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EUROPE AT A CROSSROADS: THE ROLE OF THE STATE IN A GLOBALISED ECONOMY

Introduction

Welcome Address by

Dieter Reiter

Councillor, Head of the Department of Labour and Economic Development, City of Munich

Your Excellencies,
Mr. Chrobog,
Professor Sinn,
Ladies and Gentlemen,

On behalf of the Lord Mayor of Munich, Mr. Christian Ude, I would like to extend a warm welcome to you, the participants of the 10th Munich Economic Summit, here at this business lunch.

First of all, let me congratulate the organizers on this tenth anniversary. With the Munich Economic Summit, you managed to create a forum which is famous for high-level discussions, much-noticed contributions of high-ranking business and political decision-makers and an expert audience. The City of Munich is proud to be the host city of this Summit.

Based on the experience of the financial crisis and all its implications, the role of the state in a globalized world has become a matter of considerable controversy. The advocates of privatizing and liberalizing large parts of the market have lost the upper hand in this debate, the arguments for the necessity of a national competition and distribution policy have regained some ground.

The question we are faced with today is whether we want to continue down that road of deregulation and liberalization – which, ultimately, brought us very close to the collapse of our economic system – or whether we want to return to the model of a social market economy – a model which is not so much about short-term profits but rather about long-term business success and, at the same time, about social and environmental issues.

Let me tell you about our experience with this on the local level. In the years before the financial crisis, German cities have followed many different strategies regarding the privatization of public services and the experience gained from these approaches was just as varied. The 'first the market, then the state' strategy has worked quite well in some fields. But in an alarming number of cases, the results of privatization were highly problematic and do not seem to indicate that privatization can be seen as a silver bullet. That is especially true for sectors which are prone to producing monopoly or oligopoly structures such as energy supply, public transport or water supply, just to mention a few. After years of privatizing formerly municipal services, the results are sobering.

Energy supply was one of the key sectors affected by privatization of formerly public enterprises. Today, energy supply is characterized by oligopolies of private energy suppliers. There is practically no competition on price. The transition to renewable energies is made rather reluctantly and only as a consequence of massive state subsidies and regulatory requirements. The example of Munich shows how the transition process can be sped up if a city owns a utility company. By 2025, our utility company aims to produce so much green energy, that the entire demand of the city can be met. That requires enormous investments – around 9 billion euros by 2025 – and can only be successful if the long-term goal is sustainable economic success rather than short-term profit maximization.

In the history of privatization of local public transport, more often than not, the services provided were reduced dramatically and the prices saw steep increases. If we want to push back individual motorized transport and if we want to reduce CO_2 emissions, we need high-performance local public transport systems and transport companies.

Munich's drinking water is among the best in Europe. This high quality is a result of the sustainable investment policy of the City of Munich's waterworks: for decades, they have been purchasing property in the water catchment area and they support more than 100 organic farmers around the source. Which private company would be willing to make such an effort if the quality values required by law can be met at a much lower cost?

The financial crisis also quite drastically revealed another key function of public enterprises: public enterprises can help to stabilize our economic and financial systems. During the financial crisis we saw how vulnerable our financial system really is. Our savings banks took over important parts of the credit market which could no longer be maintained by the beleaguered private banks. We would be far worse off today if the countless advocates of privatizing our savings banks had succeeded in the past and if, as a consequence, savings banks had also gambled away their customers' money on international financial markets. The lesson to learn from this is very simple: the mix of private banks, mutual banks and public banks is a factor of stability. Those banks which pursue a less aggressive approach, which avoid high risks, think and act sustainably and primarily provide services for local citizens and businesses thus pose a competitive advantage to their home communities.

I am here to make the case for a strong state or for the state having an influence on certain important fields of our lives. The co-existence of private and public service-providers might not entirely rule out undesirable developments, but different corporate strategies and business models do reduce the risk of every provider being on the same wrong track. Please do not mistake that for advocacy of inefficient and bureaucratic state-owned enterprises. The public enterprises I am talking about do not primarily focus on maximizing their profit but they have to be run like businesses: they focus on the common good, but they are not charity organizations.

German cities and towns are currently trying to correct the mistakes made in their privatization policies of the past. There are many examples of newly established or revived municipal utility companies, especially for energy and water supply, or of the repurchase of municipal transport services. Even private housing stock formerly owned by the city is sometimes bought back.

The example of Munich shows that sound budgetary policy is possible even without selling municipal enterprises or the municipal housing stock. Ironically, globalization leads to economic fluctuations getting stronger and more frequent. A strong state and, in line with the principle of subsidiarity, a regional and local level equipped with the means they need to take action to provide for their future are a necessary corrective to global insufficiencies.

Thank you for your attention!

Welcome Speech by

MARTIN ZEIL
Bavarian State Minister of Economic Affairs,
Infrastructure, Transport and Technology; and
Deputy Minister-President

Ladies and Gentlemen,

On 20 May 1506, 505 years to this very day, Christopher Columbus died. By order of the Spanish crown, the great seafarer had been looking for a shorter sea passage to India and had courageously embarked on a completely new route. In our day and age, politicians must also embark on new routes. One of the greatest challenges in view of demographic change, a growth in the public debt and increasing international competition, is to put our social system on a firm foundation for the future.

Ludwig Erhard, one of my predecessors as Bavarian Minister of Economic Affairs, once said: "a good economic policy is the best social policy". This sentence may have once been more popular in Germany than it is at present. But it is still as valid today as it was then:

- Only a dynamic, innovative economy creates sustainable jobs, safe incomes and prosperity.
- Only in a successful economy do entrepreneurs and employees pay sufficient taxes to finance government expenditures such as social insurance on a permanent basis.

This can be seen from the example of Bavaria. With an average unemployment rate of currently 3.9 percent, many parts of the State of Bavaria are on the path to full employment or have already achieved this. At the same time, the number of people whose basic livelihood depends on the help of transfer payments is declining. Compared to the entire population of Germany, Bavaria has the fewest people who depend on a guaranteed basic allowance.

The main task of an effective social policy must be to strengthen the performance of our economy in the face of global competition, for example:

- through the power to innovate,
- through highly-qualified workforce,
- through modern and efficient infrastructure,
- through a transparent and reliable regulatory framework, and
- through an energy policy that guarantees security of supply and affordable electricity.

A successful economic and social policy must therefore ensure that the dynamic forces in industry and society are given sufficient freedom and scope to be able to develop. For me, these are closely linked with equal opportunities and possibilities for participation for every citizen. What I mean here are the parts of the population whose prospects are not so bright. The following statement still holds, especially for the socially disadvantaged: now and in future, the state will continue to be the guarantor of social security. There is consensus on this among the different political camps. The shape, the range of services and the limits of the burden placed on those who have to finance social security are, and remain, the subject of contention.

In my view, a policy that activates people is always better than passive support. It is especially people with low qualifications that we can help more by making jobs in the low-productivity range possible, by providing incentives for entering employment through income supplements and by consistently building on training and further education. This is at any rate better than leaving people unemployed and supporting them fully.

In Germany, people in need who get into difficulties through no fault of their own or are unable to take control of their lives through their own efforts will continue to be entitled to payments through the basic allowance scheme. The Hartz IV, as it is called, is in principle a sensible combination of due solidarity and the incentives necessary to find re-employment. It has contributed to an increase in employment in Germany by providing more incentives to take up employment and reducing minimum-wage claims. This has also brought us one step further along the road to adapting the social security systems to demographic change. What we need for a future-proof social-insurance system, however, are further structural reforms.

This is why, in addition to the pay-as-you-go system we shall in future also be relying on capital cover. We are therefore, for example, promoting private insurance as a supplement to the statutory pension scheme. We are stepping up efforts in the direction of greater labour-force participation. We want people to start their professional life more quickly, more specifically targeted school and professional qualifications and a longer working lifetime. These measures will relieve the burden on the social insurance system. We are building on more personal responsibility and more self-reliance. For it is definitely not the task of the state to guarantee all-round insurance in every situation. For this reason, we are decoupling the health costs from labour costs in health insurance. I plead in favour of creating a health-premium model in the medium-term, with more competition, more efficiency and greater transparency.

But guaranteeing the financial viability of the social systems in the long term also calls for a solid, sustainable financial policy. This means:

- bringing the ratio of public-spending to GDP back to pre-crisis levels, and
- reducing the level of debt to 65 percent of GDP by 2020.

Ideally, what I would like to see is still a comprehensive and coordinated reform of the system of taxation and social-security contributions. Only in this way will it be possible to effectively contain errors inherent to the system such as the financing of tasks relating to society as a whole, by means of contributions, the so-called shunting yard or the far too large gap between gross and net.

Ladies and Gentlemen,

I am confident that, in the next few hours, the discussions at the 10th Munich Economic Summit will throw light on new approaches to achieving our aims by making the optimum adjustments to our course – and, unlike Christopher Columbus, we will arrive exactly where we want to arrive: at a sustainable social system.

Thank you!

Welcome Address by

JÜRGEN CHROBOG
State Secretary (ret.), Chairman of the BMW Stiftung Herbert Quandt

Dear Ministers and Ministers of State,
Excellencies,
Ladies and Gentlemen,

On behalf of the BMW Stiftung Herbert Quandt I would like to welcome you to the 10th Munich Economic Summit in the Bavarian capital! This year, it gives me particular pleasure to do so, because we are celebrating our Summit's ten-year anniversary. We are proud to look back on ten years of successful cooperation between the BMW Foundation and the CESifo Group, and for that I would like to express my sincerest thanks to Professor Sinn.

The continuous increase in the number of participants shows how widely the Munich Economic Summit has become recognized as a political and economic forum of international standing. More than 200 experts, managers, politicians, and media representatives from the EU and other countries, also outside of Europe, have accepted our invitation to participate in our anniversary Summit. Again this year, the Summit seeks above all to enable a constructive and open dialogue between the economic, political and academic sectors.

We continually and consistently strive to increase the diversity of the participants in this dialogue and therefore are pleased to welcome today representatives of the Third Sector; young, future decision-makers in industry and business, so-called Young Leaders; and last but not least Young Academics, aspiring scholars and researchers.

While we usually concentrate on specific international economic policy issues, this year's focus is on the state – the institution that provides the regulatory framework and that is itself a key economic actor. Our goal is to gauge the role the state will play in relation to society and business in a newly forming global system that is defined by upheavals in world politics, emerging economic powers, and global crises.

The first item on our agenda is to compare economic and social models: which system is innovative and sustainable enough to hold its own – or even take the lead – in the global competition? The Anglo-American system, traditionally a liberal free market system, the European system that takes a social market economy approach, or a predominantly state-run, authoritarian system such as in China? – to highlight, and describe in a nutshell, only a few.

You'd think that the European model has proven to be quite successful. After all, Europe has come out of the crisis in better shape and more quickly than other economies, current forecasts predict an economic growth of around 2.5 percent, and the German economy, the quintessential social market economy, in the first quarter of 2011 has regained its pre-crisis levels of 2008. With a predicted growth rate of up to 2.8 percent, it is considered to be the 'engine of growth among industrial countries – and not just in Europe', as the new Federal Minister of Economics, Philipp Rösler, put it in light of the positive figures issued by the Federal Statistical Office.

If only it was not for the euro crisis … While it is currently the close-to-default debtor states on the EU's periphery that are hit hardest by the crisis, there remains the risk, according to a recent IMF assessment, that the crisis will spread to the core countries of the eurozone, unless we increase financial and economic integration. However, the question of whether the European model will be fit for the future not only depends on how the EU deals with the euro crisis, but also on how it will implement 'Europe 2020', its economic reform and growth agenda. Yet it would seem that European governments are losing sight of this agenda in times of burgeoning public debt.

The misguided policy of running up even more debt – which has been pursued for years and which, by the way, is not only typical for the EU states in varying degrees – but for the OECD as a whole –, not only forces governments to implement severe austerity measures, which primarily take the form of cuts in welfare spending; it has also fundamentally called into question the welfare state and its efficiency. In Britain, for example, the government has introduced a reform policy, the so-called 'Big Society', whereby a 'civic state' characterized by 'pluralism, localism, and voluntarism' is to supersede a market-based welfare state that is seen as too bureaucratic and too expensive. Driven by the need to economize, the government aims to reduce the role of the state and wants its citizens to assume greater responsibility for shaping the system, especially the welfare system. This raises the question, however, of how much the state can and should abdicate its core responsibility of guaranteeing social welfare benefits and how many responsibilities and burdens it can expect its citizens to shoulder. These questions will be at the heart of the second panel, before we will move on to our third panel, which will focus on economic policy.

Intervening into economic processes and acting as an 'entrepreneur' itself or merely serving as a guardian of the regulatory framework for economic activities it has created – it is these two poles that define the range of possible government action in economic affairs. If we take a look at the United States, we can see that the government, in order to stem the consequences of the crisis, has widely departed from its liberal regulatory agenda by rescuing or taking over banks and companies and by launching major stimulus programs. Europe, on the other hand, proceeds much more cautiously, at least when it comes to fiscal policy measures to stimulate the economy; the EU rather focuses on reducing national debt and advocates a common financial market regulation. Is this merely a snapshot in time, where we see different strategies to revitalize national market economies? Or does this prefigure a fundamentally different understanding of the role of the state that will continue into the future?

Many of these questions, which I have touched on only briefly, will be discussed during the three panel sessions today and tomorrow, and we look forward to your active participation. In the end we will, I am sure, come away with new insights and perspectives. I wish you all an inspiring and stimulating 10th Munich Economic Summit and will now pass the floor to Mr. Sinn.

Introduction by

HANS-WERNER SINN
Professor of Economics and Public Finance, University of Munich; President of the Ifo Institute

Ladies and Gentlemen,

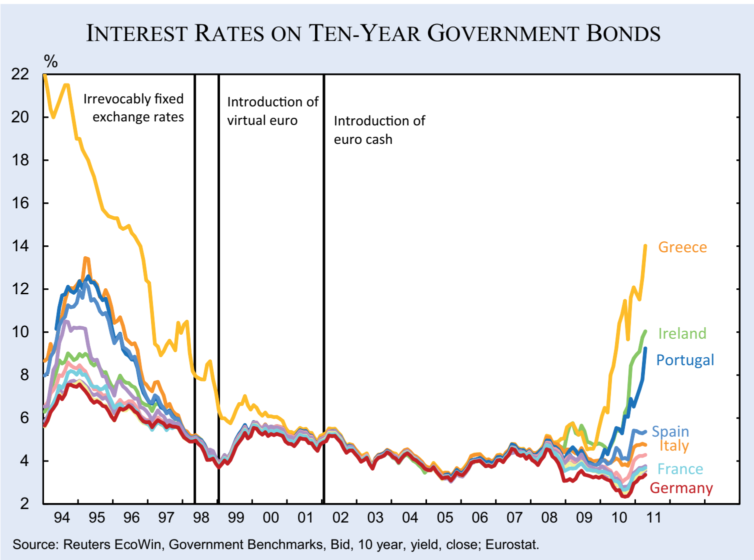
I would like to start with a diagram of the crisis. The left-hand side (see Figure 1) reveals the dispersion of interest rates before the euro was introduced. After the euro was introduced exchange rate uncertainty disappeared and the interest rates converged. This triggered a process of rapid economic growth because cheap money was available to the southern countries. On the right-hand side of the same figure you can see how the interest rates have once again spread significantly in the past few years, with Greece paying the top rate and Germany the lowest rate (see the red curve). By Wednesday the 28th of April 2010, the interest rate for Greece had risen to 38 percent. That was basically the day on which Greece went bankrupt.

What happened next? By 7 May 2010, a Friday one week later, the interest premium had increased even further, and on Saturday and Sunday the EU designed its rescue package, basically obliterating the no-bail-out clause of the Maastricht Treaty, because otherwise, it was claimed, the world would fall apart. The idea was that we had to be generous, that this would be the solution, and that the markets would calm down – which they did, but only for a while (until 1 June). The interest rate fell to 8 percent in Greece.

Unfortunately, the rescue package simply did not work. The situation now is more extreme than when the EU designed the rescue package; and the world still has not fallen apart, although we might be close to this in a sense. We are in the midst of a crisis in Europe. How the European countries react will have implications for the new shape of Europe; a new European entity will emerge out of this crisis, but we do not really know what it will look like.

What happens over the course of this year will be decisive. The European Financial Stability Facility (EFSF) in Luxembourg will have to be finalized by the end of this year, as the European countries agreed. And that will bring us a new Europe.

Figure 1



Source: Reuters EcoWin, Government Benchmarks, Bid, 10 year, yield, close; Eurostat.

Role of the government

The role of the government can best be understood in Musgrave's terms of allocation, distribution and stabilization, which I will go into. I will also talk about the public debt problem resulting from the crisis and whether Europe will turn into a transfer union or not.

Allocation

What economists mean by allocation is that the government provides goods that the private sector cannot produce, for example, infrastructure. These are so-called *public goods*, which are not divisible, but are consumed commonly by the people and therefore cannot reasonably be provided privately. Today Europe has to provide some of these goods in terms of cross-border traffic lines. A broadband network, for example, could be a government function. It is not too profitable; we don't need too many overlaying networks, and the government has to subsidize it at least.

Regulation is one of the government functions. The market economy is not a system in which everyone can do whatever they want. On the contrary, a market economy is a game with clearly defined rules, and these rules have to be made by the government. Among the rules that obviously did not function were those set out for the banking sector. The Basel system failed miserably because it required far too little equity for risky assets like Greek government bonds. The risk weights for government bonds were zero, and this was one of the reasons why the banks invested so heavily in government bonds and why so much capital flowed into the southern European periphery, which is now stuck in a crisis.

