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Is Europe's welfare system a model for the 21st century?

By Katrin Bennhold

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DAVOS, Switzerland: Along with skiing and partying into the night, Europe-bashing has long been a favorite sport when the world's business and political elite gather here for their once-a-year winter schmoozefest.

But this year, many of the critics have fallen conspicuously silent. As top executives, government leaders and a wide range of experts gathered Tuesday for the World Economic Forum to talk about the challenges facing the battered global economy, the question many were asking was this: Could the much-maligned social welfare system in Europe end up being the model for the 21st century?

In the United States, the global stock market rout has wiped out trillions of dollars in retirement savings, and rising unemployment is leaving more people without health insurance. In response, officials in the administration of President Barack Obama have been busy studying the Swedish bank bailout of the 1990s and the Swiss and Dutch health care systems. On the environmental front, the officials have been quietly contemplating whether Europe's high fuel taxes and carbon trading system are the right way to limit the burning of fossil fuels that contributes to global warming.

For China, where the demise of the American market has brought to light the perils of excessive savings at home, the government has not only recently proposed a big Keynesian-style stimulus program but has also just announced a three-year plan to provide universal health care. Though modest by comparison, China's health care plan goes in the direction of what has long been considered a fundamental right in Europe.

"When the world's biggest economy and the world's biggest emerging economy look for lessons in the same place at the same time, you know something is up," said Kenneth Rogoff, a professor at Harvard and former chief economist of the International Monetary Fund, who is one of the 2,500 participants in Davos this year. "We are seeing a paradigm shift towards a more European, a more social state."

Such shifts are rare.

The Great Depression of the 1930s eventually ushered in Keynesian demand-side policies and, after a devastating world war, firmly established the need for some sort of social safety net in every major industrial democracy.

The oil price shocks of the 1970s and a wave of inflation helped turn the governing approach in the other direction, empowering Ronald Reagan and Margaret Thatcher and other advocates of lower taxes, smaller government and deregulation.

At the opening of the 2008 World Economic Forum, a front-page article in the International Herald Tribune suggested that global capitalism was again ripe for such a generational transformation. Amid the worst financial crisis since the Depression, that transformation is now in full swing.

With whole swaths of the banking sector being propped up by trillions of dollars in taxpayer funds and hundreds of billions more being dedicated to deficit-financed public spending programs across the world, the most striking feature so far is the comeback of big government.

In the United States, the world's largest and most emblematic market economy, the surge in the growth of the government is going to be financed by a huge increase in borrowing, projected to grow to as much as 10 percent of gross domestic product this year and into 2010 from 3 percent last year.

"We're moving back towards a mixed economy," said Daniel Yergin, chairman of Cambridge Energy Research Associates in Cambridge, Massachusetts, and the co-author of "The Commanding Heights," a history of the last-such paradigm shift, the one toward wider acceptance of the market-driven economy.

The new shift is likely to go well beyond expensive short-term fixes. The ferment suggests that ultimately the United States may move closer to Europe, altering the trickle-down economic doctrine of the past three decades and establishing a new social contract aimed at narrowing the gap between the rich and the rest of society, officials and economists say.

Obama, who called for a "watchful eye" on the market in his inaugural speech last week, wants to make health insurance available to all Americans. Almost half of the $825 billion pledged to stimulate the economy is earmarked for extending health care and unemployment assistance, and investing in public schools.

Meanwhile, Beijing approved a health reform plan worth 850 billion yuan, or $124 billion, last week that sets out to provide free basic health care to the country's 1.3 billion inhabitants by 2011. Each person covered by the system would receive an annual subsidy of 120 yuan, starting in 2010.

As Pascal Lamy, director general of the World Trade Organization and another Davos regular, put it, "It's a cultural revolution."

It is no coincidence that this revolution is unfolding simultaneously in the United States and China, analysts say.

They were opposite poles in the hazardous gentlemen's agreement underpinning global imbalances in recent years - one accumulating ever more debt, the other supplying the world with a glut of savings.

But for all their differences, no two countries were more dedicated to the growth-above-all-else capitalist mantra. And no two countries have seen the foundations of their economic models more shaken in recent months.

In the United States, the crisis exposed an unsustainable credit culture and undid a highly sophisticated financial system that accounted for 8 percent of GDP and now needs rebuilding from scratch.

In China, where millions of jobs have been lost in recent years, the export-led model of the past two decades has faltered, in part because America's insatiable demand for Chinese goods has cooled. With Chinese families committed to saving for retirement, health care and education, domestic consumption in China is 35 percent of GDP, half the share it is in the United States.

"The crisis has accelerated things and made domestic demand even more of a priority," said Victor Chu, chairman of First Eastern Investment Group in Hong Kong, the biggest direct-investment group in China. "Therefore China is strengthening and deepening the social safety net."

On paper, the euro zone may look worse than both. Parts of its financial system are reeling, too, and economic growth is expected to fall for much of 2009, while many economists expect the United States to resume growth in the second half of the year. Growth in China is only slowing, not going into reverse.

But unlike the other two, Europe faces less fundamental questioning of its social contract. Higher benefits and broad-based consumption taxes serve as automatic stabilizers of the business cycle, restraining growth in good times but cushioning the downturns.

"Europe faces a plain vanilla recession," said Rogoff, the Harvard professor. "It's a deep recession and it's coming with a vengeance. But it's not a paradigm destruction."

To be sure, many remain skeptical about Europe's social model and the tradeoff between slower economic growth and greater security. Unemployment, which has consistently run higher than in the United States or Japan, is rising again, too.

Protests have broken out in several European countries, particularly among the young and immigrants who have not shared in the general prosperity. Its aging population is already pushing up the cost of medical care and retirement security.

And whether Europe's model is exportable remains questionable. For the moment, few Americans are prepared to pay for what Europeans take for granted.

Obama's advisers may be looking to Europe for inspiration and many Americans are clamoring for protections against the financial and economic storms, but raising taxes to pay for the bigger government that is on the way is still a political taboo.

Taxes in the United States account for about a third of GDP, compared with about 40 percent in France and half in Sweden.

"I do not think the American body politic is ready to recognize the tradeoff between growth and security," said Stephen Roach, chairman of Morgan Stanley in Asia.

"We want the protection, but we don't want to pay for it," Roach added, noting that European-style consumption taxes or energy taxes were unlikely to be proposed in the near future.

As a result, many economists see a complex new interplay between markets and the state emerging.

"We are going into an era with deeper suspicions of both markets and governments," said Joseph Stiglitz, a Nobel economist who teaches at Columbia University. "There will be more emphasis on the welfare state, but there will also be more emphasis on incentives within the welfare state."

One open question is whether the United States and China can undergo such a fundamental economic shift without heightening the tensions that already exist.

It could reinforce strategic relations between the countries by highlighting their mutual dependence. But as the economic crisis unfolds, there is also the chance that it could also lead to protectionist saber rattling.

Last week, Timothy Geithner, now the U.S. Treasury secretary, said Obama thought that China was "manipulating" its currency, heralding a harder line toward Beijing.

Lamy, the WTO leader, warned that there was already evidence that tariffs and anti-dumping measures were on the rise, though still generally within the limits of trade law.

"So far it's nothing dramatic," Lamy said. "But that doesn't mean there isn't the protectionist temptation. There is always a time lag before such measures are put into place."

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