Welfare Systems and Labor Markets in Europe:

What convergence before and after EMU?[1]

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"All these objectives are inextricably linked: the large market, technological cooperation, strengthening the European monetary system, economic and social cohesion and the social aspects of collective action." (Jacques Delors, 9th Jean Monnet Lecture at the European University Institute, November 1986)

"The internal effects of a mutable policy are [...] calamitous. It poisons the blessing of liberty itself. It will be of little avail to the people that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; if they be repealed or revised before they are promulgated, or undergo such incessant changes that no man that knows what the law is to-day can guess what it will be tomorrow. Law is defined as a rule of action; but how can be a rule, which is little known and less fixed?" (James Madison: The Federalist Papers #62: 317; G. Wills, ed., Toronto: Bantam Books, 1982.)

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Introduction

The quotes that open this Chapter are clear statements of principle by pioneers working on similar issues in different times and locations. The mix of social policies in Europe today, however, fails on both criteria: they are uncoordinated, often conflicting, and far from simple to understand or implement. 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. We document the current situation and analyze 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 centralization, but certainly of more appropriate 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 labor 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. We document the heterogeneity of EU countries in these respects, highlighting in particular the relationship between Welfare State configurations, average income levels, and historical patterns of social-policy intervention. Within the EU, 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 may reduce incentives to work. We analyze 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 labor-market effects of European Welfare States. The Anglo-Saxon model based on means-tested and in-work benefits have 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" labor 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 importance 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. This is meant to enhance opportunity for personal mobility, but the current framework does not take into account all implications of such interference with National social policies. For example, while the European Court of Justice emphasizes European citizenship rights in the social field, the relevant costs are usually borne by local constituencies. 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 co-ordination 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 labor-market outcomes, which is not forthcoming. We rationalize 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 centralize more decision-making powers in this area (as in the USA). The EU is, however, at most a "cooperative" federal entity: 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 others' favourite redistributive policies while failing to internalize 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.

Even though different decision-making arrangements might possibly better pursue collective interests within the EU in this and other respects, our discussion of desirable social-policy developments in **Section 4** takes the cooperative-federalist nature of current EU institutions as given. Social policy instruments may enhance or reduce incentives for personal mobility. In our view, it is crucial to configure social policy interventions so as to preserve economic mobility incentives: even though mobility is currently very limited within the EU, its development is an essential component of its design. We discuss desirable features of a framework for social-policy choices within the current institutional constraints, and we bring the general economic insights illustrated by EU-specific examples in the previous sections to bear on the allocation of social-policy choices to different layers of government:

- Solidarity-based transfers, guaranteeing a minimum welfare level, should be co-ordinated at the central level to prevent competition among subsidiary levels of government from resulting 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 minimize 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 otherwise remain on paper.

- 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 decentralized 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 and labor-market institutions that best conforms to their preferences, resources, and comparative advantage.

1. Status quo and recent reforms: the social policy of EU member countries

Our study of possible future developments in the EU social policy field begins with a review of comparative information on the current situation. Social policy is the main pillar of the modern Welfare State. Since countries put different emphasis on the goals of the Welfare State, social policies differ in such respects as the size and composition of expenditures on social protection, institutional arrangements, benefits and taxation, impact on redistribution. As to regulation, labor market institutions are particularly relevant: wage setting mechanisms, job security provisions, the treatment

of the unemployed by the non-employment benefit system, and active labor market policies are all important elements of a welfare system's efficacy and efficiency in combating poverty and social exclusion. The various aspects of social-policy intervention may complement each other, or substitute for each other: for example, similar levels of income support and insurance can be provided by either social transfers or by regulation of the employment relationship. Thus, policies and institutions vary considerably along many dimensions, and many of the relevant differences are rooted in political/historical circumstances and cultural traditions.

In section 1.1 we review the contents and instruments of social policies as they are currently conducted in EU countries. While the extent and character of social policies is quite different across countries, all national welfare systems have similar goals and face some similar challenges (which we discuss in Section 2 below). In Section 1.2 we summarize the main differences in "Welfare Regimes" across EU countries, and comment on the patterns of recent reforms (or lack thereof), aiming to assess whether reforms are reducing or increasing the disparities in social policies across EU countries.

1.1. Social policy instruments and their stated goals

Governmental policies in the social field pursue a variety of economic and political objectives. In this section, we shall find it useful to characterize the status-quo configuration of European Union Welfare States according to the instruments used, and to the intermediate goals targeted by each instrument.

The primary goal of the Welfare State is to insure the population against "social risks" as a way to increase social cohesion and equality.[2] Increased "social cohesion" and better equality of resources and opportunities may be achieved via *transfers*, either in cash or in kind (through public provision of goods and services), funded by progressive taxation. How the different instruments of social policies are conducted have relevant consequences for poverty, income distribution, and the functioning of the labor market, as governments may also try and achieve more equitable distribution through *regulation* of economic relationships, particularly those in the labor market. Social policy instruments may be usefully classified according to their goals. More or less obvious goals of the policies of interest here – each, of course, an intermediate target in pursuit of deeper ends -- are the following:

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[2] Esping-Andersen (1999) describes the social risks insured by "traditional" Welfare States, and how they may be changing in recent experience (see our Section 2 below).

A. **combating social exclusion,**

B. **reducing overall inequality, and**

C. **increasing rewards from labor market participation.**

Each of the three goals historically was and still is advocated in principle as a basis of Welfare State policies. In the *Beveredgian* tradition, the first goal is the most relevant, while *Scandinavian* countries' welfare systems aim at reducing overall inequality. The earliest social interventions, in the *Bismarkian* tradition, stressed work-related benefits as the basis for administration of transfers . In practice, however, each policy instrument within the two broad "transfer" and "regulation" classes more or less effectively targets more than one of the three social-policy intermediate goals. Moreover, and very importantly, each policy instrument entails costs. The cost of regulation is implicit rather than explicit, and stems from its interference with the operation of *laissez-faire* markets. Resources directly transferred to individuals need to be collected explicitly, however, and the means of

D. **funding of social policies**

is an important element of each welfare system.

In summary, national welfare systems differ not only with respect to the weight attributed to the three goals by their designers, but also as regards the amount of resources and regulation effort devoted to achievement of social objectives, and the detailed articulation of instruments meant to achieve them. In what follows, we list and classify policies observed in the EU.

1. 1. 1. Social protection expenditures in the EU

Table 1.1 reports social protection expenditures as a proportion of GDP in 1996 and their decomposition by functions.[3] The amount of resources devoted to social protection varies considerably across countries. Thus, the Nordic countries (Sweden, Finland, Denmark) devote about one third of GDP to social protection expenditures; slightly more than the the Continental "core" countries (Belgium, Germany, France, the Netherlands, and Austria) which devote around 29 per cent of GDP to

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[3]Data come from the *European System of Integrated Social Protection Statistics* (ESSPROS), 1996 methodology (see EUROSTAT, 1999). ESSPROS aims at collecting information which "encompasses all interventions from public or private bodies intended to relieve households and individuals of a defined set of risks or needs, provided that there is neither a reciprocal simultaneous nor an individual arrangement involved". It includes the financing and provision of benefits (cash transfers, benefits in kind) and the related administrative costs.

social protection expenditures, and significantly more than the Southern countries and Ireland, which devote less than one fourth of GDP to social protection expenditures. In terms of resources devoted to social protection, the UK is between the Continental core and the Southern countries.

However, EU countries also differ in terms of per-capita income. As shown in Figures 1.1a, and 1.1.b, there is a close relationship between social protection expenditures per capita and GDP per capita: richer countries have higher levels of social expenditure per capita than the relatively backwards Southern countries.

Figure 1.1a. Social protection expenditures (SPE) per capita and GDP per capita 1990

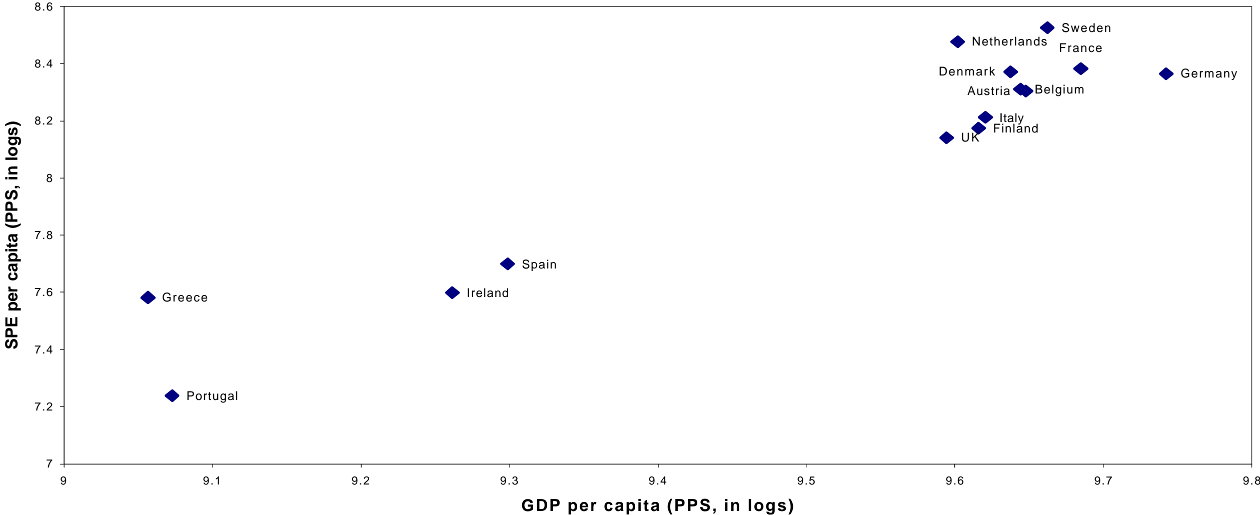
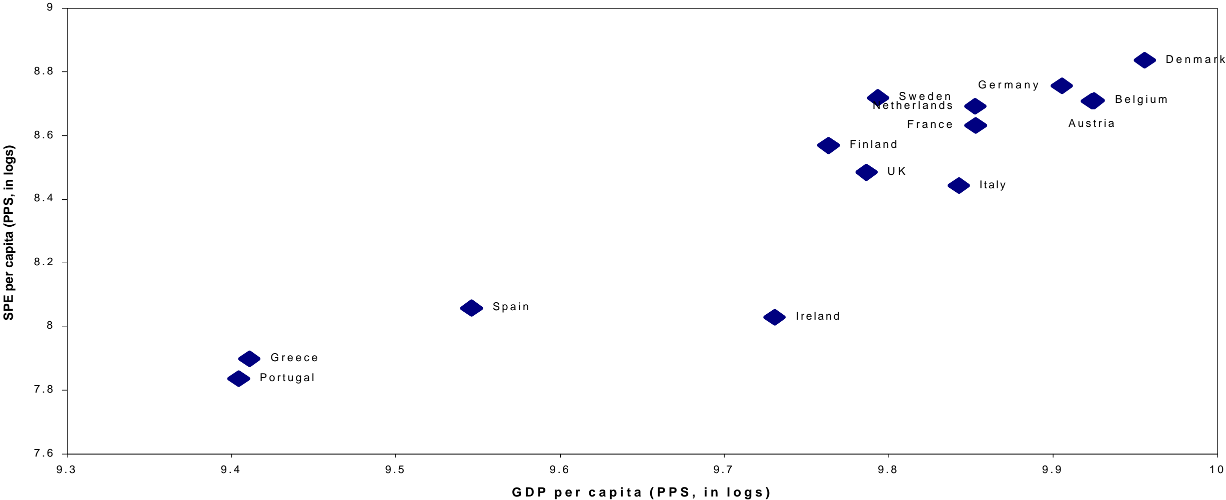


Figure 1.1b. Social protection expenditures (SPE) per capita and GDP per capita 1996



Social protection expenditures, however, do vary across countries at a given level of development. In part, this may reflect measurement problems. Gross social protection expenditures are an imperfect measure of the scope of social policies, because taxation of social transfers is not harmonized across countries: typically, countries providing higher transfers and benefits also tax these transfers and benefits more heavily. Hence, net social protection expenditures per capita are more closely related per capita GDP than indicated by Table 1.1 and Figure 1.1. Adema et al. (1996) propose a methodology to compute "net social expenditures" taking into account the three main differences in institutional arrangements across countries (the method of benefit payments, which may be net or gross of taxes; the use of tax instruments rather than cash or in-kind transfers for providing social insurance; and the degree to which governments require private agents to provide social protection). Applying this methodology to six countries (Denmark, the Netherlands, Germany, Sweden, the UK, and the US) in 1995, they find that gross social protection expenditures ranged from 17.1% in the US up to 37.6% of GDP in Denmark, and net social protection expenditures ranged from 18% in the US up to 27.9% in Germany.[4] Thus, the dispersion of net social expenditures across countries is much lower than that of gross social expenditures.