Some people claim that, because we opened up the borders within Europe, we now need minimum wages. Economists do not see this sort of regulation as being a government function. If high-wage countries seek to protect their wages from immigration from Eastern Europe with minimum wages, then immigration will fuel unemployment in the domestic population. The immigrants will come, take jobs, and drive their domestic incumbents into unemployment. This is a dangerous development, and yet some people in Germany nevertheless would like to see the introduction of a minimum wage. Millions of people will migrate within Europe over the next decade. Many of those who moved to Spain – 6 million in the last decade – are unemployed now. Those who went to Ireland and Britain largely face the same fate. However, this group represents a mobile stock of people who have already decided to migrate, so they may well now travel to other parts of Europe, where the economy is booming. Minimum wages would be the worst thing to implement. We need the migrants urgently, but in order for immigration to be a success story downward wage flexibility is necessary to generate jobs for the immigrants.

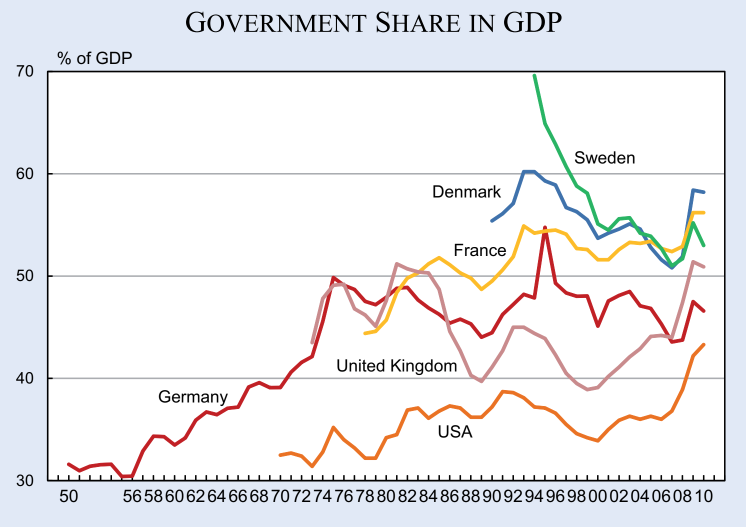
Opinions are divided about the role of *firms run by the government.* Water provision is clearly a government function because you cannot establish competition in this sector. A comprehensive study of the success of European privatization suggests that privatization makes sense where you can establish competition (Köthenbürger, Sinn and Whalley 2006). If there is no competition, a regulator appears to be needed who, however, can never be perfectly independent, but may also be inclined to follow the preferences of the industry. There are good examples of government firms that have failed, such as the German state banks. Conversely, there are private toll roads in Europe that do not work, for example in Italy. Moreover, the private railways in Britain were a nice idea in principle, but are a catastrophe if you use the system. The Thatcherite period is over, and we now have to rethink and rebalance our approach with regard to excessive privatization.

There is currently considerable discussion about green energy, and the government wants to decide how the market should provide the energy we need. I agree fully that we need a post-Kyoto agreement in which all countries participate, so as to control what Nicholas Stern called "the greatest externality ever", namely global warming. But what countries are doing at the moment is not exactly the right thing. We have feed-in tariffs in addition to an emissions trading system. This feed-in system is completely useless. It has no impact on the aggregate CO_2 output, since we already have full control *via* the emissions trading system. Feed-in tariffs in Germany not only lead to green energy crowding-out, but also to an emigration of emission certificates from Germany to other countries, allowing them to emit exactly as much additional CO_2 as Germany saves due to its feed-in tariffs. Thus the feed-in tariffs exert a zero-point-zero effect on CO_2 output in Europe. They are simply a waste of money. German electricity consumers spend 12 billion euros on feed-in tariffs, with 17 billion forecast for next year and the figure rapidly projected to exceed 20 billion euros.

It is also not the function of the government to decide to replace nuclear power with wind turbines. Given that we have the emissions trading system, the market can make this decision. Even if we replaced nuclear power plants with fossil fuel plants, there would not be any additional CO_2 output as a result of the emissions trading system. The market will find the optimal allocation. Wind turbines will be erected in the places best suited for them, like Brittany for example, where there is a lot of wind, rather than in Germany. Moreover, solar panels will be put up because the price of emission certificates is being driven up, but not in Germany where the sunshine is comparatively rare. They will be set up in the Extremadura in Spain, which is a much more efficient location.

There are lots of useful things for governments to do, as first described by the German economist Adolf Wagner in the 19th century. According to Wagner's law, the government's share of GDP gradually increases with industrialization (see Figure 2). Around 1900, the German government share of GDP was around 10 percent, whereas it is now approaching 50 percent. Even in Germany's post-war period, Wagner's law can be observed very clearly. There is a gradual increase of the government share of GDP from 30 percent in 1950 to today's 50 percent. Even the United States, which used to have a low government share of GDP, is now approaching the level of Germany and other European countries. This is due to fiscal rescue operations and the stagnation of the US economy. When I wrote my book on the Germany economy in 2003, I observed that a few years earlier Britain had a government share of only 39 percent of GDP, while Germany's was 49 percent. However, all that has now changed: Britain has a government share of GDP of over 50 percent, while Germany's share has now been reduced to 47 percent. In Sweden – an amazing development – the share decreased from 70 percent to about 54 percent. While France, with 56 percent – 9 percentage points more than Germany – has now overtaken Sweden. Sweden is no longer the primary example of a socialist state in Europe: this role is now played by France. There is only one country in Europe with a larger government share of GDP: namely Denmark, with 59 percent. If one thinks of a range between 0 and 100 and calls 0 a pure market economy and 100 a pure communist country, what are these countries closer to?

Figure 2



Source: Statistisches Bundesamt; Eurostat.

Of course, pure communism has never existed. The market always played some role in Communism. Similarly, there has never been a pure market economy; the government has always accounted for a share of GDP.

Distribution

Another function of the government is distribution. The government provides social security, which Bismarck introduced in the 19th century to pacify the left. The United States has finally realized that it needs a mandatory health and pension insurance system. Europe, on the other hand, certainly needs co-funded pension systems. Since Europeans suffer from a seriously low birth rate, they cannot simply rely on their children to pay for them. Given that there are too few children, pensions will be too meagre – unless there are more savings. Granted, saving is not that easy, considering that investments are very risky at the moment.

Taxation is also an important issue. Hidden progression is an on-going theme. Inflation and normal growth automatically increase the government share in GDP, which thus provides support for Wagner's law. It is not, however, appropriate for the government to participate to a greater extent in economic growth than the private sector. This is why the tax schedule should be adjusted automatically every year. This is an important reform that needs to be implemented. The high marginal tax rates on labour are a big problem in Germany. The overall marginal tax rate on the value-added produced by labour is two-thirds. For a normal worker, two-thirds of what s/he generates in value with his own work is captured by the state. Another important issue that needs to be discussed is capital income taxation vs. consumption taxation.

How we deal with tax-financed social benefits is also important. Germany and most other western countries, for example, largely rely on the idea of replacement incomes – incomes which the government provides if you don't have a job. This action turns the government into a competitor in the labour market, since the money the government provides under the condition that the recipients do not work is a kind of minimum wage. The private sector will not find workers unless companies pay as much as the government. That was a huge drawback for Germany until Chancellor Schröder introduced the Agenda 2010, which changed the system by reducing the replacement incomes and abolishing the second tier of the unemployment benefit system *(Arbeitslosenhilfe)*. There are now 1.5 million wage-subsidy recipients in Germany. These are working people who receive additional money from the government. This is the idea behind the so-called 'activating' of social assistance.

Another topic to discuss is how we treat immigrants. It is a sacred cow in Europe that we stick to the residence principle. If someone moves from one EU country to another he receives the social benefits according to the rules of his or her new country of residence. But why aren't such benefits based on the country that he came from? After all, all EU countries adhere to the EU's social norms, and all have social systems providing minimum income guarantees. Why don't we give every EU citizen the right, if he is poor, to collect social welfare from the government and consume it wherever he wants? When it comes to welfare benefits, I think we should consider changing the residence principle to the home-country principle, because if we don't, there will be competition between the welfare states and erosion of welfare benefits.

Stabilization

The third big function of the government is stabilization. For a long period of time many people thought this function was superfluous because the markets are stable or governments would even destabilize the economy further. But now the general opinion is that governments might be useful after all. Only few economists denied the role of Keynesian demand management at the peak of the crisis in 2008 and 2009. Thus, there was general agreement that the one-trillion euro debt incurred by governments around the world to fight the crisis was justified. Incidentally, a further 4.9 trillion euros was granted as credit facilities for banks. These were strong interventionist measures to help the world recover more quickly from the most severe recession of the post-war period.

We economists are often blamed for not having predicted the crisis, but no one gives us credit for the quick recovery from it. In fact, the actions taken during the crisis were largely in line with the formula described in most European textbooks on macroeconomics: deficit spending. If we managed to recover so quickly, instead of repeating what happened between 1929 and 1933, it was thanks to economists.

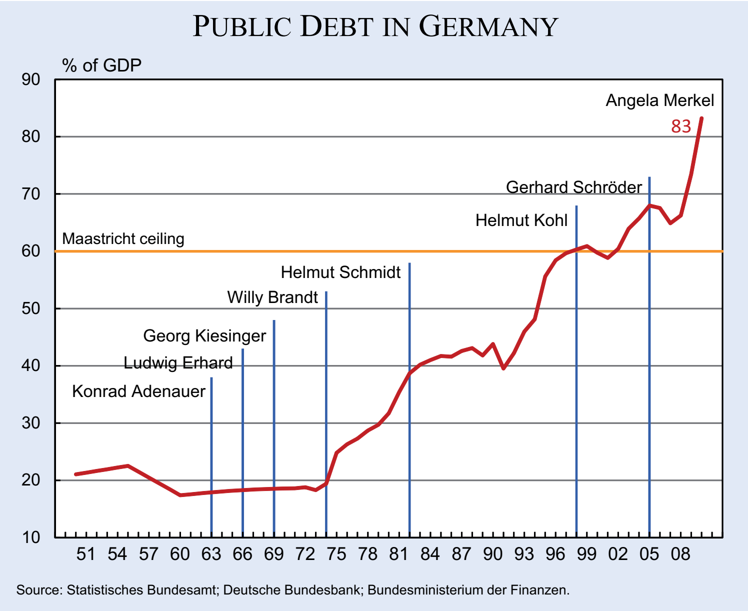
And now we have country bail-outs. The bank bail-outs cost a lot of money. It was not that the 4.9 trillion euros were completely spent; this was a facility which, to a large extent, was not made use of and is still available. That is one of the reasons why we do not have to be afraid that another Lehman Brothers will occur. These rescue facilities could easily be activated to prevent any systemically relevant bank from failing.

The country bail-outs provided liquidity, but they have also been used to shore up solvency. This is not a matter of semantics. A country can also be temporarily unable to service its debt, so it has a financial problem and requires help. This does not mean, however, that the financing of a country should continue forever. Greece has an aggregate consumption level – government and private sector combined – that is 17 percent higher than its aggregate income level – with income here being defined as disposable income, including transfers from the EU to Greece. If we continue to finance this level of consumption for a longer period, we will not be providing liquidity help. This will constitute help to maintain a living standard and to prevent insolvency, even although the country is effectively bankrupt. I said a year ago at this conference when Claude Trichet was sitting here in front of me that Greece is insolvent; I repeat that now. The longer we wait to acknowledge this fact, the more difficult the situation will become.

Public debt problem in detail

Let me now turn to the public debt problem. Milton Friedman said that with every crisis – even minor ones – government debt will continue to rise because of deficit spending during the crisis, while the reverse does not occur once the situation has improved. Figure 3 shows how the public debt-to-GDP ratio has evolved in Germany. It was 20 percent until 1970, when Willy Brandt came to power. During his government, decisions were made that laid the foundation for this enormous increase. Then came Helmut Schmidt's period, but he was just carrying out the policies of the previous social-liberal coalition. During this period, the German debt-to-GDP ratio doubled from 20 to 40 percent. Now we are at the record level of 83 percent. The curve is steeper than it

Figure 3



now saving, because its deficit is no longer 15 percent, as it was last year. In fact, if you have a deficit of 10.5 percent, you are not saving: you are increasing your debt. Spain and Portugal, in turn, have a 9.2-percent deficit.

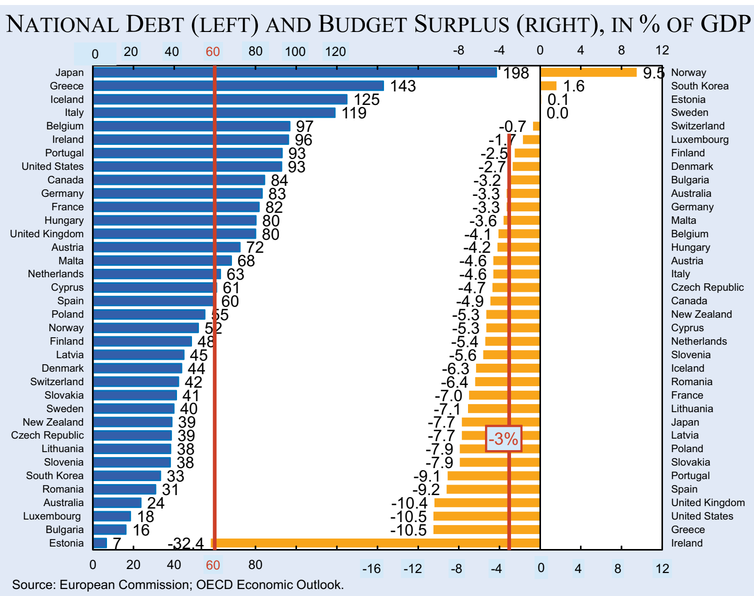
In terms of debt-to-GDP, Italy is at 119 percent, compared to the United States at 93 percent, which is rapidly approaching the 100 percent line. The similarity between the southern European countries and the United States is rather striking. The origin of their problems is also similar: the United States was, and is, living beyond its means, importing foreign capital to the tune of 5 percent of GDP per year. If you add that figure to the explosion in money supply, this is an extremely dangerous situation. The United States cannot continue in this vein year after year. Italy was a relatively good performer throughout the crisis but is now under pressure, and Germany, with 3.3 percent growth, looks good, but I will come back to that later.

has ever been in the history of Germany. Other countries are not doing much better.

Figure 4 depicts the debt-to-GDP ratio for the OECD countries at the end of 2010. The 60-percent Maastricht Treaty criterion was never taken seriously in Europe: Greece's ratio has soared to 143 percent, Ireland's to 96 percent and Portugal is about the same. Spain, despite its huge labour problems, actually looks fairly good. Looking at the deficit-to-GDP ratios last year, we can see that the 3-percent line of the Stability and Growth Pact was breached quite significantly: Ireland had a deficit ratio of 32 percent and Greece of 10.5 percent. Some claim that Greece is

The violations of the 3-percent limit are not new. Since the euro system was established, there have been 96 cases of a country exceeding the 3-percent deficit limit. In some cases this was allowed because of a recession, but even allowing for these exceptions, there were still 67 cases of breaches of the 3-percent rule. According to the original formulation of the pact, some sort of sanction should have been applied. In reality, no sanction was ever levied. This is not surprising. The 'sinners' and the 'judges' were one and the same: the judges were the Ecofin Council, and the sinners the finance ministers of Europe, members of the same council. A system of self-control will never work. This is already alarming, but the truth is that there is also a lot of hidden debt in the system that is not shown in the statistics.

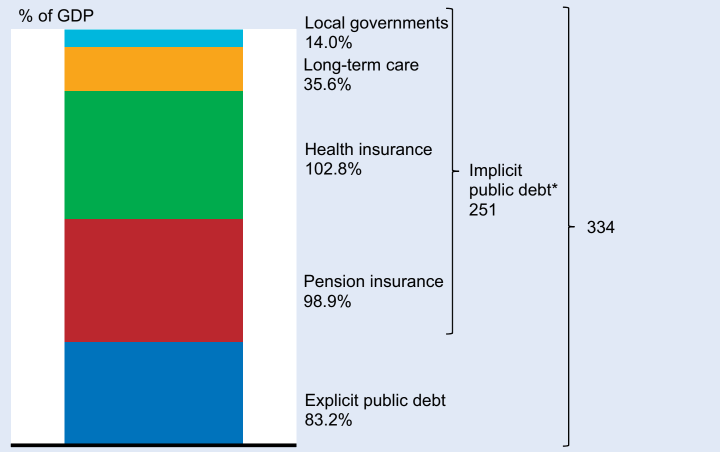
Figure 4



The deficits we referred to do not capture the whole situation.

Figure 5

GERMANY: EXPLICIT AND IMPLICIT PUBLIC DEBT IN 2010



* 2008
Source: Deutsche Bundesbank, database; Raffelhüschen and Moog (2010), "Ehrbarer Staat? Die Generationenbilanz".

