

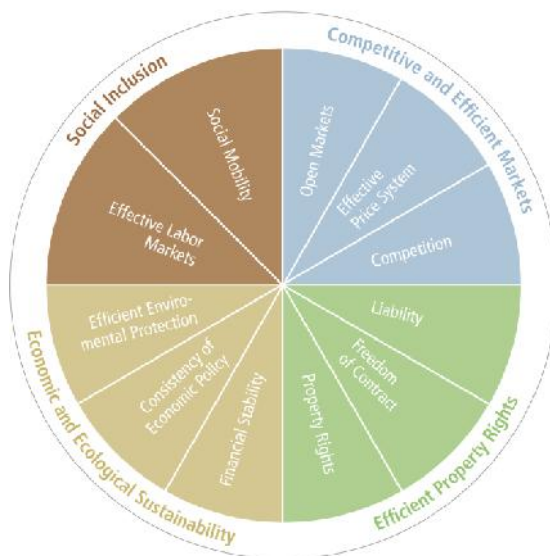


## A European Social Market Economy? - Index Results

The 'highly competitive social market economy' represents the targeted common economic order of the European Union as it is stated as a goal in the Lisbon Treaty. Yet, this endeavor requires a mutual understanding of which institutions constitute a modern social market economy. The results of the Index of Modern Social Market Economies (IMSME) show congruence around a liberal market economy, but great diversity in principles indispensable for a social market economy.

### Focus

Figure 1: IMSME Structure



The IMSME concept builds upon Walter Eucken's constitutive and regulating principles for a competitive market economy, modernizes them according to the challenges and societal expectations of today and defines them in such a way that allows for functional equivalencies in other countries.

Source: See Bertelsmann Stiftung 2012 for a description of the underlying concept and a complete list of indicators.

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Going beyond mere outcome-oriented measurement tools, the IMSME offers a concept for the institutional definition of the structures and principles that constitute this economic order (see Bertelsmann Stiftung 2012). This approach avoids the multicorrelation pitfalls of outcome-oriented indices and offers a foundation for further discussion among member states in regard to the more concrete institutions needed to truly arrive at a highly competitive social market economy. The IMSME study fills a data gap in several institutional areas of the MSME and elaborates on the way in which institutional frameworks interact with each other, either buttressing strengths or exacerbating weaknesses. Due to the importance of the interdependence of the principles, high scores in all of the principles are necessary to truly be considered an MSME. While the index project aimed primarily to create and empirically test the robustness of a concept for measuring the institutions of a modern social market economy, the key findings of this explorative study offer insights into advantages and disadvantages of the de facto economic and social orders of each country. As such, it serves as a starting point for discussions guiding institutional reforms toward a modern social market economy in the member states and at the aggregate European level.

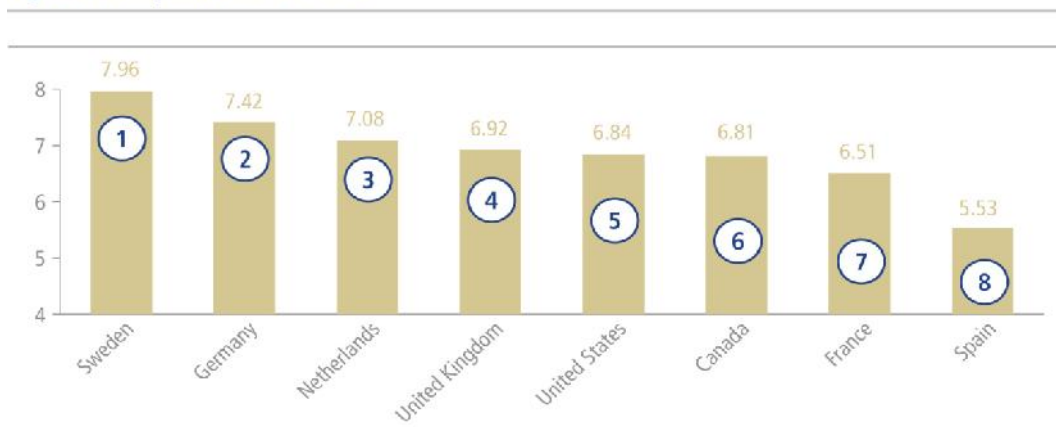
Measurable indicators for each principle make this analysis concrete and translatable into policy measures commensurate with an MSME.

## The European Social Market Economy in Focus

Heterogeneity in economic outcomes and policies among the European Union member states is to be expected considering the divergent starting points and comparative advantages of each economy. For this reason, the IMSME defined the institutions of the MSME according to underlying principles that should form a common denominator and jointly agreed-upon direction for common European policies.