More interestingly, different propensities to devote resources to social policy at a given level of development reflect differences in the preferences for social policies, in demographic and labor-market participation features, and in the role of the private sector in fulfilling some of the aims of social policy (as, for instance, in the case of private pension schemes). These factors determine not only the overall size, but also the composition of social expenditure. Table 1.1 also reports social expenditures disaggregated according to their main functions.[5] The relative importance of the various budget lines

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[4]See *OECD Social Expenditure Database, 1980-1996* and Adema et al. (1996). The corresponding figures for gross direct public social expenditure were, in terms of national GDP: Denmark, 37.6%, Sweden, 36.4%, Germany, 31.4%, the Netherlands, 31.2%, UK, 25.9%, and the US, 17.1%; for net social protection expenditures: Germany, 27.9%, Sweden, 25.6%, Denmark 23.9%, UK, 22.6%, the Netherlands, 21.9%, and US, 18%.

[5] The broad functions distinguished by ESSPROS are:

-Sickness/health care: Income maintenance and support in cash in connection with physical or mental illness, excluding disability, intended to maintain, restore or improve health irrespective of the origin of the ailment.

-Disability: Income maintenance and support in cash or kind (except health care) in connection with the inability of people with physical or mental disabilities to engage in economic and social activities.

-Old age and survivors: Income maintenance and support in cash or kind (except health care) in connection with old age or the death of a family member.

-Family/children: Support in cash or kind (except health care) in connection with the costs of pregnancy, childbirth and adoption, bringing up children and caring for other family members.

may be interpreted in light of differences in the design and implementation of social transfers, in the age structure of the population, and the incidence of non-employment across different population groups. From the Table, it can be seen that

- All countries (with the sole exception of Ireland) devote the largest share of social expenditures to old-age and survivor benefits. The burden of old-age and survivor pensions is lowest in Ireland and Portugal (5% and 8% of GDP, respectively) and highest in Italy and Austria (15% and 13.9%, respectively); in most countries, it absorbs around 12% of GDP.
- Sickness and Health Care has the next-highest share of social protection spending, at about 7% of GDP with Germany and France (8.5% of GDP) on the high side, and Denmark and Italy (5.1 and 5.8% of GDP) on the low side.
- Unemployment benefits are often regarded as an important component of social expenditures, but account for only 8% of total social protection expenditures and 2.3% of GDP in the EU average, although a significant group of countries (Belgium, Denmark, Spain, Ireland, the Netherlands, Finland and Sweden) spend over 3% of GDP in this function. Sickness and especially disability transfers perform a similar function as protection against non-employment. Hence, they represent a relatively high fraction of social protection expenditures in countries with a high level of benefits (the Netherlands and the Nordic countries) but also in the UK.
- Resources devoted to transfers to families and children are very highly dispersed. They range from a minimum of 0.4% of GDP in Spain to a maximum of 4.1% of GDP in Denmark, with other Southern countries on the low side, and other Continental EU countries with proportions around 2% of GDP. Expenditure on social exclusion is around 0.5% of GDP, with insignificant figures in Italy, Portugal, the Netherlands and Spain, and the highest values in Denmark, 1.3% of GDP, and Sweden, 1.1% of GDP. Finally, housing is the lowest spending function in most countries, with the exception of Denmark, France, and Sweden, where it represents around 1% of GDP, and the UK where almost 2% of GDP is devoted to housing transfers.
- Another important dimension in the composition of social protection expenditures is the breakdown between in-kind service and cash provisions. In this regard, the Scandinavian countries also stand out as those relying most on the provision of in-kind services: in 1992, the ratio of

-Unemployment: Income maintenance and support in cash or kind in connection with unemployment.
-Housing: Help towards the cost of housing.
-Social exclusion and others: Benefits in cash or kind (except health care) intended to combat social exclusion where they are not covered by one of the other functions.

expenditures on in-kind services to expenditures on cash provisions was about 0.45 in Sweden, 0.33 in Denmark, and 0.21 in Finland. In the rest of EU countries this proportion was lower than 0.15, except for Ireland where it was 0.16 (see Esping-Andersen, 1999, Table 8A).

Table 1.1. Composition of Social Protection Expenditures in the EU15, 1996

	Belgium	Denmark	Germany	Greece	Spain	France	Ireland	Italy	Netherlands	Austria	Portugal	Finland	Sweden	UK	EU15
% total expenditure															
Sickness/Health Care	25.8	17.7	29.7	26.3	29.14	28.9	34.3	21.5	28.3	25.2	33	21.4	22	25.4	27
Disability	6.2	10.7	7.3	8.6	7.8	6.1	4.8	7	15.3	8.1	11.6	14.6	12	12.2	8.5
Old-age	32.2	38.8	39.2	41.2	41	36.9	20	54.2	32.9	38	36	30	36.4	34.8	39.2
Survivors	11	0.1	1.9	7.8	4.3	6.6	6.1	11.7	5.5	10.5	7.3	3.9	2.5	5.3	5.4
Family and children	8	12.4	9.4	8.3	2	8.7	12.8	3.6	4.4	11	5.6	12.5	10.5	8.7	8
Unemployment	14.5	13.8	9.6	4.3	14.5	8.1	16.7	1.9	12	5.7	5.8	13.9	10.3	5.8	8.4
Housing		2.4	0.6	2.4	0.5	3	3.3	0	1.2	0.3	0	1.3	3.2	7.2	2
Social exclusion	2.3	4.1	2.3	1.1	0.8	1.7	2	0	0.4	1.2	0.6	2.3	3.1	0.7	0.5
% GDP															
Sickness/Health Care	7.3	5.8	8.7	5.9	6.4	8.5	6.2	5.1	8.3	7.2	6.4	6.7	7.5	6.8	7.4
Disability	1.8	3.5	2.2	1.9	1.7	1.8	0.9	1.7	4.5	2.3	2.2	4.6	4.1	3.2	2.3
Old-age	9.1	12.7	11.5	9.2	9	10.8	3.6	12.9	9.7	10.9	6.9	9.4	12.5	9.3	10.8
Survivors	3.1	0	0.6	1.8	0.9	1.9	1.1	2.8	1.6	3	1.4	1.2	0.9	1.4	1.5
Family and children	2.2	4.1	2.8	1.9	0.4	2.5	2.3	0.9	1.3	3.1	1.1	3.9	3.6	2.3	2.2
Unemployment	4.1	4.5	2.8	1	3.2	2.4	3	0.5	3.5	1.6	1.1	4.3	3.5	1.6	2.3
Housing		0.8	0.2	0.5	0.1	0.9	0.6	0	0.3	0.1	0	0.4	1.1	1.9	0.6
Social exclusion	0.7	1.3	0.7	0.2	0.2	0.5	0.4	0	0.1	0.3	0.1	0.7	1.1	0.2	0.4
Total	28.3	32.7	29.5	22.4	21.9	29.3	18.1	23.9	29.3	28.5	19.2	31.2	34.3	26.7	27.5

Source: EUROSTAT (1999).

1. 1. 2. Combating social exclusion

A primary intermediate goal of social policy is the first one listed in our classification above, namely that of guaranteeing subsistence to people in need, regardless of their current and past employment. To achieve this goal, social assistance schemes either provide benefits to all people below a specified level of income (general assistance), or target specific population groups like the elderly, large families, disabled individuals, immigrants, etc. (categorical assistance). Under these schemes, benefits may be in cash or may be "tied", i.e., free or subsidized access to specific goods or services (notably, housing). Finally, benefits may be provided either at the local level (with local and regional governments running their own schemes) or at the national level.[6] In most EU countries, except the UK and Ireland, social assistance plays a residual role in the provision of a safety net, as most people are covered by either universal benefits or employment-related benefits.

In any case, social assistance schemes in EU countries are quite heterogeneous. On the basis of the information in Eardley et al. (1996a), several groups of countries can be identified with respect to expenditure composition in 1990/91. Social assistance has the highest weight in the UK and Ireland. In these countries, schemes are exclusively organized at the national level; the number of beneficiaries amount to more than 10% of total populations; and expenditures on social assistance amount to around 3% and 4.3% of GDP, respectively.

At the other extreme, expenditures on social assistance schemes are lowest in Greece, Finland, Portugal, and Belgium. Among the rest of the EU countries, the Netherlands, France and Germany devote around 2% of GDP to social assistance expenditures, while in Austria, Denmark, Italy, Spain, and Sweden social assistance expenditures amount to around 1% of GDP (almost 1.5% of GDP in Austria and Italy). In Portugal social assistance is run exclusively on a national basis, and in Austria it is completely decentralized at the local level; the rest of the Continental European countries implement social assistance schemes both at the national/federal and the local/state levels, and the local component has a relatively large weight in Spain and Sweden.

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[6] Eardley et al. (1996a and 1996b) provide a very detailed description of the characteristics of social assistance schemes in OECD countries.

1.1.3. Reducing overall inequality

While specific social assistance policies may be addressed to particularly needy individuals and households, it is hard for designers of social intervention to target benefits precisely. Either to achieve the more general aim of improving "social cohesion", or as a side effect, social policy does reduce inequalities through the whole spectrum of income distribution. In order to assess the actual performance of European Welfare States, we review some evidence on the incidence of social benefits on the distribution of household income. Measures of inequality and of poverty must address complex conceptual issues, but are also importantly constrained by data availability (see Atkinson, 1998, and references therein). Since our purpose in this Section is that of documenting and characterizing the wide heterogeneity of social policy intervention in EU member countries, we summarize evidence from the first wave of the new European Community Household Panel (ECHP). The data were collected in 1994, and only preliminary statistics have been made available recently (European Commission, 1998b; Vogel, 1997).[7]

We proceed in three steps. First, we focus on the household structure in EU countries. Households are considered the ultimate focus of the social protection system. Means-tested benefits and social assistance schemes are very often defined in terms of household income, not individual income. Thus, any analysis of the incidence of social benefits should start from the description of the household structure. Moreover, in some EU countries, the "extended household" constitutes an important source of insurance to individuals and, hence, a partial substitute of the social protection system. Secondly, we document the incidence of poverty and the magnitude of income inequality across EU countries. Differences in the design and implementation of social policies are likely to translate into different degrees of poverty and inequality across countries. Finally, we report on the effectiveness of social policies at reducing inequalities by focusing on the changes in the distribution of household income due to social benefits and on the distribution of transfers across households.

Vogel (1997) collects some descriptive statistics on the size and composition of households in EU member countries, namely: the average household size, the proportions represented by several types of households, and the incidence of extended households (those including three-generation

[7] A more detailed review of recent changes in the distribution of earnings in EU countries, although based on country-specific data sets, is OECD (1999b), chapter 3.

families and those including other relatives or persons). Household formation patterns are very dissimilar across EU countries. The average household size is lower in the Nordic countries (2.1 in Sweden, 2.2 in Denmark, 2.4 in Finland), in Central Europe (2.5 in Belgium and Germany, 2.6 in Luxembourg and France) and in the UK (2.5) than in Southern Europe (2.8 in Italy, 3 in Greece, 3.1 in Portugal, and 3.3 in Spain) and Ireland (3.3). These differences mostly arise from a higher proportion of single person households in the former countries (where single person households are roughly twice as frequent as in the latter; in Sweden, the proportion of single-person households is more than three times higher than that in Greece, Spain, and Portugal). Thus, both the proportion of people below 30 years of age and that of those above 65 years of age are higher in Central and Northern Europe than in Southern Europe. Single parent households are also much less frequent in Southern Europe. Finally, the proportion of 16-30 years old living with parents is higher in Southern European countries than in the rest of EU countries. As a result the proportion of the population in extended households is around 20% in Greece, Portugal and Spain, while is almost negligible in Denmark, the Netherlands, Finland and Sweden. Vogel (1997) also presents some indicators on the degree of poverty and inequality in EU countries (see Table 1.2). The indicators refer to adjusted disposable income, computed as the sum of all income sources for all household members divided by the number of consumer units, which are defined as 1 for the first adult, 0.5 for each other member over age 14, and 0.3 for each younger child.[8] But before turning to the analysis of the distribution of household income, it is useful to describe the distribution of net earnings. The Gini coefficient of this latter distribution is presented in the first two rows of the Table (the first row, for the population between 20-84 years of age; the second, for the population between 20-64 years of age). In this regard, EU countries may be classified into three groupings: the Nordic countries, which present the lowest levels of inequality, the Southern countries and Ireland, which presents the highest levels of inequality, and the rest of the countries in the middle (although, in this regard, the UK is closer to Southern European countries than to Central European countries).

