

# THE STATE AND THE ECONOMY

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THE STATE AND THE ECONOMY  
THE EUROPEAN SOCIAL  
AND ECONOMIC MODEL  
IN THE 21ST CENTURY

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## Preface

With the seminar that gave rise to this publication, the Friedrich Ebert Foundation and *Instituto de Estudos para o Desenvolvimento* (Institute for Development Studies) continued a series of debates on the present-day problems of the European social and economic model. The organisers hope that this kind of initiative offers a “forum” for debate on the challenges resulting from the far-reaching economic, political and social changes taking place in our times.

The intention of this publication, prepared by Nuno Boavida, is to show that, in a real sense, the dialogue was productive. It reproduces the structure of the seminar mentioned above, i.e. the first part deals with the social, or welfare, state and the second with the regulatory state. The texts on which to the speakers’ contributions were based have been gathered together and presented with the summaries of the debates that followed each part.

With this publication, the *Instituto de Estudos para o Desenvolvimento* and the Friedrich Ebert Foundation hope to contribute to a better understanding of the opportunities and problems that are emerging within the context of the current political, economic and social change taking place in Europe and Portugal.

Lisboa, Outubro de 2007

JOÃO CRAVINHO  
REINHARD NAUMANN





PART I

# The Social State



# The reform of the european socio-economic model: should Europe strive to emulate the US model?

JOÃO CRAVINHO<sup>1</sup>

## *Introduction*

Following the Second World War, the foundations of economic performance and social wellbeing in Western Europe were embedded in a combination of state and market institutions generally known as the European socio-economic model. Its proclaimed objective was to ensure the joint production of growth, full employment and widely shared standards of wellbeing and social protection. Its instrument was the alliance of capitalist enterprise and the Keynesian and redistributive state extended by public investment policies enhancing both economic and social infrastructure. It is clear that there is no single European model. The general social, economic and political construct described above comprises several national varieties. Nevertheless, at this level there is no need to enter into further details. We can take the model as a general form.

Few dispute the model's success up to the early 70's. But after the first oil shock, growth and employment levels went through

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<sup>1</sup> President of the Instituto de Estudos para o Desenvolvimento and former Member of the Portuguese Parliament.

a number of crises and the confidence in the capabilities of the model to advance the future of Europe in an increasingly globalised world fell. The term “Eurosclerosis” has been coined in clear association with that loss of confidence. Nowadays, comparisons between the European Union and the United States on one hand, and fear of the emerging Asian economies, on the other hand, give a new impetus to the “Eurosclerosis” thesis, centred on the need to roll back or even dismantle the European model as a survival prerequisite in the global economy that will characterise the 21<sup>st</sup> century.

What is under severe attack is the social side of the model. Although the interests of capitalist enterprises have been central to the installation and development of the European socio-economic model, as time has elapsed this aspect has lost people’s attention. So much so that the current perception of the model is almost exclusively centred on its social side as represented by the so-called welfare state and the concomitant redistribution policies financed by high level taxes. In certain economic and political circles the latter are supposed to be the cause of the continuous European underperformance relative to the US. And they will be more so, in the future, relative to the most dynamic emerging low-wage economies in Asia, namely China and India.

In their view, the cure presupposes the drastic rolling back of the welfare state to a safety net basis, the deregulation of labour markets, with a reduction in state intervention, and concomitant taxation levels, to minimum governmental and legal functions, leaving to individual efforts and market outcomes the realization of economic performance and social wellbeing objectives previously expected from an allegedly outmoded, ineffective European model.

The implicit advice is to take the US institutional market framework as the necessary reference for the success of Europe in the 21<sup>st</sup> century, allowing at the same time an increased role for

the state as a biased “enabling state” dedicated to the competitiveness of European enterprise at the expense of social wellbeing. The new paradigm would mostly mean a retrenchment of the (welfare) state from social protection commitments simultaneously with much larger public finance support, to ensure adequate provision at a lower cost for the private sector of strategic public goods now in short supply. That is, the idea is to roll back or dismantle the social side of the model in order to strengthen the profits and growth prospects in the enterprise side, as much as necessary to compensate for the structural and innovative weakness of the mainstream European economic actors.

The European socio-economic model requires substantial changes but of a quite different nature. Significant changes are required not only on the model’s social side but also, no less, on its economic side, to reinforce synergies between economic enterprise and widely shared social well-being and high standards of living. The endeavour is to modernize, in a congruent way, simultaneously, the present welfare state and the structural foundations of sustainable business competitiveness within and outside the firm’s direct command. The enabling state is a critical ingredient of that dual modernization process as a facilitator and mobilizer in favour of the joint production of growth and wellbeing. But if it is heavily biased towards being a facilitator of profits and growth at the expense of social protection, it would hardly provide the political legitimation of an alternative to the present European model. We have a lot to learn from the strategy of the US market-centred approach, especially in the innovation field. But we must also be aware that many of the appalling social weaknesses observed in the US are endogenous to that kind of biased socio-economic model.

The European Union heads of state and government vowed, in Lisbon in the year 2000, to make the EU by 2010 “the most competitive and dynamic knowledge-based economy in the world,

capable of sustainable economic growth with more and better jobs and greater social cohesion". They were carried away by political mobilisation rhetoric and erred in setting targets impossible to achieve in that time span. But the key aspect is that they pointed in the right direction. It is important to note that the Lisbon Strategy stresses the matching of competitiveness and social cohesion objectives. Now, we must consider three interrelated questions. First, halfway to the 2010 target horizon, where do we stand? Second, what have we to say about the European model in comparison to the US model and in relation to the Lisbon Strategy? Third, what can we, indeed, must we do to fulfil the Lisbon aims in due time?

The first question can be answered in a direct, succinct manner. But the answers to the other two are a very tall order. This note can only outline an inquiry which calls attention to some aspects worthy of consideration in the debate.

### *Where do we stand?*

Where do we stand? The general consensus is that no substantial progress has been made in the half-decade since 2000, as has been shown by the Kok Report (a commission study and an independent research). Possibly, we are now further away from the target than we were 5 years ago.

The European Commission, in its contribution last October to the Meeting of Heads of State and Government, could not have been more emphatic. Two overall statements deserve to be specifically noted. The first is an incisive global assessment: "In several decades after the creation of the European Community, the existing structures helped to deliver outcomes which matched the ambitions of the Community as it was. But this is increasingly no longer the case".

The second compares EU and US performance: “The performance gap with the US has not narrowed. This applies in terms of living standards, growth and employment, but also in key areas – like investment in R&D and new technology, the number of patents issued and the percentage of the population with a tertiary education. Europe is also lagging in the take-up of new technologies important for improving productivity.” To these negative assessments the Commission adds concerns about threats coming from emerging economies, specifically China and India. By 2020, the share of India and China in the world trade of manufactures is expected to reach 50%. The share of China in global trade in goods went up to 8.4% in 2004 from 3.4% in 1995, while in the same period the EU position declined from 19.1% to 18.5% and that of the US increased from 16.5% to 17.1%. To complicate matters further, the share of high technology goods in Chinese exports is rising exponentially and the same applies to Indian exports of ICT-related services.

To summarise, the EU’s economic position in the global economy is at risk of being squeezed from the top by US innovation and financial power and from the bottom by fast growing, emerging low-wage economies which are intensely upgrading the sophistication of their technological and scientific capabilities, like China and India. Only the rapid transition to a knowledge-based economy can enhance the European position in the global economy. Thus, it is easy to understand why comparisons with the US have become almost an obsession since the “Eurosclerosis” of the early days, and much more so since the conception and launching of the Lisbon Strategy. Often, to conclude, explicitly or implicitly, the EU cannot afford to keep in place the European social model if it wants to achieve a level playing field similar to the one that led the US to higher competitiveness, standards of living and wellbeing.

For decades the rates of growth in GDP, GDP per capita and productivity in Europe outdistanced those in the US. These sub-

stantial differences point to a remarkable catching-up process which up to the early 70's closed the gap between the US and Europe in the late 1940's by almost half. However, the closure of the gap came to a halt some time ago. In recent years we have even been able to observe a reversal of the relative positions, with the US on the upper side of the comparison. In addition, job creation in the US is stronger, unemployment rates lower and periods of unemployment shorter. On the basis of such an array of indicators, it is generally admitted that the US performance relative to the EU is superior both in economic and wellbeing terms. More specifically, higher GDP per capita and higher rates of growth in productivity are equated with better performances in terms of standards of living in a broad sense or wellbeing.

The comparison of US indicators with EU averages hides the fact that some EU member states are better than the US in terms of productivity, GDP per capita or even innovation, for that matter. Apart from that, the mapping of better average economic indicators and unemployment rates into wellbeing assessments is at best a very hazardous exercise. In fact, in the US/EU case, to equate better economic indicators with better social outcomes is clearly misleading. This is a most important fact given, on one hand, the required matching of competitiveness and social cohesion in the EU strategic aims and, on the other hand, the institutional model implications explicitly or implicitly based on comparisons as superficial as those normally conducted by the European Commission and other influential bodies or researchers.

*Is the US socio-economic model an alternative?*

*The rising structural inequality in the United States*

The social landscape in the US is flawed by high levels of inequality in fundamental wellbeing dimensions. More impor-



tantly, the new dynamics of the US socio-economic model are combining domestic and globalization factors in such a way that structural inequality is rising strongly at the same time that upward social mobility is slowing down. This is a very significant departure from the mechanisms which historically helped to reconcile the outcomes of the US socio-economic model and the ethics and ideology of the American Dream. It is also a socio-economic outcome directly opposed to the EU Lisbon Strategy targets stressing the matching of competitiveness and social cohesion objectives.

The intensity and nature of a few important concerns in that respect are summarily outlined below.

### *Income inequality*

Between 1979 and 2002, according to the Congressional Budget Office (CBO) the average after-tax income of the lowest fifth only increased by 4.5% while the top fifth rose by 48.2% and the top 1 percent by 111%. The second and middle fifths rose by 12% and 15%. The quintile next to the top rose by 24% – even so, only half the rise of the top fifth.

Another way to document the rising income inequality is to look at the development of the after-tax income of each group as a share of total income. The top one percent of the population received 11.4% of national after-tax income in 2002, up from 7.5% in 1979; the various low and middle income groups all fell.<sup>1</sup> We have to go back 70 years, to the middle of the 1930's, to find narrower income disparities. A publication of the Center on Budget and Policy Priorities of the Economic Policy Institute states that “the richest one percent of households received a

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<sup>1</sup> See Congressional Budget Office (CBO), *Effective Federal Tax Rates: 1979-2002*, March 2005.

larger share of the national income in 2002 than at any time since 1937, except for 1988 and the period from 1997 to 2001". In fact, this concentration trend received a new impetus in the second half of the last decade and certainly persisted up to 2005.<sup>2</sup> This is a new turn of the socio-economic model, exacerbated by Federal policies aiming at reducing taxation for the wealthiest and freezing the minimum wage for poor low-skilled workers.

Tax-cut bills enacted since 2001 will give the lowest fifth an average tax cut of \$18 which translates to a positive change of 0.3% in their average after-tax income. The corresponding figures for the middle fifth are \$742 and 2.6%; for the top one percent \$3.900 and 4.6%; and households with income exceeding \$1 million will receive an average tax cut of \$103.000 and a 5.4% rise in their after tax-income. The 103.000 tax cut is 140 times the average tax cut that middle-income households will receive. Tax cuts enacted in 2001 but effective after 2005 will go almost entirely to people with incomes above \$200.000, reinforcing structural income inequality.

The annual cost of tax cuts for the top one percent millionaires alone is nearly equal to the amounts allocated to education and significantly higher than the amounts spent on housing and urban development and environmental protection together. The total annual costs of tax cuts are superior to the amounts the Federal government spends on education, war veterans, housing and urban development and the environment lumped together.<sup>3</sup>

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<sup>2</sup> CBO, New CBO Data Indicate Long-Term Growth in Income Inequality Countries, January 2006. See also Thomas Picketty and Emmanuel Saez, Income Inequality in the United States in *Quarterly Journal of Economics*, February 2003, updated at <http://elsa.berkeley.edu/~saez/TabFig2004prel.xls>.

<sup>3</sup> The distributional profile of the tax cuts enacted since 2001 is abundantly documented in various studies, including those undertaken by the Brookings Institution and Urban Institute Joint Tax Policy Center ([www.taxpolicy.org](http://www.taxpolicy.org)) and the Economic Policy Institute Center on Budget and Policy Priorities ([www.cbpp.org](http://www.cbpp.org)).

In the same vein, Federal policy has kept the minimum wage unchanged for the last 8 years, thus hurting the lower end of the income ladder. This decision has been devastating for low-skilled and poor workers. That helps to explain why there are millions working full time and yet living in poverty in America, the wealthiest country in the world, a fact almost unbelievable. The Economic Policy Institute notes that during the 1950's and the 1960's, the minimum wage averaged 50 percent of the wage of workers in non-supervisory positions, but the minimum wage has now fallen to 32 percent [of the average wage of about \$16 for non-supervisory workers]. In purchasing power terms, the minimum wage doubled in the transition from the late forties to the fifties, from 2.75 to 5.62, to rise again to 7.44 in 1968. It averaged nearly 6.50 in the 60's, to decline to its present value of 5.15. This decline has been devastating for low-skilled and poor workers.<sup>4</sup>

Between 1947 and 1973 productivity and real median family income both grew at the same pace, a record 103% rise. From 1973 to 2002 productivity rose by 65% but median family income only grew by 22%, a third of productivity growth. Since the 1<sup>st</sup> quarter of 2001 almost all real income growth (98.5%) went to capital, leaving labour compensation stagnant.

Differences in hours worked have been emphasised as a key distinction separating the US and EU models. And properly so. Part of the explanation may lie in diverging preferences, the Europeans favouring leisure over income, as Olivier Blanchard has strongly argued. However, it could be not so much a matter of unconstrained preferences but rather of a survival reaction to stagnant real wages. In the words of the EPI report "the necessary strategy for income growth for many middle-income families has been to devote more hours to work in the paid labour market than in the past. Largely due to the increased labour supply of wives,

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<sup>4</sup>See Economic Policy Institute Minimum Wage Issues Guide.

married couples with children in the middle income fifth, for example, were working 500 hours more per year in 2000 than in 1979, the equivalent of 12 and a half more full-time weeks per year. Because of these wives' contributions, instead of growing only 5% in real terms, middle-class family income grew 24%".

An important implication of the new model dynamics in the face of globalization and rapid technological change is the significant drop in the share of wages and salaries in GDP. It is now at 45.4%, the lowest level ever recorded, with data available from 1929, down from 49.5% in the first quarter of 2001. For the 14 quarters since then it has fallen continuously as a consequence of almost stagnating real wages and salaries. In average comparable periods since World War II real wages and salaries rose by 8.7% and corporate profits by 12.3%. In the recent 14 quarters real wages and salaries have increased by 0.3% and corporate profits by 40.4%. The US system is also known for enormous differences between CEO compensation and the corresponding figures for the average worker. In 1965 CEOs received 26 times the typical worker pay. In 2003 they received 185 times more. From 1992 to 2002, the median CEO raised pay by 80%, ten times more than the median worker.

Wage inequality is growing for a variety of reasons, some of which are related to adverse policies, others related to more or less compelling factors in the market scene. Following EPI estimates, a third of the growing wage inequality can be explained by the drop in real wages, already referred to, and de-unionisation. Another third by the increasing globalization of the economy through immigration, trade and capital mobility, and the employment shift out of manufacturing and into low-paid service industries.<sup>5</sup> All these heavy trends have come to stay.

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<sup>5</sup> Economic Policy Institute publications, including *The State of Working America 2004/2005*, documenting the rising structural inequality in relation to labour market issues.

## *Inequality in health and pensions coverage*

Research shows that in advanced countries the shares of GDP resources dedicated to several areas of investment in people are quite often not much different. What is often in sharp contrast is the source of finance and the corresponding rates of coverage. Generally speaking, lower public spending and higher private finance participation go hand in hand with more social exclusion and less coverage for the poor, the bottom and lower middle groups and, overwhelmingly, in the US case, racial minorities. The US/EU comparison provides a clear example of that situation, as it exposes extreme bias against vast segments of the American population. As far as the role of the US socio-economic model is concerned, the comparison is aggravated by the fact that in the US system enterprises central to the functioning of the model are responsible for a very high share, by European standards, of existing insurance coverage.

In a recent survey of inequality and health issues in the United States, M. Lillie-Blanton, Vice-President in Health Policy of the Henry J. Kayser Family Foundation<sup>6</sup>, criticises the existing system, on the grounds that its “outcomes are poorer than some countries that spend less” and its “performance is tarnished by glaring inequalities” adding that “poorer health outcomes in the US relative to other industrialized countries [are] explained by disparities related to socioeconomic position, race/ethnicity and insurance coverage and access to quality care. For example, the infant mortality rate, a key indicator, is 7.0 for the nation as a whole but 5.7 for whites and 14.0 for blacks. The latter figure is the same as in Kerala, India, slightly higher than in Sri Lanka

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<sup>6</sup> The Kaiser Family Foundation ([www.kff.org](http://www.kff.org)) is a distinguished source of studies and evaluations of access to health care, including insurance and inequality issues. M. Lillian-Blanton, a vice-president of the KFF, has written extensively on access disparities along income, gender, racial and ethnic lines.

(13.0) and the double of Malaysia (7.0). Heart disease death rates for male adults (25-64 years) per 100.000 persons are 142 for white males and 137 for African American males with over \$15.000 in income and 324 for white males and 391 for African American males with under \$10.000 in income.

Given the high costs of health treatment, the role of insurance coverage in the provision of access to quality care is vital, in the true sense of the word. In 2003, for 54% of the US population health insurance coverage was provided by the employer; 5% by other private sources; and 26% by Medicaid, Medicare and other public sources. But 16%, or 46 million people, had no insurance at all. Uninsured people face serious barriers in access to care. In the 12 months preceding a Kaiser Family Foundation inquiry in 2003, 42% of them experienced no regular source of care, as against 9% among insured people; 35% needed care but did not get it, as against 9% of insured people, and 47% postponed treatment because of costs while 15% of insured people experienced the same situation.

Health care inequality may well increase in the future because employment-based insurance coverage is diminishing and public-funded insurance is limited.

Regarding pensions, in 1979 half of the work force was covered by employer-provided pensions. Twenty years later only 45.5% of the work force was covered. Coverage is correlated with wage inequality. Higher wage workers are nearly 5 times more likely to be pension-covered than the low-wage ones. The racial divide is also a structural feature of inequality in pension coverage.