The great deal of variance found in the explorative study among the evaluated countries of the EU and EMU raises important questions about the degree of necessary versus actual policy and institutional coordination around jointly agreed-upon institutions. Moreover, it becomes apparent that the institutional convergence achieved thus far has primarily occurred through liberalization, by decreasing barriers in the areas of the four freedoms: free movement of people, goods,

**Figure 2: Compound Index Results**



Source: An in-depth analysis of results, complete case study country reports and the data are available on the project website: [www.bertelsmann-stiftung.de/globalmonitoring](http://www.bertelsmann-stiftung.de/globalmonitoring).

services and capital. This convergence can be seen in the clustering of rather high EU country scores in the principles of open markets, property rights and freedom of contract in Figure 3 below. Convergence in these principles alone indicates that the EU is moving toward a liberal market economy model rather than a social market economy.

The results of the explorative study support the claim by Fritz Scharpf and others that the current governance structures in the EU political economy achieve disproportionate success in negative integration (meaning the reduction of barriers), but lack mechanisms for positive integration in salient areas. The European Court of Justice has interpreted a treaty mandate to enforce negative, or liberalizing integration directly through its rulings. Moreover, rulings such as *Van Gend & Loos* (C-26/62, 5.2.1963), which defined the treaty rights not only as rights of the state, but of individual EU citizens as well, also set the stage for further, decentralized enforcement through private individuals and legal entities. (Höpner 2011; Scharpf 2009). In contrast, positive integration (meaning harmonization and coordination of instruments) in salient policy fields is currently driven largely by the open method of coordination (OMC), which has not been able to achieve the coordination of common European policies with equal success as negative integration instruments have been able to liberalize policies (see for example Goulard and Bailey 2010 for an analysis of the weaknesses of the OMC). Moving forward in this area in order to achieve a balanced social market economy requires agreement on more specific policies and instruments.

After briefly outlining areas of structural commonalities among countries in some of the principles of an MSME, this policy

brief will focus predominantly on deficits in the remaining areas of institutional diversity that are central to balancing the MSME.

## Congruity

Among the 6 EU countries evaluated, scores for the principles of open markets, property rights, competition and freedom of contract are relatively high and do not exhibit a great deal of variance, which is reflected in the clustering of scores in Figure 3 below. These areas best represent congruity in the four freedoms laid out in the Treaty on the Functioning of the European Union. Differences among EU countries in terms of property rights and freedom of contract are particularly minimal.

Despite relative congruence, some differences in the principles of open markets and competition warrant mention. In the assessment of the institutions guaranteeing open markets, for instance, all factor markets (goods and services, capital and labor) were considered and scores ranged between 7.23 to 8.79 – all above average. However, while the highest-ranking country for this principle, Sweden, has very open labor, capital and product markets, France protects its domestic markets to a higher degree than other countries in the sample do and represents the only country in the sample with higher product market regulations than the OECD average, in particular with regard to protection of national champions.

In modernizing the principle of open markets for the realities of today, open labor markets in the form of freedom of migration prove essential for an MSME. Although Germany scored high in the index overall, it received the lowest score (6) in

the sample and one of its lowest overall on the indicator measuring institutions and policies toward labor immigration and integration. It is one of the only countries that has thus far failed to design immigration laws driven by its own economic interests and provides few provisions to foster the immigration and integration of highly skilled workers. In contrast, Sweden stands out with its transparent immigration system for targeted qualified economic immigration, separate from its asylum policies driven by humanitarian intentions. As an integral component of open labor migration, Sweden's policies support and require the integration of labor immigrants.

Germany and the United Kingdom received very positive evaluations for their institutions promoting competition. A strong competition oversight authority