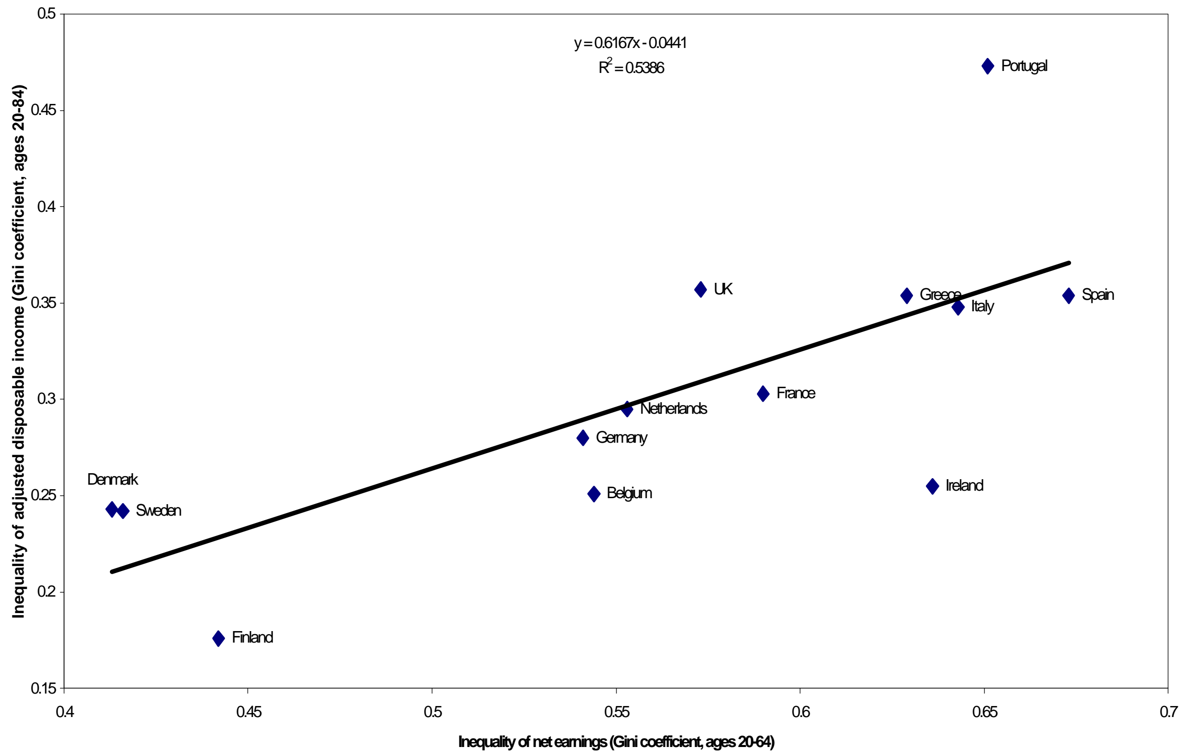
The remaining rows of Table 1.2 report descriptive statistics of the distribution of adjusted disposable income as defined above. The Gini coefficient for adjusted disposable income is much

[8] Like other equivalence scales, of course, this may or may not adequately capture the role of family composition in determining household welfare levels (see, e.g., Atkinson, 1998, p.37). Once again, complete EU coverage on a comparable basis is leads us to rely on Vogel's (1997) estimates. We should note, however, that the appropriateness of this and any other equivalence scale depends importantly on the structure of family costs, which in turn cannot be homogeneous across countries where, for example, the private costs of education and child health care vary substantially.

lower than for earnings, reflecting the obvious progressive nature not only of Welfare State subsidies and of taxation, but also the equalizing role of family arrangements in the distribution of income. Figure 1.2 shows that several clusters of countries may be identified from this perspective. First, in the Scandinavian countries both the inequality of net earnings and the inequality of adjusted disposable income are quite low. Secondly, the Benelux countries and Germany show an intermediate degree of both net earnings inequality and adjusted disposable income inequality. Southern European countries together with the UK and Ireland show a higher degree of net earnings inequality. In terms of adjusted disposable income inequality, however, only Portugal stands far above the EU average.

Heterogeneity between these clusters reflects a variety of country-specific phenomena. On the horizontal axis, the degree of earnings inequality is affected by labor market regulations (see Section 1.1.4 below) as well as by early retirement, patterns of work by age, and the incidence of self-employment and agricultural employment. As to the degree of inequality of disposable income the equivalence scale used for the computation of per capita disposable income is very relevant in light of the differences in family size across countries. The message of the Figure, however, is simple: EU countries are rather heterogeneous in the degree of disposable income inequality, which is turn positively related to earnings inequality -- indicating that neither the family nor the government can completely offset labor market outcomes in this regard.

Figure 1.2. Income inequality in EU countries, 1994



As to the incidence of poverty, we consider evidence on the proportion of households with adjusted disposable income below 50% of the national average. The Southern countries have a much higher proportion of poor households (26.8% in Portugal, around 20% in Greece, Portugal and Spain, and 18% in Italy). At the other extreme, in the Nordic countries poverty, as defined, afflicts only around 5% of the households. Symmetrical patterns can be observed in the upper tail of the distribution: rich households, defined as those with adjusted disposable income above 200% of the national average, are most frequent in Portugal, Spain, Greece, and least frequent in Denmark, Finland, and Sweden. The remaining EU countries lie in between the two extreme groups. From an EU-wide perspective, comparisons of household adjusted disposable income across countries (with PPS adjustment) yield about 16% of households below 50% of the EU average and 6.6% of households above 200% of the EU average. Obviously, households with income below 50% of the EU average represent a much higher proportion in the relatively poor Southern countries. Finally, as for recent trends, inequality and poverty were roughly stable over the 1980s (see Van Den Bosch, 1998) but appear- to have risen somewhat over the 1990s in most countries for which suitably comparable time

series data are available.

Given the high levels of social protection expenditures in EU countries, it is not surprising to find that social transfers represent an important source of income for many EU households. This is confirmed by the ECHP data, reported in the first row of Table 1.3. According to this source, social transfers amount to around 30% of net household income: the percentage is lowest in Portugal (22.1%), and highest in France (37.4%), Belgium (36.5%) and Italy (32.7%). We have also seen, however, that EU countries are heterogeneous not only with respect to the size and composition of social transfers, but also with respect to patterns of household formation. Thus, a given amount of resources devoted to social transfers may have a very different impact on household income inequality in the various countries. A rough measure of such differential effects is given by the impact of social transfers on indicators of inequality and poverty. The second row of Table 1.3 reports the difference between the Gini coefficients before and after transfers. For the EU12 the change in the Gini coefficient is .21, which represents roughly 40% of the Gini coefficient of income distribution before transfers. The seventh row of Table 1.3 similarly reports the difference between the proportion of households with income below 50% of the national average before and after transfers. The impact of social transfers on the poverty rate amounts to 22.3 percentage points for the EU12 (about 56% of the proportion before transfers). Not surprisingly, both indicators display some variation across countries: social transfers produce the largest reductions of the Gini coefficient and of poverty rates in Belgium, Denmark, and France, and the smallest in Greece and Portugal. Of course, these findings largely reflect the relative size of transfers in these groups of countries: in relatively rich countries, transfers are more generous overall, and it would be very surprising if they did *not* reduce inequality and poverty more than they do in poor countries.

To assess the efficiency rather than the efficacy of social policies, in Figure 1.3 we plot the changes in Gini coefficients and poverty rates against the percentage of transfers in household income. The slope of the regression line displayed indicates the typical improvement of the two measures of inequality "bought" by a percentage point of transfers in household budgets. The countries whose observations lie above the regression line appear to configure their transfers more efficiently than the EU12 average for the purpose of reducing inequality. By this admittedly rough measure, the French system of social transfers appears much less oriented towards reducing inequality than, for example,

the Danish one.[9] Greece, Portugal, and to some extent Spain and the Netherlands also appear to achieve smaller-than-average reductions in inequality and poverty (also Italy, only with regards to poverty) with their social transfer systems (which, of course, are very heterogeneous in terms of overall generosity, largely in line with their different average income levels).

Figure 1.3.a. Transfers and changes in inequality, 1994

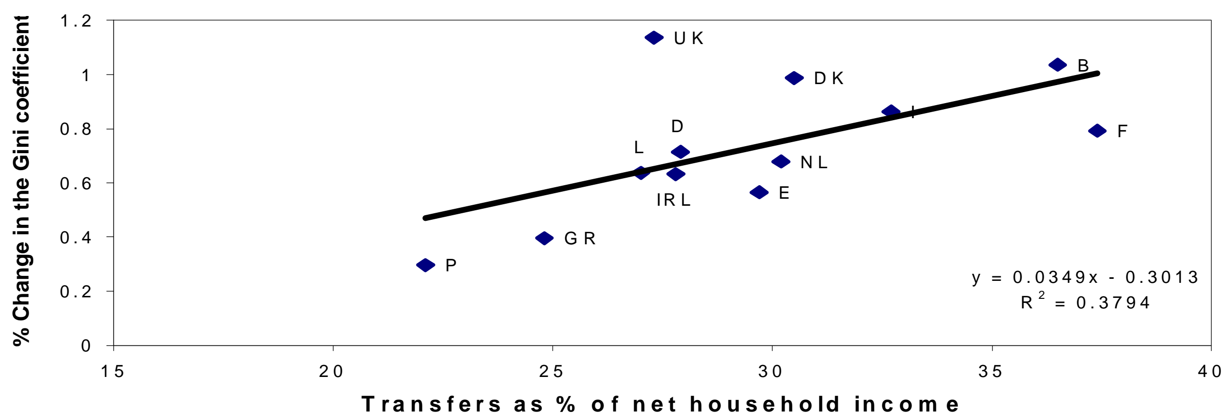
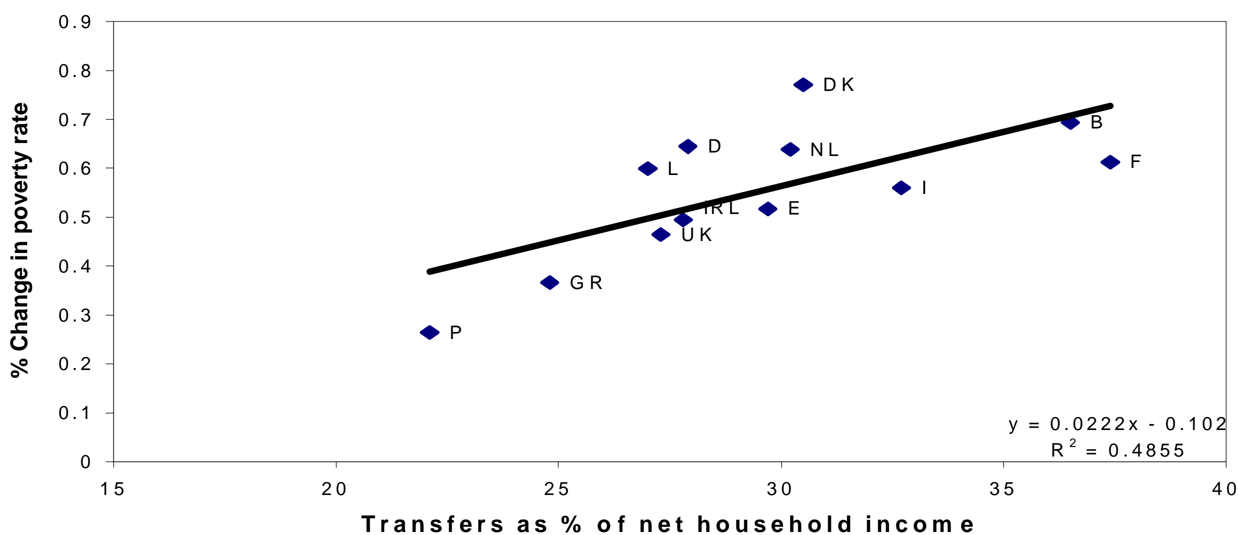


Figure 1.3.b. Transfers and changes in poverty, 1994



[9] In France, in fact, "social security was never primarily conceived as a tool to fight poverty" (Jallade, 1988, as quoted by Atkinson, 1998, p. 120).

