

There is something rotten in the welfare state of Europe

By Martin Wolf

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The time has come for Europeans to ask themselves the unthinkable: can their vaunted social model endure? It is a question I have wished to avoid. But it is irresponsible to persist in doing so. Something is rotten in the state of western Europe. The continent retains valuable assets from the past. But these are showing symptoms of decay. The underlying cause seems increasingly evident: the hypertrophy of the state.

Symptoms are not hard to find: this is a continent of high and persistent unemployment, declining productivity growth, rapid ageing and growing fiscal strains; it is also one whose once-proud role in knowledge-creation is in decline.

But in one respect, western Europe remains pre-eminent: its states are the tax-and-spend champions of the world (see chart). This is the heart of the European model. But it is no model for well-informed outsiders. Maybe they can see what Europeans will not.

The European state is maternal: protective but also infantilising. Its high taxes and benefits discourage anybody from doing too well, while ensuring that nobody does badly. Its services are available to all, but are also mediocre and inflexible. It is an example of what the journalist Andrew Neill, following Friedrich Hayek, calls the "fatal conceit": the view that society can be rationally planned and directed.*

For all its much discussed inefficiencies, the trial and error of the market economy proved more effective, because it was more creative and flexible, than Soviet planning. While a far smaller error, European social democracy looks increasingly unworkable in the long run.

If one is to assess this possibility one must look not at where the model works least well but where it works best. The maternal state is most fully developed in the Nordic countries and particularly in Sweden. **In a forceful new polemic, Johnny Munkhammar of Timbro, a free-market Swedish think-tank, convinces me that trouble abounds even in Sweden's social democratic paradise.**** Indeed, its long-run performance shows this (see chart).

What, then, are the failings of the big state? The answers include: fiscal unsustainability; mediocrity of provision; slackening work effort; slowing productivity growth; resistance to economic adjustment; flight of valuable economic resources; difficulties in absorbing immigrants; and even the undermining of the family. A social system that protects people from the consequences of their own decisions is rife with moral hazard: in the long run, it changes not just behaviour but even values in a less productive direction.

Consider each of these points in turn.

First, the services the state provides - particularly education and health - are ones on which people wish to spend more money as they become richer. It is also hard, if not impossible, to make them far more productive: teachers cannot teach more students every year. Again, if pensions are publicly provided, the government will have to spend more as the population ages.

For these reasons, the ratio of public spending in gross domestic product must rise progressively if state-funded services are to meet the demands of the population. But such increases are politically impossible and, in practice, largely ceased two decades ago.

Second, financial stringency, combined with the difficulties in running public sector monopolies, generates rising dissatisfaction with the quality of what is provided. Waiting lists are endemic in Swedish health, for example. State-run schools provide a deteriorating quality of education, argues Mr Munkhammar, while state-run universities are rapidly-growing but under-funded behemoths.

Third, output per hour in the European Union was 91 per cent of US levels in 2005 (at purchasing power parity), according to the most recent research on productivity from the Conference Board, while GDP per head was 73 per cent. Lower work effort is the cause: fewer hours worked and lower employment. Taxes, regulations and benefits at least partly explain this.

Fourth, since 2005, productivity in the EU has been losing ground to the US after a long-period of catching up (see chart). Some small countries did quite well. But the US should be compared with Europe as a whole: between 1995 and 2005, US productivity per hour rose one percentage point a year faster than in the EU. Robert Gordon of Northwestern University notes that between 1995 and 2003 western Europe lost a fifth of its catch-up on US average living standards of the years between 1950 and 1995.***

Fifth, the job security provided in many countries lowers willingness to hire. This makes it more important for workers to hang on to existing employment. That, in

turn, makes rapid economic change, including imports, more threatening. This is why countries with rigorous job protection are increasingly inclined towards protectionism.

Sixth, high taxes and the burden of regulations encourage the outflow of resources. Hans-Werner Sinn of the Ifo institute in Munich, notes, for example, that net investment in Germany, the EU's most important economy, at only 3 per cent of net domestic product is now less than the capital outflow embodied in the current account surplus.

Seventh, high minimum wages, whether set by law, trade unions or welfare benefits, combined with heavy taxes on work, generate high levels of unemployment of relatively unskilled people. In Europe today many of these people are immigrants. Consequently, immigrants and members of ethnic minorities suffer higher unemployment rates than the population as a whole. The results are seen in criminality, rioting and social disorder.

Finally, for many mothers the welfare state is a substitute for a committed father. For fathers it is an excuse for abandoning their responsibilities. For both, it is a reason not to produce the children who might help look after them in old age. The result is lower overall investment - quantitatively and, in some respects, even qualitatively - in the posterity on which the sustainability of the welfare state itself depends.

The welfare state brings significant benefits. But it can also go too far. In much of western Europe, it now has. If present trends do not reverse, growing economic, social and even political difficulties threaten. No taboo can remain inviolate, including the most sacred one of all: that of the all-providing state.

* China and Europe: the Fatal Conceit, Institute of Economic Affairs, London, November 28 2005, www.iea.org.uk; ** European Dawn, Timbro, 2005; *** Why was Europe Left at the Station when America's Productivity Locomotive Departed? NBER working paper 10661, August 2004, www.nber.org.