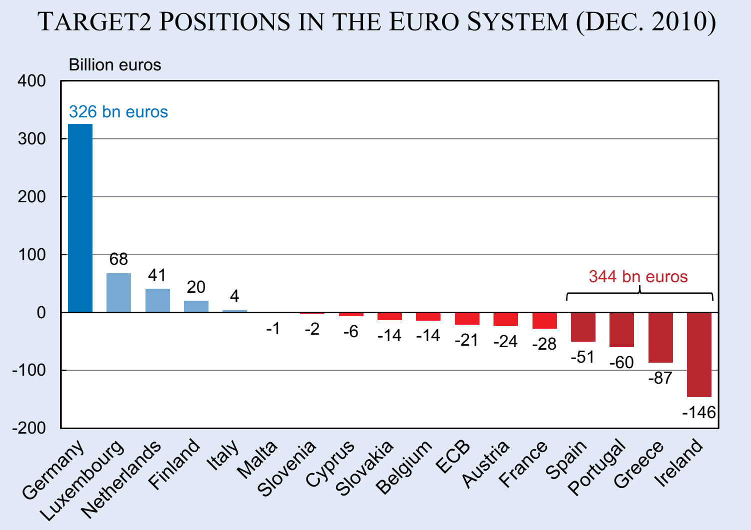
Germany, for example, had a deficit of only 3.3 percent in 2010, but if you calculate the increase in its debt and divide it by GDP, this figure is not 3.3 percent, but 12.8 percent. Why is this figure so large? Basically as a result of the bad banks that were set up to rescue the German banking system and because some so-called toxic assets were taken over by the government in exchange for government bonds. It is claimed that these toxic assets have the same value as the government bonds, so they do not contribute to the deficit. But what happens if these toxic assets have to be written off upon maturity? Would they show up in the deficits? No, by the rules of Eurostat they will never show up in Germany's recorded deficit, as write-off losses will only be counted if they occur before maturity, but no one forces the government to show these losses prematurely. No rule in Europe that refers to the deficit criterion, including the German constitutional rule recently adopted, is able to impose any limit on this sort of operation.

The next problem is the hidden debt in the social security system. Whether a person holds a government bond and the government has to pay back that bond, or s/he pays into the social security system and has a claim against the government, against future generations, this amounts to the same thing. In economic terms it is an implicit government debt. How big is this debt? In Germany the official debt amounted to 83 percent of GDP in 2010 (see Figure 5). The pension insurance debt as calculated by Raffelhüschen and Moog is 99 percent. The health insurance debt is even bigger. So it is an intergenerational transfer. When you are young and pay into the system, you implicitly build up a claim against the next generation to provide medical care for you without you having to pay for it in full at that time. This claim is a government debt for the public health insurance system. Long-term care and other obligations of local governments amount to an implicit public debt of 251 percent of GDP, as calculated by Raffelhüschen and Moog (2009) for Germany. Thus, the country's total debt-to-GDP ratio is not 83 percent, but 334 percent.

The next hidden debt item is the European Central Bank's Target debt. The function of a central bank is to create money and lend it to the private sector. During the European crisis, the peripheral countries borrowed more from their central bank than they needed in terms of currency for circulation in their respective countries. They used the funds to cover their balance-of-payments deficits. In the last three years, lots of extra euros were created in Spain, Portugal, Ireland and Greece and lent to commercial banks, which then lent them to private borrowers who bought goods and/or assets from the eurozone's core countries. The extra euros moved to the core countries, crowding out the money normally created there by way of giving refinancing credit. It was not an inflationary exercise, but it meant that part of the money circulating in Germany originated from credit in Greece. These cross-border net money flows are measured by the so-called Target accounts. If money comes to Germany *via* this route and the Bundesbank has to issue this money, because the Greeks buy goods from Germany, the Bundesbank does not receive a claim against the banking sector as is normal when it issues money, but gets instead a claim against the ECB, and the ECB in turn gets a claim against the Greek Central Bank. The Bundesbank is effectively granting loans to the Greek Central bank. In total, the loans granted by the Bundesbank to other eurozone countries to date amount to over 320 billion euros. Ireland, Greece, Portugal and Spain have also taken on liabilities. Germany's claims on the ECB amount thus to 326 billion, while the liabilities of the GIPS countries to the ECB have soared to 344 billion (see Figures 6 and 7).

The process was basically a transfer of credit through the ECB system. If a Greek wants to buy a car, he

Figure 6



Source: Whittaker, John (2011), Intra-eurosystem debts, Monetary Research, Lancaster University.

goes to the bank. The bank has no money and can't borrow in the European banking market. So what does it do? It calls the Bundesbank and says, "Please send some money to Daimler-Benz so it can deliver the Mercedes". This is a caricature, but it's basically what happened. This is how the Bundesbank's credit developed. It was zero before the crisis, because everyone thought the market would finance any current account deficits, but the markets were unable to do this. Since the autumn of 2007 the southern countries have not only received money through the markets, but also through the Eurosystem.

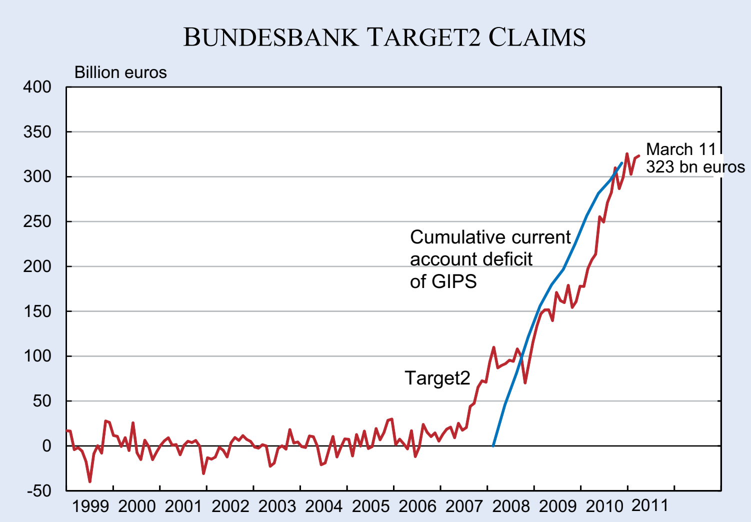
Is the EU a transfer union?

A current account deficit measures that part of the excess of imports of goods and services over exports that is not financed by gifts from other countries or other institutions. So it is the amount of capital import or external credit a country needs. Let us take the current account deficits of the peripheral countries into consideration. People say that Greece has to seek shelter under the rescue umbrella because the markets are no longer willing to finance it. This is wrong! It was not the markets that have financed Greece for the past three years; it was the ECB. And it does not want to continue doing so. Actually the ECB cannot continue this sort of financing without heavy distortions to the balance sheets of the national central banks. In fact, the stock of refinancing credit underlying the German monetary base is shrinking year by year, and the aggregate stock of refinancing credit in the non-GIPS countries in Europe amounts to a mere 180 billion euros. If they continue in this fashion for another two years, this stock of refinancing credit will be used up. Thereafter, the central banks will have to sell their gold or borrow funds from the commercial banks to sterilize the money flowing in from the periphery.

This is the reason why the second European rescue program (ESM) has been introduced: because the first bail-out system is drying out, at least in terms of the rules that constitute orderly balance sheets of the national central banks. As the ECB urged the eurozone countries to set up voluminous public credit programs for the periphery, it effectively paved the way towards a transfer union.

This is the story of Europe. Under the euro, interest convergence meant huge flows of credit to the southern countries, inflating their economies and leading to rapid growth and large current account deficits. Now these countries are too expensive and no longer competitive. That is fine if someone finances them, but the market has stopped doing so. The ECB stepped in for three years,

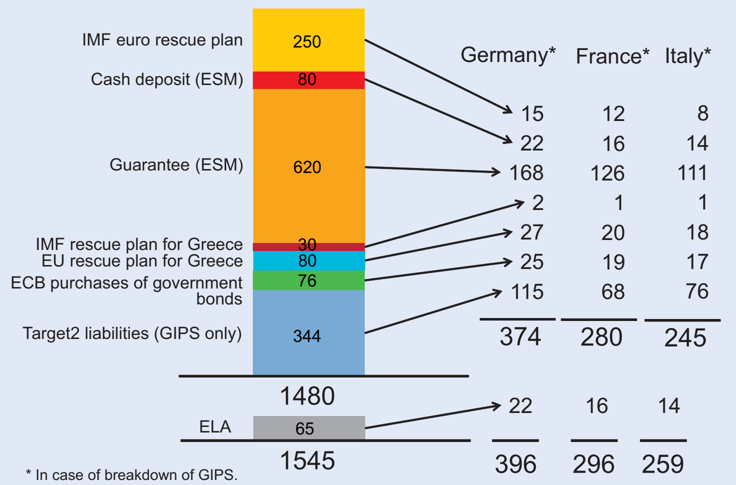
Figure 7



Source: Eurostat; Deutsche Bundesbank.

Figure 8

THE EUROPEAN BAIL-OUT FUNDS (BN EUROS)



Source: Compilation and calculation by the Ifo Institute, numbers as of May 2011.

but is no longer enthusiastic about continuing to provide credit, to put it mildly.

The next step will undoubtedly be a European transfer union, because the stock of foreign debt is growing year by year and is no longer controllable. Given the parlous state of some countries' finances, we will have to give them our money so that they can service their debt. I firmly believe that, politically, there is no real exit possibility for Europe. We will definitely go in this direction. In total, 1,480 billion euros have been committed to supporting the countries in stress (see Figure 8). If the worst comes to the worst, Germany will lose EUR 374 billion, France EUR 280 billion and Italy EUR 245 billion. Of course, this is an extreme scenario. A sovereign default will probably not occur, but what will occur are further rescue operations: a transfer union to prevent the sovereign defaults from happening.

There is no easy way out of this problem. The only solution for countries in crisis is fiscal consolidation and real depreciation achieved by cutting wages and prices so as to become competitive and run current account surpluses.

The EEAG has proposed a three-stage crisis mechanism that combines generous liquidity help with a gradual closing of the credit tap as a country moves from a liquidity to a solvency crisis. Chancellor Merkel has emphasised many times that the Greeks should change their behaviour that they should retire later and so on. I think this is the false policy approach. Rather than telling the afflicted countries what to do, Mrs Merkel should gradually close the credit tap. If the money ceases to be available, the Greeks' behaviour will change. Opening the tap, letting the money flow and then tell the countries that they cannot use it is not an effective policy; but that is essentially what we are doing in Europe with the ESM and the Euro Plus Pact.

Some conclusions

As a result of the crisis, the United States is steadily, though slowly, moving towards the European governments' share in GDP. This development is actually useful, because the United States has an underdeveloped government sector and underdeveloped social security. It would do better if the country had more social stability. In difficult times social stability is especially necessary, and without a state social security system, there could even be riots in the United States.

We definitely need a new system of banking regulations; but at the same time we need much more flexibility in the labour markets, especially in the southern European countries. Wages have to be flexible in a currency union, because within the union there are no flexible exchange rates. If we now fix wages it will be a catastrophe. Flexible wages are the only possibility for the eurozone to survive. Those countries that run current account deficits must offer cheaper labour in order to be competitive, and Germany, which has a current account surplus, has to become more expensive. Fixing the wages at the level of the bursting bubble is a recipe for disaster.

The ECB's policy of providing generous refinancing credit was defensible in the crisis – but the world economy has recovered in the meantime. What remain to be solved are the idiosyncratic problems of individual countries. These problems have to be solved with fiscal measures, and not by the ECB. My prediction is that we are now at a stage in history where we are seeing the emergence of a new European state which basically is a transfer union. I see no other way out. It is not that I want it. As an economist I strictly distinguish between a prediction and a normative statement. The only possibility that could work would be the EEAG proposal for a crisis mechanism in Europe. Last year Chancellor Merkel repeatedly said that we need a crisis mechanism, an insolvency procedure, something that makes clear how much money is available, under what conditions, and to whom it will be disbursed. But if you read the documents that are now being prepared by the EU you will see that they are only about money provisions, with conditionality to be decided later. Given this situation, there is only one conclusion to be formed: the money will be used up, we will continue to throw good money after bad, and governments will say that we do not have any other option otherwise the world will fall apart. Thus we will collect additional money and continually postpone the problem until the next government takes over. Meanwhile the problem will become bigger and bigger, and the repayment probability smaller and smaller. In the end there will have to be a debt moratorium or, its equivalent, namely an outright transfer union.

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Panel 1
Keynote Address by

ANDERS BORG
Minister for Finance, Kingdom of Sweden

Ladies and Gentlemen,

I am a little more optimistic about Europe's future than Professor Hans-Werner Sinn. To be sure, Sweden used to have the highest government share of GDP in Europe. As mentioned in the previous contribution, Denmark scores now higher, with 56 percent of GDP, followed by France (55 percent), Belgium, Finland and Sweden (all at 53 percent). In addition Sweden has a balanced budget. According to the latest forecast, the country will have this year a budget surplus of, at least, 1 to 2 percent. The reason I am more optimistic is that the European social model – the social market economy – is efficient and can adapt to the challenges of the future. I argue that if we introduce more labour market reforms and perform stringent fiscal policy in Europe, there is a good potential for the entire society to be endowed with economic growth, low unemployment and a decent degree of social cohesion.

Why is the Nordic model superior?

There are many different social models – not just one European one. The Nordic model is based on a well-functioning labour market with a high degree of unionization, but also very strong work ethics. This model is equipped with fairly high taxes accompanied by efficient tax systems. The Continental model is similar with respect to work ethics and also to fairly strong unions, but has a stronger corporate system. Thirdly, there is the Anglo-Saxon model, with a low level of tax but also a means-tested welfare system. Nevertheless, it has a very flexible labour market and weak unions. Finally the Mediterranean countries have a system with rather strong employment protection, a more rigid labour market and also a fairly large welfare state, which is, however, basically focused on retirement and pensions rather than what we have in the Nordic countries. Looking at the results, I would argue that the Nordic model has been successful, when it comes to combining high employment, favourable growth and good social cohesion: the Nordic countries have rather low poverty rates and a low degree of income inequality.

There are three reasons for the success of the Nordic countries in achieving a high labour participation ratio combined with a low unemployment rate, while in the Mediterranean countries the opposite is true. The first is that the Nordics have a strong growth culture: they are open to trade, technology and change. But they include a strong belief in rational engineering, not only with respect to manufacturing companies but also to social engineering of their welfare states. They are also societies that are based on a high degree of trust: if someone enters a business deal, it is believed that they will adhere to what they say. If people are required to pay taxes, they *will* pay taxes. And they assume that the people who collect the tax revenues will use them in a decent and efficient way. These countries have also been able to achieve a high degree of price stability and low deficits, which is important for a society's sense of stability. In addition, they also strive to uphold employment through demand policy. This is the reason why safeguarding low deficits and debt levels has always been crucial in these countries. Furthermore, their labour markets are also quite flexible, with strong but responsible unions, where wage increases are matched to productivity. And there is also a strong employment record. I would argue that there are some general lessons to be learned from the Nordics that could be applied to all countries.

Reasons for Swedish success

Why has Sweden been successful? My point is *not* that we have to abandon the social market economy in Europe. I emphasize that with limited adjustments we can make it work much more efficiently. First and foremost is the commitment to sound public finances. Flexibility is required in a crisis to restore the framework for fiscal policy. The Swedish debt amounted 46 percent of GDP when I became the Minister of Finance in 2006, and is expected to reach 36 percent this year. Such a significant reduction is not only due to good policies in the short term, but also to policies in the past instituted by the previous Social Democratic government. There has been a dramatic change in the fiscal policy framework within the last twenty years: in the early 1990s Sweden had, along with Greece, the weakest budget situation in Europe.

A particular aspect of the welfare state is that there is a strong incentive for people to leave the labour market, since a decent income is guaranteed even if they are unemployed. That means that the driving forces to re-enter the labour market are weaker. This is particularly dangerous for low-income workers: in general they do not have a promising wage career, do not love their job and so on. For them it is extremely important to have strong economic incentives. That is why Sweden has introduced an earned-income tax credit. This system is based on earned income with the purpose of reducing the wedge between being on welfare benefits and working.

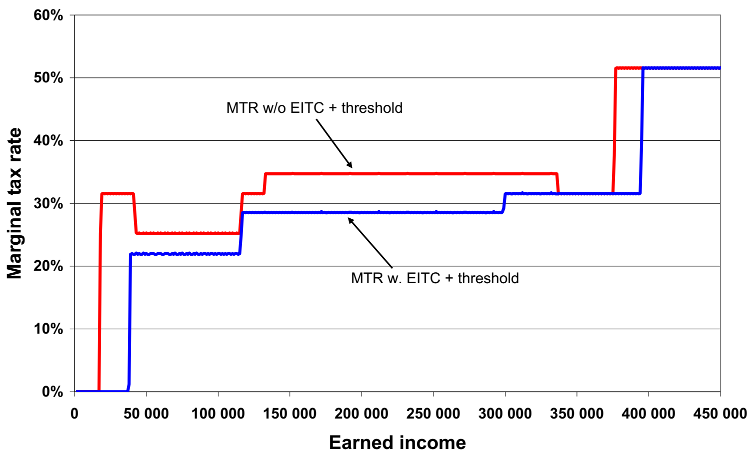
Sweden has also implemented a substantial amount of pro-growth reforms. Ownership, as we all know, is important for entrepreneurship. The wealth tax has been scrapped and the previous Social Democratic government also eliminated the inheritance tax. In addition, Sweden reduced the corporate tax rate, cut social insurance fees, and deregulated large sectors of the economy. According to the latest employment forecasts, the country expects 3-percent employment growth in the next few years. A large part of that is now coming from the social services provided by the private sector, such as private schools and private health care. Moreover, education is a cornerstone of the reform: it is essential to encourage students to move into the more sophisticated subjects as well as to improve the training of teachers and to raise their salary. Better students and better teachers in maths and in the natural sciences are two important factors that are likely to bring positive results.