Table 1.2. Poverty and inequality in the EU14, 1994

	B	DK	D	GR	E	F	I	IRL	L	NL	P	FIN	S	UK	EU14
(1) Inequality of net earnings (Gini coefficient) 20-84 years of age	.621	.511	.610	.694	.730	.657	.693	.676	.617	.623	.717	.508	.521	.650	
(2) Inequality of net earnings (Gini coefficient) 20-64 years of age	.544	.413	.541	.629	.673	.590	.643	.636	.565	.553	.651	.442	.416	.573	
(3) Inequality of adjusted disposable income (Gini coefficient) 20-84 years of age	.251	.243	.280	.354	.354	.303	.348	.255	.298	.295	.473	.176	.242	.357	
(4) Adjusted disposable income below 50% of national average (% households)	12.6	6.5	10.9	21.8	19.1	13.1	17.9	20	12.9	11.4	26.8	4.6	5.5	20.6	15.3
(5) Adjusted disposable income below 50% of EU average (% households)	8.7	4.4	7.6	42	31.7	10.5	23.8	28.3	1.3	9.2	47.5	5.8	5.9	14.8	16.2
(6) Adjusted disposable income above 200% of national average (% households)	4.6	3	5	6.9	7.7	6.4	5.9	6.3	6.1	5.3	8.1	3	3.1	6.6	5.9
(7) Adjusted disposable income above 200% of EU average (% households)	7.4	4	8.9	2.1	3.2	6.9	3.4	3.4	38.4	6.9	3	2.2	2.8	10.3	6.6
(8) Trends in income inequality in the 90s	Incr.	n.a.	Incr.	n.a.	n.a.	Incr.	Incr.	Decr.	Incr.	Incr.	n.a.	Decr.	Incr.	Incr.	

Source: Vogel (1997).

Table 1.3. Transfers and their impact on household income, 1994

	B	DK	D	GR	E	F	IRL	I	L	NL	P	UK	EU12
(1) Transfers as % net household income	36.5	30.5	27.9	24.8	29.7	37.4	27.8	32.7	27.0	30.2	22.1	27.3	30.4
(2) Change in the Gini coefficient before/after transfers	.26	.24	.20	.14	.20	.24	.22	.22	.19	.20	.14	.20	.21
(3) % Transfers going to households with income after transfers relative to national average <50%													
Pensions	17	9	6	12	10	7	18	8	8	4	25	19	9
Unemployment benefits	18	3	16	12	21	14	42	15	21	12	10	32	17
Other social transfers	12	4	15	18	19	16	34	11	21	9	29	29	19
Household members	13	9	13	24	19	16	21	18	14	14	29	23	17
Total income	4	3	4	7	7	5	9	5	6	4	9	8	6
(4) % Transfers going to households with income after transfers relative to national average >150%													
Pensions	11	6	14	26	21	25	14	20	15	26	28	18	19
Unemployment benefits	5	5	7	24	11	12	3	29	5	16	20	7	10
Other social transfers	14	3	11	23	13	7	6	19	13	14	14	6	9
Household members	13	9	14	16	17	13	18	17	14	15	17	16	15
Total income	27	20	29	37	37	30	38	35	15	32	42	37	32
(5) Households with income below 50% of average income before transfers	42.5	37.1	36.0	37.4	39.6	40.6	42.0	40.5	35.9	37.7	39.0	42.6	39.4
(6) Households with income below 50% of average income after transfers	13.0	8.5	12.8	23.7	19.1	15.7	21.2	17.7	14.5	13.6	28.8	22.8	17.1
(7) Change (5)-(6)	29.5	28.6	23.2	13.7	20.5	24.9	20.8	22.7	21.5	24.1	10.3	19.8	22.3

Source: European Commission (1998b).

1. 1. 4. Increasing the rewards from labor market participation

A third notionally distinct (but in practice intimately related) aim of European social policies is that of improving the lot of workers, chiefly by protecting them from adverse labor-market or lifecycle developments. Many of the transfers provided by social policies are employment-related, in the sense that eligibility and/or benefits are determined by previous employment spells. Unemployment benefits and pensions are, of course, the canonical examples in this context. Since contributions and benefits in these and similar schemes typically redistribute across income levels as well as over an individual's lifecycle, an intimate relationship between work-related and resource-related social policies is readily apparent. A further set of interactions are particularly important in Europe, where the goal of increasing rewards from labor market participation is also pursued by an array of pervasive regulation. Besides offering generous pensions and non-employment benefits to former workers, the "Bismarkian" Welfare State model seeks to protect breadwinners, i.e., prime-age males who are typically already employed and, in the view of Continental European lawmakers, should earn a stable flow of labor income. Hence, labor law covers all aspects of industrial relations; most employment conditions are regulated by collective bargaining agreements that may raise or supplement the minimum conditions established by the law; and governments may act as "employers of last resource". This panoply of transfers, regulations and other government interventions is intended to improve the lot of workers by affecting wage determination and other employment conditions (like working hours, health and safety at work, job security, etc.), and by providing insurance against the risks of becoming unemployed.

EU member countries differ quite significantly with regard to such policies and institutions. Some countries rely more on statutory legislation, while others allow employers and trade unions a wider autonomy to establish the regulation of industrial relations. Thorough comparative information on all the relevant aspects may be found, for example, in OECD (1994b, 1997b): here, we briefly offer a broad picture of the most relevant differences across current EU members.

As to ***wage setting***, a variety of institutional features are relevant and quite heterogeneous in the EU. In the mid-1990s, *trade union density* ranged from low values of 9% in France to 91% in Sweden. The *coverage rates* of collective bargaining agreements, however, are very high in all countries: the lowest rates are observed in the U.K. (47%), Portugal (71%), Spain (78%), Italy (81%), while the

remaining EU members display coverage rates of up to 98%. Despite recent trends towards decentralization in most countries, there are still "very corporatist" countries (like Austria) with very high levels of centralization and co-ordination and generalized extension rules, countries where a web of collective bargaining agreements at all levels interacts with medium levels of centralization and co-ordination, and countries like the UK with low levels of centralization and co-ordination. Thus, collective bargaining is the prevalent wage-setting mechanism across EU countries. Its wage-compression effects, however, are complemented by those of statutory minimum wages, which apply to workers not covered by collective bargaining. Some EU countries (like Belgium, France, Greece, Luxembourg, the Netherlands, Portugal, and Spain) have a statutory or national minimum wage that applies to all workers, sectors, and regions; other countries set minimum wages at the sectoral level, extending to most of the workforce the wage rates agreed at the collective bargaining stage (this is the case in Germany, Italy, Austria, Greece, Denmark, Finland and Sweden). Minimum wages in some countries are conditional on age or apprenticeship status, and employers and trade unions may or may not be involved in the revision of their levels, which may also be influenced by a variety of indexation mechanisms (see OECD, 1998a, chapter 2). In practice, minimum wages range from 33% of average wages in Spain to 72% in Italy, but their incidence is very different across countries: around 5% in Austria, Belgium, the Netherlands, and Spain, 8% in Portugal, 11% in France, and 20% in Greece (see Dolado et al., 1996). On top of statutory minimum wages, governments attempt to affect wage evolutions in other ways. In some countries, where civil servants' pay is not subject to collective bargaining and is determined directly by the governments, the wage evolution in the public sector may be used as a "signal device" for the private sector. Furthermore, in "corporatist countries", where there are central organisations which represent employers and workers, governments try to devise income policies arrangements meant to reduce wage pressures. The effectiveness of these income policies is under debate, as wage moderation is often reached by governments' concessions on tax reductions and public expenditure raises. However, in some countries like Austria and the Netherlands, income policy institutions are credited with having contributed to improve labor market performance.

Another institutional feature of most European labor markets is the prominence of **employment protection** legislation, which restricts employers' ability to adjust their labor force after changing economic conditions and provide some insurance to workers. This protection is accomplished by regulation of *dismissal procedures* (which may include requirements for prior warnings to workers,

written justification, notification to third parties, authorisation of dismissals for third parties, a period of notice to workers before dismissal, and provisions for appeal against unfair dismissal) and by specifying *severance payments* (whose amount may depend on the reasons for dismissal, and may be established by labor legislation, by the labor courts or by collective agreements).

Besides provisions against dismissal of workers under the "typical" employment contract, institutional arrangements vary across EU countries with respect to the admissibility of "atypical" employment patterns (see OECD, 1999a, chapter 2, for detailed information). In Southern European countries and Ireland, a sizeable proportion of the labor force is self-employed, which is, in general, subject to different regulation and benefits than the "typical" full-time employee. Not surprisingly, "atypical" employment is more prominent where "regular" employment is more stringently regulated. Thus, temporary/fixed-term/determined duration employment contracts are now widespread in countries where the degree of strictness of employment protection legislation is very high, while they remain very limited in countries with less strict employment protection legislation.[10] Finally, the incidence of part-time employment, whose regulation differs across countries, is lowest in Southern European countries which have less than 10% of total employment under part-time contracts, and highest in the Nordic countries and, especially, in the Netherlands, where almost 40% of workers have part-time jobs.

Unemployment benefits aim at compensating job losers (rather than at preventing job loss, like employment protection legislation; among EU countries, some rely more heavily on one or the other of the two policies: see Buti et al., 1998). Unemployment benefits are available under two different schemes, one based on an "insurance principle", under which both eligibility and benefits are employment-related, and another based on an "assistance principle", where eligibility is universal and benefits are means-tested. Replacement rates, eligibility requirements, generosity indexes, and benefit coverage rates differ considerably across EU countries (see Nickell and Layard, 1997, and OECD, 1997a). The Netherlands, Belgium, Finland and especially Denmark offer the highest replacement rates and duration; at the other extreme, benefits are least generous in the UK and Italy.

The coverage rates of unemployment benefits vary from 40-45 per cent in Spain and Portugal to

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[10]The liberalization of temporary employment contracts increases the flow out of unemployment and job-to-job flows (see Boeri, 1999, and García-Serrano and Jimeno, 1999) but also have negative effects on wages and productivity (see Bentolila and Dolado, 1994, and Bertola and Ichino, 1995). Also, as shown by Boeri (1999),

values above 100 per cent in the Netherlands, Belgium, and Finland. Throughout the nineties, there seems to be no significant trend in the generosity indexes of unemployment benefits in most EU countries. Generosity seems to have increased in Italy and Greece (countries where benefits were relatively low in 1990) and Denmark and Finland (countries with very generous benefits in 1990) and have decreased in Austria and Ireland (countries close to the average in 1990) and the Netherlands (a country with generous benefits in 1990).

Active labor market policies (employment services, training, employment subsidies, job creation) also vary widely in size and structure across EU countries (OECD, 1997a). Roughly half of the EU countries spend over one per cent of GDP on ALMPs, and Sweden and Denmark well above that. The UK, Austria, Greece, Portugal and Spain spend around 0.5 per cent of GDP on active labor market policies. In most of the countries, the expenditure on active labor market policies is below 45 per cent of total expenditure on labor market policies. The early 1990s feature an increasing trend in spending on active labor market policies, either in terms of GDP (with the exceptions of the UK, Greece, Portugal and Spain) or in terms of its weight in total expenditure on labor market policies, as is the case in Germany, France, and Denmark. The composition of active labor market policies is also quite varied. For instance, expenditure on training programs is relatively high (close to or above 40 per cent of total spending on active labor market policies) in France, Denmark, and, overall, in Spain (where its weight has more than doubled in five years). It represents less than a quarter of expenditure on active labor market policies in Holland, Belgium, Greece, and the UK. Furthermore, expenditure on job creation is relatively high in Germany, Belgium, Denmark, Finland, and Sweden, while it plays a minor role in France, the UK, Austria, Greece, Portugal, and Spain. Thus, there is also a high degree of heterogeneity among EU member countries in this regard. As expenditure on active labor market policies is somewhat conditioned by the incidence of unemployment among different population groups, which also varies very much across EU countries, such degree of heterogeneity should not come as a surprise.