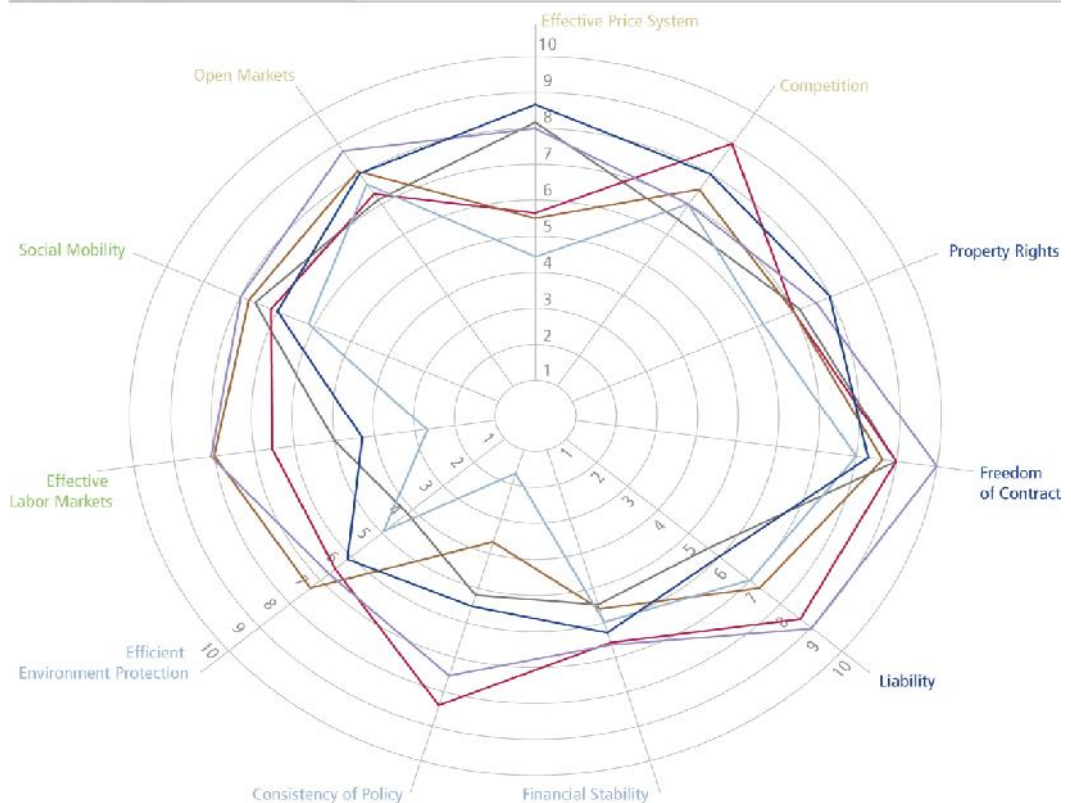
serves as a pivotal institution for fostering competition within an economy. The UK received the highest possible assessment in this regard and France and Germany score high as well. Germany's laws and rules for competitive structures in the media stand out as fostering structural diversity, which enables public access to a variety of substantive debate and information. By contrast, France and the UK lost points in the rating for their oligopolistic-media structures in the printed press and television, which have the potential to limit access to the object information that functioning competition requires.

## Variance

Variance among countries remains the most striking for the principles of consis-

**Figure 3: Congruence and Variance in Selected EU Economies**

Country comparison by principle.



— France — Germany — Netherlands — Spain — Sweden — United Kingdom

Source: Index Calculations.

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tency of policy, effective labor markets, liability, efficient environmental protection and effective price system.

### Consistency of Policy

Consistency of economic policy measures the degree to which economic policies of today can be expected to endure in the long run. Such confidence requires investment in skills and knowledge for the future, including human capital. Sweden, the highest scoring country overall, invests the greatest percent of its GDP in research and development while Spain, the lowest scoring country, invests the least. Furthermore, important policy differences between EU and even EMU countries relate to the control of financial consolidation and linking pension systems with life expectancy. Germany is the only country of the eight evaluated that has established a debt brake in its constitution. Also, while six of the eight have reformed their pension systems to integrate a link between financing and demographic change, the Netherlands and Spain have not. Such reforms are paramount to sustainable public finance and thus consistency of policy.

### Effective Price System

An effective price system is characterized by a lack of market-distorting subsidies and price controls. In practice, all of the countries evaluated employ price controls to some extent, some of which can be justified by market failure. Every country subsidizes some types of economic activities. Nevertheless, significant differences can be seen between countries that received relatively high scores such as the UK and those which scored poorly across all three indicators for this principle. France and Spain registered the most wide-spread price controls among the sample, as measured by data from the

Fraser Institute. However, France boosted its overall evaluation by maintaining a relatively low level of subsidies and transfer payments. Germany, Spain and the Netherlands lost points for comparatively high levels of price-distorting subsidies.

### Liability

Due to a lack of pre-existing data for the measurement of liability, qualitative indicators were created to measure the quality of institutions that promote liability in conjunction with property rights: private insolvency rules, the extent of incentives to encourage a long-term profit orientation among managers and the ratio as well as promotion of medium-sized companies to total companies. Sweden led the ranking for this principle, with Germany closely behind.

With respect to private insolvency rules, expert evaluators considered aspects such as debt servicing periods and mechanisms for debt collection, as both affect the borrowing and risk-taking behavior of individuals. While an EU directive from 2000 allows EU citizens to register private insolvency wherever they reside in the EU, EU countries do not coordinate their private insolvency rules, which leads to enforcement problems in member states with stricter debt servicing laws. Shorter periods in the UK, for example, induce many insolvent German residents to move to avoid the consequences of bankruptcy, which include living at a subsistence level for a period of 6 years while paying any additional income to the creditor (compare Fichtner 2010). In Spain, a lack of debt collection mechanisms may have had adverse effects on the construction boom, as mortgages became the only way to enforce collection (see Spain country report).

