How to solve an economic trilemma

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How do you combine high employment and low levels of inequality, without high taxes? There are lessons to learn from both the Netherlands and Switzerland

Since the 1990s, the Netherlands has often been presented as a role model for Continental countries seeking to create jobs and keep inequality in check. The 'Dutch disease' that prevailed in the 1970s and 1980s has become the “Dutch miracle” in the 1990s and 2000s. Over the 1990s, the Netherlands have created more jobs than any other comparable European country. This radical turnaround has been attributed to a number of reforms agreed between unions and employers to restore competitiveness: wage moderation, reductions in working time and cuts in welfare state expenditures (notably by phasing out early retirement schemes).

Even if it has been less advertised internationally, the Swiss model has also been hailed as a model of success, being able to overcome economic crises unscathed, maintain unemployment and keep inequality low. Accordingly, Switzerland and the Netherlands have been among the best performers in terms of labour force participation rates in the OECD, rivalling or surpassing Scandinavian countries. Their performance is especially impressive in terms of female labour force participation.

The interesting thing about these two countries is that they have been able to achieve high employment without the large welfare states of Nordic countries, and without the high inequality of Anglo-Saxon economies. They seem to have overcome what political economists called the 'service economy trilemma'.

Among the three objectives of high employment, budgetary restraint and inequality, European countries needed to choose two. If they wanted to increase employment without inflating the public sector (and raising taxes or borrowing), they needed to deregulate to create low-wage private sector jobs (the Anglo-Saxon way), which came at the cost of more inequality. This is partly the route pursued by Germany and its 'mini-jobs'. If they wanted to create jobs but keep inequality low, they had to dramatically raise taxes on low and middle incomes to fund service-intensive welfare states (the Nordic way). These not only employ many people, but also facilitate female employment (via heavily subsidised childcare). Countries such as France or Italy, by contrast, unwilling to deregulate and unable to create Scandinavian-style welfare states, were stuck with low employment levels.

In the Dutch and Swiss case, the recipe used to overcome this dilemma has been part-time employment: with 38 and 26 per cent respectively in 2011, the Netherlands and Switzerland had the highest incidence of part-time employment in the OECD. In 2013, 57% of Dutch women between 25 and 54, and 45% of Swiss women, worked part-time. This share was 12% in Sweden (where women can work full time due to affordable childcare) and 20% in France (where fewer women work). Part-time employment has allowed increasing female employment without the expensive state-subsidised childcare facilities available in Scandinavia, requiring both high levels of popular support, stronger left parties and stronger unions, preconditions that are difficult to find outside the Nordic countries. In turn, high employment lowers welfare expenditures and reduces the number of households with no income, lowering market inequality even before taxes and social transfers kick in.
Supply-side factors such as part-time employment are only one part of the story, however. The different trajectories of the two countries during the crisis serves to uncover the importance of demand-side factors. While both countries started from relatively similar positions in the wake of the crisis (unemployment was even slightly lower in the Netherlands), their trajectories have differed markedly.

The Netherlands entered into a serious recession in 2012 and 2013, and available forecasts point to a very weak and slow recovery. In Switzerland, by contrast, the contraction of 2009 was quickly compensated by solid real GDP growth in the years that followed the crisis. Accordingly, unemployment has also increased steadily in the Netherlands in the aftermath of the crisis (about 6.7% in 2013; still below the EU average of 10.8%), while it has stayed at very low levels in Switzerland (about 3%). The different performance of the Netherlands and Switzerland also revealed the importance of demand-side factors, namely housing prices and immigration.

In the Netherlands, growth in the lead-up to the crisis was partly underpinned by rising housing prices propelled by advantageous – and electorally popular – tax rebates that no government party was willing to abolish. This led Dutch households to contract big mortgages and fostered domestic demand. Accordingly, in 2012 Dutch private households were the most indebted in Europe: in 2013, household debt represented a staggering 285% of disposable income and 110% of GDP.

Eventually, the housing bubble burst, house prices declined by about 20%, leading the country into a recession and saddening state budgets with rising deficits. Consecutive governments, first a right-wing coalition uniting the VVD (Liberals) and the CDA (Christian Democrats) with the support of the national-populist PVV, and then an alliance of the VVD and social democrats (PvdA), implemented a set of harsh austerity measures seeking to balance budgets, in line with the agenda that the Dutch government was also pushing for debt-ridden GIPS countries. The problem was that these cuts in public spending were implemented at a time when Dutch households were also reducing their consumption to pay back their debt: this led to a recessionary spiral of important proportions which shared many similarities with the crises that have plagued Southern Europe in the aftermath of their adjustment programmes.

By contrast, in Switzerland the kind of sharp austerity drive observed in the Netherlands was made difficult by the constraints of the political system: several attempts to retrench welfare programmes have been blocked by referendums, it is difficult to build majorities across the two chambers of parliament, and many spending competences are in the hand of the cantons, preventing sharp swings in fiscal and economic policy. Even if there was no housing bubble in Switzerland – partly due to one of the lowest levels of home ownership in Europe – another factor has contributed to maintain domestic demand before and during the crisis: immigration.

In the lead up to the crisis, Switzerland has received large immigration flows from neighbouring countries due to persisting wage differentials: between 2007 and 2011, the Swiss population increased by nearly 5% mainly due to new arrivals. Due to the crisis in Southern Europe (notably in Portugal, a traditional source of migrant labour in Switzerland) but also immigration from Germany, these flows contributed to maintain domestic demand in an adverse context for exports. Indeed, the crisis in the Eurozone has led to a massive appreciation of the Swiss franc, penalising exports and leading the Swiss National Bank to purchase massive amounts of foreign currency to defend the franc. Recently, a referendum proposing a cap on immigration levels from EU countries has been accepted by Swiss voters. Its consequences are still unclear, but since
immigration has been one of the fuels of domestic demand, it could potentially have similar effects as the Dutch austerity drive.

Which lessons can we learn? First, it is possible to combine low levels of inequality and high employment without large public sectors and mass redistribution. Recent research actually shows that even Scandinavian countries draw on larger tax bases to fund their welfare states than high progressivity targeted at the rich. For that, you need high employment rates, and high female employment rates in particular. In a way, this model corresponds to the idea of ‘pre-distribution that Ed Miliband or the political scientist Jacob Hacker have tried to popularise recently.

Second, any supply-side reform designed to make labour markets more flexible is conditioned by demand-side factors (population growth, immigration, housing demand), requiring a coordinated approach between both aspects. The recent Dutch experience with austerity is a good example of this problem.

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