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temporary workers compete with the unemployed for the job vacancies and average unemployment duration may even increase as the proportion of temporary contracts increases.

1.1. 5. Funding social policies

Social policies are financed from two sources: general taxation and social contributions, which are levied on income from employment (in some countries, also on social benefits recipients) and paid by employers as well as by employees.[11] For the EU as a whole, around 40% of social protection expenditures come from contributions levied on employers, 24% from contributions levied on workers (employees, self-employed, and benefit recipients), around one third from general taxation, and about 2% from earmarked taxes (see European Commission, 1998b). There are, however, noticeable differences in the funding of social policies across EU countries, with Continental and Southern countries (with the exception of Portugal) obtaining about two thirds of revenues from social contributions, as opposed to Nordic countries, the UK, and Ireland, where social contributions account only for 40% of total finance or less. Nevertheless, the combined effect of general taxation and social contributions on wages is relatively similar across EU countries. Table 1.4 gives the OECD's estimates of the total tax wedge and employers' social security contributions for the average production worker. (see OECD, 1998b). As seen in the table the total wedge ranges from low values of around 25-35%, depending on the family stauts of the employee, in the UK, Portugal, Ireland, and Greece, up to 40-55% in Sweden, Italy, Belgium, France, and Finland. The weight of employer's social security contributions in the wedge varies significantly across countries; it is largest in the Southern countries and France, where it amounts to close or above 50% of the total tax wedge. Although EU countries are nowadays more similar with regard to the tax wedge than they were 15 years ago, the differences in the weight of employers' social security contributions within the wedge have not significantly diminished in the last decade.

[11] Additionally, earmarked taxes have been recently introduced in Belgium, France and Luxembourg.

Table 1.4. Tax wedge in EU countries (%).

	Single earner		*One-earner married couple*	
	Total	Employers' social security contributions	Total	Employers' social security contributions
Austria	41.5	14.2	28	17.6
Belgium	56.4	15.1	40.4	20.6
Denmark	44.8	0	31.1	0
Finland	50.3	12.7	42	14.9
France	49.7	21.9	40.7	25.6
Germany	51.2	9.9	35	13.1
Greece	35.8	18	35.9	19.6
Ireland	36.1	7.6	25.6	8.9
Italy	50.8	22.8	43.8	26.1
Netherlands	43.8	4.6	33.5	5.5
Portugal	33.8	15.7	26.9	17.4
Spain	38.8	18.9	33.5	20.5
Sweden	50.2	16.5	44.6	18.4
UK	32.6	6.8	25.3	7.6

Note: The total tax wedge is defined as the employees' and employers' social security contributions and personal income tax less transfer payments as a percentage of gross labor costs for employees at the average wage level. Source: OECD (1998b).

An aspect of employers' social security contributions that will be important in our analysis below is their degree of progressivity. Most EU countries' social security contributions are configured on a flat rate basis with ceilings: hence, in contrast to income taxation, contributory schemes are typically regressive. In Belgium and Italy, the contribution rate is almost 4 percentage points lower for employees earning five thirds of the average wage than for those earning two thirds of the average wage. Similar measures of contribution-rate regressivity are about 2 percentage points in the remaining EU countries, with the important exception of the U.K., France and Ireland where contributions are progressive over the same range, in that the higher-wage employees pay higher contribution rates (by 1.5, 1.0 and 0.3 percentage points, respectively; see OECD, 1998b).

1. 2. Taking stock: status quo and trends

As we have just seen, social benefits and regulations come in a wide variety of forms and countries articulate them differently. In part, this reflects the facts that the Welfare State policies had different roots and evolved in different ways across EU countries. However, it seems that in this regard the differences across countries are becoming more diffuse and distinction between "social policy models" are less clear-cut than they used to be. To some extent, social policies in all EU countries show concerns for the two goals of increasing rewards from labor participation and helping the poor and reducing inequalities, as we have documented in section 1.1. However, some authors still argue that different "models" of social policies may be distinguished across EU countries. In this section we first try to classify EU countries in different "clusters" according to the main features of their social policies, building on the basis of the information provided in section 1.1. Secondly, we also document recent reforms and developments in the social policy field. Social policies in the EU countries are in a state of flux, as governments try to cope with the consequences of new economic and political events. We assess to which degree governments are following similar strategies when reforming social policies.

1. 2. 1. One Europe, how many "Welfare States"?

Political scientists have proposed a variety of "Welfare State Regime" classifications. Some authors distinguish between the *Liberal Welfare State Regime* (US, Canada, Australia and the UK)*, the Conservative Welfare State Regime* (Germany, France, Italy, Belgium, and Austria) and the *Social-Democratic Welfare State Regime* (the Nordic countries, Denmark and the Netherlands).[12] Such classifications are intimately related to the prevalence of different types of social transfer programs. Four types of social transfers can be identified on the basis of their eligibility and benefit criteria:

i) Targeted benefits, aimed at those in proven need and providing assistance (minimum) benefits;

ii) Basic security benefits, to which all citizens are entitled, and are usually established on a flat-rate basis;

iii) Corporatist benefits, which require some previous spell of employment to be eligible and are

[12] See Esping-Andersen (1990, 1999).

related to income;

iv) Encompassing benefits, under which eligibility is determined by citizenship and employment, and are designed under a two tier (flat-rate and income related) system.

Broadly speaking, targeted and basic security benefits are more prevalent in Anglo-Saxon countries, corporatist benefits are more prevalent in Continental Europe, and encompassing benefits are more widespread in the Nordic countries. In what follows, we study how this broad characterization is supported by quantitative and qualitative indicators. We also aim at characterizing, on a similar basis, recent trends in EU social policies, attempting in particular to ascertain whether different approaches to social-policy interventions are converging or diverging in the recent past.

In our review of the current situation of social policies in the EU we have highlighted many aspects in which social transfers and regulations differ across countries. A convenient way of summarizing them is, as in Table 1.5, by presenting measures/rankings according to some selected indicators of the articulation of social transfers and regulations in these countries. In light of the evidence discussed above, an orthodox classification is the following (see also Ferrera 1998):

The **Nordic** countries (Sweden, Finland, Denmark) and the Netherlands, countries which come from a tradition of full employment and universal welfare provision. They have the highest levels of social protection expenditures (about one third of GDP), a high share of in-kind service provision, and a very low degree of income inequality (both with regard to earnings and to adjusted disposable income). With regard to labor market institutions, they have relatively generous unemployment insurance benefits, and their active labor market policies (including job creation in the public sector) play a very important role. In these countries, social assistance plays a very residual role, with some heterogeneity: the relevance of social assistance schemes changes form country to country, being highest in the Netherlands and lowest in Finland.

The **Continenta**l countries (Austria, Belgium, France, and Germany), which derive from the Bismarkian tradition. These countries devote around 27-30 per cent of GDP to social protection expenditures, and have moderate degrees of income inequality. In these countries, wage determination is mostly centralized, minimum wages are relatively high, the generosity of unemployment insurance benefits is also high, the strictness of employment protection legislation and the weight of active labor

market policies is close to the EU average, and social assistance schemes provides a general basic safety net.

The **Anglo-Saxon** countries (UK and Ireland), while closer to the Beveredgian tradition, are distinguished for having a very large participation of social assistance schemes and relatively high degrees of income inequality, especially with regard to adjusted disposable income in the UK. They also have relatively low unemployment insurance benefits, less strict employment protection legislation, wage determination is relatively decentralized, and active labor market policies are not very relevant.

Finally, the **Southern** European countries (Greece, Italy, Portugal, and Spain), whose Welfare State was developed more recently. These countries have the lowest levels of social protection expenditures (about one fourth of GDP) and relatively high levels of income inequality, which transfers do not appear to reduce as much as in other EU countries. The prevalence of "extended family" arrangements, conversely, noticeably decreases the degree of inequality of adjusted disposable income (particularly in Greece, Italy, and Spain). They are also singled out by the strictness of employment protection legislation, and relatively under-developed active labor market policies and social assistance schemes.

This four-way classification is of course only meaningful with regard to the objectives of our analysis below, i.e., for the purpose of highlighting relevant aspects in the evaluation and prospects for reforms of social policies in Europe. Formal corroborating evidence can be obtained by statistical cluster analysis on a given set of variables measuring different dimensions of social policies. When the size and composition (rankings, in the case of employment protection legislation, minimum wages, and collective bargaining) of the social policies listed in Table 1.5 are taken into account together, the following "clusterings" emerge:

- For 1990, five different groups are obtained: i) Denmark and the Netherlands, ii) Spain and Portugal, iii) Ireland and the UK, iv) Greece and Italy, and v) Germany, Austria, France, Finland, and Belgium.
- For 1996, small differences with respect to 1990 arise. The groups obtained are: i) Denmark, ii) Spain and Portugal, iii) Ireland and the UK, iv) Germany, Austria, Greece and Italy, and v) France, Finland, the Netherlands, Sweden, and Belgium.

Thus, statistical procedures to a large extent confirm the traditional groupings outlined above. In particular, the “Anglo-Saxon” cluster stands out clearly in both years considered; similarly, Spain and Portugal are unambiguously clustered together. Interestingly, there does not appear to be as sharp a distinction as might be expected between “Nordic” and “Continental” countries in the dimensions considered: while the particularly “Nordic” configuration of Danish social policy stands out on its own, Sweden, Finland, and the Netherlands are intermingled with Continental countries.

Table 1.5. Selected indicators of social policies across EU countries (circa 1995)

Level of SPE (%GDP)	Helping the poor		Reducing Inequality			Increasing Rewards from Labor Market Participation				
	Social Assistance (% GDP)	Social Assistance (% SPE)	Inequality of Adjusted Disposable Income	Extended Family	Unemployment Insurance	Employment Protection Legislation	Active Labor Market Policies (%GDP)	Minimum Wage (% of average earnings)	Collective Bargaining	Inequality of Net Earnings
Highest	Highest	Highest	Lowest	Highest	Most "generous"	Most restrictive	Highest	Highest	Most centralized	Lowest
S	IRL	IRL	FIN	GR	DK	P	S	I	A	FIN
DK	UK	UK	S	P	NL	GR	DK	GR	FIN	DK
FIN	NL	NL	DK	E	FIN	I	FIN	A	F	S
D	D	D	B	I	B	E	B	B	D	D
NL	F	F	IRL	IRL	F	F	IRL	DK	B	B
F	A	I	D	D	P	G	D	NL	S	NL
A	I	E	NL	UK	E	S	F	IRL	I	A
B	DK	A	F	F	S	B	NL	D	IRL	UK
UK	E	DK	I	B	D	A	P	FIN	NL	F
I	S	S	E	DK	IRL	NL	E	S	E	IRL
GR	B	P	GR	NL	A	FIÑ	I	F	P	I
E	P	B	UK	FIN	GR	DK	UK	P	DK	GR
P	FIN	FIN	P	S	I	IRL	GR	UK	UK	P
IRL	GR	GR		S	UK	UK	A	E		E
Lowest	Lowest	Lowest	Highest	Lowest	Less "generous"	Less restrictive	Lowest	Lowest	Less centralized	Highest

Notes: The ranking of minimum wages is taken from Dolado et al. (1996). The ranking of collective bargaining is with regard to the coverage rate of collective bargaining according to OECD (1994b).

The rest of the columns are based on the evidence discussed in Section 1.1.

1. 2. 2. Recent trends in EU social policies

We shall discuss in the next Section how a changing economic environment (especially, though by no means only, as regards the extent of European economic integration) may, by increasing their economic efficiency costs, challenge the sustainability of welfare and labor market institutions. Pressures for reforms can be noticed already, in that most countries have been revising their social programs and regulations in the last decade. Here, we offer a preliminary assessment of these reforms' scope and patterns, focusing in particular on relationships across the clusters of EU countries identified above between status-quo heterogeneity and reform trends.