### *The booming incarceration rate*

From the 80's onwards the US experienced an explosion in its incarcerated population. This boom has a disproportionate effect

on the poor, the minorities, especially the black minority, and the young. The reasons are to be found in a sustained web, based on the policies involving crime and racial relations and the outcomes of the US socio-economic model. As a leading expert in the field, Bruce Western from Princeton<sup>7</sup> aptly put it: “The prison boom was a political target that arose partially because of rising crime but also in response to an upheaval in American race relations in the 1960’s and the collapse of urban labour markets for low and unskilled men in the 1970’s”. Scant attention has been paid in Europe to this facet of the American model. But the corresponding social malaise is so pervasive and its impacts on any reasonable assessment of the wellbeing associated with the US model so negative that it deserves more than a passing reference.

Quoting Felix Elwert<sup>8</sup> from Harvard: “When parolees and probationers are added to the count of prison and jail inmates, the total number of individuals under the supervision of the current US justice system in 1999 comes to 6.3 million, roughly 3 percent of the adult population and 5 percent of the total labour force. Nationally, one percent of white men and close to seven percent of African American men are incarcerated”. According to the same author, the number of inmates in American prisons has grown from close to 200.000 in 1970 to half a million in 1980 and two million in 2000. From the 80’s to 2000 the corresponding European numbers rose from 212.000 to 366.000. While numbers quadrupled in the US, in Europe, starting from a much lower rate of incarceration, they less than doubled. “Incarceration rates in the OECD countries ranged between 60 and 130. The US, by contrast, imprisoned 680 out of every 100.000 adult residents, more than seven times the European average”.

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<sup>7</sup> The Bruce Western research is reported in depth in his recent book, *Punishment and Inequality in America*, The Russel Sage Foundation, 2006.

<sup>8</sup> See his paper, *The Effect of Incarceration on Aggregate Employment Rates*, Department of Sociology, 2004.

Even more disturbing is the composition bias of the population that is feeding the incarceration boom. Pettit and Western wrote that “the basic brute fact of incarceration in the new era of mass incarceration is that African Americans are seven times more likely to be incarcerated than whites. Among black men born in the late 1960’s who received no more than high school education, 30 percent had served several times in prison by their mid-thirties; 60 percent of high school dropouts had prison records.<sup>9</sup> Although far from being the sole factor responsible, the US socio-economic model is part of the problem, not of the solution. As already recorded, the collapse of labour markets for low-skilled people is one of the reasons for the incarceration boom. Almost four decades after its initial acceleration there are still no labour educational and active labour market policies able to abate this appalling trend.

### *The slowdown of mobility*

Mobility is the central piece of the American Dream. Blatant inequality has always been a fact of life in American society, most especially in the social field and the labour market. The political, social and ethical accommodation to this situation rests on the widely shared notion that social mobility is sufficiently intense and pervasive to make it possible to escape from the bottom and low rungs by sheer individual effort and merit. Thus, America remains the land of opportunity and plenty even for the worst-off dreamer.

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<sup>9</sup> Pettit, Becky and Bruce Western, Mass Employment and the Life Course: Race and Class Inequality in U.S. Incarceration, *American Sociological Review*, 2004, 69. Also Western and Pettit, Black-White Wage Inequality, Employment Rates and Incarceration, *American Journal of Sociology*, 2005.



This is permanent good news in the eyes of staunch defenders of the US socio-economic model as it exists. The future is always within the reach of individual effort and merit.

The bad news is that mobility is slowing down at an accelerated pace. In the report *The State of Working America 2004-05* we can find the following assertion: “Thus, there now exists far more income inequality in the United States than has been the case in earlier periods. Some commentators have downplayed this problem by citing supposedly higher levels of income mobility, such that those who begin at the low end of the income scale have a strong likelihood of leapfrogging to the top. The evidence, however, contradicts this contention. Of those who started out in the lowest income fifth in the late 1980s, more than half (53%) were still there in the late 1990s, and another 24% had climbed only to the next fifth, meaning that 77% of those who started out in the low end of the income scale remained there a decade later. Furthermore, the rate of mobility has slowed slightly over time. In the 1970s, 49% of families that started out in the bottom fifth were still there 10 years later”.

Life long income profiles also support the view that the mobility machine is increasingly slowing down as proved by the following facts: over the course of their work life, the income of median families starting out in 1949 grew 138.1%. Total growth was 100.7% for those starting out in 1959; 61.7% for 1969; and 59% for 1979’s young families.

### *The unacceptable side of the US model*

Given the rising inequality inherent in the US socio-economic model structure and dynamics, the reform of the European model should avoid at all costs opening the door to institutional innovations leading to the kind of social outcomes as appalling as

those surveyed in the previous pages. If we take the Lisbon objectives seriously, including their central aspiration to combine sustainable economic growth with better jobs and greater social cohesion, this dark side of the US model is totally unacceptable in European societies. There is no doubt that the US economy as a whole performs significantly better than its EU counterpart, in terms of GDP per capita and productivity growth rates. But the European Commission, as well as many other institutions and individual authors, are simply wrong in their EU/US comparison when they equate higher growth trends in the US with unqualified superiority in terms of standards of living and well-being trends. This is certainly the case for those in the top income brackets, but not so for the many more millions and millions who are less well-off. If anything, the EU model outcomes are vastly superior regarding distributional, social cohesion and related social protection issues.

We all know that in America we can find plenty of admirable civic, cultural, caring and socializing opportunities, as good as (sometimes better than) those that can be found anywhere else in the world. The problem is the heavily biased access to them, socially-wise.

### *The need to revitalise the EU model's economic basis*

The key problem to solve in the near future is how to revitalise the economic foundations of the European model in the face of a twin challenge. The first challenge is to take advantage of globalisation in defiance of increased competition coming, simultaneously, from the US in the most innovative markets and from the emerging labour-abundant and technologically fast-upgrading Asian economies, advancing in low and medium technology markets. The second challenge is to negotiate the mobilization of

extra resources — necessary to finance aging and human improvement related to social spending.

The answer to this twin problem is, in principle, simple enough: the continued success of the European model, adequately reformed, requires above all a significant jump in the long-term productivity growth rate, adding at least 1.5 percentage points to the trend over the last ten years. Where should we look for the determinants of such a sustained productivity rise?

### *The determinants of productivity growth*

The standard policy advice prevailing in Brussels, as a European echo to the Washington consensus, was to deregulate as much as possible using the US as a benchmark, and to leave the rest to the market. The high point of this approach already seems to be in the past, although the attitude is still heavily entrenched in important decision-making centres. To the surprise of many, in 2004 the European Commission published a study showing the rather limited potential of deregulation, in comparison with other determinants of labour productivity growth.

According to Cecile Denis, Kieran McMorrow and Werner Rögger, as recorded in Table I of the study *An Analysis of EU and US Productivity Developments*<sup>10</sup>, the effect on the annual labour productivity growth rate of moving the EU to US levels of regulation would only be 0.15 of a percentage point. However, the effect of a permanent 1 percentage point increase in R&D spending would be 0.60, 4 times higher, and the effect of a permanent 1-

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<sup>10</sup> Cecile Denis, Kieran McMorrow and Werner Rögger, as recorded in Table 10, Figure 48, of their *An Analysis of EU and US Productivity Developments*, Economic Paper n.º 208, July 2004, p. 40, Directorate-General for Economic and Financial Affairs, European Commission, <http://europa.eu.int/comme/economy-finance>.

Table I  
Overview of long run effects of labour productivity determinants

MAJOR DETERMINANTS	EFFECT ON ANNUAL LABOUR PRODUCTIVITY GROWTH RATE (PERCENTAGE POINTS)
Physical investments + regulation (capital deepening)	
Physical investment (permanent 1 percentage point increase in investment share) .....	0.05
Regulation (EU moving to US levels of regulation) .....	0.15
Knowledge investment (TFP)	
R&D (permanent 1 percentage point increase in R&D spending) .....	0.60
Education (permanent 1-year increase in average education) .....	0.45
Aging (permanent 10 percentage point decline in youth dependency ratio) .....	-0.25
Openness & market size (permanent 10 percentage point increase in intra-european trade) .....	0.10
Hours worked (capital deepening)	
Permanent 1 percentage point increase in hours worked	-0.25

*Source:* see text.

year increase in average education levels of the labour force would be 0.40, more than 2.5 times.

R&D and education clearly emerge as the most potent determinants of labour productivity growth. Another study of the European Commission reports that R&D represents 43% and education 31% of the determinants of US labour productivity growth in the period 1950-2003.<sup>11</sup>

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<sup>11</sup> C. Denis, K. McMorrow, W. Röger and R. Veugelers, The Lisbon Strategy and the EU Structural Productivity Problem, Economic Paper n.º 22, February 2005, p. 40, Directorate-General for Economic and Financial Affairs.

The performance of each determinant of labour productivity growth cannot be seen in isolation. On the contrary, it can only be understood embedded in the context of a wide array of interactions, institutional and otherwise, which define a specific innovation model. Adding to these multidimensional and interconnected characteristics of the innovative process, we must also keep in mind the specificity of each innovation territory or domain. Somehow, this conditions the effectiveness of possible policy transplants from one innovation model to another. Thus, the purpose of the following remarks cannot be, of course, for us to end up with some sort of shopping list but, rather, to identify, in a broad manner, what we can usefully learn from a comparison of the innovation models prevailing in the US and the EU.

On that basis, the superiority of the US innovation model and the weaknesses of its EU counterpart are clear. That is the unmitigated conclusion of the above-mentioned study by the Directorate-General for Economic and Financial Affairs on the Lisbon Strategy and the EU's structural productivity problem.

Building on recent research about knowledge creation and absorption processes embedded in national innovation systems, they use the concept of a national innovation capacity, "defined as the ability of a nation to not only produce new ideas but also to commercialize a flow of innovations over the long term... From this perspective a range of factors are deemed to be important for an effective effort", namely overall innovation infrastructure able to guarantee a sufficiently developed "supply" side of R&D, and broaden framework conditions/flanking policies to ensure a sufficient and sophisticated "demand" for innovation and the interconnectedness of the overall innovation system. "Perhaps the most critical element in the framework is

Table II  
 Production and absorption of new technologies

Production and absorption of new technologies: key to an effective long run productivity strategy		
75% of US productivity growth rate for the period 1950-2003 was based on more knowledge intensive forms of investment (R&D + human capital)		
US has a superior innovation model to that of the EU in terms of both knowledge creation + absorption		
More resources (financial + human)	Better linkages between the key innovation actors in public + private sectors	Better framework conditions (healthier creative destruction + market experimentation processes)
US superiority is reflected in:		
Proven ability to re-orientate its R&D activities towards the new high productivity, growth areas	Higher rates of return on their R&D investments	A high and rapidly expanding share of internationally mobile R&D expenditures
Reforming the EU's innovation capacity: action is needed in terms of resources, framework conditions and linkages		

Source: C. Denis, K. McMorrow, W. Röger and R. Veugelers, The Lisbon Strategy and the EU's structural productivity problem, European Commission, Directorate-General for Economic and Financial Affairs, Economic Paper 221, February 2005, page 55.

the interconnectedness of the agents in the system, linking the common innovation infrastructure to specific technological clusters”.<sup>12</sup>

A careful assessment of the situation in the US and EU allows the authors to draw a number of important conclusions that can be summarised as follows:

- “Firstly, in terms of absolute expenditures, the US retains a sizeable advantage over the EU in terms of overall R&D spending”
- “Secondly, the EU’s R&D expenditures are not focused on the best industries from a high productivity growth rate perspective”
- Thirdly, given that the productivity enhancing characteristics of ICT were already known in the first half of the 1990’s, what is particularly significant ... “is the fact that the US’s dominance in ICT manufacturing was not seriously challenged over the second half of the 1990’s”
- “Fourthly, ... in each individual sector while the EU may be dominant in low productivity growth, high technology industries, such as cars and chemicals, the US is dominant in the high productivity/high technology areas of IT hardware and electronics”

The EU problem is specifically due to the big members: France, Italy, Germany and the UK. Smaller members, like Finland and the Netherlands, show a good performance even in comparison with the US. As the study emphasises “the most significant issue posed by the above analysis is not so much the differences in the amounts of resources devoted to the knowledge production sector, but the EU’s systematic failure (espe-

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<sup>12</sup> Op. cit. pp. 41 and 42.

cially in the larger member states) to refocus its R&D activities over the 1990's, firstly on *established* high productivity growth industries such as ICT, and secondly on *potentially* high productivity growth industries in the pharmaceutical/biotech area and perhaps also in a number of service industries (software and computer related services)".<sup>13</sup>

In the chart reproduced above, the authors of the European Commission study rightly emphasise the need for in-depth reform of the EU's innovation capacity for that purpose: "Action is needed in terms of resources, framework conditions and linkages".

### *A final note*

The belief that increased innovation capacity can only be obtained if Europe comes very close to the adoption of the social side of the US model is against logic and common sense. The most critical battle for the future of the European model is about the revitalisation of the EU's innovation capacity. If this battle ends up in sustained improvement in EU competitiveness and growth prospects, then the social side of the model is certainly affordable and can strive to function at no greater cost than parameter adjustments to the new realities of social justice and fairness in a rapidly changing world. Finally the dramatic and significant changes in the European goods, services and labour markets need to be matched with an increased perception of fairness in the sharing of the corresponding benefits. Reversing the strategy, that is, dismantling the social side of the European compromise between labour and capital in the expectation of a derived innovation boom fuelled by low social costs, is certainly a fuzzy dream

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<sup>13</sup> Op. cit figures 48 and 49.



of market fundamentalists. More disastrously than that, it can also pave the way to disruptive social antagonism at the cost of weakened governability. Thus, at the cost of competitiveness and the national capacity to innovate.



Changing relations between state and market  
Recent reforms of social democratic governments  
in six European countries

ALEXANDER PETRING

*Introduction*

The relationship between state and market has undergone several changes over the recent centuries and it has never been without tension.<sup>1</sup> Times of a fully state-controlled market were followed by the decades of early capitalism. The second half of the twentieth century seemed to bring a conciliation of state and market in a growing number of states, especially in Europe. And as the taming of market forces was a key concern of social democracy from its beginnings, the 50s and 60s were known as the “golden age of social democracy”. In those days social democracy was not only successful in terms of elections and government participation but also with respect to economic management in many European countries. Keynesianism provided social demo-

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<sup>1</sup> This article is based on the research project “The Capacity to Reform: Social Democracy in Power” funded by the German Science Foundation (DFG). The full report will be published in January 2006: Wolfgang Merkel, Christoph Egle, Christian Henkes, Tobias Ostheim, Alexander Petring: “Die Reformfähigkeit der Sozialdemokratie. Herausforderungen und Bilanz der Regierungspolitik in Westeuropa”, VS Verlag 2006. An English translation is forthcoming.

cratic parties with a theory which reconciled the interests of the working class with the successful management of the economy. Not only social democrats relied on Keynesian instruments, as the Nixon Government in the US or Edward Heath in the UK demonstrated. Those days were the honeymoon of the democratic nation state and the market economy.

Over the last two or three decades a new stage in the relationship between state and market has evolved. But this is, as is often argued, not a voluntarily chosen relationship nor is it the intended consequence of governmental policies nor, again, does it represent the preferences of citizens. In contrast, globalization and Europeanization are the reasons why the state has lost its power to pursue Keynesian policies, to control the level of unemployment and to levy taxes equally on citizens, companies and capital.

Is it true that state intervention in the economy at the beginning of the 21<sup>st</sup> century is without effect, if not counterproductive? Should governments retreat from all measures that could also be fulfilled by the market? Are there new areas for state intervention in the 21<sup>st</sup> century? To answer these questions, recent reforms in fiscal, employment and social policy in six western European countries with social democratic governments will be analyzed.

Social democratic governments are, for various reasons, good subjects in the search for an answer to this question. First, they are not suspected of fostering (neo)liberal policies for their own sake. The investigation of social democratic policies should therefore draw the line between effective state interventions on the one hand, and inefficacious or even counterproductive measures on the other hand. Second, during the 1990s, several European countries were governed by these policies, so that a cross-country comparison within a relatively fixed period is possible. The countries under investigation will be Denmark, France, Germany, the Netherlands, Sweden and the United Kingdom. Within those six countries fiscal policies, employment policies and social policies

will be compared. Those policy fields have always been crucial to social democratic policy-making. The main reforms will be described briefly and the related performance in the three policy fields will be evaluated. Thereafter, a typology of social democratic parties will be developed.

*The fiscal, employment and social policy  
of social democratic governments*

*Fiscal policy*

The two most important issues in fiscal policy are taxation and budgetary policy. The budgetary situation of all governments at the beginning of their incumbency was at least displeasing. How did the governments react to this situation?

Table III  
Public debt and yearly deficits in 2003  
(changes compared to values at assumption of office)

	UNITED KINGDOM	NEDERLANDS	GERMANY	FRANCE	DENMARK	SWEDEN
Debt as % of GDP	39,70% (-11,1)	54,30% (-22,1)	64,20% (+3,3)	63,90% (+4,6)	44,70% (-36,4)	52,00% (-21,9)
Deficits as % of GDP	-3,40% (-1,4)	-3,20% (+0,3)	-3,80% (-1,6)	-4,20% (-1,2)	1,20% (+4,9)	0,20% (+9,5)

Source: Eurostat 2005.

Sweden, United Kingdom and Netherlands succeeded in reducing the debt burden and budget deficits, mainly by means of expenditures cuts. New Labour used the attained room to manoeuvre for higher public spending subsequently, especially in

the NHS Programme and extra spending for schools and transport. The Danish social democrats started with a deficit-financed spending program and tax reductions. After the economic upswing taxes were increased and the deficit decreased significantly. Germany and France failed (or, in the latter case, did not want) to curb expenditure. A fiscal squeeze of rising expenditure and declining revenues led to their recurrently breaking the Maastricht rule to keep the budget deficit below 3%.

The tax policies of the six countries also differed to a substantial degree. The two Scandinavian countries maintained their high tax burdens. This is particularly true for personal income taxes and VAT. The exception is corporate taxes and capital taxes. They had been reduced to stop capital outflow which caused tremendous problems to Sweden's economy during the early 1990s.

