

# SOCIAL EUROPE IN A CLIMATE OF AUSTERITY

Christopher Pissarides

*Regius Professor of Economics, London School of  
Economics;*

*Professor of European Studies, University of Cyprus*

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Eurofound stands for Improvement of Living and Working Conditions through social dialogue. Currently, in the midst of high unemployment and increasing inequality, living and working conditions for ordinary people are worse than in 2007. But recession is not the only problem. Even when countries are recovering, the gains go mainly to the wealthier classes, which did not suffer much in the recession. Why?

The reasons are fundamental and long standing. Capitalism, say of the unregulated US type, is good for giving incentives for invention and growth, but it is not good for the distribution of the rewards. Especially after the digital revolution and globalisation, distribution has become worse. A few individuals become very wealthy but global competition for those with less education and skills keeps their earnings low.

In this context the social dialogue is essential in maintaining some balance in the distribution of wealth. Agreements about wages and working conditions based on dialogue between organised labour and organised employers are likely to have a better outcome for distribution than atomistic capitalism. But the conundrum how to ensure that the rewards from innovation and growth remain strong after redistribution is unresolved.

In addition to that, social dialogue between the social partners but excluding government is not likely to have the desired outcomes. We need more than social dialogue, important as it might be. The social partners are not strong enough to enforce a better distribution of the fruits of production across the nation. I believe that social dialogue is more effective at sectoral level but the problem of distribution also has a national dimension.

Government needs to support low incomes and provide basic services. This is at the core of what we call the European social state. But there isn't one European social state; there are four. And they are evolving all the time. The Anglo-Saxon one, mainly found in Great Britain and Ireland, espouses competitive and open markets with some support to households both through transfers and through the provision of free or subsidised services such as health and education. But it does not extend beyond these basic services. It is successful in achieving the production efficiencies associated with free markets but it tolerates a lot of inequality. It is no coincidence that the financial sector developed more in Britain than in countries on the continent of Europe.

The Scandinavian model is one that espouses fairly free markets but with much more social support than the Anglo Saxon model. A key feature of the Scandinavian model is that the welfare support is provided mainly through subsidised services offered in the market, not through transfers of money to families. For this to work a country needs to have an efficient public sector that is trusted by the people and rely on constructive social dialogue. It works well in the Scandinavian countries. It is supported by high taxes, which are a disincentive to some people, but tax evasion is low. Despite its apparent successes it has not been transferred successfully to other countries. It is interesting to hear the views of social partners why this has been the case.

Finally, in continental Europe we have a halfway house of fairly unencumbered markets combined with social transfers and in southern Europe we have another mix, with more regulated markets, some (but limited) social transfers and more reliance on the family for social support.

I consider a successful European model one that combines an economy that creates many jobs, is flexible enough to adopt new technological advances and contributes its own share to research and innovation; and with a social state that provides good quality social services and minimises poverty. The perfect state does not exist: for example, the United States fails because it does not provide enough basic social services, the United Kingdom does better but it is characterised by large inequalities and more recently it has failed to innovate and grow. In Scandinavian countries the high taxes are a deterrent and in southern Europe the labour

market outcomes are not good, with low employment, too much protection of incumbent employees and not enough social support to underprivileged households.

There is still a lot of work that needs to be done to find ways of organising a social state and the social dialogue will play an important role in this work. Let me compare two countries, Sweden and the United Kingdom. They have approximately similar high employment levels but Sweden has much more comprehensive provision of social services. The biggest contrasts are found in social care, such as childcare. But look behind the aggregates and you will find that the high employment levels in Sweden are mainly in government-sponsored social sectors – education, health and government services – whereas in Britain they are in business services and in lower-level services such as repairmen and domestic workers. The latter type of service is absent in Sweden because the high taxation discourages workers from entering these sectors, preferring the government-sponsored social sectors.