The generosity of EU national welfare systems has hardly decreased during the first half of the nineties. Social protection expenditures have actually increased as a fraction of GDP: in gross terms, total spending on social protection increased from 26% of GDP in 1990 to 28.5% of GDP in 1995 in the whole EU (European Commission, 1998b). In fact, according to the most recent EUROSTAT estimates, between 1990 and 1996 social expenditure increased as a fraction of GDP in each of the member countries but Ireland, where it remained more or less constant, and the Netherlands, where it fell by about one and a half points.[13] Of course, the dynamics of the denominator during the recession of the early 1990s determine most of the increase in the ratio of social protection expenditures to GDP observed during the 1990-95 period: in Figure 1.4, increases of the ratio have been very mild after 1993, and negative in all countries except Germany, Greece, France, Austria, and Portugal. Nevertheless, the overall rise in expenditures over the 1990-95 period seems contradictory to the fiscal pressure exerted by the Maastricht Treaty's convergence criteria. The fall in public deficits despite non-decreasing social expenditures reflects four features of recent experience:

i) fiscal consolidation proceeded with higher intensity after 1996 (period for which there are no ESSPROS data available yet),

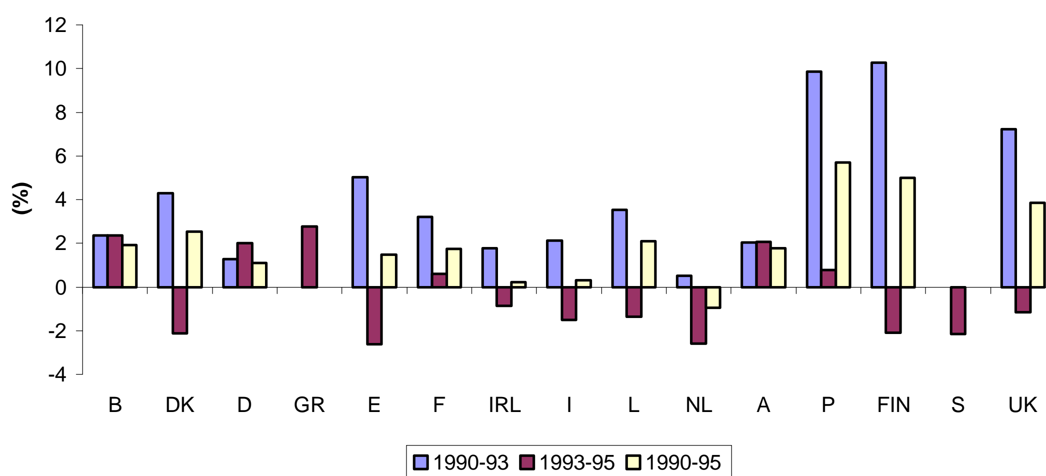
ii) faster economic growth in the second half of the nineties as compared to the 1990-95 period,

iii) other budget lines, mainly public investment, have borne the brunt of expenditure cuts, and

iv) tax increases (and non-fiscal revenues, like privatization revenues) have played a

more important role than expenditure cuts in the sharp reduction of EU public deficits during the 1992-97 period.

Figure 1.4. Average annual rate of growth of the ratio of social protection expenditures to GDP



Source: ESSPROS and Statistical Annex to European Economy, EUROSTAT.

Thus, the evolution of total social protection expenditures seems to suggest that there is no significant trend towards a retrenchment of social policies in EU countries, except in the Netherlands and Sweden. However, there is some evidence that countries have been changing the implementation of social policies during this period. Kalisch et al. (1998), in their analysis of member countries' responses to the OECD Caring World questionnaire, highlight the following main developments during the nineties:

- There has been a reduction of eligibility requirements for social protection programs, reducing payments and improving administrative practices to lower expenditures and enhance individuals' economic independence,
- There has been better co-ordination of services, as well as some decentralization of social policy programs to local and regional governments,
- Social security payment structures have been modified to increase financial incentives to work, and
- There is a trend away from public systems towards greater reliance on private social policy agreements.

[13] ESSPROS data for Greece and Sweden are only available for 1993 onwards. Lindbeck (1997a) provides an excellent description of the evolution of social polices in Sweden in the early nineties,

However, some of these qualitative trends are still not detectable in the data on the composition of social protection expenditures. Figure 1.5 plots the variation of the ratio of social protection expenditures by function to GDP during the 1990-96 period. Old-age and survivors transfers account for most of the increase in the ratio of social protection expenditures to GDP: it has decreased only in the Netherlands, and only in Germany, Greece, Finland and the UK is not the item which increased most. We will not analyze in any detail the demographic trends behind these developments, and the overall sustainability of European pension schemes: of course, however, the ominous burden of pension payments will loom large in our discussion of funding requirements and participation incentives within the integrated European economy.

Housing and social exclusion are the items which have displayed the largest rates of growth in relative terms (although, given their small weight, their increase in terms of GDP is smaller than for old-age and survivors). The ratio of expenditures on unemployment and disability, a function often regarded as an important source of pressure on the social policy budget, to GDP have increased on average by 0.75 points. The largest increases occurred in Finland, Germany, the Netherlands and Portugal (where unemployment benefits were almost zero before 1989). Finally, as for expenditures on family assistance, some countries have increased payments, especially for low-income families, which has resulted in some increase of expenditures in terms of GDP (mostly noticeable in Denmark, Germany, Austria, Finland, and the UK).

Tightening of eligibility criteria in social protection schemes has taken place mainly by the strengthening of means tests. Figure 1.6 plots expenditures on means-tested benefits as a proportion of GDP, and its change during the 1990-96 period. Clearly, higher means-tested expenditure could reflect more intense take-up of existing means-tested programs, rather than legislative strengthening of means-testing rules. With the only exception of Belgium and Italy, all EU countries have increased the amount of resources devoted to means-tested benefits. This increase has been largest in Finland, the UK and Ireland, i.e., in the countries where means-tested social protection arrangements were more important to begin with (excluding Ireland). If anything, this indicates that social policy intervention schemes are becoming more dissimilar in this respect.

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documenting a significant retrenchment in Swedish social policy.

Figure 1.5. Changes in social protection expenditures, 1990-96

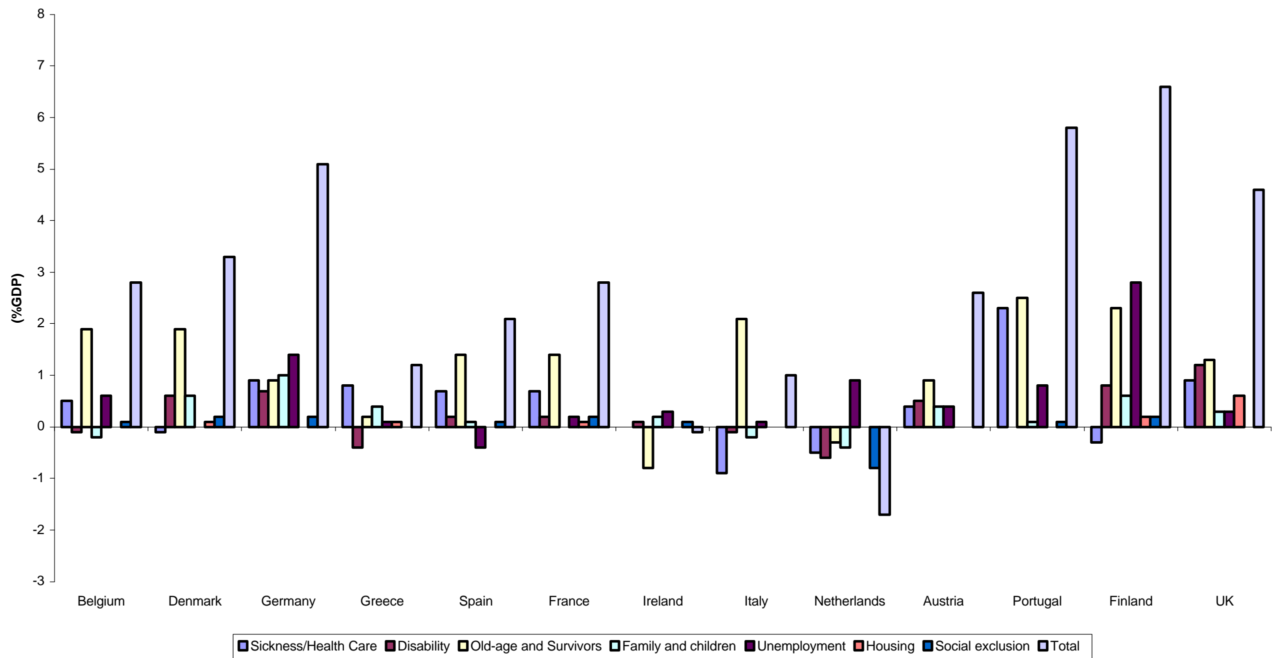
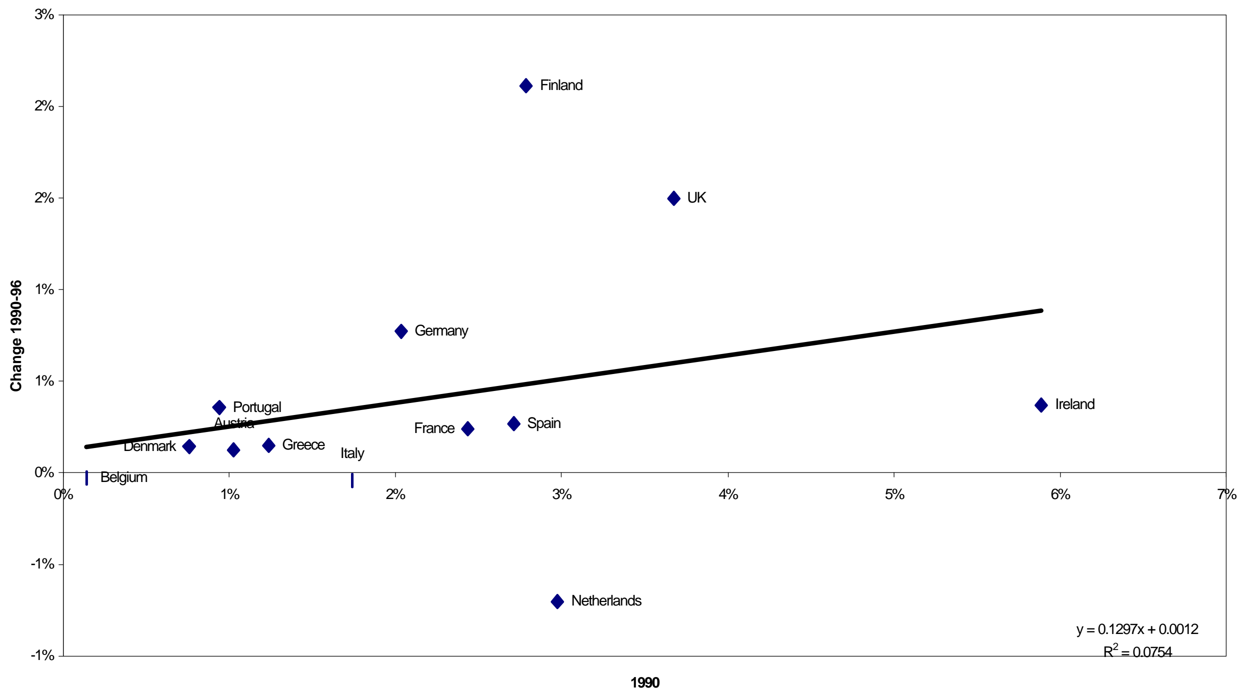


Figure 1.6. Means-tested Social Benefits (as %GDP)



Source: EUROSTAT, ESSPROS. Data for Sweden not available.

Work tests are also more and more relevant in social protection schemes. There are increasing requirements, regarding active job search and acceptance of job offers, for individuals of working age who claim social benefits. This trend is more apparent in the UK, where social policy reforms embraced the lemma "Welfare to Work" and conditions for receiving benefits were established in terms of participation in active labor market programs or labor market participation. However, the idea that social policies should ensure the "employability" of benefit recipients is shared by all countries. We shall discuss below in some detail the Luxembourg employment guidelines. In the data, concern about the labor market implications of social policy intervention is apparent from the fact that expenditures on active labor market policies have increased in almost all EU countries. Finally, in the countries relying heavily on unemployment benefits based on the insurance principle, active job search requirements are becoming more relevant as a requisite to receive unemployment benefits.

