consensus among the largest EU members to take the lead on reform. Let us hope that the new Constitution along with the entrance of new member states from the east will provide the strong impulse needed to drive the reform process. Time is running short to try to preserve the EU social model alive and keep it functioning efficiently.

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