During the crisis, all of the Nordic countries expanded active labour market policy measures. But the Swedish system comprises a lot of tax-based incentives. If a company hires someone who has been unemployed for over a year, it receives a double deduction in social insurance contributions: they are waived for the new employee, and the government subsidizes an additional contribution for as long as the individual has been unemployed. The social insurance contributions have also been cut in half for individuals. For household services and repairs, the tax wedge has been reduced significantly, because in those areas a wedge is particularly costly in a high-tax society such as ours. These are not huge shifts at all. But Sweden has shifted the balance towards dynamism and stronger incentives for the employable to join the labour market. This can obviously be done in any country.

Let me point out that we used to have much higher taxes in Sweden, as shown in Figure 1. If we go back ten years, the tax rate was almost 40 percent. The red line is the tax rate when I became Minister of Finance in 2006, and the blue line is the current rate. The country has cut taxes substantially at the lower end in order to provide stronger incentives to join the labour market. With a good welfare system there is a huge threshold effect. If a poor person joins the labour market, welfare benefits, as well as unemployment and housing benefits, are reduced. Thus, for rather large groups of individuals there is very little return if they decide to work. By reducing the taxes at the lower end such a system lowers the threshold effect, with very strong employment effects. According to the calculations of the Swedish National Institute of Research, the impact would be equal to a 10-percent increase in income for a female employee working

Figure 1

REDUCED MARGINAL AND AVERAGE TAX RATES IN SWEDEN



Source: Ministry of Finance, Sweden.

part-time. This is a substantial shift in Swedish tax policy. Obviously the country needs to do more: for example, the state income tax brackets rise very steeply, a problem that needs to be tackled in the future.

Sweden has also achieved a major reform of its early retirement and health care systems. Despite having one of the healthiest populations in Europe, with one of the highest average life expectancies and excellent conditions in the working environment, it also had a fairly high degree of illness. When the relevant reform measures related to labour supply were implemented, the number of working hours developed substantially better than expected. So over the last two to three years the tax revenues have considerably exceeded expectations. And the country has not cut benefits, although the OECD has always argued that Sweden needs to reduce them. Instead, it implemented much tougher administrative procedures.

What should be done in Europe?

What does Europe have to do to meet the challenge of Asian competition as well as of demographic and public finance crises? We need to make our tax system more competitive, while spending more money on infrastructure, education, research and development. How can this be done? The only solution is that more people work, while at the same time reducing transfers to the people outside the labour market. By doing so, we can strengthen public finances, introduce better conditions in the labour market and also reduce unemployment levels.

In the past, German unemployment was stuck at a high level, whenever there was a crisis. This time, however, unemployment has come down. That is the payoff from implementing substantial labour market reforms. So a stringent fiscal policy, combined with labour market reforms, is crucial. But if we want to preserve social cohesion, it is also necessary to invest in education, implement active labour market policies, and safeguard people in the labour market. This can be achieved in any European country.

The second challenge for Europe is obviously Asia's increasing strength. For me this is not a problem but a challenge. For Swedish and German companies with high productivity levels, this represents an opportunity. We can sell more trucks, more cars, and we can work more efficiently together because we have a different corporate advantage. On the other hand, it is also clear that almost all Swedish and German companies will have to adjust to efficient Asian competition. At the same time, these are countries that are spending large amounts on education, training people and providing them with high-quality academic degrees, and learning to run companies in an efficient manner.

We can choose to see this as a threat, as it is perceived in the United States, or as an opportunity. There will be 2 billion people entering the modern economy; 70 million Chinese are entering the consumer market every year. Nowadays Asia comprises 70 percent of world demand. Europe needs Asia, but in order to face the challenge we have to implement proper policies – strong public finances, labour market reforms, investment in education, and an economy based on openness. In my opinion, the conclusions are very clear: we do not have to abandon the social market economy, and we do not have to follow the US model with very low taxes and no social protection. What we need to do is to reform the way the welfare state functions today: Europe should:

- reinforce the incentives for people to stay in the labour market, especially for those with low earnings;
- encourage more entrepreneurship and dynamism in our industries, change the tax system so we do not tax ownership and corporate profits, in the same way as Sweden has done; and
- revitalize the educational system and give priority to knowledge across the entire society, as low knowledge inequality can reduce income disparity.

Panel 1

Competing Social Models in the Global Economy

Peter Birch Sørensen
Professor of Economics, University of Copenhagen

Comparing social models: changing fads

Which social model is likely to be most competitive in a globalized economy with free flows of goods, services, capital and people across borders? That question has been hotly debated for some time, and the answers to it have varied a lot over the years. Indeed, the perceptions of which social model is most successful seems to be highly subject to fads and heavily influenced by the most recent economic performance of various countries. In my own country in the 1980s, business leaders and policy makers were looking for so-called blond Japanese managerial types to run our businesses: if we could only foster entrepreneurs who could import Japanese business practices to our Scandinavian environment, and if our policy makers could only imitate the apparently very sophisticated and successful Japanese industrial policies, we should be able to replicate the strong performance of the Japanese economy – or so many people thought. Then enthusiasm for Japan evaporated with the bursting of the enormous Japanese real estate bubble in 1989–1990 which has left the country in the quagmire of economic stagnation for more than two decades now.

As the world gave up Japan as a role model for economic development, the good economic performance of the American economy during the 1990s led many observers to argue that the US economic and social model was highly fit for an era of intensifying global economic competition. But after the bursting of the dot.com stock market bubble in 2000 and the meltdown of the US financial system in 2008, it has become somewhat harder to believe in the strength of the *laissez-faire* oriented US model.

In Europe there was a lot of focus on the booming Dutch economy during the 1990s. Policy makers from other countries were flocking to the Netherlands to study the secrets of the so-called Dutch Miracle, hoping to be able to reproduce the miracle at home. But at the turn of the millennium the Dutch economy had become strongly overheated, so the economy was already starting to turn down when it was hit by the global recession of 2001. The Dutch economy had to struggle for several years to recover from this bust.

In their never-ending quest for miracles, international observers now turned their eyes on Ireland, a country which for a long time had produced truly spectacular rates of economic growth. Unfortunately the Irish growth model ended up relying on a credit-driven real estate bubble which was no less spectacular, and we all know how the Irish story ended.

For a while during the last decade, Denmark also enjoyed some popularity for our so-called flexicurity model of the labour market. The flexicurity model seemed to combine a low level of unemployment with a high degree of equality and social protection. But regrettably, we Danes repeated the mistake of the Dutch and allowed our economy to overheat in the run-up to the financial crisis, and so we were more vulnerable when the crisis struck. With the sluggish performance of the Danish economy in the aftermath of the crisis, we are no longer so interesting to foreign observers.

Instead, the revitalization of the German economy has created a renewed interest in the German economic and social model, often referred to as the social market economy. The rehabilitation of Germany as an economic role model is remarkable, considering that the German economy was widely believed to be quite weak only a few years ago.

The point of these observations is that international perceptions of the strengths and weaknesses of different social models appear to be highly dependent on the ups and downs of the business cycle. For a long time, the structural weaknesses and underlying imbalances in an economy can be hidden by an economic boom, but they suddenly stand out clearly when the business cycle takes a serious downturn. In retrospect it always seems easy to see the flaws of an economic and social model that has suffered a set-back, but diagnosing its vulnerabilities ahead of time is usually a lot more difficult. Think of the recent financial crisis: by now we economists have come up with a lot of good explanations why it occurred, but very few of us saw the crisis coming. This should make us humble when we try to identify the most competitive social models.

What do we mean by a 'competitive' social model?

Why are scholars, policy makers and journalists so keen to study alternative social and economic models? Obviously because they hope to learn some economic and social engineering that can be used to improve their own societies. However, a trivial though very important point is that policies and social structures that seem to work well in one country are often very difficult if not impossible to replicate in other countries. National economic and social policies are developed in a local context conditioned by the country's historical and cultural traditions and specific deep-rooted institutions. Moreover, policies are often complementary: the success of a specific policy may depend on whether other supporting policies are in place.

But although one country's successful policies are often difficult to transplant to other countries, it is still interesting to discuss which economic and social policies are likely to be most competitive in today's globalized economy. For this purpose I must explain what I mean by the 'competitiveness' of a social model. An individual business manager might say that a national economic and social environment is 'competitive' if it allows his or her business to survive and grow in the global market place, provided he or she is no less competent than the average manager of competing foreign firms. From a broader social perspective it is less obvious how one should define and measure the competitiveness of a social model. Any definition will be somewhat subjective, since it involves ideas about the good society about which opinions are bound to differ.

Nevertheless, I would argue that a country's economic and social model is 'competitive' if it allows its citizens to share the benefits from globalization in an equitable manner. There are several aspects to this definition. First, there are net benefits to be shared: globalization is not a zero-sum game. This may seem trivial to this audience, but the public debate often leaves the impression that if some countries benefit from globalization, others are bound to lose. This is of course wrong: globalization allows all countries to benefit from trade and specialization.

Second, my definition of competitiveness acknowledges that while a country as a whole will gain from participation in the international division of labour, globalization certainly has the potential to create losers as well as winners within the country. After all, international trade and capital flows often induce changes in the relative prices of goods, capital and labour, and these relative price changes imply a redistribution of market incomes. The Portuguese consumers of textiles imported from China or India will benefit from cheaper goods, but the competition from abroad may mean that Portuguese textile workers must either take a real wage cut or face unemployment. The challenge for policy makers is to carry out economic and social policies ensuring that all citizens receive a fair share of the gains from globalization. In my example, this may mean that the government should help the Portuguese textile workers to upgrade their skills and/or help them find employment in other sectors. More generally, a competitive social model is one that avoids the counterproductive social conflict and low social mobility that often comes with a highly unequal distribution of income.

A third requirement implicit in my definition is that a competitive social model should enable the country's average living standard to grow at a rate that is at least comparable to the trend growth rate of other countries at a similar level of development. I realize that this requirement may be challenged by raising the philosophical question whether economic growth in rich countries actually makes their citizens happier. However, just as people tend to become frustrated if they see their income lag behind that of their fellow citizens within the country, they also tend to become dissatisfied if they see their living standard fall relative to that of citizens in similar countries with whom it is natural to compare themselves. Hence it does not seem unreasonable to say that a country has a competitiveness problem if it experiences a subnormal economic growth rate for an extended period.

Are the economic and social models found in Europe 'competitive' in the sense I have described? In discussing this issue, it may be useful to take a brief look at the Chinese and American social models since competition from these countries is often seen as a threat to the European welfare states.

The Chinese model

Any attempt to characterize the Chinese social model is inherently problematic since today's Chinese society is a vast and complex organism displaying many contradictions and paradoxes. Although the strategic industries are controlled by the allegedly Communist state, many parts of the Chinese economy look like a ruthless version of 19th-century Klondyke capitalism.

Arthur Kroeber (2008) has argued that China's bureaucratic culture is what distinguishes the country from much of the rest of the developing world. According to Kroeber, China's 'bureaucratic authoritarianism' builds on a long historical tradition of governing the country through a loyal and relatively competent civil service. Despite the many stories about corruption, Kroeber argues that China's economic success stems to a large degree from the country's skillful bureaucracy.

China has been good at combining an abundance of cheap labour with Western technology to mass produce manufactures for the world market. It follows from what I have already said about the benefits of international trade that Europe and other parts of the advanced world should welcome the entrance of countries like China and India in the global economy. Adapting to the new patterns of world trade may require some restructuring of the European economy, but European consumers undoubtedly benefit from the cheap goods imported from Asia.

Yet there is at least one aspect of the Chinese economic model which may be problematic for the rest of the world. China saves an abnormally high share of its national income, leading to a massive capital export that is reflected in large current account deficits in many other countries, the United States being the prime example. If the Chinese surplus capital were systematically channeled into high-yielding productive investment in other countries, it would be all to the good. But unfortunately historical and recent experience shows that large and persistent current account deficits often lead to the accumulation of unsustainable piles of private and public debt which end up triggering a financial crisis and/or a sovereign debt crisis. Of course, it takes two to tango, so the Chinese are not the only ones to blame for the current account imbalances which rose to unsustainable levels in the run-up to the recent financial crisis and which are now building up again. Irresponsible macro policies and regulatory failures in the advanced economies are the other side of this problematic coin. Still, if we are to reduce the global imbalances that threaten the future stability of the world economy, the big Chinese savings surplus must come down.

The high household savings rate in China seems to have deep historical and cultural roots, but in part it may also reflect the absence of a well-developed public social safety network. Despite its allegedly communist foundations, the Chinese government has not managed to establish welfare programs securing sufficient public support for the elderly, the sick, the disabled and the unemployed. Hence Chinese households must undertake large precautionary savings for a rainy day. Establishing such public welfare programs would not only seem to be in the interest of the ordinary Chinese citizen; it would also help to bring down the large Chinese savings surplus, thereby contributing to a much needed rebalancing of the world economy.

In summary, copying the Chinese economic and social model or just parts of it seems neither possible nor desirable. On the contrary, China and the rest of the world would probably benefit if the Chinese imported some of the European welfare state practices.

The US model

Before turning to Europe, let me also offer a few remarks on the *laissez-faire* oriented American economic and social model. As I mentioned, many observers saw the dynamism of the US economy during the 1990s as proof of the superiority of the American model. Subsequent events have exposed some less flattering aspects of the US economic system. The American model is now in trouble, struggling to recover from a devastating financial crisis and with a sovereign debt crisis looming in the horizon. Yet history shows that one should not underestimate America's ability to reinvent itself. The strength of the US economy is its capacity to innovate, and perhaps that capacity will serve as a basis for a new era of prosperity once the current debt problems have been overcome.

However, as I see it, a major weakness of the American economic and social system is its inability to halt the long-lasting trend towards greater inequality in the distribution of income and wealth. Former IMF chief economist Raghuram Rajan (2010) argues that the irresponsible loosening of credit conditions in the run-up to the financial crisis was due in large part to pressure from politicians who were looking for a quick and easy fix to the problem of stagnating or falling real incomes for the poorer segments of the US population. Rajan points out that the US educational system has failed to upgrade the skills of a large part of the American work force to the requirements of an advanced knowledge-based economy. Hence many American workers face falling real wages and poor employment opportunities. For them the American Dream is increasingly unlikely to ever come true. Yet politicians insisted that even people who could not afford it should be granted credit to buy their own home. We all know how this subprime story ended.

Of course there were many other forces at work in the build-up to the crisis, but Rajan's story reminds us that large and growing inequalities may threaten the stability of an economic and social model. Rajan believes that the US government needs to spend more money on improving its educational system and on active labour market policies to reverse the trend towards growing inequality. Other observers argue that the American government should spend more on infrastructure investment and on environmental protection. All of this will require more public revenue, just as it is hard to see how America can solve its public debt problem without raising additional tax revenue. From an outsider's perspective, this should not be difficult. The US tax level is relatively low by international standards, and if the country were to return to the far from punitive level of income taxation prevailing during the Clinton era, a large part of the fiscal gap would be closed. Further, the United States is the only OECD country that does not have a value added tax; it does not have a carbon tax and its gasoline tax is way below any reasonable estimate of the external cost associated with fossil fuel consumption.

Yet the current majority of the US Congress seems determined to avoid any kind of tax increase, even if it takes the form of closing obvious loopholes in the tax code. But let us not be too pessimistic. As Winston Churchill once said, you can always rely on the Americans doing the right thing, once they have exhausted all other possibilities.

European welfare state models

The US economic and social model is sometimes held out as an example of the so-called residual model of the welfare state. In its pure version, a residual welfare state is characterized by a relatively small public sector, a limited degree of redistribution of income via the public budget and welfare programs which are systematically means-tested and targeted towards low-income groups.

The continental European welfare states come in different varieties, but scholars often group them into two broad categories, although no individual country falls squarely into any of these two categories. One category is referred to as the 'universal' model because it offers various social security transfers and key social services such as education, health care, child care and care for the elderly to all resident citizens regardless of their labour market status. This model involves a large public sector and a high degree of redistribution financed by general tax revenues. It is based on the philosophy that people in social need should be supported by the public sector regardless of the ability of their families to support them. The Nordic countries are usually seen as coming close to this way of organizing a welfare state.

Another archetypical European social model is the Bismarckian or labour-market based welfare state. In this system you earn your right to social security benefits by participating in the labour market. Hence benefits are tied to social security contributions, and needy individuals with little or no attachment to the labour market are supposed to be supported by their families. Families are also given a key role in the production and financing of child care and care for the elderly. Since social security benefits may well be high, the public sector is not necessarily small in a labour-market based welfare state, if you include social security contributions in your measure of public revenue, but the degree of income redistribution is less than in a universal welfare state. Germany is often quoted as an example of a Bismarckian welfare state.

In practice countries do of course mix elements from the various theoretical welfare state models. For example, in Germany needy citizens are entitled to some amount of unemployment benefit and social assistance benefit even if the benefits are not matched by prior contributions. As another example, although the Danish pension system offers a universal flat public retirement benefit on a pay-as-you go basis, an important second pillar of the system consists of the occupational fully funded pension schemes based on contributions from employers and employees. In this way the Danish pension system combines elements of the universal and the labour-market based model of the welfare state.

Some years ago when the ongoing process of globalization caught the attention of social scientists, it was quite common to argue that the growing international mobility of capital and labour would gradually force the European welfare states in the direction of the residual Anglo-Saxon welfare state model. The idea was that countries with a high level of taxation and redistribution would induce capital and high-income earners to flee the country while attracting low-income earners relying on public transfers. In this way the public finances would be systematically eroded, ultimately forbidding an ambitious welfare state policy.