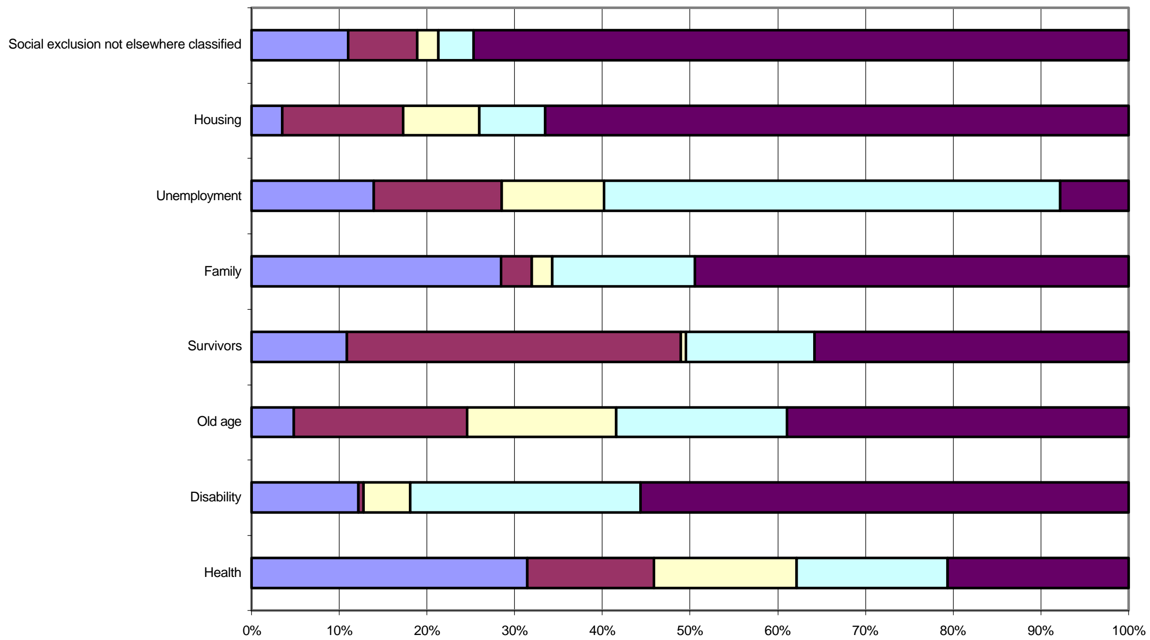
To provide another rough indicator of convergence (or lack thereof) we have computed sums of squared deviations of social expenditure shares (with respect to total social expenditure rather than GDP, to eliminate variation due to income levels). We decompose the observed sums of squares (SS) in a component deriving from within-model variation, and one deriving from across-model mean variation. In the two charts of Figure 1.7, the portion of the SS accounted for by variation across models is represented by the dark bars at the right.

The explanatory power of "models" is limited from this empirical perspective. Many of the differences are in e.g. regulation and wage institutions, which are difficult if not impossible to interpret quantitatively. Nevertheless, it is interesting to find that the differences across "models" explain, with few exceptions, the largest proportion of the total SS, both in 1990 and 1996. As for the comparison between 1990 and 1996, this proportion has actually increased half of the functions (Unemployment, Old-age, Disability, and Health), and decreased in the other half (Social exclusion, Housing, Family, and Survivors). These two findings suggest that

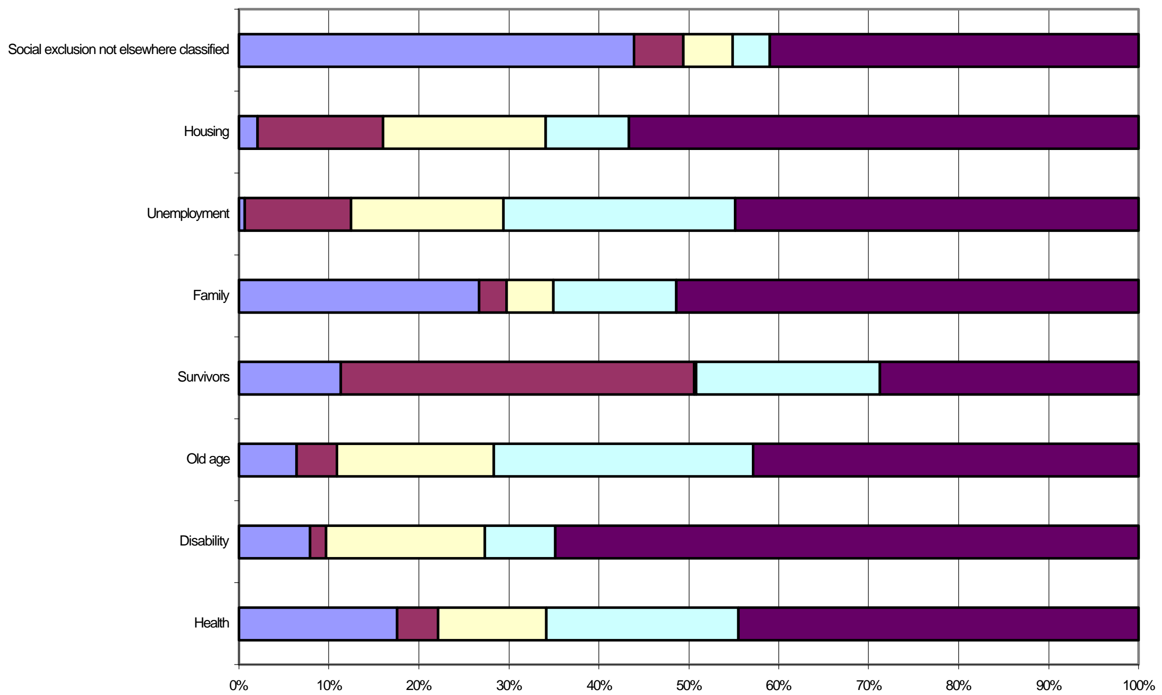
- the clustering of countries around "models" proposed above is not at odds with the differences in the composition of social protection expenditures, and that
- between 1990 and 1996, there is no clear trend at the convergence in composition of social protection expenditures. On the basis of this admittedly rough measure, there are no signs of decreasing heterogeneity across "models."

Figure 1.7. Decomposition of the differences in the composition of social expenditures

1990



1996



As to regulations, quantitative indicators are not available, since rankings are not comparable over time. All EU countries have, to some extent, introduced legislative and institutional changes meant to improve the functioning of the labor market. In some countries, not only the number of reforms have been very large, but also some reforms were, to some extent, contradictory with each other when considering their effects on the flexibility of labor market institutions: we discuss the evidence briefly in Section 2.4.3, in light of theoretical considerations. With the sole exception of the UK and the Netherlands (with regard to non-employment benefits), reforms aimed at increasing flexibility have been mostly marginal, not fundamental, so that the institutional framework of EU labor markets has not drastically changed.

2. Social policy and economic performance

Section 1's analysis of EU national welfare systems' panoply of variously motivated instruments paints a rather complex picture. We now step back from it momentarily to discuss theoretical issues in the motivation and implementation of social policies, and to consider broader patterns of evidence emerging from historical patterns and from the experience of non-EU countries. Section 2.1 offers some broad considerations on the desirable economic role of social policy, and we discuss its possible undesirable side effects. Redistribution is also motivated by social and political considerations: Section 2.2 briefly reviews evidence on its economic effects in a sample of countries wider than the EU one, and Section 2.3 discusses channels through which social policy may interfere with the functioning of labor markets. The effects of social policy instruments (in the labor market and elsewhere) depend, of course, on the characteristics of the economic environment in which they are implemented: Section 2.4 outlines how productivity, demographic, and economic integration trends may explain a deterioration of social-policy performance over the last two decades.

2.1 The economics of social policy

Economists often find it useful to think of a hypothetical situation where all markets are perfect and complete. In such a world, "social policy" should be limited to simple redistribution; taxes and subsidies should be designed so as to be as non-distortionary as possible; and deregulation should be pursued as an end in itself. Reality, of course, is very different from the economist's reference point. Social policy can play a meaningful role if is substitutes missing or highly imperfect market interactions. For example, appropriate health and safety regulation can improve on market outcomes when the latter could not ensure that workers are suitably informed about the characteristics of their workplace, because it is too easy (and profitable) for employers to misinform them and too costly for individual workers to obtain the relevant information. For similar reasons of asymmetric information, it may be impossible for *laissez faire* economies to supply insurance against the risk of becoming or remaining unemployed. Workers would not try as hard to avoid unemployment and find new jobs if they were covered against the negative consequences of the event. And by purchasing insurance at a given market price, workers who know they have particularly high unemployment risk would make the scheme unprofitable for insurance providers or unattractive to workers with average risk. One can then see why social policy would try and remedy the *ex-post* inequitable or "unfair" labor market treatment of workers who, lacking

insurance, become or remain unemployed despite their best efforts.

If socially agreed forms of income redistribution and regulation can indeed perform the same function as the market interactions they mean to replace, then the Welfare State can improve economic efficiency as well as equity. As in the case of public goods, economic interactions often need to be mediated on the basis of collective agreements rather than of individual choices. An economic case can be made for arrangements that mimic the features of desirable contracts not supported by *laissez-faire* economic interactions.

Social policy intervention, however desirable, unfortunately does face much the same information constraints that prevent markets from achieving first-best equilibrium configurations. Information problems plague public intervention in both its efficiency-seeking and equity-seeking dimensions. Clearly, workers have no less incentive to decrease their effort when covered by social instead of private insurance. Collective information-gathering facilities may be superior to those of private agents (and both may be improving over time as information technology progresses), and governments should be better able to enforce transfer and regulation schemes (at least in the absence of corruption). Even the fictional Big Brother governments of Orwell's *1984* and Bradbury's *Fahrenheit 451*, however, obviously enjoy much less than perfect information and enforcement facilities. Imperfect information about effort and about personal characteristics plagues social policy with the same problems that make it so hard for private markets to address the adverse effects of otherwise desirable contractual arrangements. On the other side of the coin, efficient provision of social protection cannot eradicate all "unfair" inequality. If individual characteristics and behavior are not verifiable, then richer individuals may take advantage of subsidies or tax exemptions meant to benefit a society's more unfortunate members. Accordingly, standard optimal-taxation theory stipulates that some admittedly "unfair" inequality must survive redistribution efforts. In simple terms, if individuals with higher pre-tax welfare cannot be singled out *ex-ante* but only on the basis of information revealed by their behavior, they must remain better off after the introduction of tax-and-subsidy packages, for otherwise they would have no incentive to reveal their true pre-tax standing.[14]

Because of these incentive or "loophole" problems, redistribution schemes generally increase pre-tax inequality as they attempt to decrease post-tax welfare inequality. Most straightforwardly, progressive income taxation decreases labor-supply incentives for high-ability workers – surgeons, for example. Lower supply of such high-skill services must

increase their price in equilibrium (to an extent that, of course, depends on the elasticities of demand and supply). Qualitatively similar dynamic mechanisms may be at work in the presence of uninsurable uncertainty, i.e. in a situation where social policy can be expected to substitute missing markets. To the extent that unemployment insurance decreases job-search incentives, more individuals can be expected to be unemployed (and, at zero income, increase pre-tax inequality). Also, ex-post redistribution increases risk-taking, like a well-functioning financial market would. This improves the economy's productive efficiency but, as individuals engage in more risky activities, pre-tax inequality can increase so much that post-tax inequality is also higher than in the absence of social redistribution (Sinn, 1995).

The direction of these effects is unambiguous: to some extent, social policy must be less than fully successful. Their intensity, however, depends on many details of the economy's productive and informational structure, and on the administrative structure of social policies themselves. In principle, social policies' side effects may be so strong as to defeat the very purpose of policy interventions. For example, as already mentioned, social insurance may so strongly encourage risk-taking that not only pre-tax, but also post-tax inequality is larger than in the absence of social policies. Publicly provided pensions and taxation of private capital income may reduce private wealth accumulation so much as to leave the old as poor as they would be if they were left to their own devices. Non-employment benefits and labor taxes may so discourage (through "poverty traps") labor-force participation and human capital accumulation as to leave disadvantaged individuals as poor as, or poorer than, they would be in the absence of policy interventions. Finally, social policy might defeat its own purpose through general equilibrium interactions. Lower efficiency and slower capital accumulation may so adversely affect aggregate income that poor individuals, even as they obtain a larger share of it, are worse off than they would be if they could obtain their smaller slice of a larger *laissez-faire* social pie.