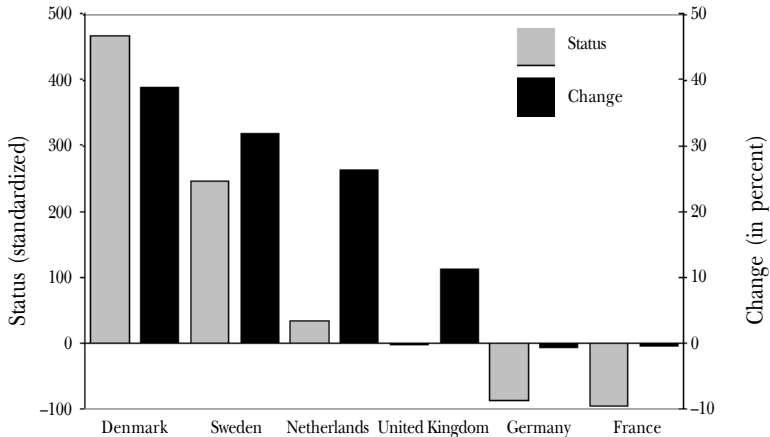
In the United Kingdom the tax burden for the lowest incomes and for families with children, in particular, was reduced substantially. On the other hand, several indirect taxes were raised — the so called “stealth taxes” — and the overall share of taxes as a percentage of GDP thereby increased.

In the Netherlands and in Germany, the higher incomes benefited more from the changes in personal income taxation than the lower incomes. Only in the Netherlands can a significant increase in the share of indirect taxes in the overall tax burden be observed. The French socialists pursued a distinct policy: income taxes and capital increased, the share of indirect taxes in the total decreased.

A somewhat clearer trend can be observed with respect to corporation tax. Again, with the exception of France, all countries lowered corporation tax or maintained comparatively low levels. There are also similarities with regard to indirect taxation, for example all countries implemented so-called eco-taxes on fuel, gas, water or electricity.

The relative performance of the six countries in fiscal policy can be illustrated by standardization of national debt and structural budget deficits (see Figure 1). The status in 2002 shows the Scandinavian countries performing best, followed by the Netherlands. The budget deficit in the United Kingdom in 2002 lowered the British performance; Germany and France performed worst. The indicator for the difference between incumbency and end of government (or 2002) depicts a similar ranking: the German and French policies produced deteriorating outcomes; the other four countries were able to improve their fiscal situation.

Figure 1  
Comparison of performance in fiscal policies\*



\* For the standardization of status at the end of a government and the year 2002 respectively, the country-specific percentage deviations of national debt and structural budget deficit were calculated on the basis of (arithmetic) means of the six countries under consideration. From the beginning of a government till its end and the year 2002, respectively, the total sum of percentage point differences of both indicators was used in order to generate the index of change. In both cases, positive figures account for lower debt or deficits; negative figures signify higher debt or deficits. *Source:* own calculations on the basis of OECD Economic Prospects No. 70, Dec. 2001/No. 73, June 2003, Paris.

## *Employment policy*

Employment policy consists of three core areas: labour market regulation and employment protection legislation, public employment, and legislation related to unemployment insurance and labour market programmes.

With regard to employment protection legislation, in the mid-90s the differences between the countries were considerably high. While regulations concerning regular employment have been maintained at their respective levels, the regulations for flexible employment have been reduced. Again France is the exception: legal provisions for flexible employment have been tightened by the Socialist government. The small increase in regulation in the UK is mainly due to the signing of the EU's social charter and the introduction of the related minimum standards. The improvement in workers' rights has mainly enhanced individual rights; the bargaining position of trade unions has not been strengthened significantly. France is the only country where legal measures to reduce working time have been pursued. The main changes in the Netherlands have been the upgrading of social security entitlements for part-time workers and promotion

Table IV  
Employment protection legislation 2003 (and change since end of the 1980s)

	REGULAR EMPLOYMENT	FLEXIBLE EMPLOYMENT	OVERALL SCORE
United Kingdom	1.1 (+0.2)	0.4 (+0.1)	0.7 (+0.1)
Germany	2.7 (-0.1)	1.8 (-2.0)	2.2 (-1.0)
France	2.5 (+0.2)	3.6 (+0.5)	3.0 (+0.3)
Sweden	2.9 ( $\pm$ 0)	1.6 (-2.5)	2.2 (-1.3)
Denmark	1.5 ( $\pm$ 0)	1.4 (-1.7)	1.4 (-0.9)
Netherlands	3.1 ( $\pm$ 0)	1.2 (-1.2)	2.1 (-0.6)

*Source:* OECD Employment Outlook 2004.



of female and part-time employment via the tax system. Increasing part-time work is the most important factor for the tremendous increase in female employment during the 90s.

With regard to public employment, the two Scandinavian countries have by far the biggest public sector: over 20 percent of the labour force is on the state's payroll. Germany, United Kingdom and the Netherlands have a significantly smaller public sector (between 8-10%), while in France about 15% of the labour force is in public employment. Public employment has been a traditional instrument in the employment policy of social democratic parties, but at least in those countries with a low or medium share of public employment like the Netherlands, Germany or France, no big changes took place. The Scandinavian countries maintained their comparatively high levels, although the numbers in Sweden are decreasing.

Only little changes occurred in the duration and level of unemployment benefits. Eligibility criteria have been tightened to some extent, but especially in the Danish and Swedish cases, the status quo was comparatively generous.

The most striking similarity in the employment policies of the six social democratic governments was the introduction or expansion of activating labour market policies (ALMP). The so-called New Deals were one of the most important policy measures of New Labour's first term and, with the exception of France, all other countries made participation in those labour market programmes obligatory and non-cooperation punishable (in Germany not until 2004). But under the surface of this similarity, big differences remain (see Table V).

The relationship between "rights and duties" for the unemployed in the Scandinavian countries differs a lot compared to the United Kingdom. The spending for education and training is remarkably higher in Sweden and Denmark. Although New Labour spent extra money for the New Deals, the training pro-

Table V  
Labour market expenditure 2002

	DENMARK	SWEDEN	GERMANY	NETHERLANDS	FRANCE	UNITED KINGDOM
Unemployment rate	4.6%	5.1%	8.6%	2.8%	8.7%	5.2%
Expenditure for education and training (% of total spending for labour market policy)	14.97%	26.93%	13.04%	3.67%	8.72%	5.20%
Average spending for education and training per unemployed (in €)	8409.43	7288.39	2548.07	1879.17	995.86	299.16

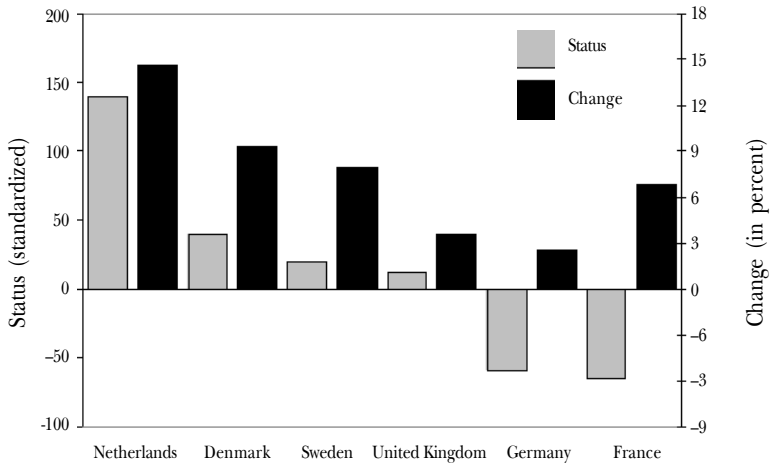
*Source:* Eurostat

grammes are still underdeveloped compared to the Scandinavian countries. In the Netherlands the activating measures came along with the decentralization of job centres and promotion of private providers of training programmes. In France, ALMP have been implemented with no additional sanctions for the unemployed not accepting a job offer. Therefore the “activating” part of labour market programmes is still small. In general, Activating Labour Market Policies can be interpreted as a marketization but, within those schemes, cross-country differences remain strong and the state plays a central role at least in the Scandinavian countries.

To sum up, the United Kingdom pursued the most market-oriented way in labour market policy, followed by the Netherlands. The Scandinavian countries also resorted to ALMP but public spending on training and education is remarkably higher, and public employment is still on a very high level. While in Germany only little changes occurred (up to 2004 when the so called “Hartz-reforms” were implemented), France followed a rather traditional approach.

What pattern do we find with regard to the outcomes of employment policy? The employment performance indicator (see

Figure 2  
Comparison in performance in employment policies\*



\*For the standardization of status at the end of a government and the year 2002 respectively, the country-specific percentage deviations of rates of employment and unemployment were calculated on the basis of (arithmetic) means of the six countries under consideration. From the beginning of a government till its end and the year 2002, respectively, the total sum of percentage point differences of both indicators was used in order to generate the indicator of change. Positive figures indicate lower rates of unemployment and higher rates of employment, respectively; negative figures signify higher rates of unemployment and lower rates of employment, respectively.

Source: own calculations on the basis of the European Commission, Eurostat (<http://www.europa.eu.int/comm/eurostat/>) (January 2004).

Figure 2) combined employment and unemployment rates. The status indicator for 2002 maps the four countries with either market-oriented policies (United Kingdom, Netherlands) or a mixture of state and market policies (Sweden, Denmark) with the best performance. Although some positive developments in Germany and France can be observed, their record is still poor.

## *Social policy*

The easiest way to measure the degree of state intervention in social policy is to look at the social spending ratio. The lower the ratio of money spent by the state for social issues, the more citizens have to rely on private insurance. But an increase in social spending could have several reasons. Measured as a percentage of GDP, social spending will automatically rise if unemployment increases. The same counts for an increasing number of pensioners, or constant social spending combined with a shrinking GDP. For this reason, a so-called “standardized social spending ratio” has been developed<sup>2</sup>, which controls for the two biggest external push-factors of public spending: the ratio of pensioners and the unemployment rate (Siegel 2002).

While the difference in social spending at the beginning of the terms in office and 2002 indicates expanding state activities in Germany but retrenchment in Denmark and Sweden, the numbers for standardized social expenditure indicate the opposite (see Table VI). Obviously, a big share of the rising expenditures in Germany can be explained by rising unemployment rates and higher numbers of pensioners. Denmark seems to adhere to massive social spending although the unemployment rates have been declining. Because of these contradictory findings we should have a closer look at social policy. What reforms have been implemented in health, pension and family policy? Compared to fiscal and employment policy, heterogeneity between the six countries is much bigger in this policy field. Policy changes in the countries were mainly following the paths of their respective welfare systems.

The Scandinavian tax-financed welfare systems with their strong bias towards social services maintained their core features. While

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<sup>2</sup> Cf. Nico A. Siegel 2002: Baustelle Sozialpolitik. Konsolidierung und Rückbau im internationalen Vergleich, Campus, Frankfurt am Main.

Table VI  
Social expenditure and standardised social expenditure

	SOCIAL EXPENDITURE (% OF GDP)			STANDARDIZED SOCIAL EXPENDITURE		
	BEGINNING OF TERM OF OFFICE	2002	DIFF.	BEGINNING OF TERM OF OFFICE	2002	DIFF.
Netherlands	31.7%	28.5%	-3.2	96.06	94.37	-1.69
Denmark	31.9%	30%	-1.9	78.57	87.72	9.15
Sweden	36.8%	32.5%	-4.3	82.51	82.70	0.19
United Kingdom	27.5%	27.6%	0.1	71.80	74.39	2.59
France	30.8%	30.6%	-0.2	72.47	74.09	1.62
Germany	29.3%	30.5%	1.2	72.52	71.93	-0.59

*Source:* OECD, own calculations.

the level of benefits was maintained (in Sweden cutbacks of benefit levels occurred only temporarily), the social services have been expanded. Both countries increased public employment in the health care systems and expanded their child care facilities. Indeed, decentralisation and more power for local governments to decide over the entry of private providers into child care, care for the elderly and parts of medical care led to more competition in the field of social policy in Sweden. However, the strong role of the state in social policy has been maintained in both countries.

In the United Kingdom, the use of the tax system for social policy purposes was one striking trend. The working families tax credit the child tax credit, and the pension credit connected social transfers with work incentives or were used as an implicit means-test. Although public employment in the NHS has increased since 2000, New Labour also resorted to market instruments like Public Private Partnerships (PPP) and the Public Finance Initiative (PFI). In pension policy, one can also see a mixture of private and public instruments. Besides extra spending for pensioners with low incomes, occupational pensions or state-controlled private pensions should become the central income source of pensioners in the

future. As a result, in the UK extra spending in some areas of social policy (health, education) was combined with a still strong or increasing private or market pillar (pensions, health).

The politics of the social democratic governments in the contribution-financed welfare states of Germany and France were mainly concerned with stabilizing expenditure. While Germany failed, with the exception of the introduction of a private pillar in the pension system, in France expenditure has actually been increased by the introduction of a health insurance scheme for low-income earners. In both countries, the governments were not able or willing to implement bigger reforms despite the obvious necessity.

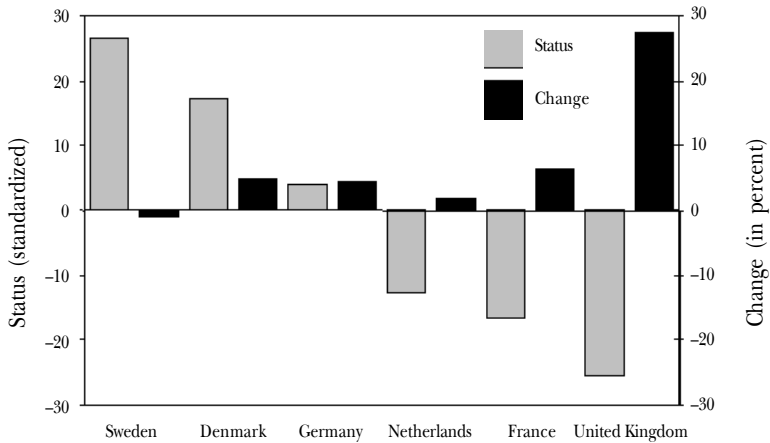
In the Netherlands, also a contribution-financed welfare state, reform took place. Sick pay and disability insurance have been privatized. Not employees but employers have to pay for the insurance. Besides this privatization, structural reforms changed the administration of social security. Several bi- or tri-party administrative bodies have been transformed into independent administrations or supervisory bodies controlled by the state.

The performance in social policy shows a somewhat different picture compared to fiscal and employment policy. Again, the Scandinavian countries are performing best. Although the development in Sweden was negative, the government was able to maintain the highest level of social spending per capita and the lowest rates of poverty. Contrary to this, New Labour produced obvious positive changes, but in relation to the other five countries the status in 2002 was still below average.

### *Conclusion: three different strategies*

The lower ranking of United Kingdom and the Netherlands in social policy compared to fiscal and employment policy hints at

Figure 3  
Comparison of performance in social policies\*



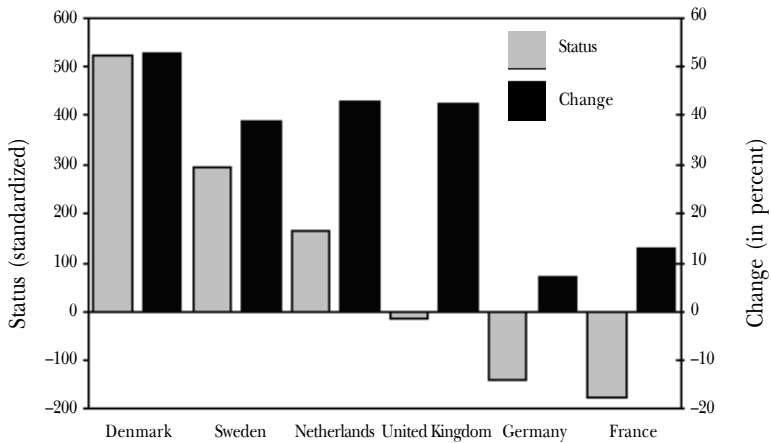
\* For the standardization of status at the end of a government and the year 2001 respectively, the country-specific percentage deviations of social spending per capita in real terms and the rate of change in the risk of poverty before and after social transfers were calculated on the basis of (arithmetic) means of the six countries under consideration. From the beginning of a government till its end and the year 2001, respectively, the total sum of percentage point differences of both indicators was used in order to generate the indicator of change. Positive figures indicate higher rates of social spending and a higher rate of change in the risk of poverty before and after social transfers; negative figures signify lower rates of social spending and a lower rate of change in the risk of poverty before and after social transfers, respectively.

Source: own calculations on the basis of the European Commission, Eurostat (<http://www.europa.eu.int/comm/eurostat/>) (November 2004).

possible trade-offs. The more liberal and market-oriented policies produced good records in fiscal and employment policy at the expense of social policy. The overall performance demonstrates this in comparison to the Scandinavian countries. Although the indicator for change depicts a positive development, the status of both the UK and the Netherlands is worse than those of Sweden

and Denmark in particular. Denmark and Sweden demonstrate that the way out of high public debt, high budget deficits, and high unemployment does not necessarily mean a massive re-trenchment of the welfare state. France and Germany are clearly at the bottom of the ranking. In both countries, the increase in debt and budget deficits has not led to better outcomes in employment and social welfare. The overall performance shows that sticking to the traditional policies of the 70s, as France did, or being unwilling to reform and modernize the welfare state, as happened in Germany, leads to poor results.

Figure 4  
Comparison of overall performance of social democratic governments\*



\* In order to calculate the overall performance of social democratic governments, the total sum of country-specific figures of status and figures of change was used. *Source:* own calculations.

<sup>3</sup> Cf. Peter A. Hall 1993: Policy Paradigms, Social Learning, and the State. The Case of Economic Policymaking in Britain, in: *Comparative Politics* 25 (April 1993), 275-296.



In order to systematise these findings, on the basis of a classification scheme of policy changes by Peter Hall<sup>3</sup>, a typology of social democratic parties can be developed. Peter Hall distinguishes between first, second and third order changes.

- First order change: If instrument settings are changed in the light of new knowledge and experience while the overall goals and instruments of policy remain the same, we can speak of a first order change in policy.
- Second order change: When the instruments of policy as well as their settings are altered, though the overall goals of policy remain the same, we speak of second order change.
- Third order change: If simultaneous changes in all three components of policy making are taking place, i.e. instrument settings, the instruments themselves, and the hierarchy of goals behind them, we can call these wholesale changes third order changes.

Germany and France have hardly changed existing regulations and instruments and are therefore called *traditional social democracies*. As showed before, they also failed to achieve the traditional goals. This seems to be the paradox of the French and German social democracies which adhered strongly to traditional goals but have been far from achieving the objectives.