Medium-sized enterprises often link management closely to ownership, which

tends to go hand in hand with liability. Germany received the highest marks for its long tradition of promoting a strong Mittelstand through various mutually reinforcing institutions. Slow SME development in France, on the other hand, despite well-targeted policies in this area, demonstrates the necessity of a long-term horizon and consistency of policy to successfully implement new institutions. Spain received one of its highest scores in this area, owed to its rather successful decentralization of policies to promote SMEs.

In a more direct measurement of manager liability, Swedish law has an array of provisions that earned the country the highest ranking for institutions that encourage responsible management, holding individuals accountable for their actions. Across the EU, incentives to promote long-term rather than short-term profit orientation varied significantly, with the UK and Netherlands scoring only higher than the United States, which stood out among the sample as an economy that focuses heavily on short-term profit orientation, has the least amount of mechanisms for manager liability and reinforces this orientation through institutions in other areas related to manager liability. A lack of employer-employee parity serves as a related example – absent workers council rights (or other forms of decentralized institutions that foster employee-employer parity), the US does not benefit from the increased managerial transparency that often accompanies such councils.

#### Efficient Environmental Protection

None of the countries in the sample obtained an optimal score for market instruments that effectively internalize externalities. Sweden received a good score due to an array of taxes that raise the price of certain goods closer to their actual cost. The country also invests revenue

from green taxes like the congestion tax in Stockholm to finance improvements in public transportation and infrastructure. While Germany levies an energy tax, it channels revenue to finance the social security system rather than focusing on reinvestment in environmentally-friendly infrastructure. As such, the internalization effect of green taxes in Germany is limited. Despite common rules for environmental policy among EU countries, compliance and enforcement differ. Germany and Spain subsidize pollution-intensive industries to a larger extent than others and gas taxes greatly diverge within the same EU framework.

#### Effective Labor Markets

A framework for effective labor markets provides the foundation for active participation in social life, both during working years and later in retirement. Spain scored very low on this principle. The country report describes how the weakness or dysfunction of some institutions actually reinforces poor performance in other areas as well. Sweden and the Netherlands score consistently high for their institutions fostering an effective labor market. Germany's active labor market policies (ALMPs) achieve the best rating for the country's success in activating the long-term unemployed and making financing decisions based on cost-effectiveness analysis. However, despite Germany's current economic performance, the structural analysis that serves as the basis of this assessment reveals weaknesses in the form of asymmetries that foster a dual labor market. While Germany does not protect the core of its labor market to quite the extent that Spain does, the recent Hartz reforms did further labor market dualism by focusing liberalization in the low-wage sector. Therefore, in times of recession, this structural weakness in Germany could become more prominent.

Overall, significant variance also exists within this principle among EU member states. Alongside Spain, the UK and France also receive very low scores. Spain and France share very high employment protection and dual labor market structures in particular between job market entrants and older, established workers as well as between the large and protected public sector versus the private sector, which decreased the score for effective labor markets in these two economies. Fixing the insider-outsider dilemma in France and Spain will prove difficult due to the lack of a functioning social partnership in both countries. Labor unions have traditionally fought for protection of incumbents, making reforms that concentrate on liberalizing parallel, outsider labor markets the easier choice. In contrast, the UK avoids the dual labor market structures of Spain and France, but lost points in the assessment for having levels of employment protection across the board deemed too low. Moreover, neither Spain nor the UK has implemented significant active labor market policies. While France, on the other hand, invests a significant amount of public funds into ALMPs, it concentrates its efforts largely on subsidies for employers and incentives for requalification and mobility while maintaining relatively lenient benefit qualification rules.

## Conclusion

A previous policy brief (Shupe 2012) drew attention to the weaknesses of the current governance instrument—the open method of coordination—for coordination and convergence of some of the most salient policy areas in the EU. Among these weaknesses are the lack of sanctions and its outcome orientation. This policy brief went beyond considering differences in eco-

nomical performance to highlight the divergence in the structures and underlying principles that drive member states' policies in particular in areas of financial consolidation, effective labor markets, liability, efficient environmental protection and an effective price system. Precisely these areas are crucial for the fulfillment of a social market economy.

In order to achieve the integration success that has occurred in the areas of the four fundamental freedoms, agreements on the concrete policies and institutions that constitute a highly competitive social market economy are needed. Absent further political coordination, the common denominator of the de facto European economic order will remain limited to the liberalization of the European common market.

## Further Reading

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## Policy Brief 2012/07: Sustainability and solidarity – basic ideas of new financial structures

Federal financial structures which include fiscal equalization between the German states remain indispensable for leveling out significant regional economic differences and for ensuring sufficient funding for the responsibilities of the public sector across the nation. The necessary revisions of financial structures beginning in 2020 provide an opportunity for a substantial overhaul. The objective is to consolidate in the long term the budgets of federal, state and municipal governments and to safeguard a modern welfare state.

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