Welfare Systems and Labour Markets in Europe: What convergence before and after EMU?

Giuseppe Bertola (E.U.I. and Università di Torino)
Juan Francisco Jimeno (Universidad de Alcalà and FEDEA)
Ramon Marimon (E.U.I. and Universitat Pompeu Fabra)
Christopher Pissarides (London School of Economics)

Executive summary:

Despite obvious interactions between economic integration and social-welfare provision, little is done at the central European Union level to bring social policies together and address country-specific crises and integration challenges. The failure to provide guidance on the challenges facing social provision at the country level, in light of the removal of economic borders across the Union, exposes European policies to the twin risk of inertia on the one hand, and uncoordinated and unsustainable reforms on the other. In this Report we document the current situation and analyse the reform pressures in the new united Europe. We argue that current European Union decision-making procedures lead to slow and inefficient action at the central level. There is a pressing need for reform of European welfare policies, not necessarily of centralisation, but certainly of more appropriately allocation at different levels of government.

The review of institutional information in **Section 1** demonstrates that the aim of social-policy intervention in Europe is not only the reduction of poverty but also the regulation of economic relations. A wide array of financial and other instruments are designed to reduce inequality in the labour market. There are large differences across EU countries in the relative importance attached to social policy goals, the instruments used and the success in social policy performance. Still, it is possible to identify patterns in each of these respects, and trace them back to the historical origins of the Welfare State in each case. The Scandinavian model of universal social protection as a right of citizenship coexists with the Anglo-Saxon model of the U.K. and Ireland; with the "Bismarkian" employment-based model of Germany, France, Austria, and the Benelux countries; and with the much less mature, more fragmented, and highly idiosyncratic arrangements in the remaining Southern members. We document these patterns and, examining recent indicators, find no evidence

that systems of welfare provision are either shrinking within countries or converging to each other.

Section 2 steps back from the complex configuration of EU social policies to examine briefly their motivation and effectiveness. Social policies are meant on the one hand to improve on *laissez faire* economic outcomes, by providing collective insurance against individual misfortune; and on the other hand to ease social tension, by redistributing resources to individuals who could never purchase insurance even if the relevant markets existed and functioned well. In principle, neither class of redistributive policies need reduce economic efficiency. In practice, however, extensive social policy intervention is associated with reduced employment rates. We analyse in some detail the effects of social policy instruments in this respect, and we focus especially on how recent macroeconomic developments have magnified the undesirable labour-market effects of European Welfare States. The Anglo-Saxon model based on means-tested and in-work benefits has proved unable to stem the tide of increasing wage inequality. The Continental model of employment-based instruments and wage compression has led to long-term unemployment. And the Scandinavian model, which tries to break out of the trade-off between social protection and employment by "active" labour market policies, has proved too expensive in the face of recent developments. Each Welfare State faces its own challenges, and country-specific features of welfare provision imply different reactions to similar exogenous events. A further potential crisis factor is represented by economic integration, both within the EU and on the wider "global" scale. Integration reduces the effectiveness of social policies by giving more opportunities to individuals to "opt out" of supposedly mandatory redistributive schemes (e.g. through migration) and, through tax competition, generates "races to the bottom" in the provision of social policy.

Section 3 considers the import of such tensions in the EU context. No large-scale race-to-the-bottom tensions are apparent in the recent European experience: national policies display remarkable stability, stemming from well-rooted Welfare State traditions. EU institutions, however, do interfere with national policies, chiefly by enforcing deregulation when existing policies are deemed incompatible with the Single Market and by extending social policy coverage in each country to all EU citizens. Some recent policies also reduce the discretion of national policy makers: for example, the fiscal policy constraints imposed by the Growth and Stability Pact reduce the member states' degrees of freedom in the implementation and reform of social policies. Explicit coordination of social policies at the EU level, however, does not go beyond declarations of principle. EU-wide action would require unanimous agreement in policy areas that affect redistribution and labour-market outcomes, which is not forthcoming. We rationalise unanimity requirements by considering the character of politico-economic interactions within the EU institutional framework. If the EU were a traditional federalist entity, and central policies were decided by a democratically elected European executive power, it would make sense to centralise more decision-making powers in this area (as in the USA). The EU, however, is, at most, a "cooperative" federal entity; i.e., a supra-national layer of institutions is laid over well-defined and heterogeneous national decision-making bodies. In such a situation, social-policy intervention at the central level would be distorted by strategic interactions among policy-makers who represent national or regional constituencies.

In the cooperative-federalist structure of the EU, the very limited budget of EU social policy expenditures is a self-restraining device. Had there been a larger budget, national interests would encourage "log-rolling" – i.e., approval of each other's favourite redistributive policies while failing to internalise their system-wide financial implications. And unanimity requirements are equally rational, inasmuch as they prevent majorities of national representatives from pursuing their own rather than the collective interest. Thus, the weaknesses of the current configuration of EU decision making in the social policy area are rooted in the nation-based and very heterogeneous character of its constituency. It would be futile to blame them on unanimity requirements and budgetary limits *per se*, which may instead prevent distortions in the very complex central decision process engendered by heterogeneous objectives.

Other decision-making arrangements might possibly better pursue collective interests within the EU. Our discussion of desirable social-policy developments in **Section 4**, however, takes the cooperative-federalist nature of current EU institutions as given, and brings the general economic insights illustrated by EU-specific examples throughout the report to bear on how social-policy decisions might best be allocated to different layers of government:

- Solidarity-based transfers, guaranteeing a minimum welfare level, should be coordinated at the central level to prevent competition among subsidiary levels of government from result in either unacceptably low levels of welfare provision, or in more or less implicit limits to economic integration. Standards should be specified carefully, taking into account local specificities, so as to ensure that labor mobility is not driven by "welfare shopping" motives. In light of the very heterogeneous levels of developments within the EU, some inter-jurisdictional redistribution is hardly avoidable. Hence, minimum-welfare transfers and services should be co-financed by a specific budget line item at the EU level. To ensure that the relevant issues are addressed clearly and minimise political distortions, the relevant funds should be clearly isolated in the EU budget. Central co-financing of social assistance programs would also provide means for *enforcement* of EU-wide guidelines: clearly, the minimum-welfare guidelines envisioned here, however carefully crafted from a technical viewpoint, could easily remain on

- Quasi-market arrangements meant to provide insurance, such as unemployment benefits and pension schemes, should not redistribute resources *ex ante* and should not be funded at the federal level, because economic incentives for factor mobility and allocation are best preserved when benefits and contributions balance each other within appropriately defined local markets. Inasmuch as *laissez faire* markets fail to provide adequate levels of insurance, however, participation in such schemes needs to be mandatory and comprehensive. Hence, minimum contribution rates and standard configurations should be agreed centrally so as to eliminate opportunities to “opt out” by individuals and by local constituencies.
- To fully exploit the advantages of heterogeneity and decentralised decision-making within the EU, central institutions should not specify uniform guidelines for other aspects of social policy. Rather, experimentation should be encouraged and closely monitored by EU institutions, which should play an active role in disseminating clear information as to the character and performance of locally financed policies and enable individuals to select the configuration of local social policies that best conforms to their preferences, resources, and comparative advantage.