The *modernized social democracy* does not “liberalize” existing structures of the welfare state and the labour market, but it modernizes them. The so-called “social investment state” reforms social welfare, adapting it to the changed context (global competitiveness), but it does not replace it. This type of social democracy neither limits public social responsibilities nor does it focus increasingly on market solutions for crucial societal problems. It rather expands the role of the “enabling state” to the field of

Table VII  
A typological classification of the six social democratic parties

	CHANGES	FISCAL POLICY	EMPLOYMENT POLICY	SOCIAL POLICY	CHANGE OF POLITICS (OVERALL)	TYPE OF SOCIAL DEMOCRACY
PS France	Goals Strategies	No No	No No	No No	First order	Traditional Social Democracy
SPD Germany	Goals Strategies	No No	No Yes	No No	First order	Traditional Social Democracy
SD Denmark	Goals Strategies	Yes Yes	No Yes	No No	Second order	Modernized Social Democracy
SAP Sweden	Goals Strategies	No Yes	No Yes	No Yes	Second order	Modernized Social Democracy
PvdA Netherlands	Goals Strategies	Yes Yes	No Yes	Yes Yes	Third order	Liberalized Social Democracy
New Labour United Kingdom	Goals Strategies	Yes Yes	No Yes	Yes Yes	Third order	Liberalized Social Democracy

social investments. Therefore, reducing monetary transfers, activating people and including them in the labour market by keeping the standards of social security and social services high is the modern social democratic trade-off. Denmark and Sweden fall into this category.

*Liberal social democracies* at least partially replaced existing state regulations by market solutions and converged towards liberal ideas. The assurance of social-political minimum standards and inclusion in the labour market was pursued more on the basis of

Table VIII  
Formative characteristics of politics of social democratic governments

	LIBERALIZED	MODERNIZED	TRADITIONAL
Fiscal policy	Limit on expenditure and tax reduction; competition-oriented taxation; focus: consolidation	Limit on expenditure and increase in receipts; progressive system of taxation and business taxes sensitive on globalization; consolidation and redistribution	No limit on expenditure but fiscal reform; only provisory competition-oriented taxation; no consolidation
Employment policy	“Activating” labour market policies; focus: inclusion in the labour market	“Activating” labour market policies; focus: investment in human capital	Passive labour market policies; Focus: security of incomes
Social policy	Cutback and privatization; increasing importance of private pensions; focus: poverty prevention	Retention of a high standard of social security and the importance of social services; focus: equal life chances	Retention of a high standard of social security; limited options for increasing social services because of high transfers; focus: protection of status

economic need than social security. New Labour and, to a much lesser degree, the Dutch social democrats (borderline case) show visible traits of this type of social democracy.

What can be learned from those findings with respect to the relationship between state and market? First of all, if the circumstances change due to globalization, Europeanization and demographic change, instruments must be changed, too. The traditional instruments and settings are no longer able to produce or even sustain societal prosperity. That does not mean, however, that state intervention is obsolete. But with scarce resources, the maintenance of the welfare state requires priorities for state engagement. The preconditions of strong and stable welfare states are high employment rates. Therefore the tax systems should provide work incentives and promote female employment. However, the need to lower taxes in some areas at internationally competitive levels does not mean abandoning progressive income taxation altogether. But high tax rates have to be legitimized by means of high quality social services. Social security systems should focus not on the protection of status but promote equal life chances via investment in health services, child care and education. Monetary compensation for unemployment could be the task of the welfare state only for a limited period of time. Sustainable employment policies rather mean investing in training and education — not only for the unemployed but also for people in work.

If the traditional aims of justice, fairness and solidarity should be maintained, the demands on the state are not shrinking but rising. Faced with today's challenges two options remain: to modernize the instruments or to abandon the traditional aims.

APPENDIX

Overview of Central Policy Measures

Tabela IX  
Overview of reforms in social policy

	LABOUR (UNITED KINGDOM)	PVDA (NETHERLANDS)	SPD (GERMAN)	PS (FRANCE)	SD (DENMARK)	SAP (SWEDEN)
Financing	Higher public spending since 1999, PPPs	No changes	No major changes	No major changes	Reduction in contributions; increasing private co-payments	Reduction in contributions for employees; increase in tax financing
Health policy	Privatization	Maintained co-payments; introduction of up-per limit	Introduction of co-payments	Maintained co-payments; introduction of up-per limit	Privatization of sick pay and disability scheme (employers); introduction of co-payments	Maintenance of co-payments; relief for low incomes
Pension policy	Financing	Stakeholder pension, minimum income guarantee	Reduced pension levels, eco-tax to stabilize contributions	Pension reform (contribution-based)	Maintenance of three-pillar model	No changes

Pension policy	Private and occupational pensions	Tax relief for private pensions	Introduction of a state-controlled retirement pension supplement	Introduction of a state-controlled retirement pension supplement	Introduction of a state-controlled retirement pension supplement	No changes	Tax relief for private pensions
Family policy	Child care and family benefits	Extension/introduction of parental leave; extension of child care; measures fighting child poverty	Extension of public employment in child care	Planned extension of child care	Introduction of limits to co-payments for child care; pre-school (free of charge)	Integration of benefits for child care into tax system; tax relief for part-time work; extension of child care via collective bargaining	Income-related family benefits; comprehensive child care maintained
Summary	More means-tests and careful extension of benefits	More competition and privatization	Privatization and benefit cuts; small increase in tax financing	Increase in tax financing and small extension of benefits	Stabilising of benefits; extension of social services	Stabilising of benefits; extension of social services from taxes towards contributions	

Appendix I  
Overview of reforms in fiscal policy

BUDGET POLICY	SD (DENMARK)	SPD (GERMANY)	PS (FRANCE)	LABOUR (UNITED KINGDOM)	PVDA (NETHERLANDS)	SAP (SWEDEN)
Formal or informal commitments	Commitment to surplus over the economic cycle	—	—	“Golden rule” (debt only for investment, balanced budget over the economic cycle, <i>comprehensive spending reviews</i> (departmental budgets over three-year periods)	“Zalm-Norm” (expenditure limits; additional receipts for debt reduction and tax reduction)	Yearly expenditure limits



Expenditures	Deficit-financed spending programme; no significant expenditure cuts	Zig-zag-course	Moderate expansion of expenditures	Adherence of conservative spending plans, expansion after consolidation	Expenditure limits; lower increase in expenditure than revenues	Temporarily, cuts in social benefits; expansion after consolidation
Revenues	Raised indirect taxes (ecotaxes)	Tax reduction	Tax reduction	Raised indirect taxes	Tax reduction after consolidation	Higher tax burden for high incomes
Result	Consolidation	Failed consolidation	Failed consolidation	Consolidation	Consolidation	Consolidation

Appendix II  
Overview of reforms in tax policy

TAX POLICY	SD (DENMARK)	SPD (GERMANY)	FS (FRANCE)	LABOUR (UNITED KINGDOM)	PVDA (NETHERLANDS)	SAP (SWEDEN)
Corporate taxation	Reduced	Reduced	First raised, reduced in 1999/2000, special rates for small and medium companies	Reduced, special rates for small and medium companies and R&D	Elimination of upper rate of corporation tax, special rates for start-ups and R&D	Reduced, special rates for small and medium companies
Income taxation	Reduced; (esp. lower incomes), elimination of tax privileges, later raised upper rate of income tax (59%)	Reduction, higher incomes benefited more; upper rate of income tax in 2005: 42%	Small reduction (esp. low incomes); small reduction of upper rate of income tax (52.5%)	Reduction for families and low incomes (tax credits; reduction of lower rate of income tax); upper rate of income tax: 40%	Tax reform: simplification and reduction (lower incomes benefited more); upper rate of income tax: 52%	Almost no reduction; raised upper rate of income tax (55%)

Capital taxation	Maintained low rates (DIT)	Changes in details without effects	Raised rates in land and property, higher tax exemptions, reduced rates for dividends	Introduction of a flat rate (DIT)	Maintained low rates
Indirect taxation	Introduction of eco-taxes	Introduction of eco-taxes	Introduction of eco-taxes, introduction of eco-taxes, reduced indirect taxation	Introduction of eco-taxes	Introduction of eco-tax ; raised eco-taxes;
VAT and reduced VAT-rates	VAT unchanged: 25%	VAT: 16% (7%)	VAT: 19.6% (3%), VAT: 17.5% (5%), VAT: 12% (6%)	VAT: 19% (6%)	VAT: 25% (6%), VAT: 12%
Result	High progression, high tax burden for all incomes	Alleviated redistribution	Redistribution strengthened	Targeted relief for low incomes, redistribution in general	Progression slightly strengthened; work-incentives for spouses, motion of part-time work
					High progression, high tax burden for all incomes

Appendix III  
Overview of reforms in employment policy

	LABOUR (UNITED KINGDOM)	PVDA (NETHERLANDS)	SPD (GERMANY)	PS (FRANCE)	SD (DENMARK)	SAP (SWEDEN)
ACTIVATING LABOUR MARKET POLICIES	Individual reintegration plans with sanctions	Yes	Rudiments	Rudiments	Yes	Yes
	Labour market programmes with temporary public employment	No	No	For young unemployed	For old unemployed	For long-time unemployed
	Relevance and impact of job subsidies	High	High	Low	Medium	Medium
PASSIVE LABOUR MARKET POLICIES	Cutbacks in the level of unemployment benefits	No	Since 2005	No	No	Temporarily
	Shortening of duration of payment of unemployment insurance	No	Since 2005	No	Yes	Yes
	Tightening of eligibility criteria of unemployment schemes	No	Since 2005	No	Yes	Yes

EMPLOYMENT PROTECTION LEGISLATION		Deregulated status quo maintained	Deregulation	Regulated status quo maintained	Regulated status quo maintained	Deregulated status quo maintained	Regulated status quo maintained
Regular employment		Deregulated status quo maintained	Deregulation, more rights for part-time workers	Slight deregulation	Regulated status quo maintained	Deregulated status quo maintained	Deregulated status quo maintained
Flexible employment		Deregulated status quo maintained	Deregulation, more rights for part-time workers	Slight deregulation	Regulated status quo maintained	Deregulated status quo maintained	Deregulated status quo maintained
Share of regular public employment		Small increase from an average level	Small decrease from a low level	Small decrease from a low level	Small decrease from an average level	Constantly on a high level	Small decrease from a high level
Summary		ALMP with a deregulated labour market	ALMP with a flexible labour market	Little ALMP and almost unchanged labour market regulations	Little ALMP and unchanged labour market regulations	ALMP with a flexible labour market	ALMP with comprehensive education and training programmes

Note: ALMP — *Activating Labour Market Policies*.



## Central areas for public intervention in the economy: changes in the relationship between state and market

JOÃO FERREIRA DO AMARAL<sup>1</sup>

### *Social democracy on the defence*

I intend to address the question of public intervention in the economy in a necessarily very fragmentary manner, given the enormous breadth of the topic. I shall assume from the outset that there is no distinction between levels in the state or, if you will, the public levels at which intervention will be carried out. I am not going to enter into the discussion of essentially national intervention versus EU intervention, for example. Though it is a very important problem, I do not plan to deal with it here.

The public opinion environment in relation to issues of the role of the market economy and the role of the state in the economy is beginning to change for the better. In fact, from my point of view, over the last 25 years socialist or social democratic thinking has been completely supplanted by neo-liberal thinking. Various circumstances were involved in this change.

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In the first place, it was connected with the actual economic theory that emerged in the 1970s (which is in decline today, except in the institutions of the Treaty of Maastricht), the so-called New Classical Economy. This school of economic thought emerged as an important support for neoliberal ideas.

In the second place, it was related to the decline and fall of the Soviet Union, which led to the hurried conclusion that, with the Soviet regime coming to an end, the only alternative model was purely and simply the market economy, the neoliberal market economy. In fact, this did not have to be the conclusion, precisely because the gulf between social democratic regimes and the Soviet regime was tremendous.

In the third place, within the idea itself that the neoliberal model was the only one, an attempt was made somehow to make this universal adoption of the neoliberal model inescapable, by observing the trends in the development of the economy and world society as a whole and arguing that only the market economy could respond to these trends.

In my point of view, the three main trends that can be found today in the economic and social development of humanity are: *globalisation*, *population ageing*, which is general though more active in richer countries, and *environmental pressure*. I shall not address environmental pressure, not because it is not important but because it would demand a different scheme of analysis that would not fit into this space.

### *Globalisation, ageing and state intervention*

As I have mentioned, there has been a desire to convey the message that both globalisation and population ageing should lead to a drastic reduction in state intervention in the economy and the adoption of general deregulation and the privatisation of



public services or social security schemes. This link between one thing and the other is completely wrong. If anything can be said about these two trends, it is, precisely, that they create a much stronger pressure on a liberal market economy than one with state intervention. That is, they are trends that would lead to the need for state intervention rather than the opposite. Globalisation for an obvious reason: if we adopt the theses of the liberal economy, globalisation would lead to a drastic and abrupt fall in the standard of living in the richest countries. That is, equalisation would be achieved with low labour costs, which would obviously be unacceptable for the richer economies.

In the case of population ageing, for a different reason, though one that is equally obvious: the market economy is ill at ease with large income-redistribution activities. In fact, in a market economy, income distribution is connected with participation in the productive process, and all schemes of income redistribution create certain dysfunctions in the market economy. This is valid for private capitalisation systems, too. In my point of view — and I will return to the subject in a moment — private capitalisation systems are extremely negative for the development of macro-economy. In the first place, they do not create more saving; this was a thesis that was defended when there was insufficient empirical evidence. In reality, it has been ascertained that the global savings rate does not increase because of the fact that social security systems become private capitalisation systems. In the second place, they generate enormous financial instability, along with general speculation that affects the efficiency of the economy. I sometimes wonder what the development of the world economy — and that is already what it is, in terms of financial speculation — would be if all the social security systems in the world were private capitalisation systems. The efficiency losses in the economy would probably be brutal.

### *Competitiveness and social inclusion*

Accordingly, these two trends, globalisation and population ageing, far from creating an environment in which there is an inescapable movement towards the liberal market economy, on the contrary, in my judgement, should bring to mind the potential that the so-called European social model possesses, or something similar, precisely to deal with these trends. In this aspect, the basic principle that should be adopted is that *solidarity, or if you prefer, social non-exclusion, is an important factor of competitiveness*. This implies that the competitiveness of economies may be based on various factors. In poorer economies, it will probably and inevitably be based on low salaries but, in the richer economies, it may be based, exactly, on greater social cohesion and less social exclusion. There are many reasons for this and I think it is worthwhile systematising all the aspects in which greater social cohesion and less social exclusion improve competitiveness. There are obvious cases. For example, the negative effects on competitiveness of the expenditure necessary to guarantee personal security and that of property in a society with extensive exclusion. And, without a doubt, we see that, despite all the difficulties of some European countries, their external competitiveness continues to be good. Another example is the behaviour of German competitiveness, certainly much better than that of the USA, which, for all its reduction in wage costs, all its attempts at drastically reducing regulation and all its concentration on incomes and wealth, has rising deficits in its external balance.

### *Areas of state intervention*

If this principle is adopted, the four main areas in which it is of interest for the state to participate actively in the economy

would be as follows (I mention the Portuguese case though it would probably be possible to extend the analysis to other cases):

- First of all, the state should be *the economy's supreme investment manager*. When I speak of investment, I mean it in a broad sense, investment in physical capital and investment in human capital. Obviously, with regard to human capital, the state is more than this — it is an actual investor, on a large scale, in human capital. In fact, a large part of education is financed with public funds, just like occupational training and scientific research, and it is inevitably so if we wish investment in human capital to attain desirable values. Economic theory states, in effect, that investment in human capital is what is called a merit good, a good that, if its accumulation were exclusively left to the development of the market, would certainly produce an investment level far below what is desirable. Therefore, in order to achieve an adequate level of investment in human capital it is necessary for the state not only to regulate at the highest level but also make its own investment in human capital. With physical capital, the question of infrastructure arises, in which, naturally, the role of the state is irreplaceable precisely because it often reflects the period involved in recovering the benefits of the investment. Then we have the other physical investment, which is not in infrastructure. Here, obviously, private decision-making should prevail — in which the state should concern itself fundamentally with creating the right conditions for quality private investment to exist, i.e. it should guarantee that there is a favourable climate for innovation and quality that allows the private investor who has good ideas to advance with them, even if he or she has a limited amount of money. It is not a matter now of direct intervention, but

intervention that motivates when necessary. Management, at a very general level, of investment related to the economy and society in general is thus an irreplaceable function of the state and, on the principle of improving competitiveness through social cohesion, I consider it a function that will be increasingly important since, for example, human capital strengthens social cohesion and external competitiveness.

- A second area that the state should guarantee is *the sustainability of the social security system*. I am clearly in favour of a pay-as-you-go system, for various reasons. From a macroeconomic point of view, it is much more efficient and also more transparent, i.e. it gives everybody a clearer picture of what is in question regarding the repercussions of population ageing on the sustainability of the system. Quite simply, a pay-as-you-go social security scheme (which has, therefore, necessarily to be public) requires certain conditions to operate. One of the conditions required is that the accounts always balance, i.e. income always equals expenditure. This means making adjustments when expenses are tending to go up without an increase in income, by adjusting the retirement age and the substitution rate and sometimes adjusting the income itself, if it is a case of this. But it does not seem to me that there is any impossibility at the outset of a pay-as-you-go system functioning, and functioning well, even with a very elderly population. Principally, it will be a much less negative system from the viewpoint of macroeconomic operation than a private capitalisation-type system, associated with every kind of financial speculation. A pay-as-you-go system is an automatic stabiliser, in contrast to the capitalisation system, which, on the contrary, due to its speculative effects, is normally destabilising.

- A third area for the state to guarantee is a *National Health Service*. Here, too, it seems evident to me that privatisation is not the solution. It is not the solution for many reasons, which economic theory, moreover, also explains. The issue involves services in which consumers are neither very clear about what they are consuming nor what their needs are. Furthermore, privatisation implies that terminal patients necessarily have a far lower capacity to be provided with assistance in a private insurance system, and so on. There are, therefore, reasons for which the health service is, for the most part, in the hands of the state and, in my opinion, these reasons should continue to prevail. But for the system to work, an essential condition has to be guaranteed: that is, as with the social security, the National Health System accounts must balance. What has happened in Portugal is not admissible, where money was spent unwisely and then the system was in debt (a trend, let us hope, that we are now managing to reverse). This situation is unacceptable, not only because it creates a debt that someone has to pay but also, fundamentally, because it is the source of a waste of resources, in that it fails to create incentives for the money to be used properly. Thus, an essential condition for a national health system to be maintained is that income and expenditure are balanced.
- Finally, a fourth area of state intervention is *the protection of the unemployed*. In fact, what we can see from the trends in present-day societies, barring a radical change in the way work is understood, is that the trend will be towards societies continuing to operate with relatively high unemployment. This means that the state has to ensure the protection of the unemployed and also guarantee that, while they are unemployed, they develop their future employability.