There was also a widespread belief that a welfare state of the Bismarckian type would be more robust to globalization than the universal welfare state because the Bismarckian model involves less redistribution. Yet the experience of recent decades is that the Nordic countries have performed relatively well in economic terms and that globalization has not forced them to dismantle the key elements of their welfare states. In the final part of this talk I will offer a few observations on the likely reasons for the relatively good performance of the Nordic model.

The Nordic model: strengths and vulnerabilities

How is it possible for the Nordic countries to maintain such high levels of taxation and redistribution without seriously undermining the economic incentives to work, save and invest? One simple reason is that the Nordic governments have managed to keep the bases for their income and consumption taxes quite broad by international standards. This helps to keep marginal tax rates down. Moreover, the Nordic so-called dual income tax combines progressive taxation of labour income with a low flat tax rate on capital income, thereby reducing the incentive for capital flight.

The expenditure side of the Nordic welfare state budgets also helps to broaden the tax base by encouraging female labour force participation. Given the generous public provision of day care and care for the elderly and the sick, women have been freed from many of their traditional duties in the home and have found more time to participate in the formal labour market where the income they create are part of the tax base. To a large extent the production of public welfare services involves paying women to carry out the same kind of work which they previously performed for free at home.

Some critics have argued that the high rates of employment in the Nordic countries simply reflect an overexpansion of the public sector. According to this view the Nordic countries have managed to keep unemployment low only by offering an increasing number of low-productive public sector jobs to pick up the growing slack in the private demand for low-skilled labour. This is the so-called 'Scandinavian trick': instead of paying out unemployment benefits, the Nordic governments offer the unemployed a public sector salary along with a desk from which they can carry out their low-productive work.

I do not deny that you can find examples of low-productive public sector activity in Scandinavia, as elsewhere. But I don't think the theory of the Scandinavian trick provides the main explanation why the Scandinavian countries have managed to keep unemployment relatively low even among the unskilled. The fact is that public sector employees in the Nordic countries tend to be relatively well educated. In Denmark, with which I am most familiar, the average public sector worker has a higher level of education than the average private sector worker.

I rather like to think that the relatively low unemployment rates in Scandinavia are to a large extent a payoff from the Scandinavian labour market policies. The Danish so-called flexicurity model is often mentioned in this context. The flexicurity model combines liberal rules for hiring and firing with relatively generous unemployment benefits and an active labour market policy. The active labour market policy in turn combines generous public spending on adult education and training with tough demands on recipients of unemployment benefits to search actively for work even if that involves crossing geographical or occupational boundaries.

The flexicurity model is often portrayed as an implicit social contract between employers, employees and the state. Employers benefit from the liberal hiring and firing rules. Employees and their trade union representatives accept a low degree of formal job protection because the state offers a decent level of unemployment compensation and helps people to qualify for a new job by offering additional education and training, if necessary.

This description paints a rather harmonious picture of the flexicurity model. I do believe there is some truth in this vision. However, Danish economic research suggests that government training programs for the unemployed are not in themselves very effective in getting the unemployed back to work. On the other hand, a lot of research indicates that the tough demands on the unemployed to either find a job or to enroll in an active labour market program provides a strong incentive for many people to find work *before* they are recruited for some program activity in which they are not interested. In other words, the strict requirement that the unemployed be active in one way or the other seems to be an important reason for the success of the flexicurity model.

The flexicurity model does seem to facilitate reallocation of labour towards more productive uses. At least it is a fact that the rate of labour turnover in the Danish labour market is high, and the incidence of long-term unemployment is low by international standards. More generally, it appears that the extensive social safety nets and the active labour market policies of the Nordic countries have helped to ensure popular acceptance of the economic restructuring that comes with globalization. The Nordic countries have a long tradition of supporting free trade and have been good at adapting to the recent changes in the international division of labour.

However, the Nordic welfare state is based on a high level of taxation and extensive public intervention in many important aspects of life. The broad acceptance of this social model may be due to the fact that the Nordic countries have small and homogeneous populations. Historically these countries have therefore been able to foster a degree of solidarity and trust among citizens which may be difficult to replicate in larger and more diverse societies.

The Nordics do not have any historical experience with immigration on a significant scale, and that may be one reason why populist political parties with an anti-immigration platform have recently gained ground in the Nordic countries. But apart from the cultural aspects, there is also an economic challenge here: a large fraction of recent immigrants to Scandinavia come from backgrounds with no tradition of female labour force participation and with low education levels that are hard to square with the high wages paid for low-skilled labour in Scandinavia. Hence these groups are hard to integrate into the Nordic labour markets. The problem is that maintaining a high employment rate is key to the fiscal viability of the Nordic social model.

More broadly, increasing international factor mobility does pose significant challenges to the universal model of the welfare state where all residents are entitled to transfers and public services regardless of whether they have contributed to public revenue or not. Population ageing will also put growing pressure on the Nordic public finances, and dealing with this challenge in countries where the level of taxation is already very high will not be easy. Yet I take comfort in the fact that the Nordic countries have so far been quite good at implementing politically difficult economic and social reforms without throwing the welfare state baby out with the bathwater.

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Panel

The Chief Economics Commentator of *The Times,* **Anatole Kaletsky** chaired the first panel and began by describing how capitalism has evolved historically in response to new situations. As a reaction to the current crisis, a new model of capitalism may emerge with a new system of checks and balances between the market and the state where each exerts a disciplining force on the other. Europe, in his opinion, is well placed to lead the thinking for this new form of capitalism.

The first panel statement came from the Bavarian Finance Minister, **Georg Fahrenschon,** who outlined the basic principles of the social market economy. (1) Fair competition: supply and demand should be determined by prices and markets, not by government intervention. This encourages companies to improve their competitiveness. (2) Social equilibrium: a social market economy combines economic efficiency with social responsibility. It was

Germany's social safety net that helped it cushion the effects of the last crisis. Still, too much redistribution is detrimental to economic incentives. This right balance must be found. (3) Subsidiarity: the focus is on the individual; the state sets the ground rules, pursuing an 'active and activating economic policy'. In the last crisis, economic stimulus and stabilisation programmes were necessary, but they "must not mutate into permanent measures". (4) Self-responsibility: everyone must bear responsibility for their own action. Risk and responsibility are inseparable, for individual as well as for institutions. (5) Subsidiarity: 'long-term development instead of short-term success, enduring values instead of quick profits' should be the guiding principle of all businesses. One reason Germany quickly overcame the crisis was the sustainable practices of its many small and medium-sized businesses. These principles of the social market economy can be adopted by other countries and adapted to their individual requirements.

Martin Wolf, Chief Economics Commentator of the *Financial Times,* stressed that the differences among the various economic models – Anglo-Saxon, Social Market, Nordic, Southern European or Asian – should not be exaggerated. The UK economy, for example, conforms less to the Anglo-Saxon model; it is much more like continental Europe, 'in all the bad ways'. In terms of the share of public spending in GDP, Britain is very solidly in the European pack, the United States is approaching the Europeans and France is ahead of most Nordic countries. In terms of borrowing, however, the Anglo-Saxon countries are far in the lead, which does, on the other hand, contribute to the dynamism of German export markets. There is also no real difference among the models with regard to long-term performance. Also when looking at what happened in the crisis, "GDP and unemployment performance in the crisis is not model-specific". In terms of GDP, the US economy was the most resilient in the crisis and Britain performed miserably. In terms of unemployment, it doubled in the United States and productivity soared. "Britain had a very modest unemployment increase despite a GDP catastrophe", which implies that it has a very continental labour market. "The United States is out there on its own with a properly functioning labour market", and it may benefit from this in the long run. All this calls into question the existence of an Anglo-Saxon economic model.

Michael Hüther, Director of the Cologne Institute for Economic Research, listed some of the factors that helped the German labour market overcome the crisis so successfully: the moderate wage policies in the late 1990s, the recent labour market reforms, and the short-time working subsidisation scheme, all of which helped stabilise employment in Germany and put firms in a position to step up production quickly. He went on to comment that despite the converging trends brought about by globalisation and system competition, "key areas of economic activity … follow very strong national patterns and structures". However, a country's institutional arrangements are only sustainable if they are sufficiently flexible and responsive.

Neo Boon Siong, Nanyang Business School in Singapore, provided the Asian perspective on the panel topic. His government has always regarded economic growth as the key to solving social problems. After stagnant growth during the crisis, Singapore has returned to high-level growth, largely due to its flexible response to changes in the world economy. Given its small size, the country is dependent on its human capital. It is highly connected to the rest of the world and has created a business-friendly environment. The financial reserves it had built up helped it overcome the crisis. During the crisis, labour was subsidised for the first time and unemployment did not exceed 4 percent. The government also guaranteed a portion of bank loans in the crisis without intervening in banks' market decisions. Finally, Singapore's social safety net is constructed in such a way that the work ethic is not eroded.

In the discussion, **Elmar Brok,** Member of the European Parliament, pointed out that important decisions need to be made at the *European level* in three areas: (1) stricter control of national budgets, (2) a more effective stability programme and (3) improving the competitiveness of the EU countries.

Barbara Judge, Chairwoman of the UK Atomic Energy Authority, raised the question of the extent to which the female labour participation rates are a success factor of the Nordic economies, especially in the light of shrinking work forces. Anders Borg agreed that this is a factor and stressed the structural reforms in Sweden that have given women incentives to enter the labour market: eliminating family taxation, almost cost-free child care, an autonomous pension system that encourages working and a cost-effective health-care system.

Hans-Werner Sinn wondered whether Sweden's success was because it turned away from the Scandinavian model, and also why the government sector is so large in the Nordic countries. Is this not a form of hidden unemployment? Anders Borg argued that Sweden has not abandoned the model but has reformed it, keeping its core values: high labour market participation rates, limited income inequality, gender equality and openness. The reforms have placed an emphasis on welfare services, which are more efficient than economic transfers. Peter Birch Sørensen addressed the problem of the 'Scandinavian trick' of a large public sector to maintain a high level of employment. Many public sector employees are women working in the area of social services, performing tasks that were once unpaid. Theoretically, this work could be privatised and receive a government subsidy, thus reducing public-sector and increasing private-sector employment. The effect would be the same.

Michael Fabricius, Managing Director of Fabricius Vermögensverwaltung GmbH, expressed the concern that self-reliance is being weakened in Europe and that too much responsibility is being transferred to the state. He asked how Sweden managed to get the balance right between government responsibility and leaving room for entrepreneurship. Anders Borg replied that Sweden's competitiveness is ranked fairly high although the country is weak in entrepreneurship. His government has tried to improve the situation of ownership by lowering taxation. "Ownership is one of the key links to entrepreneurship" and it is a mistake to tax it too much.

Neo Boon Siong cautioned that competiveness should not be looked at in terms of Europe alone to the neglect of the dynamism of the market economy that is developing in Asia. Since the private sector behaves globally, it is necessary to view the competiveness of European companies and countries in the light of the global environment.

Panel 2
Keynote Address by

URSULA VON DER LEYEN
Federal Minister of Labour and Social Affairs

The German economy is performing incredibly well. We have a so-called 'German job miracle'. Public confidence in our economy is high, so basically I could say everything is fine now. But if we go on like this – especially if we consider social security – we will have a huge problem. If we manage to change our work patterns, we might be able to handle the problem. The challenge we are facing is demographic change. In the last 50 years the average pension term has almost doubled in Germany, from ten years half a century ago to 18 years today. In 1960, when I was born, one pension was financed through the contribution paid by five individuals in gainful payment. This figure has already fallen to three. And when I turn 80 (in 2040), there will be twice as many 80-year-olds in our country as there are today. And the ratio of people of working age to those in retirement will be just two to one. These are the well-known key demographic figures that have steered our adjustments to the pension system.

As most people know, the German pension system consists of three pillars: the statutory pension insurance, which is the strongest pillar, occupational pension schemes, and private pensions. The focus within the last decade has been to bolster the second pillar, the company pension pillar, and ten years ago the government introduced the third pillar, the so-called Riester pension, a form of government-aided private retirement provision. A particularly high number of low-income earners and families with children are already benefiting from this scheme. Contributions start from as little as 5 euros a month. With these subsidized additional pension provisions, there was a very clear message sent to contributors. And the message is: only those individuals who make additional provisions will be able to maintain their standard of living once they retire. The second message was also clear and simple: maintaining the same standard of living will not be possible on statutory pension insurance alone. That message has been understood. Half of all employees who are subject to pay social security contributions are also entitled to occupational pension, and at present the number of so-called Riester savers stands at 14.6 million, which is quite a good figure.

This was not enough, however. There had to be more reforms. If we had left everything as it was, for example, at the time of German reunification, the contribution rate would have continued to rise dramatically, up to 36 percent. So three major reforms were implemented. The first was that the pensions of those who opted out early were subject to deductions. That was fair and it reduced the incentive to retire early. The second was that the pension adjustment had to be curbed, i.e., pensions no long increase automatically in line with wages. And the third step was implementing a statutory retirement age of 67, which will be reached in 2029. In return we have limited the contribution rate to 22 percent until 2030.

As far as risks go, I think what counts is the mix of the pension system. Despite the crisis, which as far as returns were concerned was worse than originally anticipated, no company pension schemes failed and no cuts were made to private pensions. This shows that the pay-as-you-go system has its advantages if the risks are mixed and combined with a privately-funded scheme. So far the pension system in Germany appears to be demographically solid. This will all work out if there are enough people who earn a living and pay into the social security system. The huge risk is thus the development of a very dramatic trend towards a lack of skilled labour force for Germany. The key issue of the coming decades is the question: will we be able to tackle the skilled labour deficit in Germany? The shortage we face is not one of work but of people. If we fail to take action, if we do not change the patterns of work we have now, the German workforce will shrink by more than 6.5 million in the next 15 years. At the moment already a third of companies are facing difficulties in finding qualified workers.

In other words, if we fail to plug the skilled labour gap, companies will have to resort to alternative strategies. There are basically three alternatives: increase automation, which will reduce opportunities for low-skilled workers and lead to a rise in unemployed low-skilled workers. Or companies will invest less in Germany, which is also bad. Or we will have to work longer hours with the same amount of people. This is exactly the opposite of the efforts taken now to improve the work-life balance, especially for women with children. If we have to work longer hours, we will push them out of the labour market. The good news is that the skilled-labour supply can be raised considerably. If we had an extra million employees paying social security contributions, that would generate a good 9 billion euros in additional income for the German social security system, and this means approximately 5 billion euros that would go into the statutory pension system.

So the question for us is who will do the work. The largest and most important group is women. It is the largest source of potential that can be tapped most quickly. The employment rate of women at the moment is 70 percent. It has risen a full ten percent in the last decade. Despite this momentum, there is still considerable room for improvement. It will require a change in behavior and work patterns, however. More than one-quarter of the female population aged 15–65 are not employed right now, and many of them have median-level or advanced education qualifications. They are not employed because they face a huge problem reconciling work with family duties – finding family-friendly jobs, sufficient child care and all-day schools, which are not widely spread in Germany. In addition, up to 45 percent of women work part time and if we compare the numbers of female part-time workers across the Eurozone, there is an exceptionally low rate of women working full time in Germany. In terms of weekly working time, German female part-time workers work the shortest number of hours. So if we were able to increase the percentage of women who work up to 77 percent, which in Denmark or Iceland is the standard, and if we were able to raise the proportion of those working to 66 or 70 percent, we could generate up to 1.5 million more skilled workers in Germany in the next 15 years. But this would mean a huge effort with respect to all-day schools, high-quality child care and the reconciliation between work and family. We also need to see more women in managerial positions, which is why we are considering a quota. The proportion of women on the executive and supervisory boards of listed companies is only 3 and 10 percent respectively. That puts us behind Brazil, China and Russia and at the same level as India. As the OECD recently put it in a headline, "It's all about babies and bosses".

The second group is comprised of older workers. Of course demographic change means we live longer, so why not work longer? The unemployment rate of those over 55, which is the so-called 'older worker', is a good 57 percent. This is an average figure at the international level. If we were to follow the lead set by the best-performing countries in Europe, which is around 70 percent in Sweden, for example, our labour force could increase by 1.2 million by 2025. If Sweden can do it, why not Germany? Here the principal duty lies with the companies. The government just sets the framework for this issue (in contrast to women's issues). The main duty of the government was to remove disincentives. We phased out the partial retirement act, which was a strong incentive to get rid of workers early, we gradually increased the retirement to 67, and we made it more difficult to continue relying on unemployment benefits as a means of financial support until retirement, which was a kind of bridge from employment to unemployment benefits and then to retirement. But the measures to employ older employees must originate largely within the companies themselves.

The third group is young people, a very important group. Although we have improved, the number of school dropouts – those who receive no certificate – is still 7 percent. Additionally, 10 percent of all trainees quit their vocational training. Both facts will inevitably lead to long-life unemployment for those concerned. Without a certificate and without vocational training there are no opportunities on the modern labour market. It is our plan to halve these numbers. If we are successful, this will give us another 600,000 qualified skilled workers over the next 15 years.