The contrast is even more stark when we look at countries like Sweden and Italy. Italy also has high taxation, nearly as high as Sweden, but it does not use the revenues to sponsor employment. It pays its civil servants and politicians more than most other European countries and costs in the public sector are generally high. As a result, employment in Italy, especially of women who populate the government-sponsored jobs in Sweden, is very low; and market activity is also stifled by the high taxation and regulation. It appears to be like a country that needs a more constructive social dialogue and needs to deregulate its markets more.

As we move further into the 21<sup>st</sup> century our needs in Europe will shift more towards health services and domestic assistance, partly because of an ageing population and partly because of rising living standards. But if our companies are to succeed in a world with increased global competition we will also need to provide more business services of a more specialized nature. In that sense we need to reform our economies and move on to more modern states. States that can support simultaneously better private sector services to businesses and households, and comprehensive social support to less privileged persons.

We do not have a template yet. It is with pleasure that I see growing interest in the European Union for employment in sectors such as health and personal services, something that did not feature in the Lisbon Treaty or in subsequent documents written as recently as ten years ago. But more discourse is needed and the social dialogue can play a key role here. The models currently in use have some failures that need to be addressed: for example, I don't think a free national health service like the one in the UK is sustainable, because of high and increasing costs. Long waiting times and lower quality services will be a real threat. Nor do I think southern European companies have much chance to succeed in world competition without reforms to their regulated economies.

The mention of employment trends and needs as we move deeper into the 21<sup>st</sup> century brings me to my next and more controversial topic, employment needs now. In 2008, six years ago – although it does not seem like that – Europe and

North America went into recession because of financial failures in the housing market. The recession spread but whereas the world outside the euro area recovered and started growing again, in the euro area we are still in recession. There are frequent claims of success: that the euro was threatened but it is now safe, that in virtually the whole of the euro area national incomes are growing again, and so on. But despite these claims debt levels are still high, unemployment is still very high, incomes in most countries are still below 2007 levels and policy flexibility has been lost.

In Europe we always took pride in our social diversity and this extended to our economic policies. Once we agreed to adopt the single currency we have lost the diversity in monetary policy and we have to accept that this as a necessary consequence of aiming at bigger targets. But I believe that the attempts to impose a single economic model on our economies have gone too far, with negative consequences for many countries, especially the ones of the European South. Let us switch to some economics now and see how we got to this point and where are we headed?

We got into recession because of financial failures originating in housing markets. Low interest rates and the apparent protection of a single currency led to a massive expansion of the construction sector in several countries, especially Ireland, Spain and Portugal and (to a lesser extent) Cyprus. This expansion was backed up by debt. When demand for housing collapsed and debts could not be serviced, banks throughout the Eurozone came under threat. Governments took on the task of supporting and saving their

banks, but whereas countries like the UK could afford to do it, the governments of the smaller southern countries could not. Greece got into a similar debt situation but less because of the housing market and more because of mismanagement of public finances. A similar Greek problem inflicted Cyprus, but to a lesser extent. The end product was the same in all countries, high sovereign debts that could not be serviced. Access to financial markets was denied and they had to go to their partners in the European Union and to the IMF for rescue.

This automatically split the European Union, and in particular the euro area, from a Union of equal partners into a Union of creditors and debtors: prudent bankers on the one hand and misbehaving customers on the other. This is not the basis of a successful partnership that will lead Europe to the successes needed for Europe 2020. The social dialogue can play its part to help but power lies elsewhere; it lies in the hands of the creditors and the institutions that have the power to save the economies of the near bankrupt nations: the European Commission, the IMF and the ECB.

To see the next steps and see more clearly where we went wrong in this difficult phase lets ask what correction mechanisms there are in free unencumbered markets, when high and unsustainable debts hit a nation. A nation with its own currency will suffer massive depreciation and most likely large inflation. This will erode its purchasing power and the living standards of all its citizens will fall, as foreign goods become more expensive. But this depreciation also has two beneficial outcomes. It makes the country's goods cheaper abroad and erodes the real value of the debt.