These are the four basic areas of state intervention, which are clearly at variance with the liberal economy or the new classical economy as developed by the theorists of the 1970s. The model that Alexander Petring presented, corresponding to the “modernised version”, makes complete sense. For the social state to remain functional, it must modernise. It cannot maintain solutions that, in the present day, no longer make sense and, principally, cause disruption in the operation of other systems, including the economic system, though not that alone.

### *The risks. The case of health*

What are the risks for this action by the state? It is worthwhile considering them to prepare the adjustments that will prove necessary and to prevent the state from remaining blocked in its action.

One of the risks of the social state is that there are groups that lean on the state, the so-called special interest groups. There are groups that lean on the state or obtain income from it without returning any benefit to society and without having any connection with special situations of exclusion or poverty. This risk is always present but it can be combated, by observing the experience of others, reflecting on one’s own past and taking suitable corrective measures.

A second risk is that people’s initiative will be taken away. This risk is real, though often inflated. It can be combated by always demanding a personal effort (appropriate to the individual’s capacity) whenever a claimant benefits from state support.

Another risk is financial unsustainability. This risk is perhaps greatest in health, for which expenditure in all countries is tending to increase at very high rates.

This aspect of health is beginning to provoke a great deal of reflection. We cannot forget that financially restricting this sector may mean people's deaths and, therefore, it is obviously not a sector in which restrictions can be applied lightly. The difficulty lies in the fact that, even if the funds for health are judiciously applied, they will tend to increase. To deal with this difficulty, in the case of Portugal, since expenditure on the National Health Service corresponds to around 75% of the personal income tax collected, I have suggested that a part of personal income tax — which may be this 75% — be earmarked for health expenditure. The earmarking of income is not a principle that is well accepted by public finance purists but, from my point of view, the position of these purists is out of date. Earmarking income is justified in order to finance expenditure that always tends to rise. The part of the income tax rate allocated to health should be adjustable in accordance with the development of health expenditure but, for the other part, allotted to financing the state's general expenses, a rise is not justified, although a *rise in the progressivity* is. Another of the unproven assertions of neoliberalism is that progressive taxes are inefficient from the economic point of view. They are not. There is no reason for that. The hypotheses necessary to prove this supposed truth are in no way realistic, referring to a world that is not ours. Thus, state expenditure such as health should be financed — in a desirably increasing part — by progressive taxes.

### ***Conclusion***

I see no reason for social democracy and socialism to have any complex about the supposed American paradise and the extra terrestrial worlds of neoliberal theories. The great promises of the neoliberal economy in the 1970s have not been kept and, there-

fore, there are good reasons to place our hope in the European social model. But, for this, imagination and a reformist attitude are needed. If I had to make reference to the preceding paper, which I thought very interesting, I would say that I decidedly supported the “modernised version”.



## Debate

During the time assigned for the open debate, some of the participants addressed questions to the speakers' table. A summary of the the contributions from the floor is given below, followed by a synopsis of the speakers' responses.

The first participant recalled the difficulty of importing the American model if we restrict it to the economic and innovation systems and avoid importing the social model. She considered that it is asserted with undue superficiality that the Scandinavian models cannot be imported, suggesting that an analysis be made of what can be imported into Portugal. This analysis should particularly consider risks of misuse of the system and issues related to civic values and social egalitarianism.

The second participant questioned the speakers on the common ground between the various social models in Europe. In the opinion of the participant, every country has its own model, which needs to be modernised and requires certain reforms in the areas of tax policy, social policy and social protection.

For this speaker, governments that have recently attempted to introduce the reforms mentioned have encountered serious obstacles, related in particular to the immediate sacrifices demanded of

a specific population segment, as compared to the benefits that the reforms would offer the great majority of citizens in time. In the speaker's opinion, a large part of Europe is not ready to tolerate certain reforms that are necessary or even indispensable.

The participant suggested that the problem of social security could be minimised not only through alterations in the parameters of the reforms but also with income generated by economic growth. However, he questioned the grounds for the idea that Europe will again achieve the growth rates of the past, since the old continent has to face competition from two regions. On the one hand, he mentioned that Europe was in a difficult position with regard to mid-range and top of the range products, with the USA occupying a more innovative and competitive position. On the other hand, Europe was also in a complicated situation with regard to low added value products based on intensive labour, with the emergence of countries such as India and China.

With regard to the entry of China and India to the world economy, the same participant commented that the opportunity resulting from this entry resides in the fact that, as these countries gradually develop, they are generating greater purchasing power and creating huge markets for the European economy. However, the risk involved in the competition from India and China is more serious than it may seem. This is because these countries possess an enormous labour reserve that allows long-term competition based on low costs, and this population will not be able to achieve similar per capita income levels to those prevailing in Europe, which could, possibly, generate more markets for European economies.

The following participant stated that there is a certain consensus in Portugal regarding the reforms to be applied to the welfare state, and it will be possible to re-establish a sense of social cohesion in the Portuguese population.

In her view of the matter, the present problem does not lie in the fact that these systems are in need of modernisation, but in

the difficulty involved in convincing the population that reform is necessary and should be carried out with a sense of social cohesion. On this point, the speaker recalled the lack of social solidarity with the immigrant population, since these workers are also part of this system, and drew attention to the increasing display of feelings of xenophobia. For this reason, the participant reiterated the need to deal with immigrants' problems at a European level, not that of the nation-state because, as she stated, it will be difficult to carry this out without a European policy to combat the expansion in xenophobia in various countries. The example cited was that the African population living in Portugal presents high unemployment rates, given that these emigrants have been substituted by others who are more productive.

In her opinion, social welfare systems have been getting poorer, since they result not only from the collective wealth, which tends to decrease, but also the ability to distribute wealth which is being progressively weakened by the competition between states to attract investment.

Finally, the participant said that the American and European economies display a trend towards privatisation that extends to the most essential functions of the state, e.g. health, pensions and security. Accordingly, she questioned the state's growing dependence on private initiative for the exercise of its traditional functions. Allied with private capital's liking for these sectors (where there is little competition in general, combined with shelter from international competition), this dependence may inhibit the future development of the countries involved.

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João Ferreira do Amaral, a speaker on the panel, mentioned the importance of proceeding towards modernisation of the welfare system, while recognising that, from the outset, there is seri-

ous opposition. He also noted that this reform should consist of political action with a sound base, though there are also partial solutions that may facilitate reform.

For Ferreira do Amaral, one of the solutions may include the preparation of an annual report for the most important systems (e.g. social security and health). This report should be drawn up by a group of independent specialists in each area, with an obligatory, unclassified advisory statement, and be forwarded to the Assembly of the Republic. Experience has also shown that the careful selection of specialists with relative independence plays a decisive role in the dispassionate assessment of the situation. In this way, the general public will be far more favourable to implementation of reform than when no reasons are given.

A second solution may include the participation of civil society in managing these systems, in terms of participation on a consultative or informative basis. João Ferreira do Amaral said that the selection of representatives, using minimally representative processes that merit the people's trust at a national and local level, may help to increase the sense of responsibility for decisions and lead to better acceptance of the necessary reforms among the citizens.

Addressing the issue of foreign investment, the speaker also stated that it is possible to attract this type of investment without putting the European social model in question, since the destination of this investment is not only related to low salaries. Although foreign investment is also linked with low salaries and low protection levels, in fact most of this investment still takes place among developed countries.

For Ferreira do Amaral, investment in Portugal in the last 15 years has been misguided since, fundamentally, it has been channelled towards the production of non-tradable goods. On the one hand, this approach was the result of the macroeconomic policy of moving closer to the single currency, which led to significant revaluation of the Escudo. On the other, the deficiencies in the

way in which the state operated, particularly the bureaucracy, helped to chase away this foreign investment. In conclusion, he stressed that there is no incompatibility between attracting direct foreign investment and maintaining a high level of social protection.

The speaker João Cravinho began by stating that we need to take two essential issues into account in order to advance in the right direction, using them as “stones to build pathways”. The first is associated with the issue of risk and the way in which it is perceived and the second is related to the present-day complexity of economic systems.

João Cravinho said that the reform of social systems, and change in them, often fail because they are extremely complex systems — to the extent that negligence of any critical component means that the objectives are not attained. For the speaker, another aspect of this question relates to past time, i.e. what historians and economists call *path dependence*<sup>1</sup>. In fact, as the participant called to mind, in considering the future of a country in the year 2025 or 2030 it is necessary to carry out a certain number of changes in a short time, confront vested interests and mobilise new actors.

The speaker also analysed the problem of risk in the light of the topic of the welfare state or social protection systems. He mentioned that, for example, when there is a risk of unemployment that the market does not resolve, the need arises to create a system to manage this risk or, again, when there is a risk of sickness, a system needs to be created to manage the risk associated with health.

João Cravinho underlined the fact that the risk of change and the risk of innovation exist and, consequently, the need to find systems to manage these risks exists. For him, these systems

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<sup>1</sup> An expression signifying dependence on the past or the path travelled.

should be analysed in terms of risk/guarantee, since in this way the European social model is seen to be more and more up-to-date from the viewpoint of installing a management system for the risk of innovation and the risk of change.

He recognised that these changes may be highly complicated, since the concept of innovation covers many different situations, with very different consequences and requirements.

He went on to mention that European systems have been, and still are, directed towards the adoption and absorption of technological advances made by others (e.g. catching-up) and the introduction of incremental innovation. In his opinion, the problem of incremental innovation is not very serious in Europe. In fact, some countries have surmounted it or are in the process of doing so very successfully, since an incremental innovation demands competition, formation of the single market and a suitable supply of qualified personnel for the educational and research systems.

However, European countries reveal great difficulty when confronted with innovations that de-structure existing systems, i.e. system innovation. Such innovation demands action in various highly different fields in space and time and, with regard to the European situation, is more de-structuring. In his opinion, this type of innovation causes political difficulties, in particular because the entrenched power systems present short horizons.

In his view, the problem of system innovation is serious, since it demands efforts on a broader scale than that represented by the dimension of any member state: it is not possible to rethink systems while ignoring the regional scale or acting in isolation without a European policy. In fact, the problem of system innovation not only de-structures but also demands that as much (or more) attention is given to organisational innovation as productive innovation (which is centred on the material content of the objects of innovation). João Cravinho added that organisational innovation demands changes that must include overall systems of power and,

as explained, power systems are not focussed in this direction because they possess an accounting system covering their own profits and losses.

For João Cravinho, in every basic area in innovation systems there are simple measures that unbalance and de-structure the established systems and that, when applied with good sense to certain critical points, in a short time accelerate organisational change, change in production and the impact of this change on the whole system. On this point the speaker gave the example of applying a rule in education: banning universities from employing the product of their own PhD programmes. In his opinion, this provision would revolutionise the university system much more than the thousands of euros invested in it and could be one of the most powerful in modernising Portugal.

In the speaker's view, risk management systems contain an absolutely fundamental element, which is the collective perception of catastrophe. The problem is to know what is understood by catastrophe. It may be possible to perceive collective catastrophes that are approaching and, consequently, manage that risk politically. However, this exercise would imply a new type of actors in the world of politics, knowledge, civil society, trade unions etc, though they do not all have to advance simultaneously, as it is enough to unbalance the system if some of them advance. The system normally rejects actors who promote imbalance but the rebalancing takes place afterwards on a different basis.

João Cravinho took advantage of the earlier participants' questions to express his views on the issue of economic growth. He affirmed that threats can be opportunities, stressing that it is generally thought that the economic rise of China is harmful for growth in Europe and the USA, since it causes strong direct competition. He demystified this idea, however, reminding the audience that the Chinese will also generate new markets and great savings in the future.

To reinforce this idea, the speaker told the story of a group of researchers who studied world systems that analyse the macro-economic impact of ageing. A few years ago they published an analysis in which they stated that Europe, the USA and Japan would face serious problems. According to the study, the issue of population ageing would give rise to a drastic reduction in support for the older population, as the only solution to avoid disaster in those regions' economies. More recently, however, the same group published another study in which they stated that they had forgotten China and, when this country was included in the model, all the earlier conclusions changed radically. The article "Is China going to eat our dinner?" gives a negative response to the question formulated in the title, since the enormous saving rate in China "is going to invite us for dinner and pay for it", the speaker said.

In conclusion, João Cravinho stated that innovation is possible, it requires alliances which are not very extensive but very strong at critical points, and it demands a consciousness of the risk of catastrophe. Under these conditions it is possible to plan the process of mobilising society.



PART II

# The Regulating State



# The regulatory state and the development of autonomous market governance institutions

JACINT JORDANA<sup>1</sup>

## *Introduction*

In recent decades important public policy changes have occurred in a wide range of countries. Taken as a whole, they suggest the emergence of a new model for the state based on instruments of economic and social regulation as the primary formula for public action. Simultaneously, direct action by the state in the provision of public services is avoided. The privatisation of numerous public companies and market liberalisation, in combination with the rise of frequent initiatives directed at regulating a significant number of sectors in detail, have acquired great prominence in the formulation of public policies.

The growth in state regulatory action has also led to the creation of new institutions in different countries and sectors. The institutional changes produced have been remarkably extensive, affecting a number of social and economic sectors. One of the most visible signs of these innovations has been the massive

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<sup>1</sup> Pompeu Fabra University and Institut Barcelona d'Estudis Internacionals (Barcelona Institute of International Studies).

spread of independent regulatory authorities, as the new institutional model for the management of public decisions in many territorial and sectoral fields, both in Europe and worldwide<sup>2</sup>. Nowadays, the presence of independent regulatory authorities represents a widespread phenomenon, in which a wide spectrum in the degree of independence is to be found, as well as in the level of responsibilities assumed. As a whole, this institutional formula may be understood as one of the most visible aspects of the emergence of the new state regulator, which has expanded on a global scale in recent decades.

Numerous instruments are used in regulation, including tools for many different purposes. However, the basic component of these instruments is that they make use of coercion, usually based on state power. Another characteristic of regulation instruments, when compared with regulatory policy in the past, is that we are dealing with sophisticated regulation technology, based on the contributions of economic theory and other social sciences. These new regulation instruments have also attracted governments because they do not carry very high implementation costs, they need few monitoring resources and the political risks involved are not very high. In addition, their political impact is relatively high. Thus, governments apply complex forms of regulation in different policy areas in a much more intense way than in the past. This has involved an important revolution guided by this new generation of policy instruments based on regulation. This revolution began in recent decades, also stimulated by international organisations such as the OECD and has been progressively carried forward by many national governments.

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<sup>2</sup> David Levi-Faur, 'Herding towards a New Convention: on Herds, Shepherds, and Lost Sheep in the Liberalization of Telecommunications and the Electricity Industry', Nuffield College Working Paper in Politics, W6-2002, Oxford, 2002.

With regulation instruments, it is not only intended to control the markets and develop their efficiency but also to intervene in other fields such as the social sectors or environmental and health protection though, in these cases, the basic objective is to guarantee individual well-being. The intellectual foundations of this state regulator model are profoundly different from other, earlier models, diverging in such different aspects as belief in the public sector's ability to drive the economy, assumptions on the effectiveness of different intervention instruments and the identification of key actors to activate economic growth.

The concept of the state regulator implies considering a perspective on the characteristics and forms of action by contemporary states that is based on the assumption that their intervention is governed by the use of formal and explicit rules. Moreover, these rules are directed towards defining the behaviour of all individuals and organisations under their authority, in relation to the specific activities requiring control and a centralised supervisory body. It has recently been argued that there is a broad process of change in traditional state forms in the face of the characteristics of the regulated state, inasmuch as these forms of intervention are more and more extensive, to the detriment of other instruments such as public subsidies or the direct provision of services. Majone stresses that the transformation process from the "positive" state to the regulatory state has been an underlying element of economic policy in recent decades and indicates the emergence of the institutional web of the European Union as an example of a fundamentally regulatory state. His interpretations clearly show us that these regulatory changes have a joint logic, reinforcing each other

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<sup>3</sup> Giandomenico Majone, 'From the Positive to the Regulatory State. Causes and Consequences of Changes in the Mode of Governance', *Journal of Public Policy*, 17 (2), 1997, pp. 139-167

globally<sup>3</sup>. It is thus possible to underline that the emergence of the regulatory state does not restrict itself to intervention with regard to certain productive or service sectors, but represents a wider phenomenon with implications for public action and its impact on society and the economy, as a whole.

### *The spread of independent regulatory agencies*

During the nineties, the “new” institutional model for independent regulatory entities spread throughout a large number of countries — both developed and developing — and was applied in a variety of sectors, especially in distribution services (public services) such as electricity and telecommunications, financial services and, less intensely, other fields. In recent years, this diffusion process has attracted the attention of a significant number of academics and specialists in various disciplines and related areas of interest, who analyse the change in the nature of the state<sup>4</sup>. Different analytical perspectives of this question have appeared:

- a) from a positive point of view, it is a matter of observing the diffusion process, identifying the variables that influence this process most and analysing their impact on the political processes that they affect;
- b) from a legislative point of view, it is a question of discussing the advantages of independent regulatory agencies and analysing whether the degree of “independence” reached by them influences the results of instrumental policy or the issues of transparency and legitimation related to them.

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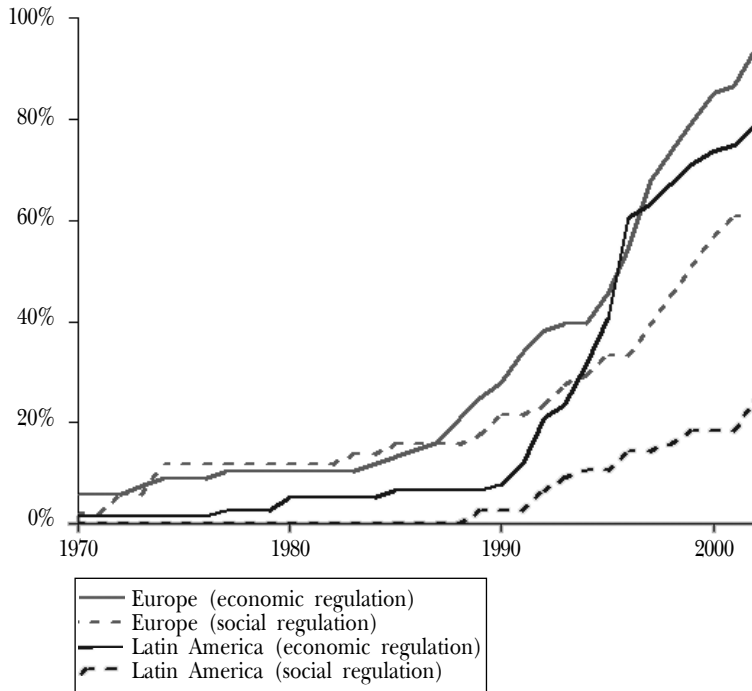
<sup>4</sup>For a review, see Véase Moran, “Understanding the regulatory state”, *British Journal of Political Science*, 32 (2), 2002, pp. 391-414.