The last step concerns skilled migrants. Germany needs migrants and the pre-requisite is a complete change in mind set: first we have to be open to the topic in order to welcome migrants. Since 1 May there is now full freedom of movement for labour in the EU. Although many were fearful of how many might come, the fact is that there are more opportunities than risks. The experience of our neighbours who have already opened their border has shown that most migrants are well trained, young and mobile. The experts from the Institute of Employment Research expect an additional migration to Germany – resulting from this movement within Europe – of 100,000 per year, which will not be enough if you remember that we need 6.5 million skilled workers. In other words we also need to recruit talent from beyond Europe's borders. And that means we will have to remove any bureaucratic obstacles facing them and of course obstacles in our minds. We need a change in our mindset and a change in the discussion about the migration of skilled workers. We have discussed migration itself but we have never differentiated between skilled and unskilled migration. What we have to learn is to be open to the world because if we are not, those talents from different parts of the world will of course go elsewhere. Being highly skilled, they have many options.

In summary, to maintain Germany's social market economy, Germany has to change its work patterns substantially and therefore the motto is: "Let's get to work".

The Role of the State in Society – Government vs. Citizen Responsibility

Giuseppe Bertola
Professor of Economics, Edhec Business School

The title of this panel may be a little misleading if it gives the impression that citizens should deal with social issues as individuals, rather than through collective institutions. Human beings, unlike some other animals, do not hunt alone or in small packs, and do not just squirrel away stocks of food to shelter future welfare from bad luck and old age. In history protection from life risks has always led to the same increasingly complex social interactions that, through markets or governments, enable mankind to enjoy a better standard of living.

Human societies establish chains of command, organize information flows and enforce property rights for the purpose, not only of organizing production efficiently but also of distributing it across individuals and over each individual's lifetime. So while the issues discussed in this panel are very topical, as there is no doubt that recent and likely future developments pose very serious challenges to the role of governments in social protection, they are also very old.

Income sharing and the nation

To identify the sources and possible solutions of current challenges it may be insightful to recall why and how governments came to play an important social protection role.[1] Historically, the largest step away from traditional sharing of income within extended families or tribes occurred with the industrial revolution. Organization of production in large firms eased division of labor and made it possible to exploit economies of scale, but also severed the blood relation and personal acquaintance ties that bound village-sized societies together. A society of city-dwelling workers required a new social texture, based on disciplined execution of simple tasks as well as on self-interested market participation. And it needed to organize transfers of resources over time and across individuals through collective schemes, as well as through the increasingly sophisticated contracts made possible by the development of stock markets, banks and insurance companies.

The same advances in communication and transport that increased the scale of production and trade also made it possible to develop cultural traits that would allow resources to be shared more broadly. Contracts that entail more than a spot exchange need to rely on legal enforcement when they extend beyond the range of personal reputation and trust. The new nations established in the last few centuries were based on more or less artificial ethnic ties, but especially on the development of cultural features common to all social classes in large geographical areas. This was a new development, as the cultural basis of previous large-scale political entities was too shallow to even establish a common language outside of the elite classes, and made it possible for industrial production to support, over the same relatively short span of history, unprecedentedly fast and broad economic growth.[2]

The socio-political infrastructure of nations not only provided a suitable legal framework for large-scale operation of markets, but also extended the scope of solidarity beyond each individual's immediate circle of family and acquaintances, making it possible to fund and administer the formal social insurance schemes needed to replace the family- or village-level safety nets destroyed by urbanization. As regards pensions, the mostly public and unfunded pension schemes of European countries reproduce at the national level the old-age support that used to be supplied across generations within families or villages. The pay-as-you-go relationship between contributions and pensions reduces capital accumulation below what would be implied if each individual had

[1] See e.g. Bertola (2007) on the origins of national social protection schemes; Foucault (1975) or Seabright (2010) on more general socio-economic features of industrial societies.

[2] Maddison (2007) estimates that world per capita income has grown by more than 600 percent since 1820, only by 20 percent between 1500 and 1820.

to provide through savings for old age: but the same would have been true in villages where adult children cared for their aging parents instead of accumulating resources for their own old age. In modern societies with looser personal ties, public schemes can in fact be more efficient than financial market contracts if individuals do not have accurate information about their future needs and current investment opportunities, and the government's ability to enforce mandatory participation can prevent individuals from free-riding on the social assistance that the government is bound to provide if they do not save enough (or do not have enough children) to provide for themselves in old age.

Europe and finance

As recent events have made clear, and as the Panel is meant to discuss as regards old-age pension schemes specifically, no solution is perfect. New problems arise from the solution offered by nations to the problem of adapting market and social infrastructure to the transition beyond agriculture and villages. In order to foster solidarity within their boundaries, nation-states cultivate not only their citizens' common cultural roots, but also the fear and hostility towards strangers that make war politically acceptable. Changes over time of the environment in which nations operate are also problematic, as the socio-economic scale that was suitable for the early mass-production stages of industrialization need not remain efficient forever: further fast progress of communication and transportation technologies, and the spread of nationalism to less developed regions of the world, undermined the socio-economic foundations of closed and imperialistic nations.

Over the last few decades, solutions to such new problems have emerged. On the one hand, in the form of a European process of supranational economic and monetary unification that was explicitly motivated by the desire to prevent further war through economic and cultural convergence. On the other hand, in the shape of increasingly sophisticated and broad financial markets that are potentially capable of engineering the transfers of resources that once took place in families and villages, and that national schemes may find it increasingly difficult to organize in an environment where trade and factor mobility undermine governments' ability to enforce mandatory contributions and taxes.

Just like other national solidarity-based programs, public unfunded pension schemes can be undermined by trade and factor mobility opportunities that, at least to some extent, effectively make it possible for income earners to opt out of supposedly mandatory taxes and contributions, by producing abroad, and for poor individuals to seek subsidies in more generous systems. A more imminent challenge to public pay-as-you-go pension schemes arises from demographic trends that, in most developed countries, call a shrinking number of working-age individuals to provide for ever larger cohorts of retirees.

Ageing is also a problem for funded pension schemes, however. In modern economies, private savings increase the stock of productive capital, rather than a hoard of accumulated consumption goods. To the extent that a smaller labor force decreases returns to investment, it also reduces the viability of funded pension schemes. From this perspective, it is unsurprising to see that defined-benefits pensions disappear even faster in the private sector than in public-sector pension reforms. Regardless of whether they are funded or unfunded, private or public, pension schemes can react to demographic trends in two ways only: by delaying retirement, and by adapting old-age benefits to longer survival probabilities.

Ageing internationally

Life expectancy does not only vary across generations within the political and cultural boundaries of nation-states. It varies with socio-economic conditions within generations, and within countries and cities.[3] And its generational dynamics are rather different across countries, making it at least potentially possible to seek international solutions to national pension problems. Just like in early industrial societies old-age support could not be provided by families, nations where a shrinking labor force challenges both public and private retirement schemes may need to rely on globalized economic interactions.

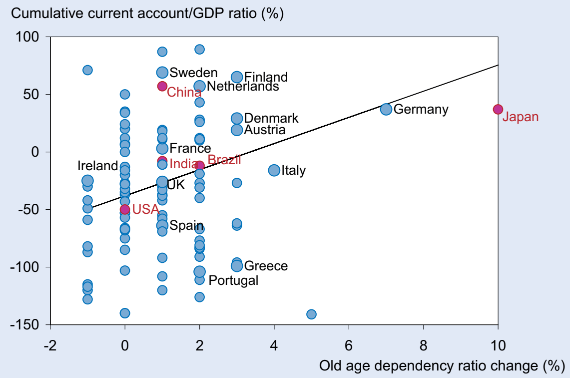
Figure 1 reveals two interesting and relevant facts. Between 1999 and 2009, Germany has been getting older faster than any other country but Japan, and has accumulated one of the largest current account surpluses among industrialized countries. This country-specific observation lines up neatly in the figure

[3] For example, life expectancy decreases by roughly one year per Tube stop along lines than run from Central London to the East End: see http://eurohealthnet.eu/research/health-inequalities/health-differences-europe.

Panel 2

Figure 1

RELATIONSHIP BETWEEN CUMULATED CURRENT ACCOUNT AS A SHARE OF GDP AND OLD AGE DEPENDENCY RATIO CHANGE, 1999–2009



The line is an unweighted least squares regression estimated on all data available from the World Development Indicators. Dots plot all observations with cumulated current accounts between -200% and 100%.
Source: World Bank.

with the strong and statistically significant relationship, across all countries with available data, between cumulated current accounts and changes in old age dependency ratios over the last ten years. For countries that need to provide for their ageing citizens, it is very sensible to consume relatively less, and to invest their savings in countries where young workers will remain relatively abundant over the relevant time horizon.

As usual, there is no perfect solution: international opportunities come with international pitfalls. The savings that German society entrusted to its banks were invested in the liabilities of countries that had less severe ageing problems and were also growing fast, such as the United States of 1990s productivity miracles, and the EU peripheral countries that had been catching up since their accession in the 1990s. Past performance, as usual, does not guarantee future returns. Hopes of reliable repayment waned as the recent crisis made it doubtful that the United States could rejoin its past growth path, and made it certain that Greece will be unable to replicate the 30-percent real per capita GDP growth it experienced between 2000 and 2007.

While disappointing international investment returns may lead some to advocate a return to earlier nation-centered configurations of socio-economic relationships, more likely developments can be identified analyzing the problems that emerged during the crisis for the European Union and financial development solutions to the problems of nation-based systems. Unification of markets, and then of monies, has been meant since the 1950 in order to prevent further wars between European nations. The process was enlarged in the 1980s to countries burdened by a history of colonial or imperial rule and fascism, and then to Central and Eastern European countries that had experienced Soviet domination, aiming to foster their cultural and economic convergence by adoption of *acquis communautaire* good government practices and of a market-based economic framework. The acceleration of financial development was also meant to address the real problem of matching, in better ways than those of families and governments, the diverse investment and savings of individuals and countries interacting in increasingly complex and open economies.

Just like those who invested in innovative financial products expressed faith in the power of diversification, those who bought Greek debts purchased a stake in that supranational European project. The financial and economic crisis of 2008–09 showed that diversification is powerless in the face of aggregate shocks; that macroeconomic shocks can undermine confidence in private and public debt repayment by slowing down prospective growth of incomes and tax revenues; and that default can occur and spread as loss of confidence drives unsustainable default premia into debt service ratios. It did not show that that development of financial markets and supranational institutions caused any of these age-old problems: rather, it indicated how further evolution of those welcome developments may make future crises less severe.

Beyond the crisis

Financial markets will need to be better regulated internationally, within Europe as well globally. And Europe will need to move further beyond its past national configuration, because it would be poorly equipped to compete with such multi-ethnic continent-sized entities as China and the United States if social cohesion and political consensus still needed to rely on recent and sometimes artificial feelings of national solidarity.

The European economic integration process was always meant to extend solidarity beyond the borders of previously belligerent nations. This is not easy, of course, and fiscal and social policies have so far remained assigned to national governments. Just like renouncing monetary sovereignty was necessary to ensure that European market would be stable and large enough to allow the large-scale investment and production of modern technologies, however, social policy and income transfers will ultimately need to transcend the boundaries of the nations that existed in Europe over the last few centuries. The scope of collective policies cannot be very different from that of economic interactions made possible by the progress of communication and transportation technologies. Every society needs a system of income transfers and public debt service, while part of that system in a closed economy, needs to rely on tax revenues that in an open economy can quickly disappear as economic activity moves elsewhere.

It is for this reason that in the United States most states are legally bound by balanced-budget rules,[4] and the Federal government backed public debt since the very beginning: as George Washington wrote in 1793 to the House of Representatives, *"no pecuniary consideration is more urgent than the regular redemption and discharge of the public debt: on none can delay be more injurious, or an economy of the time more valuable"*.

In Europe, the Maastricht Treaty's debt and deficit constraints aimed at addressing much the same problem as state-level balanced budgets in the United States but could not be enforced while national governments retained all fiscal policy powers and all political legitimacy. Unfettered economic integration, however, is logically inconsistent with subsidiary fiscal powers. If factors and goods can move freely across the boundaries of fiscal constituencies, tax bases will ultimately be too elastic to support income redistribution and issuance of public debt for tax-smoothing purposes.

Just as in the United States and other large Federal countries, fiscal union will be the solution to the problems made evident by the current crisis. Not a perfect solution, of course, and fraught with new pitfalls. But certainly a better development than a return to closed national economies unable to support economic progress, and a feasible one if elements of fiscal and social union will be accompanied by the development of that common political culture which would support restraints on national government powers, and complete the process which, in the aftermath of World Wars, envisioned economic union as a means to a cultural union end.

Extraordinary changes are needed, and possible in the aftermath of a crisis that brought about unprecedented coordination of macroeconomic policies not only at the global level, averting the danger of a new Great Depression; but also at the intergovernmental level in Europe, averting the danger of sovereign insolvency and financial meltdown. Recent institutional developments in Europe combine the relevant ingredients (extended solidarity as regards public debt management, and shared responsibility through policy monitoring and coordination as regards old-age and social policies) with political concerns that still make it difficult for countries to help each other financially, and to accept supranational coordination. The Franco-German proposal to enforce by intergovernmental methods a coordinated increase of retirement age and harmonization of corporate tax bases in the euro area was met with considerable skepticism in Spring 2011. Only a rather loose 'Euro Plus Pact' was annexed to the March 2011 European Council Conclusions, whereby common objectives should be 'politically monitored' by Heads of State or Government and the European Commission should agree with EU member countries the sustainability gap indicators for pensions, health care, and social benefits. The regulatory framework that would make it possible for private financial markets reliably to fill citizens' old-age protection needs is also hard to implement and enforce supra-nationally.[5]

The future and the past

While the shortcomings of financial markets and of economic union without political union have been very apparent in the current crisis, socio-economic institutions will certainly evolve further. It would not be constructive to lament the demise of national system or advocate a return to those or other obsolete organizations. Rather, it may be useful to remember that nation building processes went through much the same difficult steps as Europe is called to climb.

The boundaries of the German Empire and of other national entities were established by wars, by 'blood

[4] See e.g. Bassetto and McGranahan (2011) for institutional information, theoretical considerations, and empirical evidence.

[5] The European Commission's 2010 Green Paper on pensions COM(2010)3765 notes that there are substantial gaps in EU-wide regulatory aspects and advocates a EU role in 'surveillance, coordination, and mutual learning'.

and iron' in the words of Bismarck, who quickly proceeded to cement national solidarity through provision of social protection. The process that is leading to Europe's further unification is peaceful instead, indeed rooted in the desire to prevent further wars among Europe's peoples. Its steps, however, do resemble closely those of the process that over some 50 years in the nineteenth century led Germany to economic before political unification,[6] and certainly fostered doubts similar to those that many now express about Europe's integration process. Political consensus can no longer be based on national identities when economic and social interactions take place either at sub-national levels, or globally on the internet. Abandoning the euro would make no more sense than re-adoption in German regions of pre-Deutsche Mark currencies, as might yet happen if Landesbank losses caused by an unlikely (but still possible) collapse of the single European currency proved difficult to manage within Germany's federal fiscal system.

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Panel

Panel Chair **Robert Thomson,** Managing Editor of *The Wall Street Journal* and Editor-in-Chief of Dow Jones, had an optimistic and a pessimistic view on ageing. The optimistic view is that most of the people attending this Summit will grow much older than at any previous time in history; the pessimistic view is that they will be unaffordable. Actuaries, he quipped, have therefore become very fashionable. To put a figure to the pessimistic view, he quoted a couple of statistics: by 2035, two-thirds of every federal tax dollar in the United States will go to state health care and pensions. In New Zealand, the number of people over the age of 85 has trebled over the past 30 years. The challenge, then, is sizable – and growing.

The first panel speaker was Bavarian Economics Minister **Martin Zeil**, who started by quoting Ludwig Erhard, the father of the social market economy and of Germany's 'economic miracle': *a good economic policy is the best social policy.* And that is exactly what Mr Zeil believes every country needs in order "to put [its] social system on a firm foundation for the future". The main task of an effective social policy, he said, must be to strengthen the performance of the economy in the face of global competition by supporting innovation, education, efficient infrastructure, transparent regulations and a sound energy policy. But at the same time the state must continue to be the guarantor of social security. People in need should continue to be entitled to transfers through the basic allowance scheme, which in Germany is "in principle a sensible combination of due solidarity and the incentives necessary to re-enter the labour market". It has contributed to an increase in employment by providing more incentives to take up a job and reducing calls for a minimum wage. "We are building on more personal responsibility and more self-reliance, for it is definitely not the task of the state to guarantee all-round insurance". This has also brought Germany one step further along the road to adapting the social security systems to demographic change.

Mr Zeil was followed on the podium by **Aigars Štokenbergs,** a former Latvian Minister of Economics who is now Minister for Justice. Given that the economic and demographic situations differ, he said, "there are no one-size-fits-all solutions". For instance, Latvia's raise of the retirement age from the current 62 to 65 by 2021 may sound modest, but life expectancy in his country is somewhat lower than elsewhere, with 13 survival years for men and 20 for women. The country has undertaken a number of other reforms of its social security systems, including raising the number of years to qualify for a minimum pension and reducing some contributions to the disabled and to working parents. But not without hitting some snags: some measures were overturned by the Constitutional Court, forcing a repayment of the benefits that had been slashed. But his country remains ambitious: it wants to reduce its budget deficit to 2.5 percent of GDP in 2012, with a view to fulfilling all conditions to join the eurozone in January 2014. As regards the future, from a social standpoint, he mentioned a min-

[6] The pan-German Zollverein and Münzverein closely resembled the process of market and monetary unification in post-war Europe. As in Italy, monetary union occurred in Germany at the same time as political unification; in older nations, such as France, political union preceded the monetary reform process necessitated by the industrial revolution in the 19th century.

ister in the Norwegian government who had just become a father and who is taking parental leave as a result. *That* is the kind of future way Mr Štokenbergs wants for his own country as well.

