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Europe's social model will crumble without reform

The so-called "European social model" has for a long time been held up by Europeans as proof that there are some things they do better than the US. Although the US may have the more dynamic economy, Europeans take pride in belonging to a more cohesive and inclusive society. The big question is whether this model is sustainable.

Official data tend to confirm the Europeans' perception that their society is more equal than the US. As measured by the Gini coefficient – where 0 equals perfect income equality and 1 a situation where one person takes all the income – inequality in the European Union is 0.1 lower than in the US. The average income of the richest 10 per cent of the population is 5.6 times that of the poorest 10 per cent in the US and the gap is growing; in the EU the richest 10 per cent have an average income of 3.5 times that of the poorest. The proportion of the population in relative poverty is 17 per cent (and 21.9 per cent among children) in the US, compared with 9 per cent (and 10 per cent among children) in the EU. Last, the US has more than 2m people in jail – more than twice the figure for the EU, whose population is 100m greater.

There is no doubt the US is a more efficient economy than the EU but that Europe's society is more equitable. The EU and the US exemplify the trade-off between efficiency and equality identified by Arthur Okun, the late US economist. But the long-term sustainability of the European model looks uncertain for two main reasons.

First, to maintain a generous welfare system it is necessary to have a very efficient economy to generate the revenue to pay for it. Unfortunately, the EU has a lower rate of employment and of productivity than the US. In 2002, for every 100 working age people (aged 15 to 64) the US employed 75 and the EU only 66; if the EU were to achieve the US rate it would have to employ 17m more people than it does today. Each US employee works an average of 211 hours more each year than his EU counterpart. Productivity in the US is 23 per cent higher per employed person and 10 per cent higher per hour worked than in the EU.

Residual total factor productivity – that is, excluding labour and capital accumulation – is also 7 per cent higher in the US. These are the main reasons why, over the past 40 years, average annual gross domestic product growth has been 0.8 per cent higher in the US than in Europe, and why GDP per capita is more than 30 per cent higher in the US than in the EU.

The second factor that threatens Europe's social model is its ageing population, a trend that is much less pronounced across the Atlantic. The EU fertility rate is 1.3 children per woman, in the US it is 2.05 children. Life expectancy is one year higher in the EU. According to UN forecasts, even taking into account an increase of fertility in both economies in coming decades – to 1.7 children in the EU and 2.2 in the US by 2050 – the average age will go up from 39 to 48.5 in the EU and from 35.6 to 41.3 in the US. The Organisation for Economic Co-operation and Development predicts that the dependency rate, which measures the total number of people aged 65 and over as a proportion of people of working age (in this case aged between 20 and 64), will go up from 26 per cent in the EU at present to 52 per cent by 2050, and from 22 per cent to only 37 per cent in the US.

Research carried out independently by the European Commission, the OECD and the Centre for Strategic and International Studies shows that, by 2050, the increase in public budget expenditure on health and pensions as a proportion of GDP will be between nine and 10 percentage points higher in the EU than in the US. How is the EU going to cope with such a large level of public expenditure when its ratio of public debt to GDP is already close to 70 per cent, and should be below 60 per cent to comply with the Eurozone's Stability and Growth Pact?

The answer is simple: by making its economy more productive and its welfare state more efficient and less burdensome. Achieving this is rather less simple but by no means impossible, as Finland and Sweden have shown. Both these countries have managed to preserve generous welfare systems by improving the efficiency of their economies and their welfare systems, albeit with some pain. Both have more flexible labour markets than the EU average and impose relatively light taxes on capital. They also collect heavy taxes on habits such as smoking and drinking as well as on luxury goods, because these sources of revenue are less sensitive than capital to tax rates.

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At the Lisbon summit in March 2000, just before the bursting of the financial bubble, EU leaders signalled that they were taking the productivity issue very seriously. They approved a reform agenda that aimed to make the EU "the most dynamic and competitive economy in the world by 2010" – a bombastic target that most European economists and analysts regarded with the greatest distrust.

The Lisbon bubble burst a little after the financial one and at the next summit it was already clear that most European leaders were not ready to make the reforms needed to increase the EU's average employment rate to 70 per cent for men and 60 per cent for women, to open public services markets to competition, to spend more on research and development, and so on. Since then, there has been lots of rhetoric but little action. Only recently have Germany and France, confronted with sluggish growth, mooted vital labour and pensions reforms.

But reforms aimed at making the EU economy more efficient and competitive are only half the story. Also needed are other, equally difficult, measures to make the European welfare state sustainable in the long term. One of the most crucial is to increase the age of retirement. It seems absurd that when life expectancy was 70 years the retirement age was also 70, but now that life expectancy is touching 80 the retirement age is 65 and the effective one less than 60. Early retirement in many EU countries is a rational strategy for companies facing high and uncertain firing costs but it is a costly one for society as a whole. Reforms to make labour markets more flexible are a necessity.

Increasing the number of hours worked will also be vital to avoid the move of industries and services offshore. Selective immigration should be a priority to rejuvenate the labour force and to increase the number of contributors to social security; management of immigration should fall exclusively to the EU and not be left to individual member states. Public "pay as you go" pensions systems should be complemented by measures to encourage greater use of private schemes.

The sooner such reforms are carried out the better; an ageing electorate will probably make it impossible to enact them later. But they are not optional. Without them – and efforts to galvanise the EU economy – Europe's much-vaunted social model will become a thing of the past.

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