The creation of independent regulatory bodies in certain European countries was understood, in part, as an obligation inherent in the maintenance of enterprises with public capital, at the same time as they opened the market in certain regulated sectors. In other cases, the establishment of the authorities represented the product of complex institutional balances, derived from the existence of a divided government, with different powers fighting for control of regulation (as happens in the USA). Even so, different reasons can also be found in other territorial contexts. Nevertheless, besides the concrete reasons that directly conditioned the adoption of these new institutional realities, there were certain common elements that favoured their rapid spread, especially in the 1990s. From that decade, the principle of “the appropriate” gradually imposed itself on numerous economic — and, to a lesser extent, social — sectors. It was spread by the networks of international actors, who took certain classical reference points from the Anglo-Saxon world and presented the need to adopt the independent regulatory authority model as a key act for driving on the new method of carrying out regulatory policies, considering that the independence of the regulators was a guarantee of “modernity” in the new era following privatisation and the opening-up of the markets. Undoubtedly, the principle of “the appropriate” facilitated the accelerated spread of the new institutional model, but that spread has not included absolute mimetism with regard to the regulatory authorities’ characteristics, since in every case specific adaptations have been made according to the characteristics of each sector and country – both with respect to the nature of their independence and the scope of their responsibilities.

The creation of regulatory agencies is not a new phenomenon (at the beginning of the 20th century regulatory agencies already existed) but it has boomed in recent decades. During most of the 20th century, there were only specialised regulatory agencies in

a few countries and a few sectors. However, in the 1990s, we observed an explosion in their numbers and activities, in many different sectors. Figure 5 illustrates the coverage of different policy sectors and regions by regulatory agencies, which are relatively independent and concentrate on the use of regulatory instruments alone. As can be observed in Figure 5, there was a tremendous explosion in the creation of regulatory agencies in

Figure 5  
The spread of regulatory agencies in 36 countries and 7 sectors  
(percentage cover)



Source: Fabrizio Gilardi, Jacint Jordana and David Levi-Faur (2006), "Regulation in the Age of Globalization: The Diffusion of Regulatory Agencies across Europe and Latin America", Working Paper 2006/1, Institut Barcelona d'Estudis Internacionals.



the course of the 1990s. As it is possible to observe in the graph, the trend is very similar between Europe and Latin America. It seems, therefore, that this is not an exclusively European or specifically Latin American phenomenon but a global phenomenon for many sectors: the regulatory agency now registers a predominant presence in the policy-making and guidance of the sector.

The very rapid spread of the independent regulatory authority model in the last decade raises a number of questions for us on the use of explanations based on the politicians' rationale to explain the process. It also presents us with the question of knowing to what extent the spread of this institutional model reflects the influence of the USA, as the main point of reference for political innovations and institutional changes in recent decades, with its traditional model of the regulatory state as the basic point of reference. In this connection, we can also ask whether a fair part of the spread of these innovations is not due to the fact that the independent authority model has been converted into a symbolic reference to the construction of the regulatory state, as the face of the most "appropriate" institutional form for developing regulatory policies after the recent processes of economic liberalisation — inclusively, in a way that is independent of considerations of their effectiveness. It would be a matter, then, of a phenomenon of institutional isomorphism, where the homogeneity of the whole would respond to social and occupational pressures to adapt itself to the predominant forms in its contexts. With this focus, it may be easier to consider that the adoption of institutional innovations involves two distinct levels, each with its own logic. The first level is related to the effects of imitation on a global scale, where an increase in the number of cases adopting the innovation raises its value; the second relates to the effects of adaptation on a local, sectoral or national scale, where its value depends on its capacity for institutional efficiency. For this reason, it should be taken into account that the model of independ-

ent regulatory authorities, as institutional formulas, includes an adequate number of degrees of flexibility to be able to fit into different contexts, exercising different functions in practice besides its own symbolic efficiency.

In all countries, the new regulatory authorities have been fitted into institutional contexts that were created in earlier times for different forms of public intervention — and other objectives — and which reflect a varying degree of latitude in their action to participate in policy-making. For this reason, we can see that the accumulation of different institutions, intervening in the same public policy area, with their own methods of proceeding, based on their own criteria of dependence, has complicated decision-making processes in the regulatory policy area, including when the new regulatory authority possesses independent powers. The combination of specialised public bodies and other bodies with a more general reach (such as those charged with protecting consumers or guaranteeing qualifications), whose objectives display a certain degree of conflict between them, also shows that, with varying independence, the regulatory bodies only represent a part of the institutional arena in which the policy is carried out. Thus, we can conclude that despite the apparent similarity in the new regulatory institutions in many countries and sectors, the institutional contexts in which they operate may be very different and, accordingly, their interaction may produce very different effects.

It should also be borne in mind that the different public and private actors participating in the arena of regulatory policies react in a joint fashion to the set of institutional incentives — pursuing their own interests — and not in a separate way for each of the institutions present. In addition, independent regulatory agencies only represent a segment of the institutional field within which regulatory policy is made and carried out. For all these reasons, to analyse the development of regulatory policies it is

essential to understand how the institutional constellations operating in the different regulatory policies function and what their joint effects are for the policy process. Examining the institutional constellations is the way to understand the dilemmas in decision-making that arise in each case, and to identify the cognitive mechanisms present in the agreements for these new institutions. As an initial definition of institutional constellations, we could describe them as the set of formal institutions and interconnection rules that affect public decision-making processes in a certain regulatory arena (including interpretative structures), defining the patterns of interaction of those responsible for sectoral policy decision-making. We can distinguish three different dimensions in these constellations: institutional diversity, the distribution of responsibilities and power structures; in the first, the institutions active in the sector are identified and, in the other two, it is possible to see their basic properties: the scope of decision-making and the ability to control each institution<sup>5</sup>.

### *The institutional characteristics of regulatory agencies*

The institutional design of regulatory agencies can be very different; this is not always the same when observed in detail. When governments want agencies to intervene more actively in the market, more power may be assigned to the regulatory agencies. On the contrary, when more policy guidance for the sector is expected, fewer responsibilities are assigned to the regulatory agencies. When governments fear that regulatory agencies may be captured by business interests, the legislation for the regulation

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<sup>5</sup> Jacint Jordana and David Sancho, "Regulatory designs, institutional constellations and the study of the regulatory state", in J. Jordana and D. Levi-Faur (eds.), *The Politics of Regulation. Institutions and Regulatory Reforms in the Age of Governance*, Edward Elgar, Cheltenham, 2004, pp. 273-295.

is highly detailed, not allowing the agencies to interpret the basic regulation. Thus, great variety is to be found among them, depending on the intentions of the government that created them and the characteristics of the market. But, in general, we find specific positions of the independent agencies between markets and states with the objective of controlling, guiding and fostering the development of the market. In fact, the reason for the agencies' independence is to avoid their being seen by private actors in the market as part of the state, rather than institutions that are closer to the actors in the market and are able to adopt a less distant form of active intervention than traditional state intervention.

In observing some of the pioneering countries in the 1980s, such as Chile and the United Kingdom, certain interesting parallels may be encountered. In fact, both countries stimulated regulatory policies '*avant la lettre*', with particular governments (the Pinochet dictatorship in Chile and the Conservative Thatcher government in Great Britain). They also articulated them almost without precedent, although they only lightly drove forward the transformation of their model of the state. In both cases, the criteria of management independence and a break with bureaucratic tradition clearly predominated over the criteria of political independence for the construction of regulatory bodies. Nevertheless, in the following years, when regulatory agencies spread throughout the world, the associated institutional model was based on the principle of delegation, defending the regulator's political independence of the government with arguments based on the stability and credibility of regulatory decisions. This had more profound consequences on the structure of state power. In other words; the reasons why the Chilean or British model — moderate in terms of institutional changes — did not become universal do not seem to have too much to do with the result of their liberalisation initiatives unless, simply, these initial models

did not fit in well with the institutional standards that figured as “appropriate” formulas during the 1990s and concentrated more on the idea of political independence.

These standards were transmitted by networks of actors moving in an ever more globalised world, through various sectoral and occupational dimensions. The examples taken were the Anglo-Saxon traditions and the particular adaptations carried out by European countries from the 1980s. This was the moment of the confirmation of the regulatory state indicated by G. Majone when analysing the particular constrictions in the institutional design of European Union political bodies. The paradox is that, in both cases, the independence criterion adopted for the regulating authorities represented a (possibly satisfactory) response to the highly specific conditions of their respective forms, which led to the formation of an increasingly fragmented model of the state. Nevertheless, given the central position of these countries in the 1990s, the formula of exception became the model to be followed in the context of the regulatory reforms that spread throughout the world, generally stimulating intense institutional change. It may be concluded that, in combination with the symbolic weight of adopting that element of the “appropriate”, the success of the diffusion lies in the extraordinary flexibility of the processes of adapting the new regulatory authorities to national situations, with criteria of political independence being incorporated into the different institutional designs adopted. Components such as the selection and appointment systems for those in charge of regulatory authorities are good indicators of this flexible adaptation and, undoubtedly, there many different formulas. This facilitates the adoption of these new institutional forms in conditions that vary considerably in relation not only to the institutions present in each country but also international limitations. Accordingly, the multiplicity of institutional constellations has become even greater, in the light of the variety of adaptations. Moreover,

in the face of a traditional, highly hierarchical model of the state, we are now encountering a gradual change in state structures, with distinct degrees of internal tension and fragmentation.

It should not be forgotten that the practices used in state-building are also strongly affected by different ideological ideas and methods regarding how public administrations should be organised. So we see that many reforms based on the creation or strengthening of independent regulatory institutions were spurred on by a common cultural scheme that considered this kind of institutional form the most appropriate for carrying out regulatory tasks. The various influences exercised by the new public management planning and the legislative proposals derived from agency and incentive theory, which emerged from economic theory, have had an important role in the proposition of conceptual models for the definition of these new conceptual models<sup>6</sup>. For example, the idea of delegation arises from this context, in the sense of guaranteeing regulatory authority leaders independence in their decision-making and freedom from possible interference by the executive or legislative branches. That idea may, however, be firmly claimed by collective professional groups in different sectoral areas, for whom these arguments would represent a sphere of protection in the decision-making in their policy field.

### *The aspiration to institutional independence*

We know that regulatory agency independence as a whole is a myth, since there are many degrees of independence. If all the countries in the world are considered together, on a scale from 1 to 100, we can detect a high level of variation, in which there

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<sup>6</sup> Christopher Hood, *The Art of the State. Culture, Rhetoric and Public Management*, Oxford University Press, Oxford, 1998

are some countries with highly independent agencies and others with agencies possessing very little independence. For example, it is well known that the independence of the regulatory authorities created in northern European countries is greatly limited. This is because they have a different regulating agency tradition and have not adopted the US model with the same vigour as certain countries in southern Europe or Latin America. The issue here is not only a problem of political independence but also of the breadth of the responsibilities attributed. There is also great variation among countries. For example, there are agencies in Spain with particularly reduced powers, almost to the point of their being mere consultants. One aspect that can be seen to be highly present in this whole enormous explosion in regulatory agencies that we observe in general is the topic of professionalisation. Regulatory agencies were not created to be filled with civil servants and the work positions have been occupied by another kind of professionals — economists — who possess a highly specialised knowledge of the sector and regulation and closely identify with the sector, with which they have a very direct relationship. State professionals reflect a more generalist profile. This professionalisation is a difference that can be observed everywhere and involves far stronger international connections with sector enterprises, on account of the professional knowledge of the sector. This characteristic is acutely present in all countries: it is creating a new type of government that is formulating numerous questions and new dilemmas such as the issue of control between these professional groups, with their protection and independence, and traditional state institutions. This is something new and it will possibly take a few decades to understand how this new model of the state — an impressive phenomenon for its extent and comprehensiveness — fits in.

On the issue of the regulatory state it is important to analyse the dynamics of the growth in the number of agencies and the

quantity of sectors in which they have sprung up, not only in privatised sectors, since this growth has extended far beyond these into very different sectors. In all cases, there is regulation in various state sectors and, if we asked specialist staff if they would like to have an independent agency, the response would be positive, including in the health sectors. What is important here is the distinction made above between social and economic regulation. Independent regulatory agencies were created where it was intended to create or stimulate markets. The basic principle was not to safeguard the functioning of the market but, rather, to guarantee quality, risk reduction, values etc. The motivation to create regulatory agencies was intense and, on many occasions, the regulatory capacity was strongly maintained within traditional state structures. This element stresses the relationship between the creation of independent regulatory agencies and the creation of, or the will to stimulate or supervise, specialised markets — a relationship that it is important to take into account when the topic of democratic control over independent and autonomous regulators is assessed. We should remember that the discussion is not so much about how the regulators are controlled but how the market is controlled democratically; and it is here that we find the basic problem. Because there may be regulation by a ministry that is completely captured by the companies in the sector, in which case democratic control would be purely formal. In practice, there would be no democratic control by those who would be controlling the sector (and it happens in many cases): the enterprises would be dominant. On many occasions, the problem does not lie in formal or non-formal independence, but in the capacity for public intervention in one form or another and the ability to govern, guide or correct markets, when such action is considered of public interest. Accordingly, this should be the focus of this discussion rather than purely formal independence.



There are numerous studies on independence which distinguish between formal independence and real independence. With regard to the former, various dimensions are normally considered, which have to be aggregated to arrive at an index of independence: on the one hand, there is the appointment of those in charge and, on the other, the organisational aspects of the body or institution. Then there are the aspects of the financing or the agencies' capacity to impose sanctions. And the control aspects: who controls the regulatory entities? All these aspects are elements of independence. Finally, there are those who devote themselves to studying this question in quantitative terms, producing indices to demonstrate which regulatory agencies are the most independent, in a comparison of countries and sectors. These dimensions should not be forgotten because, if only one of them is considered, e.g. who appoints the regulator or if they do so for an indefinite period or not, a distorted view of the degree of independence may be obtained, since aspects such as financial independence may have interactions with the question of the independence that is related to the appointment. It is necessary to view formal independence as a multidimensional context and, then, real independence, which is much more difficult to measure because the formal aspects may all seem highly independent but not be in practice. There are many examples of this in Latin America and a certain number in Europe. How is real independence measured? There are studies that carry out this task, identifying the preferences of the prime minister, the government or parliament, the preferences applied by the regulator and the companies' preferences, and they try to understand which are the most similar. In a historical sequence, this may also show how the regulator leans more to the independent component or that of the companies or government, depending on the formal aspects. When we speak of independence, we must bear a series of distinct dimensions in mind, as a multi-dimensional

concept is being dealt with and, accordingly, a certain confusion is sometimes generated.

In all cases, there is no doubt that this idea decisively inspired numerous designs for regulatory authorities established in the 1990s and also represents an important aspect of the political culture of that time. Academic interpretations of the rise of independent institutions have tended to be converted into *ex-ante* explanations, e.g. the argument that the existence of independent regulators increased the credibility of regulatory policies, thus facilitating the attraction of new investors (on the assumption that the policies would be stable and consistent, on the fringe of influences derived from the political and electoral struggle). Especially in economic areas where processes of privatisation and the opening-up of markets are produced in association, this type of argument was highly influential, though only to show the respective international community, formally, that all the necessary changes had been made to overcome the infirmities of earlier historic periods.

### *Economic regulation and social regulation*

On the topic of social regulation and economic regulation, the literature offers a highly classical distinction that describes social regulation as regulation in sectors where the principle leading to public intervention is not an economic principle connected with making the market function, but one involving the protection of social and natural interests, e.g. the environment, public health or pharmaceutical products. This is the idea of social regulation, applied in these sectors with regulation to protect the public. Thus, the principles are not economic and may even seriously contradict those that are — a situation that leads to the other topic: that of gaining an understanding of what prevails when this contradiction

exists. The idea defended is that social regulation could be extended to other fields such as the social sectors. But that is another topic. In the USA in the 1960s and 1970s, when social regulation was applied to the environment, food sectors and work, a conflict arose between industries that did not want this kind of regulation and consumer associations and trade unions, who supported the introduction of this kind of social and non-economic regulation. Some authors understand that part of the conservative reaction of the 1980s, following the advance of social regulation, was from the business sectors that were protecting themselves in the areas that this non-economic regulation was entering.

In social regulation, the measures for regulating society are not focused on the creation and governance of markets. Accordingly, if regulatory agencies are set up with the specific target of creating and governing the market, what do these institutions mean for other types of regulation? For these areas of regulation that are not really economic, it is unclear if the regulatory agencies are capable of performing so well. This is an important area of debate and analysis as we do not exactly know the best ways of creating institutions to foster areas of social regulation where market efficiency is not the most highly valued objective. For example, what institutions are necessary to prevent life-cycle risks, to guide coordinated behaviour, or separate certain resources from market assignment? All these regulatory objectives are not economic regulation and there is no specific kind of institution designed to work in this area and implement regulation. So we find that, in certain places and certain countries, this type of social regulation is still in the hands of normal, traditional ministries and, in other cases and other countries, we find it in new institutions that are like regulatory agencies for economic questions but are not, in fact, focused on governing the market.

It is undoubtedly important that we manage to make the markets efficient, make them function well and eliminate market

failures. Regulation may be the way to attain this objective and, for this reason, may be favourable to society. But there is another topic which it is necessary to ponder, that is to what extent we wish to resolve all social problems through the market and whether other social problems exist that demand public intervention, but we consider that is not necessary or is not fitting to create a market or to maintain a market for them all. Clearly, the alternative is non-regulatory public policies, the traditional alternative. That is the way it was, with subsidies, transfers, etc., generating the distribution. This is fine and, certainly, may continue in many fields. But I insist that, between economic regulation, which seeks efficiency, and the distribution and redistribution of public sector resources, there is room for social regulation. Examples are blood and organs in the area of medicine. They are not a market. There is an assignment system in health, based on non-economic regulatory criteria, according to needs. But in some countries, for example, assignment criteria exist and assignment is sometimes regulated with educational materials, which are not necessarily offered by the public sector but by private or semi-private bodies; but there is regulation to define what the system of assignment is. These are examples of social regulation where it is considered that, socially, is not appropriate that a market exists or that everything is controlled by the market, however efficient it is, because there are social values that conflict with the logic of the market. This is an important issue for debate and there is room for a kind of regulation that is distinct from economic regulation.