The last speaker was **Kurt Biedenkopf,** a former Minister-President of Saxony. In the 1950s, he said, with the country recovering from the war, Germany defined the social function of the state as helping citizens to help themselves. If they should be unable to do so, they would be supported by the state for their basic needs, but not beyond. In other words, the state should not become a nanny to its citizenry. Now, fifty years later, a wealthy population has come to expect more expenditure by the government on social security, but we are now in a situation "where it is necessary for the people to relieve the state of some of the promises it has made, by providing more for their own future". This requires a cultural change, but that cannot be achieved by political fiat. Social systems, after all, have deep cultural foundations. Furthermore, "we have no experience with an ageing society. We have never had one in history". It is likely that people will have to work for as long as they live, or as long as they can, with 'the 70-year-old taking care of the 90-year-old', while the working population finances the younger retirees. We will need more personal solidarity, more mutual support in the community. But given that the elderly will command many votes, there is the risk of the elderly pushing laws through that will oblige the young to pay for what they decide they need. A backlash would be likely.

During the ensuing discussion, Mr Thomson asked whether there should be a distinction in the retirement age between people who do administrative work and those who do heavy manual labour. Mr Bertola settled for '60'. "Given that after 60, in some trades you cannot do the same work you did before", he stressed that what is important is that the opportunity must be open for those reaching that age to do something equally useful.

Mr Štokenbergs argued that we should think about 'integrating the elderly into work'. A simple calculation, he added, says that people spend 20 percent of their lives in their formative years, 20 percent in retirement, and 60 percent working. If they live longer, the equation should also change: it now means *we simply have to work longer.* Retraining would play a big role in keeping people in occupation.

Mr Biedenkopf pointed out that retirement age is a fairly new concept. When it was introduced in Germany in the late 19th century it was 70: "none of the workers secured ever reached this age". A better way would be to set an age, say 65, after which the government will cover your basic needs, and if you continue working beyond that age, your retirement payment increases, as if were capital-based. This would eliminate the need for the government to prescribe the retirement age. People would have an incentive to decide themselves how long they wish to work. "Retirement age will not be very stable in future", he predicts.

Mr Bertola added that the approach must be two-pronged. On the one hand, giving people who want to continue working the chance to do so, and on the other, take account of the differences in life expectancy. As an aside, he also pointed out that retirement age is handled as a nationwide issue, when in fact "moving east from central London, life expectancy decreases by one year every Tube stop". Mr Biedenkopf immediately retorted that "this is one additional reason why the government should not prescribe a particular retirement age".

Mr Thomson then threw a provocative question to his panellists: "do you think people in Portugal or Greece retire too early or have too many holidays?" Mr Bertola approached the answer from an angle: "the feeling in Germany, as I understand it, is that if you have to bail out a country for the unsustainable promises it made to its own people, then the promises must be changed". Mr Štokenbergs, in turn, said that the key issue is not how many holidays they have, "but how well prepared people are to take on the challenges of the modern world".

Mr Biedenkopf concurred. Compared to the situation of 50 years ago, he said, Germans have now 52 additional holidays just by not having to work on Saturday. "This is perfectly alright. Holidays by themselves are not an expression of whether countries are lazy or productive. If the productivity of a country is such that it can produce what we all need in four days, then the holidays would be three days per week". We would first have to look at the productivity of the countries where these holidays are earned. If the Portuguese want to have the number of holidays they have, let them have them. "But they should not pass on the cost of their holidays onto others".

Panel 3
Keynote Address by

Rainer Brüderle
Chairman, Free Democratic Party (FDP) Parliamentary Group, German Bundestag;
Former Federal Minister of Economics and Technology

You invited me as Minister of Economics and Technology, but today I am here as Chairman of the second largest government group in the Parliament, which means I will be able to speak more freely.

I will start with the currency issues. The euro member states are currently struggling to find a good solution for some of its 'problem children' in the South and on the island. We are talking about soft refinancing, extending the duration of loans and adapting the loan conditions. Everybody agrees that it should be soft. This reminds me of the 'gentle birth' services of a midwife. In 99 percent of the cases it works fine, but most parents prefer a hospital with a paediatric intensive care ward. Professor Sinn expects a significant haircut. Mr. Peet's Economist has already outlined a refinancing scenario, with realistic numbers. The German federal government is working hard to avoid a miscarriage, as Professor Sinn and Mr. Peet fear.

Now to the panel topic of subsidiarity versus centralism. The euro countries have established a fund called ESM – the European Stability Mechanism. This is a centralistic instrument and I was in favour of it from the start. Europe should be in a position if necessary to help itself. I am convinced that we need an ESM but it also needs to have teeth. And here we come to the various levels of subsidiarity.

Subsidiarity requirement number one: the problem countries should only get money if they increase their competitiveness and they need to do their homework: privatisation, social reforms, liberalisation. Otherwise the ESM will not give anything.

In Germany we secure this with the second subsidiarity requirement: the right of parliament to decide. In Germany, emergency aid should only be granted if parliament agrees. The power over the purse is an elemental right of parliament which we will exercise responsibly.

This brings me to the third subsidiarity requirement: we need an insolvency regulation for countries. The private creditors must be involved sufficiently and the liability principle must be guaranteed. We cannot only pick out the positive things. A market economy carries with it chances but also risks, and with risks you must also be prepared to take the consequences. To put it bluntly, pocketing the profits and passing on the losses to the general public, the taxpayer – this can and should not be the rule. It can also not be the aim to balance out all inequalities in the market economy. This would eliminate the innovative force of markets and competition. It would punish performance and expropriate the successful.

This takes us to subsidiarity requirement number four: the treaty for more competitiveness, the Euro Plus Pact, should not be the nucleus for an economic government according to French example. We do not need a political counterweight to the European Central Bank; we will not move Europe forward with a pan-European corporatism. We must see to it that the ECB shifts from the crisis mode back to normal operations. The ECB must not continue to purchase government bonds. On the contrary, the ECB must again put its house in order. I am optimistic that the candidate Mario Draghi appreciates the independence of the ECB. To me he is the most 'Prussian' Italian I have ever met.

As Professor Sinn mentioned, I do not agree with politically determined export quotas. In a market economy you cannot correct international flows of goods politically. Demand and supply determine the direction and the speed. German cars, chemicals and machines are bestsellers in India, China and other parts of the world. Our export strength also benefits our trade partners, our European neighbours. Before we export, we import considerable supplies to start with: 100 euros in exports already contains 40 euros of imports. So we also pull our European neighbours up with us. The German export strength is the engine of European development. With the calls for increases in domestic demand in Germany, we must not forget this. We do not need a fixed target for our current account. Our companies are competitive on their own. The innovation and performance range of the companies determines their success on the world markets. The companies know what they are doing, they have good ideas and they are far-sighted. Europe would not be helped if Germany became less competitive; Europe would be helped if others became more competitive. The Euro Plus Pact only makes sense if it is understood as a benchmark. The weaker will learn from the strongest so that we all will become stronger and more successful. That is the point. The member states make a commitment to make reforms themselves. This means responsibility and subsidiarity are taken seriously. The participating states take efforts to improve competitiveness, employment and to strengthen the sustainability of public finances and to bolster financial stability. This should ensure that a sovereign debt crisis will not even emerge in the future.

China, India and Brazil are not waiting for Europe. If we want to continue to be an international player, we must position ourselves competitively and in Europe this is only possible if we rely on a market economy. A market economy depends on decentralised decisions, market prices and competition must determine what happens. As in football, you need a middle field, but if everyone wants to play there and everything is decided there, the team is easily paralysed. Dynamic teams do not function exclusively on a centralistic basis. A team must be good in the forward and defending positions as well. This is should also be the case in Europe.

Panel 3

The Role of the State in the Economy: Centralisation or Subsidiarity?

Jeffrey D. Sachs
Director of the Earth Institute, Columbia University, New York

The topic of the panel, the topic of the summit – the role of the state – and this panel the role of subsidiarity is extremely timely, obviously, both for Europe and the United States. Both the European Union and the United States are in a state of crisis right now. The crisis has different features in our two zones, and analysing it – contrasting the features of the US fiscal system and role of the state and the counterpart in the European Union – is, I think, extremely helpful. In the United States we are facing a chronic budget crisis and an undersupply of public goods. Europe is facing a crisis of a starkly divided Europe and the inadequacy, in some ways, of the European-level institutions to address that sharp division.

So let me turn first to the United States and offer some brief thoughts. The United States right now is in a crisis of the state. In my view a crisis of chronic undersupply of public goods – infrastructure, education, healthcare, help for the poor, help and financing even for diplomatic and international development initiatives – and that undersupply of public goods is creating a certain kind of rot in the US economy and society right now. We are not supplying the public goods to narrow income inequalities, to help the poor escape from the cycle of poverty, to ensure an adequate level of healthcare, education, family care or day care for young children that the normal high-income society would produce. The United States has become more unequal in income and wealth than at any time in US history. The redistribution of income from the super-rich to the working class poor is very limited right now, and there are extremely stark ideological divides and differences of opinion about what to do.

I would put it this way: the United States is essentially the lowest tax revenue country within the high-income world, within the OECD high-income countries, when you measure tax revenues as a share of gross domestic product. The United States, including federal, state and local government revenues, is now collecting about 31/32 percent of GDP in revenues, even significantly less this year because of the business cycle. And that is far below the European average of 40 percent of GDP, and, of course, far, far below the levels of northern Europe, which reach nearly 50 percent of GDP or even higher in some countries. The United States is chronically, from a social, ideological, political-organisational point of view, an anti-tax society – the whole country was born in an anti-tax rebellion – and US federal tax paid as a share of national income has been fairly constant, about 18 percent of GDP over nearly half a century. State and local taxation has risen gradually and very modestly to perhaps 10 or 12 percent of GDP, leading to this overall level of roughly 30 percent of GDP in tax take.

We cannot run our society at this level but the public does not really know it, unfortunately. Our federal taxes are completely eaten up by the military budget, Medicare and Medicaid in health, Social Security, and interest payments on the debt. All the rest of government at the federal level, whether it is infrastructure, education, energy, agriculture, diplomacy, international assistance – that is all on borrowed money now because we don't raise enough revenues actually to run our government. Yet politically the Republican Party is essentially 100 percent organised around further tax cuts. The Democrats are more or less organised around holding things where they are, and almost no one is telling the truth to the American people that you cannot run a modern society at 30 percent of GDP in total revenues. That is the American crisis. In terms of the division of those revenues, the federal government is collecting, as I said, about 18 percent of GDP and the state and local governments about 12 percent of GDP in revenues. So they are divided roughly two-thirds at the federal level and one-third at the state and local level. I think, from a division point of view, that is probably OK. I'd even like to see a bit more at the federal level, because the states themselves are engaged in a race to the bottom right now, where they are each trying to cut their taxes to try to attract business from their next-door neighbours. That kind of race to the bottom is, of course, a classic prisoner's dilemma where each of our state-level government decision-makers is operating in a game that is leading to a loss of revenues for all of the states and inadequacy of public goods provision that is being exacerbated by that race to the bottom.

Now the US system from a subsidiarity point of view has the fairly desirable feature that first there is lots of mobility within the country and there is a fair amount of redistribution of income through the federal tax system – partly it is direct taxation at the federal level that is directly redistributed to state and local governments in programs like Medicaid, part of it is the play of automatic stabilisers, where when one part of our country has an economic decline its tax burden goes down automatically while the receipts of federal moneys go up in unemployment compensation and so forth. So we have a fairly good internal redistribution system both through migration and the fiscal system, but the crisis is that the overall level of public revenues is chronically too low and the American society, in my view, is sinking as a result of this. We are simply losing the bottom half of the population, which is not getting the healthcare, the skills, the infrastructure and the environmental safety it needs. And the whole world is paying a price when the United States is unwilling to invest in sustainable energy and climate change, in global poverty reduction and so on.

On the European side, at least my view looking from outside in, is that the overall levels of taxation – averaging about 40 percent of GDP and going up to about 50 percent of GDP – are far better than the United States. I don't think Europe is overtaxed, despite the usual assumption. I think the United States is undertaxed, and I hope Europe preserves its tax base. Europe's problem, it seems to me, if you compare it to the US system, is that Europe collects all its taxes at national, state and local levels and very little at the European-wide level through the assessments to the European Union. So if you take the EU or the euro area as the analogy to the US federal level, then the EU has a budget of about 1 percent of the gross product of the EU, I understand, and that means in effect there is no significant collection at the European-wide space. And I think Europe pays a price for this, quite predictably. When the euro was established, something I strongly supported then and continue to support now and believe in, I published a paper at the time that said Europe is obviously not an optimum currency area, even though it is interconnected economically. Migration levels are rather modest and fiscal policy is national, not European-wide. There are not automatic stabilisers European-wide; there are not cross-country transfers European-wide; there is no mechanism for bank bailouts European-wide. And of course Europe is living through that drama right now. It does not really have an effective response today to Portugal, Greece, Ireland – Spain to some extent, although I am more optimistic about Spain.

When a part of Europe, especially the southern tier or Ireland, gets into a deep crisis, this is borne entirely – I think it is fair to say – at the national level. The most Europe has done is to give some fairly short-term loans. But there is no fiscal remedy, and migration, which of course should be a part of the solution, exists but is rather moderate. So my take on the European side, simply put, is that the overall level of taxation is much smarter than in the United States because Europe can run a civilised economy, one that has social security, one that makes transfers to the poor, one that ensures coverage of healthcare, one that ensures better quality of public education and more access to higher education, one that actually delivers more social mobility in Europe than in the United States these days according to all of the OECD findings. So don't slash taxes for the US liberal model. We don't provide the public goods we need to hold our society together. But do find a way, in my opinion, to bolster the role of the fiscal system at the European-wide level so that there can be more automatic stabilisers, more cross-country transfers and more ways to resolve these sharp crises that arise when the poorer and more vulnerable regions of Europe fall into crisis, even as the heart of the European economy, especially Germany and northern Europe, are doing quite well. It's kind of a convergence argument in a way.

I'd like to see the United States be more like Europe, especially more like northern Europe, and I'd like to see Europe be a bit more like the United States of Europe – the famous idea – in terms of acting like a somewhat more unified fiscal space to go along with the unified monetary area and the unified single market. I am a huge fan of what Europe has accomplished. I think it is the best model of regional integration in modern history and for the world. And I think it needs to continue to be in the forefront and adding that part at the European-wide level in my opinion would bolster the great results that Europe has achieved in its modern history. So continue to be a role model for us in the United States. Eventually we will learn something about being civil even to our poor people, and we will learn that taxes are not the bane of civilisation but the key to it. And I hope that together then the North Atlantic can be a dynamic role model for the rest of the world economy rather than two regions holding on for dear life as we watch China and India and others soar.

Panel

John Peet of *The Economist* chaired the third panel and started by drawing two conclusions from the conference thus far: (1) the size of the state is probably too large but because of demographic pressure it will not be possible to shrink it very much, perhaps only to 40–45 percent of GDP; and (2) Europe has a very low productivity growth which underscores the importance of making our public and our services sectors more productive.

The first panel speaker was **Norbert Reithofer,** CEO of the BMW Group, who stressed the role of governments in ensuring that "we have the freest possible markets with few trade barriers and world-wide fair competition on a level playing field". Promoting new technologies, such as e-mobility, is an important joint task of government and business.

In the opinion of **Dennis M. Nally,** Chairmann of PWC International in New York, "we all have an interest in making sure that free-market capitalism works properly". Despite the different models, we all share one core assumption: "the private sector and not the state must be the primary engine for economic expansion". Many issues, like trade, currency, financial crime and the climate, can only be dealt with at the international level. These issues should be addressed not only by governments but also by businesses: "business has to maintain a more central role in sustaining the market system and improving its performance in society as well".

The problems of the banking sector in Britain were described by **Lord Oakeshott of Seagrove Bay,** Liberal Democrat Member of the House of Lords. Making banks safe is vital for the future of the British and European economies. The banking system in Britain is so large "that it dwarfs the rest of the economy. To compete with New York, Frankfurt and Zurich, Britain unfortunately ended up with a 'light touch regulation' of the banking sector". Britain now has a very distorted economy with a huge financial and a small manufacturing sector. It is the job of the state to curb the power of the banks.

Rolf Alter, Director for Public Governance and Territorial Development of the OECD, asked whether we have taken advantage of the crisis to re-establish the balance between government and markets. We need to look not only at government size but also at its quality, which is a matter of how government interacts with citizens and with business. Europe also needs to look beyond its borders, especially at the dramatic developments in North Africa and the Middle East. In terms of government quality, the OECD with its 34 member countries strives to be a 'club of good policy practices'.