Eventually the country's currency becomes so cheap that foreigners are willing to hold it again and the country returns to financial markets.

In the absence of a currency that can depreciate, smaller countries in the Eurozone can replace this correction mechanism with one that takes longer but, at least in theory, has the same outcomes. Practice, however, proved different. They can take up something known as “internal depreciation”. Essentially, this means wage reductions to lower production costs, which in turn will bring price reductions and will make the country's goods more competitive abroad. As the demand for the cheaper goods by foreigners rises employment in the country is restored and the country returns to financial markets.

This is indeed the correction mechanism taken up in Greece, and this country will forever be a classic example of internal devaluations in student economic textbooks (just as my own country is already an example of another sad phenomenon, the bail-in of financial institutions).

Why hasn't the theory of internal devaluations worked? In particular, why do we still have these horrible unemployment rates and these very high levels of debt? For the answer to these questions we do not need to go further than the most revolutionary book ever written in economics after Adam Smith launched the science, John Maynard Keynes's *General Theory of Employment, Interest and Money*.

As an aside, we might note that Keynes's book was written in 1936 in response to the Great Depression in the then



industrial countries of the world. In 1946, when Keynes died, Winston Churchill declared “we are all Keynesians now”. Then came the oil crisis, Milton Friedman, Ronald Reagan and Margaret Thatcher and there were no Keynesians left. But what I see now in Greece and the European South is the ghost of Keynes rising from the dead.

Internal devaluations in today’s world do not work – at least not in anything like a reasonable time, before we lose a whole generation of young people. Wage reductions are difficult to implement because they cannot be uniform and they affect people’s living standards selectively; prices do not have much room to fall, because a lot of goods and services that we consume at home are imported and their prices are fixed in international markets; internal devaluations bring deflation which makes the debt situation worse; and they reduce living standards, they lead to further falls in demand and to more recession. Instead of correcting the imbalance in the first place we make it worse: more debt and more recession. It used to be known as the Keynesian multiplier; it is still a multiplier.

What can we do to get out of this situation? In my view we can do a lot but we are doing very little. Whether we like it or not debt levels are high and need to be repaid; the traditional cure of more spending by the government is out of the question. We also have to deal with rising unemployment because of the initial problem of the collapse of construction and the loss of confidence in the banks. That also brings recession through deflation. We need to find a weapon against deflation elsewhere. The obvious answer is monetary policy and public investment.

Monetary policy needs to be expansionary to reverse deflation and turn it into inflation, depreciate the euro and put more liquidity into the economy. Fiscal policy at EU level can also help by financing investment projects that can generate a multiplier like the one that I described before but in reverse; one that will bring more demand and more job creation rather than less demand and more unemployment.

The Federal Reserve in the United States had a Chairman that studied the Great Depression, so he understood well what was needed. He adopted “unconventional measures” to boost demand in the United States and within a couple of years the economy was out of recession. Another economist, sitting in the Governor’s office in London, took similar action. But the ECB, despite frequent talk by its President that is in the right direction, has been unable to act, except when the economy was close to the cliff, or when not acting threatened to undo its own credibility. The ECB has an inflation target of 2% or just under; it waited until inflation went down to 0.5% before taking limited action. By its own estimates it will take another 3 years for it to rise to close to 2%. The euro is far stronger than required by the South. And unemployment is far too high. Unconventional measures in monetary policy will help.

I mentioned before that the debt crisis created creditors and debtors. Not surprisingly, the policy needs of the creditors are different from the policy needs of the debtors. Germany has inflation just over 1% and about 5% unemployment; Greece has inflation of 1% below zero and 26% unemployment. How can you find a policy that suits them

both? You cannot. The ECB has a real problem and it is choosing the easy route. Follow conventional policies that work in the long run, and anyway they are not too bad for leading economies like Germany even in the short run. Everything will be OK in the long run. Well, I hope Keynes is proved wrong in one of his most famous dictums: in the long run we are all dead!

Thank you!