### *Conclusions*

Following this explosion in regulatory agencies and regulation instruments, we observe that the structure of the state is changing in many countries. We have many little islands of public govern-

ance that are more or less connected to each other, though without the strong hierarchical dependence that the state had in the past. This challenges our vision of the state in a series of areas, also because these islands of public governance are not only connected at a national level but, in most cases, are also strongly connected at an international level. For example, the regulator in any policy sector in one country is sometimes much more connected and has more links with the same regulator in other countries than with the ministry in the same country. So these new types of state structure are not only based on the fragmentation of the state at a national level, but also on regulators that establish stronger links at an international level, and this is changing our view of the state.<sup>7</sup> In the regulatory state a new mode of economic governance is emerging, where those in charge of regulatory agencies are professionals and the traditional bureaucrats no longer guide policy. These professionals have a narrower interest in and a narrower knowledge of one sector than the traditional bureaucrats and this also has certain costs.

To conclude, we shall summarise some of the problems that this new type of regulatory state is creating. The first is the problem of information. Negative externalities can justify public intervention in markets by means of regulatory instruments and the imposition of sanctions. This is something that can work quite well but markets sometimes fail and a different kind of intervention is necessary to create and sustain public goods, but this is not a function that the regulating agencies are well-designed to perform. The second problem is that the regulating agencies are specialised in creating markets, and they can do it quite well, and are used for converting public goods into private goods through technical innovations, creating competitive markets. Once again, we ask whether this is the best public intervention for all cases

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<sup>7</sup> Anne-Marie Slaughter, *A New World Order*, Princeton University Press, 2004.

and whether, for any public problem, the best way is to create a new market. However, having a regulatory agency is frequently a stimulation to create new markets. From this a final question emerges: many regulatory agencies have been created to address a series of problems connected with market malfunctions or to create new markets, but is it still necessary to create more markets for any type of social and economic problems? Should the regulatory agencies also expand their focus more intensively to other activities beyond regulating markets?

# The regulatory state and liberalisation

JOÃO CONFRARIA<sup>1</sup>

## *Introduction*

In this paper I intend to address two aspects that seem fundamental in the institutional changes that we have experienced in the past 20 years. In the first place, the regulatory state, an expression that was popularised with the state's withdrawal from productive activities, combined with an increase in the rules imposed on the private sector. In the second place, independent regulation, which has received very wide publicity amongst us. I shall discuss one of its inevitable and core aspects: the possibility of the exercise of discretionary power, in an economic sense, and its regulatory and political consequences.

## *The regulatory state: origins*

Regulation may be seen as state intervention in the private area of the economy for the purpose of increasing market effi-

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ciency. It has long been apparent in the Portuguese economy, since the advent of the modern state and liberalism. In the 20th century in Portugal, various types of “state” reserved their own modes of intervention for themselves, with differing effects on companies and markets.

From an economic point of view, the 1933 constitution established a regulatory state. It assumed that private initiative was good. However, it would need to be systematically corrected. This correction was necessary because an excess of competition was feared. Many of the reasons for the state’s mistrust of market mechanisms, a mistrust which prevailed in Portugal and other western countries in the 1930s, were based on the idea that competition was something potentially destructive, which ultimately had negative effects on investment and economic growth. Forms of coordinating company pricing and investment decisions were promoted to avoid the destruction of wealth resulting from the excesses of competition, which, it was admitted, would occur in the absence of this coordination.

The 1976 constitution was also regulatory in its own way. Or in its own ways, as it showed itself as a text adaptable to circumstances<sup>2</sup>. In an interpretation that is perhaps more appropriate for the first stage of the period in which it was in effect, the idea implicit in state intervention in the private sphere was that the market mechanism was essentially bad from the point of view of fairness and economic growth. In the long-term it would be condemned by its own historical dynamics. At the time, large-scale private companies were distrusted and the concentration of private capital was rejected. Market mechanisms were tolerated at the level of small and medium-sized companies, though in practice they did not operate freely, with intervention at the level of interest rates, wages and the prices of goods and services and in

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<sup>2</sup> Franco and Martins (1993).



the field of export and investment incentive systems. It was the state's responsibility to define strategic sectors and assume a fundamental role in economic development. Private initiative, moreover, was excluded from various sectors of activity, while the supremacy of the state corporate sector was revered.

Another interpretation of the 1976 constitution, the one that, over time, ultimately established itself, coincides more with "present-day modernity". The market was finally favoured as the form of economic organisation. And the distrust connected with the scale and concentration of private capital was moderated. Large private companies were considered desirable. But corrective intervention was thought necessary, depending on the structure of the market and corporate behaviour. The protection of consumer interests was considered a core objective of this intervention. In this context, moreover, reflecting the opposite perspective to that prevailing during the *Estado Novo*, the promotion of competition was given priority and seen as an appropriate means of economic progress. This vision of the role of the state was consolidated with the constitutional revisions of the 1980s and 1990s and is the one that predominates today.

The regulatory state is thus nothing new in Portugal. But something new is apparent in the political and economic discourse (the two sometimes coincide because we economists are a rather flexible kind in these matters). At the level of this discourse, the significance given to regulation coincided with the beginning of privatisation and the beginning of the state's retreat from a direct presence in the productive sphere. Thus, we need to know why the state decided to withdraw from these activities.

I consider that, in a discussion of these issues, it is worth recalling arguments of economic efficiency. They do not cover the whole topic and, on the contrary, open new paths in the interpretation of the Portuguese political process over the last two decades.

A starting point is the inefficiency observed in the production of goods and services by the state and state enterprises. This occurred in many countries and Portugal is no exception. We can all remember the time when it was necessary to wait months or years for a telephone line at home. Many good people who built a house had problems with the electric company (EDP), the water company (EPAL) or the services under municipal control. There arose a widespread and robust mistrust of the punctuality and quality of public road, rail and air transport. In brief, for various reasons, there were many cases in which experience of the management of state enterprises was infelicitous. Moreover, it was not a technological problem: it was a problem of the companies providing the services and, therefore, of the government, which decided on or regulated the investments to be made and intervened directly in their management. Thus, there were important failings by the state in the matter. Of course, the expectation developed that private property and management would increase the efficiency of enterprises and, since privatised companies were profitable, the surplus generated would be used to stimulate the economic system. Naturally, these arguments were important in justifying — from a public interest perspective — privatisations in industries such as the cement and brewing businesses, the financial sector, and telecommunications, energy and transport. This represented an admission of the superiority of the private sector over the state in company management and the reinvestment of profits.

The perception of the ineffectiveness of the state, based on the experience of Portuguese life, was strengthened by a new consciousness of the promise of private initiative, which reflected a movement in Europe and the whole western world that reclassified the market as the most appropriate form of economic organisation. There was also a general ideological process, which radically changed the nature of political debate from the 1980s in

relation to the ideological predominance of socialism in earlier decades.

Against this background, it is to be expected that the state's retreat from direct productive activity will continue — without doubt, where the production of marketable goods is at issue, i.e. goods that can be produced and traded using market mechanisms, as in the cases of education and health. In the search for lower costs or better quality, it is clearly possible to substitute private for state production in these sectors. The same, however, can be said about public goods, in the traditional economic sense, i.e. goods for which there is no market. In these cases, the state has a fundamental role to play in guaranteeing the provision and supply of these goods to people. But it seems to be increasingly understood that this does not imply direct state production. Private sector involvement may take different forms, including management contracts, subcontracting in the implementation of investment, outsourcing of activities or franchises. At the limit, the production of public goods may be totally transferred to private entities that are duly compensated by the state. For example, to quote a classic example of a public good in economics literature, the lighthouse service can be provided by private enterprises on the basis of a contract with the state. In general, there are a large number of possibilities and a certain amount of historical experience of their execution. In recent years, these forms of private sector involvement in the production of public goods, or private goods directed towards objectives of public interest, have been termed public-private partnerships. Here too, the term seems to be newer than the reality to which it refers.

As with privatisation, greater efficiency is expected in the implementation of activities and in the reassignment of the surpluses they generate.

This said, there are further explanations to be considered if we are to interpret these trends towards change in the role of the

state — specifically those connected with the political process. They are not always directly related to pure perspectives of public interest, though they do not have to be incompatible with them.

In the first place, there is the problem of income for the state. In my view, a serious mishap in our privatisation process was the weight ultimately given to the acquisition of immediate income for the state. The predominance of general macro-economic objectives was closely related to this. Privatisation was seen as a politically painless way of reducing the public debt and budget deficit, with the sacrifice of legitimate sectoral policy objectives.

At the same time, there is a natural accumulation of private interest in access to the surplus generated in profitable industries, which were given priority in the privatisation processes. Or access to the opportunities for profit in different partnerships with the state sector in areas extending from education and health to infrastructure. The main interested parties to appear in this process were large transnational organisations, sometimes with local alliances. Thus, the formation of global enterprises was accelerated, in industries essentially producing non-tradeable goods and services that were not integrated into international trade and, therefore, had fundamentally national or regional markets.

The political dynamics resulting from private interest pressures on privatisation processes need not be incompatible with increased efficiency. Precisely because, in principle, the greater the efficiency gains, the more natural the private pressure for change. The popularity of privatisation resides exactly in the idea that efficiency gains from privatised enterprises are enough to counterbalance a certain increase in market power resulting from price policy changes in relation to the former state enterprises. That is, clearly, in cases in which privatised enterprises operate in non-competitive markets, a not unusual situation. In every case, it is wise not to ignore the possibility of an accumulation of private

pressures with essentially redistributive purposes, of transferring surpluses from the state to private economic groups or for division among private economic groups.

### *The regulatory state: perspectives*

For similar reasons to those behind privatisation, the state's role in the economy is still developing, with its apparent retreat from direct productive activities and the private sector's increasing involvement in these same economic activities. In this sphere, there is room for various types of relationship between the state and the private sector.

In some cases, goods and services usually produced by the state can be produced by private enterprise in competitive markets. It may also happen, as is perhaps more probable, that activities carried out by the state start to be performed by the private sector as a monopoly or under conditions of limited competition.

In this case it is necessary to resolve various institutional problems that present a fundamental challenge to the state's regulatory activity.

First of all, the choice of which private enterprises to involve in the different projects. Open bids for tender and the processes for auctioning licences demand great technical skill on the part of public administrations when, at any level, they define the public-interest objectives to be given importance or the selection methods for the different bids.

Another problem is the state's role in regulating prices and service quality over the period in which the project is carried out.

One option is to give priority to private contracts. As a hypothesis, a road transport or port terminal may be constructed by the private sector and may freely negotiate the prices of the services that it provides. A case in the private contract area that terminated

in a near-monopoly situation, presumably unintentionally, was cable television in Portugal in the 1990s. In 1991, it was decided that the service would be provided on a free enterprise basis, with any company being able to enter the cable business. The general result was the establishment of local unregulated monopolies. They are now tending to disappear under the influence of technological progress.

In the second place, cases should be considered where the state has greater weight in defining prices and service quality, through contracts, in particular those covering concessions (i.e. franchises). In this area we can have contracts where almost everything is defined and where all the main contingencies possible are provided for, as well as the behaviour to be adopted in each of these contingencies. Alternatively, we may have contracts which allow the possibility of periodic state intervention, in particular on prices and service quality. Cases of franchises with almost all the rules defined and state intervention highly limited throughout the period of the franchise are to be found in the water and natural gas markets. Franchises explicitly allowing periodic state intervention in the regulation of prices were in effect in the telecommunications markets throughout the 20th century.

Therefore, what we have here, in our lives, is a retreat from direct productive activity by the state, which is increasingly substituted by different forms of private intervention and contracts with private enterprise. These contractual forms extend from free competition to regulation.

It will always be said that, following regulation, there is a further leap, in the form of the setting-up of public companies or direct administration by the state, but this is going back to square one. And here we arrive in the realm of regulation. I consider that the proper domain of regulation is state intervention in private interests. By certain mysterious designs of the Portuguese language and Portuguese life, we also apply the term “regulation” to

the process in which public administrations impose rules on public companies. This is a peculiarity because at a certain juncture, under the mantle of regulation, what we are talking about is problems with the internal organisation of the state. But it does not matter at all, as long as we do not forget that the same word is being used to mean different things. To illustrate the point, in the case of an organisation with which I was connected, ICP-Anacom, its regulatory function in relation to Portugal Telecom as a private company was not, in principle, the same as that in relation to CTT — Correios de Portugal, as a public company. For the simple reason that a public company should have public-interest objectives and therefore theoretically, objectives that are relatively coherent with those of the regulating authority. The regulation, as it is termed, of REFER is a different case. This raises certain problems which it is important not to neglect, though we lack the space here to examine them in detail — in particular, the problem of knowing how far the state as a shareholder can or should act differently from the ministry that is in charge.

The regulatory state that we have been constructing is present in many sectors of economic activity, in varying forms. It does not go back to the traditional idea of regulating monopolies, of regulating in order to obstruct monopoly power, in terms of price and quality. It should be said, moreover, that price and quality regulation should be understood as simultaneous processes, as two sides of the same coin, of the same economic problem. It does not make much sense to talk of one without talking of the other. But, returning to our earlier idea, there is an increasing number of relatively diversified perspectives of regulation. In the first place, they correspond to a broader perception of market failures. For example, state intervention in health and education markets is necessary for reasons of efficiency, because in these cases the free functioning of the market leads to services being produced in quantity and quality that are out of phase with what would be

efficient. This is not the result of monopoly power but other market failures related to imperfections in access to information or the distortions in behaviour and results that may be generated by risk and uncertainty. For these reasons, in the origins of the welfare state, we can find arguments of economic efficiency. The problems of access to information lie at the base of the proliferation of regulations aimed at guaranteeing quality and security in different goods and services markets, the capital markets and the labour market.

So we have here a huge area of regulatory intervention by the state. In this context, some commentators distinguish between economic regulation, which is linked more to controlling monopoly power and social regulation, which is more connected with questions that in current usage we tend to include in the “social” domain. However, irrespective of this more or less social character, there are important failures in the markets for housing, health, labour and access to information which justify corrective state intervention to promote economic efficiency. I prefer this more integrated perspective of understanding economic reality and therefore argue in favour of a concept of regulation tied to the correction of market failures<sup>3</sup>.

### *Independent regulation*

Independent regulation by the government has been considered a distinctive aspect of the institutional changes in Portuguese society since the end of the 1980s<sup>4</sup>. Moreover, independent regulation is sometimes identified with the regulatory state, which is to confuse the nature of the matters with the instruments

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<sup>3</sup> Noll (1989), Viscusi et al. (2000).

<sup>4</sup> Moreira and Maças (2003).



used. But it is worth examining the idea and consequences of independent regulation more closely, at least so that we can understand each other better.

In the first place, an independent regulator is one that has its own powers, conferred by the government, to make decisions on issues that are clearly specified in the law, with objectives that are well established in the law. There are, of course, other attributes of independent regulation, of which, in particular, I shall mention financial and administrative autonomy and restrictions on the appointment and removal of officials. However, I think we can argue that these other attributes are useful in providing better assurance of the exercise of the “own powers” that are at the core of regulatory independence.<sup>5</sup> For this reason I am going to discuss the question of the exercise of a regulator’s own powers.

Ideally, regulatory activity would be exclusively technical. It would be a question of choosing the most appropriate technical instrument to produce a certain result laid down in the law and defined by the legislative process, by those who have the democratic legitimacy to do so. The traditional example of an independent regulator is that of a central bank acting in very precise circumstances, in particular when the inflation rate objective is defined politically, without any ambiguity associated with the definition of inflation or with important horizons of time. Realising this objective by manipulating monetary policy instruments is then an essentially technical problem in the area of the central bank’s independent action.

However, for most regulatory problems it is not feasible for the legislator to give a precise definition of objectives that can be attained by an independent regulator in an exclusively technical manner. For example, a frequent objective is to defend consumer interests. But how are these defined? And, naturally, with what

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<sup>5</sup> Confraria (2005).

quality levels? Besides this, as a general rule, there is a restriction on consumer protection, namely, an appropriate return on capital invested. But what is an appropriate return on capital invested? What methods should be used to calculate the cost of capital? What time periods should be considered? How should incentives for the introduction of new technology be treated? In addition, the legislator often sets the promotion of efficiency as an objective of regulation. In this case, the regulator ultimately has to define the conditions of economic efficiency, not always a placid process in practice. And the problem becomes more complicated if we think of the differences between statistical efficiency and dynamic efficiency. Certain ambiguities are also inevitable when objectives are defined to promote competition and investment. There are various concepts of competition and the relationship between competition and investment is not always straightforward.

This is all simply to illustrate the fact that the regulator, in fact, has something that is called discretionary power. On this matter, there is a curious story that took place in the 16th century. I think we can find an analogy between early 21st century independent regulators and the viceroys, that particular institution of the Portuguese in 16th century India. Before leaving Lisbon with the ships of the line, the Viceroys had to swear an oath in which they gave their word on two or three things. One of them is very amusing: they swore that they had not pulled strings to obtain the post and this act was being carried out as a sacrifice. Another was that they would fulfil exactly what the king wanted them to do. Normally, in the letter accompanying them, there was a list of tasks that the king ordered them to carry out and, obediently, they swore that they would comply. But later, with natural wisdom, the King perceived that he was dealing with what we term today incomplete contracts. He understood that there were a series of things that the viceroys would have to do in response to circumstances that he, the king, did not know about or could not foresee

at that moment. So, for these situations, it also made no sense to give precise directions. But, as a precaution, the viceroys had to swear that, in all contingencies which could not be foreseen at that moment, they would always endeavour to protect the king's interests. All was well, up to this point. The interesting part of the story, according to Diogo do Couto, the chronicler of so many misadventures of the Portuguese in India, is that when many of the viceroys arrived in Goa they tried to avoid discharging the obligations explicitly laid upon them and, in particular, interpreted all the ambiguous or unforeseen situations to their own advantage. In other words, they forgot that they should always be trying to act in defence of the king's interests. And they sought legal grounds for this behaviour by commissioning opinions from "the men of letters of all the faculties"<sup>6</sup>, who must have been the equivalent, at the time, of the university professors of other centuries. All of this had a profoundly disquieting consequence: the systematic devaluation of what we would term today the public interest.

This story serves to illustrate some of the risks involving independent regulation. The "implicit" contract between the regulating authority and the government is also an incomplete contract. It is difficult or impossible to define objectives and functions in an unequivocal manner and one that does not produce discretionary power. An independent regulator has to find operational definitions for efficiency, consumer interests, competition and innovation. Clearly, we are talking of discretionary power in an economic sense, i.e. of a regulator that can take its own decisions and have its own agenda.