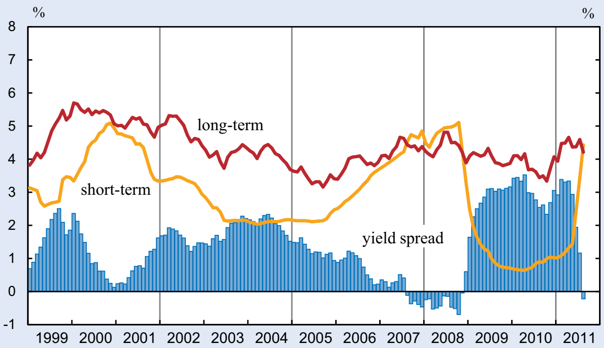
The last panel commentator, former German MP **Friedrich Merz,** stressed that our problems need to be solved at the European level. The EU Internal Market has been a great success, with the EMU as the next logical step. The promise of a stable currency has been kept, but the promise of a political union is still outstanding, and it is precisely the current crisis that is showing is the 'lack of political integration in Europe'. There are consequences of this deficiency. (1) ESM will only buy time, in which a 'restructuring mechanism' for states in the EU must be devised. (2) Competitiveness must be improved, but within a Europe with a stronger political union.

In the discussion, Mr. Peet asked about the acceptance of a 'transfer union' in Germany. Friedrich Merz replied that Germany has benefitted from EU developments in the past twenty years. Since much of Germany's wealth depends on the euro, it is obliged to help the troubled countries. This requires a sort of transfer union in Europe, which must be properly constructed. Hans-Werner Sinn replied that it is a 'false assessment' to say that Germany gained most from the euro. The euro has helped Europe in general including Germany, but under the euro capital flowed out of the country into the European periphery, "while Germany had the lowest net investment share in GDP among all OECD countries". This retarded growth in Germany led to mass unemployment and to a real economic depression. The domestic economy stagnated, which necessitated the Schroeder reforms. It is 'a big mistake' to interpret the export surpluses as a gain for Germany. In response, Mr. Merz pointed to the strong growth in Germany in 2010 after unit labour costs had been reduced. Germany is still one of the countries that is "benefitting from the European development economically and politically the most". What is important is to make the EU more competitive as a whole, not just individual countries. For Europe, the question is one of global competitiveness, and Germany is only one part. Mr. Reithofer added that "to be a strong global player, you need a strong home market" and for his company Europe is the home market because of the single market reforms. Having the euro also helped his company to master the crisis. Rolf Alter stressed that taking a national approach is no longer adequate. We cannot "pursue policies at the level of nation states when the markets are so heavily integrated". Since the most integrated markets are financial markets, the response to them is hardly to be found at the national level. Elmar Brok pointed out that Europeans cooperating with the Americans would be able to set standards in the financial world; the nation state is too small for this. The EU can only survive if all member states see it as a win-win situation, which means that the weaker states must be helped under the condition that they put their houses in order.

Anatole Kaletsky observed that there is an unnecessary confusion between two financial crises. There is a sovereign debt crisis in Greece due to incompetent and even dishonest management of the government. In Ireland and Spain, however, it is not a sovereign debt crisis but is all about the banking sector. The problem is that we have a single market in European banking but a national system of regulation and guarantees for these banks. "We need a euro-wide system of recapitalising, guaranteeing and regulating the banks". Friedrich Merz agreed and added that the critical point is what competencies should be transferred to the European level and which ones should be left at the national level. A strong European Commission should make this clear. Social security and health care should remain national competencies, but others such as banking regulations or capital requirements cannot be left at the national level. The preventive control of deficits and debt is needed at the European level as a way to avoid crises. Lord Oakeshott made the observation that Ireland was a state that was controlled by its banks. Banking regulations at a European level are not realistic until the British banking system is reformed. Rainer Brüderle stressed that a common market requires common rules. On the other hand, we have very strong competition in the financial markets between New York, London and the continental financial centres. London has its own ideas, especially with regard to the financial transaction tax. "We have nearly overcome the financial crisis, but we have no new rules". At the G20 meeting in Korea, for example, there were very few common ideas. "And I do not think we will have enormous progress in the coming years. That is the risk for the next crisis. Without a minimum of common rules we will have another crisis".

Financial conditions in the euro area

Nominal Interest Rates a)

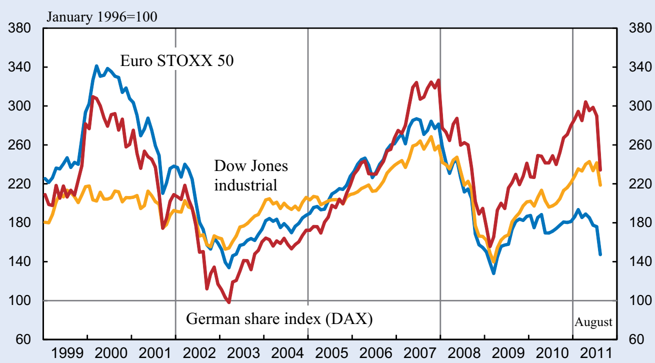


a) Weighted averages (GDP weights).

Source: European Central Bank.

In the three-month period from June to August 2011 short-term interest rates increased. The three-month EURIBOR rate grew from an average 2.43% in June 2011 to 4.43% in August 2011. Yet the ten-year bond yields decreased from 4.37% in June 2011 to 4.21% in August 2011. In the same period of time the yield spread also decreased from 1.94% to – 0.22%.

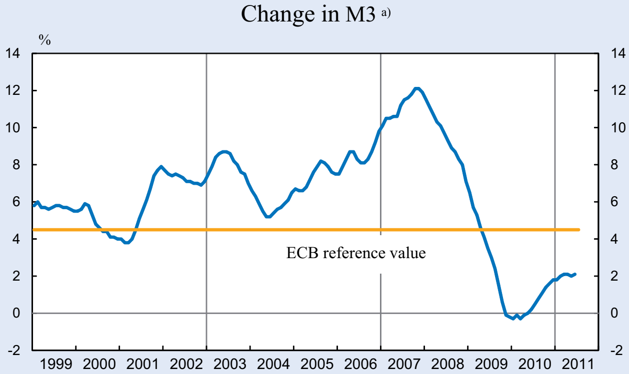
Stock Market Indices



Source: Deutsche Bundesbank, Dow Jones & Co., Inc.

The German stock index DAX declined in August 2011, averaging 5,785 points compared to 7,159 points in July 2011. The Euro STOXX also decreased from 2,743 to 2,230 in the same period of time. The Dow Jones International declined as well, averaging 11,327 points in August 2011 compared to 12,512 points in July 2011.

Change in M3 a)

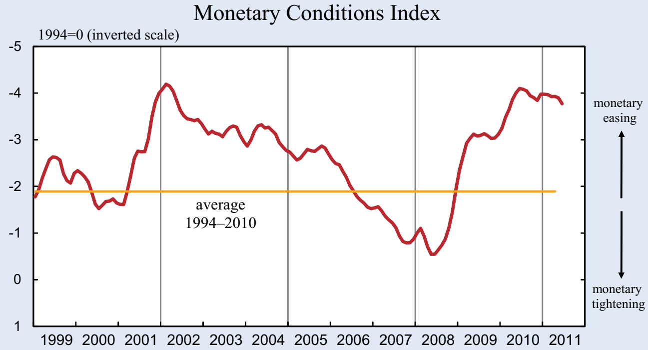


a) Annual percentage change (3-month moving average).

Source: European Central Bank.

The annual growth rate of M3 increased to 2.0% in July 2011, compared to 1.9% in June. The three-month average of the annual growth rate of M3 over the period from May to July 2011 slightly rose to 2.1%, from 2.0% in the period from April to June 2011.

Monetary Conditions Index

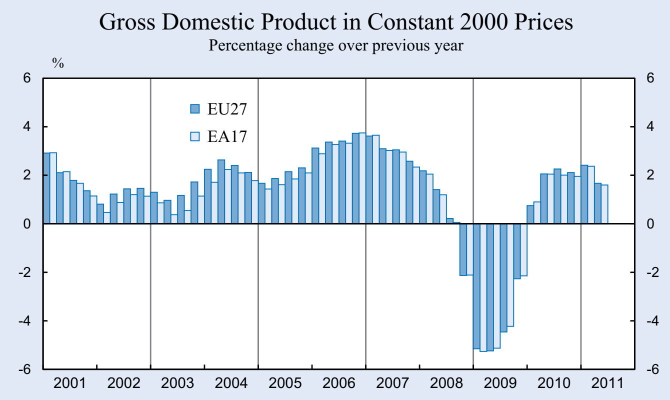


Note: MCI index is calculated as a (smoothed) weighted average of real short-term interest rates (nominal rate minus core inflation rate HCPI) and the real effective exchange rate of the euro.

Source: European Central Bank, calculations by the Ifo Institute.

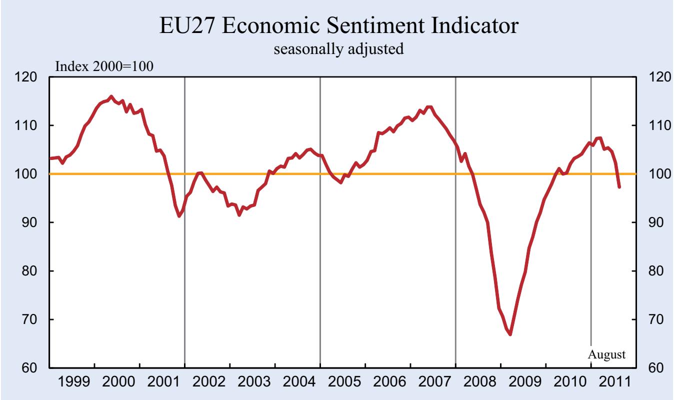
Between April and November 2009 the monetary conditions index remained rather stable after its rapid growth that had started in mid-2008. The index started to grow again since December 2009, signalling greater monetary easing and reached its peak in June 2010. In particular, this has been the result of decreasing real short-term interest rates. In June 2011 the index has continued its slow downward trend.

EU SURVEY RESULTS



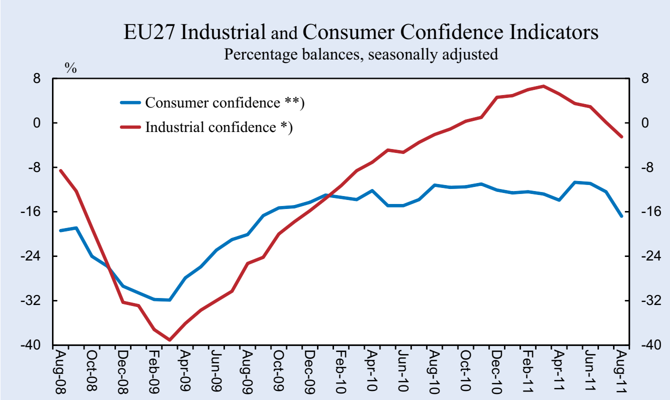
Source: Eurostat.

According to the second Eurostat estimates, GDP increased by 0.2% in both the euro area (EU17) and the EU27 during the second quarter of 2011, compared to the previous quarter. In the first quarter of 2011 the growth rates were 0.8% in the euro area and 0.7% in the EU27. Compared to the second quarter of 2010, i.e. year over year, seasonally adjusted GDP increased by 1.6% in the euro area and by 1.7% in the EU27.



Source: European Commission.

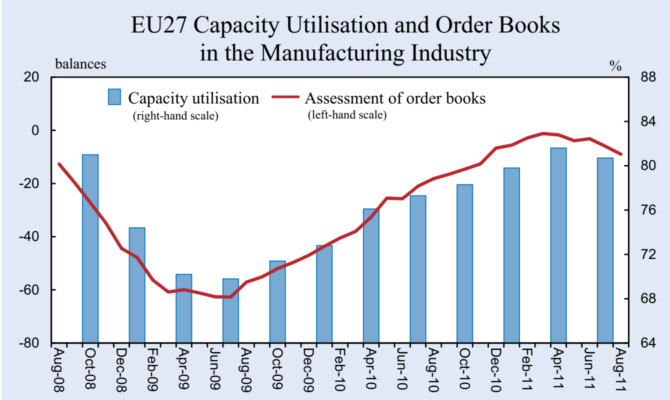
The Economic Sentiment Indicator (ESI) continued its downward trend in August in both the EU27 and the euro area (EU17). The indicator declined by 5.0 point in the EU27 and by 4.7 points in the euro area, to 97.3 and 98.3 respectively. In both the EU27 and the euro area the ESI stands below its long-term average.



Source: European Commission.

* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).
** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

In August 2011, the *industrial confidence indicator* declined by 2.6 points in the EU27 and by 3.8 points in the euro area (EU17). On the other hand, the *consumer confidence indicator* decreased also in both the EU27 (– 4.4) and the euro area (– 5.3).

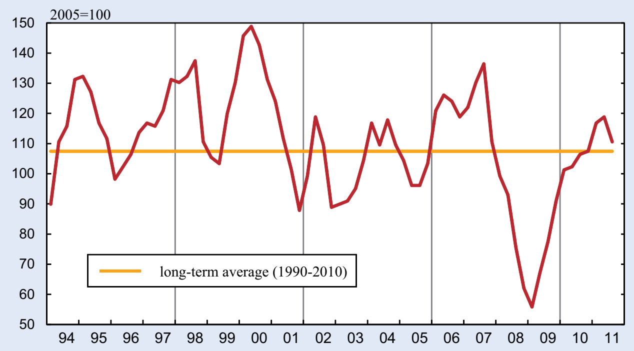


Source: European Commission.

Managers' assessment of order books worsened from – 6.0 in July to – 9.0 in August 2011. In June 2011 the indicator had reached -3.2. Capacity utilisation also increased to 80.7 in the third quarter of 2011, from 81.6 in the previous quarter.

Euro area indicators

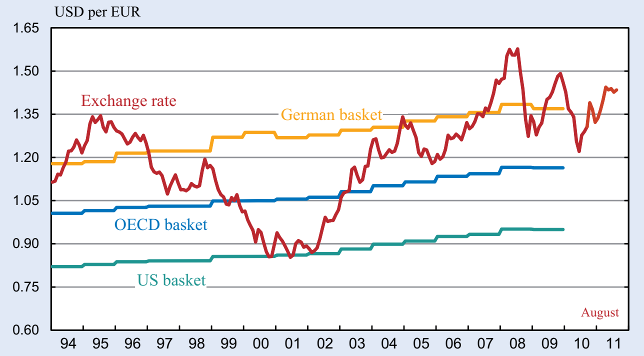
Ifo Economic Climate for the Euro Area



Source: Ifo World Economic Survey (WES) III/2011.

The Ifo indicator of the economic climate in the euro area (EU17) has fallen in the third quarter for the first time since the beginning of 2009 and now stands only slightly above its long-term average. The assessments of the current situation are somewhat less positive compared to the second quarter of 2011. Above all the expectations for the coming six months weakened noticeably. Economic activity in the euro area is entering a difficult phase.

Exchange Rate of the Euro and PPPs

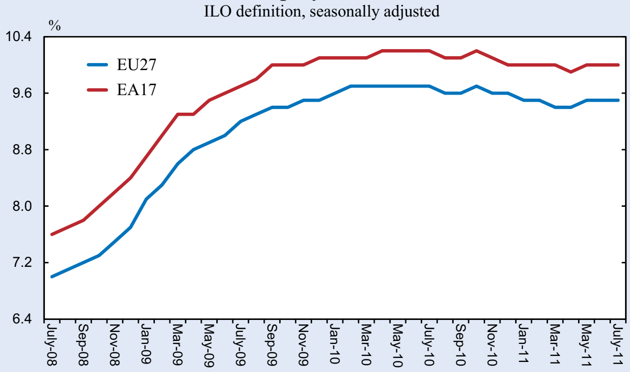


Source: European Central Bank, Federal Statistical Office, OECD and calculations by the Ifo Institute.

The exchange rate of the euro against the US dollar averaged approximately 1.43 $/€ between June and August 2011. (In May 2011 the rate had also amounted to around 1.43 $/€.)

Unemployment Rate

ILO definition, seasonally adjusted

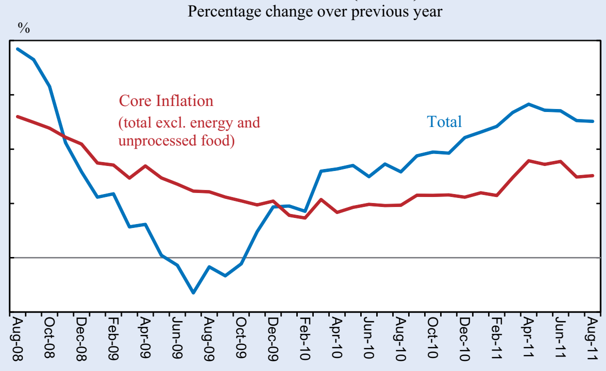


Source: Eurostat.

Euro area (EU17) unemployment (seasonally adjusted) amounted to 10.0% in July 2011, unchanged compared to June. It was 10.2% in July 2010. EU27 unemployment stood at 9.5% in July 2011, unchanged compared to June. The rate was 9.7% in July 2010. In July 2011 the lowest rate was registered in Austria (3.7%), the Netherlands (4.3%) and Luxembourg (4.6%), while the unemployment rate was highest in Spain (21.2%).

Inflation Rate (HICP)

Percentage change over previous year



Source: Eurostat.

Euro area annual inflation (HICP) was 2.5% in August 2011, unchanged compared to April. A year earlier the rate had amounted to 1.6%. The EU27 annual inflation rate reached 2.9% in August 2011, unchanged compared to April. A year earlier the rate had been 2.0%. An EU-wide HICP comparison shows that in August 2011 the lowest annual rates were observed in Ireland (1.0%), Sweden (1.6%) and the Czech Republic and Slovenia (both 1.9%), and the highest rates in Romania (7.3%) and Estonia (5.1%). Year-on-year EU17 core inflation (excluding energy and unprocessed foods) slightly increased to 1.51% in August 2011 from1.49% in July.

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