That said, does independent regulation make sense or not?

I would say yes. Independent regulation did not come tumbling down from heaven. It was demanded by society because the

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<sup>6</sup> Couto (1980).

idea has somehow become widespread that innumerable failures are associated with government<sup>7</sup>. Basically, it is also a response to the ideological changes in society, which can be explained from the scientific viewpoint by the theory of public choices and the theories of state failures. Thus, the idea has been generated that government and the political process are to be mistrusted and, consequently, independent regulation is necessary to avoid the politicisation and party-politicisation of decisions that should be technical. We may say with a certain assurance that independent regulation has helped to strengthen the credibility of the state.

Knowing whether it should be extended in general to all sectors of activity is a different question. Our experience has shown that there are different, and sometimes complex, motives behind the creation of independent regulators. There are cases in which the intention is to make the state's impartiality vis-à-vis difference enterprises more evident, in industries undergoing processes of liberalisation and privatisation. In other cases, it is important to protect technical decisions from politically-based interference. It has sometimes been useful to set up new organisations, endowed with greater management flexibility than traditional public administrations. In my view, it is still too early to see how this process will end. Precisely because it is related to the future development of the public service and the connection between public administrations and political power.

At this point I should like to pick up the idea that the number of purely technical decisions can be reduced. The most immediate consequence is that many of the independent regulatory authorities' decisions have political implications. Hence, political supervision of regulatory activity is a natural corollary of the definition and practice of independent regulation. If it does not exist, we have power that is exercised by someone who is not

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<sup>7</sup> Wolf (1988).

elected and, to a certain extent, is not effectively accountable to anyone. This last statement is, of course, controversial and demands some discussion. It is certain that, in our legal system, the parties affected by a regulatory decision can lodge an appeal against decisions with the administrative or commercial courts, depending on the case. However, the effectiveness of our legal system is not an assumption that people accept lightly in these times. People must have their reasons for this idea, which obviously reduces the ability to control the discretionary power in regulation. But even if it were not the case and the legal system were more effective, it must be said that the supervision of independent powers of regulation is not only a problem of legality. The political supervision of regulatory activity must be questioned. And political decisions should be seen in the place where they belong. They cannot be confused with court decisions, which are not intended for playing politics.

Against this background, political supervision should mean, in the first place, that the regulator has to explain very carefully “what it has done” and “why it has done it”.

In those areas in which the legislator has set out objectives without ambiguity, in which the contract to provide regulation is a complete contract, the regulator has to explain to the government how far those objectives have been fulfilled. It has to explain whether it did or did not deliver. But, then, there is the whole area in which it is possible to create and use discretionary power. Here it is of fundamental importance to give account, before the legitimate political power, for options taken. Within the Portuguese regulatory framework, I think this process should take place at a parliamentary level and represent a permanent element of the institutional framework for regulatory activity.

This parliamentary intervention could even begin before the leaders of the regulatory authorities take up their posts. The transparency associated with regulation would certainly emerge

in stronger form if, before appointment, candidates for an office were required to explain and justify, at a parliamentary level, their positions on prominent regulation and market issues. Similarly, their technical credibility would emerge the stronger for their efforts.

For such a purpose, it would be of interest if select committees in the areas where there is independent regulation were set up in the Assembly of the Republic. They may well be as important as the select committees on the budget or state accounts. In the latter case, moreover, there are many supervisory bodies on a subject that always has great public awareness: the European Commission, the government, the opposition, half the academic world... The area of independent regulation has had less evident supervision at a political level. And the problem may be considerably more difficult. Regulatory decisions are often extremely specialised, which makes evaluating them very difficult. It is not a question of the regulators' or politicians' competence: it is one of the nature of the problem. This is an area in which the institutional framework of Portuguese regulation can be improved.

### *Final comments*

State regulatory activity is tending to increase in Portuguese economic life, accompanying a process of increasing private sector involvement in the production of goods and services that were traditionally the state's responsibility. In this regulatory activity, the role of independent regulation has become more obvious. It raises problems of its own, related to transparency and the legitimacy of the use of power, and Portuguese institutions have room for improvement.

It is important to remember that state regulatory intervention is not limited to independent regulation. It is to be found in more

traditional frameworks for the operation of public administrations: it faces its own demands and requires additional specialised capacities for creative interaction with the private sector to become viable. But those are issues for other debates.

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## Debate

At the beginning of the second debate, Jacint Jordana took advantage of the space for discussion at the end of the papers to reiterate the classical distinction between economic and social regulation. The latter is understood as regulation in sectors where the principle leading to public intervention is not the economic principle of making the market function, but that of protecting social or national interests. These sectors are, for example, the environment, public health or pharmaceutical products. For the speaker, the idea of social regulation involves intervening in them with regulation for the protection of the citizens, based on non-economic principles or even ones that contradict them.

In his view, the principle of social regulation is a different concept from the idea of examining the principles that prevailed during state intervention and, thus, it would be a different topic, to discuss if social regulation could be extended to more fields than now as, for example, in the social sectors. When social regulation was introduced in the USA for the environment, food and labour during the 1960s and 1970s, a conflict of a non-economic nature emerged between industry (which did not want this kind of regulation) and the consumer associations and unions, which

argued in favour of it. Some authors maintain that it was a question of the reaction of business sectors in the face of the advance of social regulation, a position interpreted in the 1980s as a conservative reaction.

In his turn, João Confraria said that he did not agree with the distinction between economic and social regulation, except if it were as a question of terminology. Economic regulation is all regulation that has its origin in situations where the market functions badly. Traditionally, economic regulation is associated with regulation aimed at correcting monopoly powers, controlling the entry and exit of enterprises to and from the market and controlling investment. However, economic regulation is any kind that is aimed at regulating a particular market.

For João Confraria, environmental relations or the regulation of food products are cases that need regulation because the market functions badly on account of asymmetries. In the latter case, for example, as consumers do not know enough about the quality of the food they wish to buy, they need to be protected in relation to this lack of information. Another typical case of information asymmetry and, therefore, economic regulation is the area of medicines, in which consumers know much less than the vendors about the nature of the products they wish to acquire.

João Confraria recognised, however, that if these cases are called examples of social regulation, then it must be recognised that this is a kind of regulation that is also based on economic factors that, in the final analysis, are related to the fact that the markets do not provide information or protection against risk.

In conclusion, the moderator Reinhard Naumann said that the basis of this controversy lies in the existence of two different concepts of what “economic” is. The broader concept introduces an economic distinction, whereas the narrower concept introduces the idea of social regulation. The aspect that represents

social regulation in Jacint Jordana's understanding is encompassed by the concept of "economic" for João Confraria.

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Certain members of the public then added comments on the different topics addressed by the speakers. The main subjects dealt with related to the border between regulation under the responsibility of the political authority and regulation via independent entities with political supervision; the clarification of regulators' powers, missions and functions, with democratically elected bodies (e.g. parliament) also carrying responsibility for the regulator's work; the adoption of parliamentary control mechanisms (e.g. attribution of accountability, periodic reports, supervision of statutes), as a way to solve the contradictions existing in the regulatory bodies; and, finally, the existence of a regional Iberian energy market, coexisting in this space of two distinct regulatory bodies.

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João Confraria mentioned that the case of regulating the energy sector reflects the limitations and characteristics of discretionary power. The Portuguese regulatory body is free to define the regulations on prices and even the method of regulating the prices that it wishes to introduce, in an attempt to avoid situations of discrimination and price differentiation between different consumer groups.

In his view, though the government could have defined the contract between itself and the regulator in a different form in the regulator's statutes, it opted to grant the regulatory body the power of choice. However, the limits of this regulation model are more immediate on account of the Spanish question, all the more

so since situations of price discrimination may carry a social cost, in particular if this involves some type of subsidy. However, in an open economy, in which this kind of procedure may affect investment and work flows, the final calculation is ambiguous.

One participant stated that it was useful to make a distinction between discretionary power and arbitrariness since, though discretionary power is entrusted to certain independent authorities, it has been possible to reduce the degree of arbitrariness in the decisions. Gains have been made with the demand for greater formalism in regulation, even at the cost of, for example, various errors in regulation being tolerated. Thus, though the regulators may have their own agenda, it must now be disclosed.

João Confraria confirmed that discretionary power exists and a certain possibility of arbitrary action persists. He also thought that Parliament has failed to carry out its function not only because supervision by Parliament for independent regulatory activity is necessary, but also because, if the regulatory activity is exercised by a directorate general of a ministry, the same supervision by the Assembly of the Republic continues to be necessary. In short, it is not because the activity of regulation is exercised by the government (and is no longer carried out by a regulatory authority) that supervision is no longer necessary, since the point of departure is that there are failures (in the performance of the state bureaucracy or the representative government) which mean that the final result of decisions does not represent the public interest.

In this speaker's view, the popularity enjoyed by the regulatory authorities in different societies may have at least two kinds of complementary explanation. On the one hand, a certain mistrust established itself in society, since the result of the political process at the level of representative government was often contrary to socially recognised and defended interests. On the other, regulation was possibly an arbitrary process in which certain decisions lacked justification.

Consequently, the popularity of independent regulation stems from the creation of a system that is independent of political fluctuations and desirably independent of the involvement in party politics which these processes suffer. However, even if a system that is independent of political connotations has been created, it is not necessarily perfect, since every bureaucracy presents operational defects and has its own dynamics which do not guarantee that it is necessarily in line with the public interest. To minimise distortions, the speaker affirmed, this new bureaucracy's field of action should be strictly delimited, in the first place, or a clear objective should be defined, as far as possible, and parliamentary supervision guaranteed.

For João Confraria, a pricing rule set by the government demands as much supervision by the Assembly of the Republic as a pricing rule set by an independent regulatory body. This is not a scenario of a balance of powers in the legal sense of the term, but rather a balance of powers in the face of failures in the political decision-making process. In this case, society's best defence involves guaranteeing the transparency of matters in the right place: Parliament. However, the Assembly of the Republic should have a certain ability to monitor the regulatory body's action, as regulatory bodies often only make the journey to Parliament in situations of great media coverage, for example, the renewal of a television broadcasting licence. For the speaker, questions that are more important but related to activities of less media interest can often have an equally significant material and technological impact.

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João Cravinho commented that the problem of supervision by Parliament exists but it presents a difficulty: existing legislation does not give Parliament powers beyond the general powers of

the Assembly of the Republic. For example, the legislation already charges the regulators with the duty of sending their reports to Parliament. Moreover, some of the regulators are bodies that, by their statutes, are at the disposal of the Assembly for the purposes of cooperating in a legislative, or some other process. However, this cooperation is not present in the statutes of all the existing regulators, and the legislation is incomplete, not giving enough importance to the regulators' duty to propose legislative changes.

João Cravinho gave an example of a proposal for a legislative change formulated by the CMVM (Securities Market Commission), a body that in Portugal has taken very important action for market transparency and for the alteration of the concepts relating to the governance of quoted companies by way of regulations or legislation. However, many of these proposals submitted to the government were refused or ignored, without their direct dispatch to Parliament ever being considered. In the speaker's view, the powers of the regulatory authorities should contain the possibility of their submitting proposals to the government, with the obligation to send them also to the Assembly of Republic, since this is the seat of the legislative power.

For João Cravinho, the situation in Parliament presents three great problems. In the first place, the political pressures of the opposition agenda are directed towards what is of media interest and those of the government agenda lean towards what is efficient (though without any noise) regarding promotion of the government's agenda. As Parliament is highly governmentalised, with one party at present possessing a majority, it ultimately cedes implicitly to the government's line, with matters of great interest at a media level being avoided.

In the second place, Parliament has real agenda difficulties since it has to deal with many issues on many fronts, and its committees cannot analyse everything. Finally, the Assembly is

very badly equipped for detailed technical discussion, which is often of great importance. This is because members of Parliament basically depend on formal opinions and the lobbying (pressure) of the contesting parties and do not possess the actual technical capability to decide on or closely examine the issues for themselves, remaining dependent on the various contesting parties. For the speaker, this is the general political process of lobbying but, in the context of the regulators, it is sufficient to reduce the intensity of Parliament's own interpretation.

João Confraria added that the problem sometimes also arises that members of the independent regulatory authorities simultaneously exercise functions as government consultants.

In his turn, Jacint Jordana took the opportunity of the discussion to provide certain additional information. In the first place, there is still no accepted theory that, on a general level, explains the creation of thousands of regulatory agencies (2000-3000) in the last 15 years. This act of creation is characterised by an impressive explosion of "institutional creativity" in almost all the countries of the world. In his opinion, there are many explanations for this growth, such as the arguments of the credibility or failures of the state. In addition, it is known that the US independent agency model stood as an example throughout the world. These agencies are termed "independent" because they are not linked to the government or Parliament. The latter created the agencies so that, on the one hand, the executive did not hold so much power and, on the other, to maintain direct control of them. For this purpose, it used very detailed regulations on what they could do and on the negotiations that they could have with the executive.

However, despite certain hypotheses explaining the explosion in regulatory bodies, there is no authentication of the reason for their appearance. There is a fair amount of information on what these agencies are and it can be seen that their level of independence varies greatly. For example, the independence of regulatory

agencies is greatly reduced in northern European countries, since they have a different regulatory agency tradition and did not adopt the US model with the same intensity as certain countries in southern Europe or Latin America. In these cases, it is not only a question of a problem of political independence but also the breadth of responsibilities.

Jacint Jordana added that the topic of professionalisation is greatly present in all discussions on the explosion in the creation of regulatory agencies, since they were not created with jobs for civil servants but, rather, another type of professional: economists. In his view, economists identify themselves and have a more specialised knowledge of the sectors and regulation than the traditional civil servants, who are more commonly generalists. In addition, economists possess international connections and far stronger ties with the businesses in the sector.

Jacint Jordana revealed that these characteristics are generally present in all countries, a fact that is creating a new type of government and generating many questions and new dilemmas, e.g. the control between these nuclei of professionals, with protection and independence, and traditional state institutions. In his view, we are dealing with a new phenomenon and it may take a few decades to understand what this new model of the state is. Moreover, the phenomenon is also impressive on account of the comprehensiveness and extension that it presents.

Orlando Graça Lobo analysed the case of the regulatory body for the Portuguese energy sector. He began by stating that, though the Regulatory Body for Energy Services (ERSE) is often accused of possessing discretionary powers, this regulator has a legal framework with well-defined powers. This was the result of a creation process for the regulator, which with certain natural conflicts ultimately brought a great deal of transparency to the sector. However, the speaker disagreed with the government's being solely responsible for ERSE and stated that this responsibil-



ity should be extended to Parliament through select committees for assessing regulators.

Orlando Graça Lobo also accepted the possibility of cancelling some of the present powers such as the power to regulate the sector directly but agreed with the power to set rates, though in Spain, for example, it is the Directorate General for Energy that defines them.

With regard to the regional electricity market in the Iberian peninsula (Mibel), he stated that, though there is no absolute need for a single regulator for the market to be able to function, the coexistence of two with different powers requires a minimum of harmony. The theoretical Portuguese model is better because the table of tariffs set in Portugal is more transparent, is additive and seeks to avoid cross subsidies, whereas in Spain the process is clouded with special tariffs for special producers with industrial guarantees.

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Mário Beja Santos analysed the consumer movements and stated that these are generally made up of people with a liberal tendency, from the 'left convergence' or the area of the European People's Party. They have a broad vision of the set of questions or goods to be regulated.

According to this speaker, there was a significant expansion in the list of services of general interest subject to regulation that was the subject of legislation in Portugal in 1996. It only included essential public services (e.g. energy, water and fixed telephones). Besides this expansion, other issues have arisen which have been considered in line with European trends. In his view, the discussion around the internal market directive not only concerns the country of origin, but also the quantity of goods that can or cannot be regulated without the authority of the nation-state.

Beja Santos stated that Commissioner Emma Bonino contributed to the approval of a directive on services of general interest that uses concepts such as universality (universal service legislation), quality, transparency, adaptability and the independence of regulatory bodies. The Commissioner asked Parliament for help in formulating a concept that can apply to the whole of Europe, maintaining its diversity and specificities. Beja Santos mentioned the existence of a new mentality that shows through in Emma Bonino's directive and can be summed up in the idea "Stop talking in a closed circuit" (with the closed circuit here including the state, business and the unions), since this implicitly leads to the attainment of partial objectives that are of no interest to most citizens. In his opinion, investors and small, medium and large operators, together with consumers, should be involved.

The speaker then recalled that, in 1996, the Essential Public Services Law appeared. This legislation was very important for consumers in various respects, since it put an end to interruptions without notice, financing of the companies and initial deposits, giving the regulator the right to intervene.

Beja Santos also addressed the hypothetical necessity of framework legislation for regulation in Portugal, despite the existence of the Essential Public Services Law. In his view, such a law would be neither necessary nor even desirable since it would run the risk of being countered by European legislation.

The speaker stated that, in the first place, the state should give a categorical sign that it wishes to stop applying economic restrictions or choosing political managers for company boards. It is important to discuss what independence is and to understand who is responsible for what when the nuances between the meanings of arbitrariness, legitimacy and discretionarity are being discussed. Like the earlier speakers, Beja Santos inclines towards the parliamentary dimension in the control of regulation, though recognising that this implies the existence of a government pact,

in particular between the two parties that form majorities, so that it will be possible to reach agreement on how to prevent manipulation of regulatory bodies or their use for perverse purposes.

Another aspect addressed by the same speaker relates to the need to promote a framework of provider responsibility towards the consumer, which in many regulatory bodies has not been defined, in particular the stipulation of the competition rules, with dynamic regulation.

For Beja Santos this legislation should also exist to prevent collisions between the Competition Authority and other bodies. To illustrate the point, the speaker mentioned that a regulatory body was recently created in the area of the Portuguese press. It should work in cooperation with the Competition Authority, since there is a possibility of problems arising involving the formation of press cartels, which are in no way beneficial to the consumer, the freedom of expression or the maintenance of pluralism and democracy itself.

In summary, the stipulation of competition rules to combat inefficiencies is a principal with a broad reach, which is already present in various pieces of national legislation. But, in the speaker's view, it is necessary to approve a relationship that is obliged to produce good and properly adapted legislation.

Beja Santos concluded by stating that it would be useful to launch a nationwide debate with the representatives of decision-makers, operators and suppliers on the question of what regulation should be overall, how we should proceed and take action and what benefits would result from creating these rules of the game for the functioning of investors and operators of different levels and types. This harmonisation for protection would have to be of a high level since it is not only a constant in various countries but also, if there is no agreement on the concept of what a high protection level is, the trend is towards negative discrimination or the obstruction of access to a certain type of goods.



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