2.2 History, politics, and the effects of the Welfare State

If the unavoidable side effects of social policy interventions were so strong as to defeat its intended economic purposes, one would of course wonder why such misguided interventions would ever take place. Before discussing some of the relevant empirical evidence, however, we need to acknowledge that social policy cannot be studied from the purely economic viewpoint. The Welfare State does not only supply insurance to individuals,

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[14] For treatments of standard optimal-taxation problems, see Atkinson and Stiglitz (1980) or the original contributions of Mirrlees (1971) and Diamond and Mirlees (1971).

like a hypothetical financial market would. It also offers a minimum standard of living to individuals who could never purchase insurance in the market, and – aiming at reducing social tensions and preventing exploitation -- redistributes income on the basis of social, rather than individualistic, solidarity criteria. Hence, social policies have political and often nationalistic motives beyond the more directly economic mechanisms illustrated above.

Whatever the possible economic rationalization of the complex Welfare State schemes discussed in Section 1, their history has firm nationalistic and often paternalistic roots. The bureaucracy-based Welfare State as we know it was introduced and developed in the context of the European militaristic Nation-State, a fact which, of course, has particularly interesting implications as formation and continued integration of the European Union makes that concept obsolete. The employment-related old-age and sickness benefits introduced in Bismark's 19th century Germany were meant to keep revolutionary pressure under control. Similarly, the Beveridgian Welfare State of the United Kingdom and other Anglo-Saxon countries was formulated and implemented in the nationalistic climate surrounding World War II.[15] The current configuration of these two models in Europe, alongside the egalitarian Scandinavian Welfare State and the mixed and underdeveloped schemes prevalent in Mediterranean countries, remains difficult to understand without reference to their origins. A second important aspect of real-world social policy provision is the fact that Welfare State features are not designed and implemented once and for all, at a constitutional stage where their economic and social purposes can be best taken into account behind a veil of ignorance. In reality, "winners" and "losers" are quite easy to identify for many, if not all, policy instruments. Hence, the original design of social-welfare policy systems are the result of complex political interactions, where special interests play an important role, and the same is true of their reforms (or lack thereof). The politics of welfare are the politics of the status quo: each member of the Welfare State "families" identified in the literature has its own history-dependent, layered structure, shaped by bureaucratic and political resistance to change at least as much as by its intended purposes.[16]

The remarkable heterogeneity of social-welfare policies and its rather exogenous (to economics) sources are actually a blessing for research on their economic implications. As we noted in Section 2.1 above, theory indicates that Welfare State policies may hamper economic performance and increase pre-tax income inequality at the same time as they try to

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[15] See Rhodes and Meny (1998b) for further details and references.

[16] See, e.g., Esping-Andersen (1990), Pierson (1999), and references therein to the abundant political-science literature on this subject.

redress market failures and/or equalize incomes. The quantitative importance of these effects, however, needs to be gauged empirically: to the extent that each national experience may be treated as a separate experimental outcome, researchers can rely on ample comparative evidence from different countries. Such exercises, of course, are more informative when conducted on sets of countries which implement different sets of social policies, but are otherwise comparable. Hence, it is advisable to broaden the scope of our discussion beyond the confines of the EU, and consider comparative evidence from other industrialized countries.

The extensive Luxembourg Income Study (LIS) data sets cover 5 non-EU countries (Australia, Canada, Norway, Switzerland, and the United States); among EU countries, however, Austria, Greece, Portugal, Spain, and Luxembourg are not covered. The LIS evidence does not support the notion that social policy's "side effects" may be so strong as to defeat its intended purpose: more generous Welfare States are unambiguously associated with lower poverty rates (see Kenworthy, 1998, or Förster, 1994). Table 2.1 reports some relevant statistics. The side effects of social policy do not appear to be so strong as to increase the incidence of pre-tax absolute poverty -- which is high in rich, non-redistributive economies such as the U.S. rather than in countries with pervasive and generous redistribution schemes. Social policy, in short, does accomplish its stated purpose of reducing poverty. The data indicate that post-tax poverty is highest in the United States and other Anglo-Saxon countries: despite the fact that these countries are relatively rich on an absolute scale, their reliance on targeted benefits (rather than on universal or employment-related welfare provision and labor market regulation) apparently leaves many of their citizens poor on an absolute basis. It is also interesting that Italy, the only member of the Mediterranean EU cluster in this table, displays a very high rate of absolute poverty. This may reflect its particularly heterogeneous regional income distribution, but also the relatively inefficient and misdirected configuration of its social policies: Italy, like most Mediterranean countries, has no minimum standards for social assistance provision, and many of its transfer programs fail to target the poorest citizens.

Table 2.1: Post-Tax/Transfer Absolute Poverty Rates (%), circa 1991

		Percent of the U.S. post-tax/transfer median at which the poverty line is set		
	Year	50%	40%	30%
Australia	1989	20.1	11.9	5.6
Belgium	1992	14.2	6.0	2.2
Canada	1991	11.3	6.5	3.1
Denmark	1992	13.5	5.9	3.4
Finland	1991	8.1	3.7	1.4
France	1989	19.7	9.8	4.8
Germany	1989	11.5	4.3	2.1
Ireland	1987	43.7	29.4	15.6
Italy	1991	26.1	14.3	5.6
Netherlands	1991	16.0	7.3	4.2
Norway	1991	4.0	1.7	0.7
Sweden	1992	11.0	5.8	3.1
Switzerland	1982	6.2	3.8	2.7
United Kingdom	1991	27.0	16.8	6.1
United States	1991	17.7	11.7	6.6

Percentage of individuals in households with post-tax/transfer incomes (adjusted for household size) below poverty line in 1991 U.S. dollars. *Source:* Kenworthy (1998), calculations from the LIS database. The numbers in the table refer to the percentage of each country's citizens living in households whose per-capita income (adjusted for purchasing power on the basis of OECD estimates, and for size using the standard square-root equivalence scale) falls below a given amount, defined as a percentile of the U.S. income distribution. "Post-tax and –transfer income" of the households surveyed in the LIS microeconomic data sets account for income from all sources, government benefits (including "near cash" benefits, such as food stamps), and tax payments.

The data also give no evidence that the generosity of welfare policy has long-run adverse effects on broad measures of economic performance (see, e.g., Perotti, 1996, and other references in Bertola, 1999b). This is of course not surprising from the economist's viewpoint outlined above: if social policy is mostly aimed at mending the shortcomings of *laissez faire* markets, then it might be expected to foster rather than hinder production. We illustrate this evidence simply in Figures 2.1 and 2.2 by plotting income level and growth indicators against an index of Welfare State generosity, namely the extent of within-country redistribution measured by the difference between pre- and post-tax and transfer relative poverty rates.[17] This index is of course a very rough measure of Welfare State intervention. On the one hand, if individuals do work and save less because of taxes and transfers, then the change in poverty rates overstates the effect of social policy (which increases pre-tax inequality at the same time as it decreases post-tax inequality). On the other hand, Welfare State institutions achieve their more or less obvious goals with different instruments, such as public employment and wage-setting institutions, that have broad effects on pre-tax inequality. The evidence should be further qualified by the observation that, to the extent that social policy does reduce economic efficiency, exogenously richer societies would generally find it easier to afford production losses – to imply that redistribution and economic performance could be jointly, rather than causally, determined in the data. In practice, however, there is essentially no relationship between the extent of redistribution and GDP growth rates, and a very mild negative statistical association between redistribution and income levels.[18]

[17] The pre-tax and –transfer figures used in the chart are those computed by Kenworthy (1998): they are based on the LIS database "market income" variable, including cash receipts from all sources other than transfers or gifts, and adjusted for family size on a square-root equivalence scale basis. Unlike the figures reported in the table above, those plotted on the horizontal axis of the Chart are relative poverty measures, i.e., computed as the percentage of individuals falling below a country-specific percentile of adjusted per-capita income measures. This is a more appropriate measure of the extent to which social policy affects the country-specific indicators on the vertical axis.

[18] The t-statistic of the (positive) coefficient of the levels regression is 0.93; that of the negative coefficient of the growth-rate regression is 2.2 in absolute value, slightly above the 5% one-sided critical value with 13 degrees of freedom.

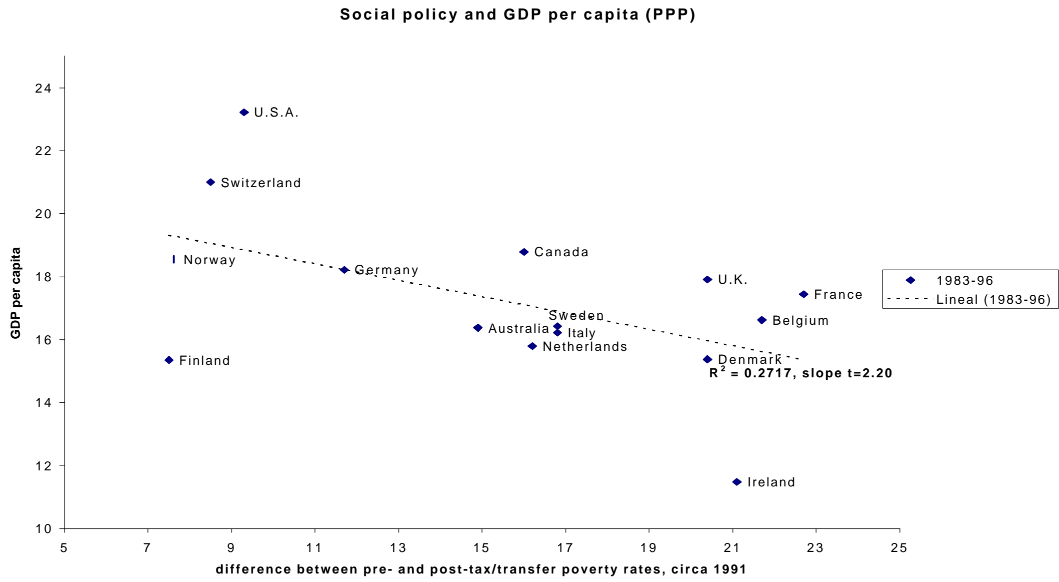

Figure 2.1. Sources: poverty rates, Kenworthy (1998); time-averaged income levels, our computations on PPP –basis data drawn from the OECD Economic Outlook database.

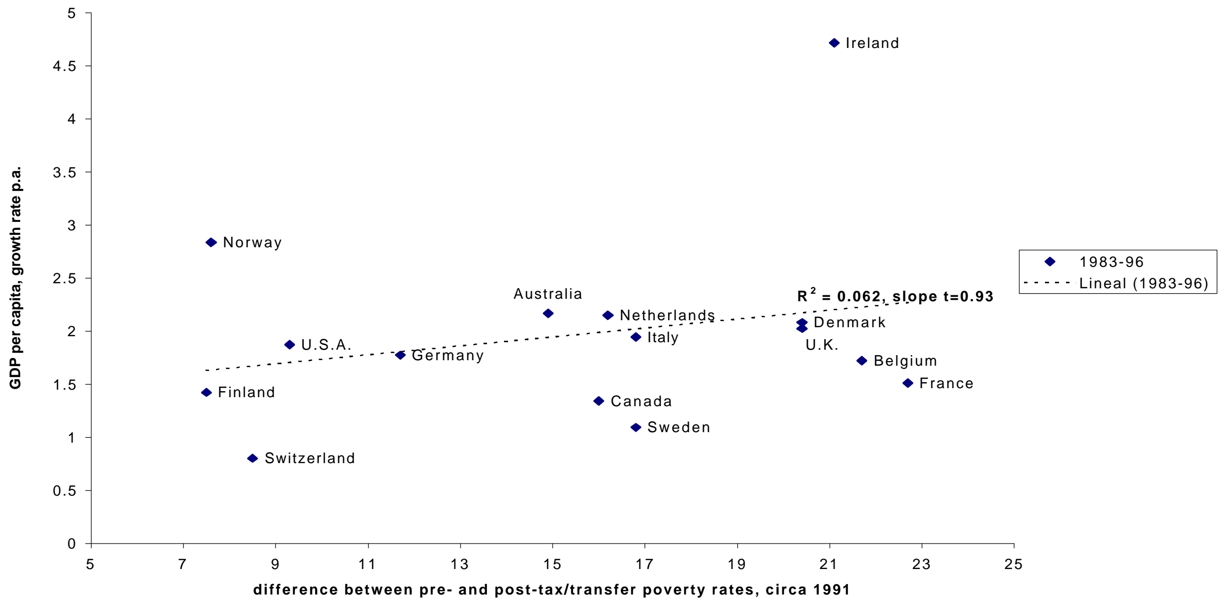

Figure 2.2. Sources: poverty rates, Kenworthy (1998); income growth rates, our computations on PPP–basis data drawn from the OECD Economic Outlook database.

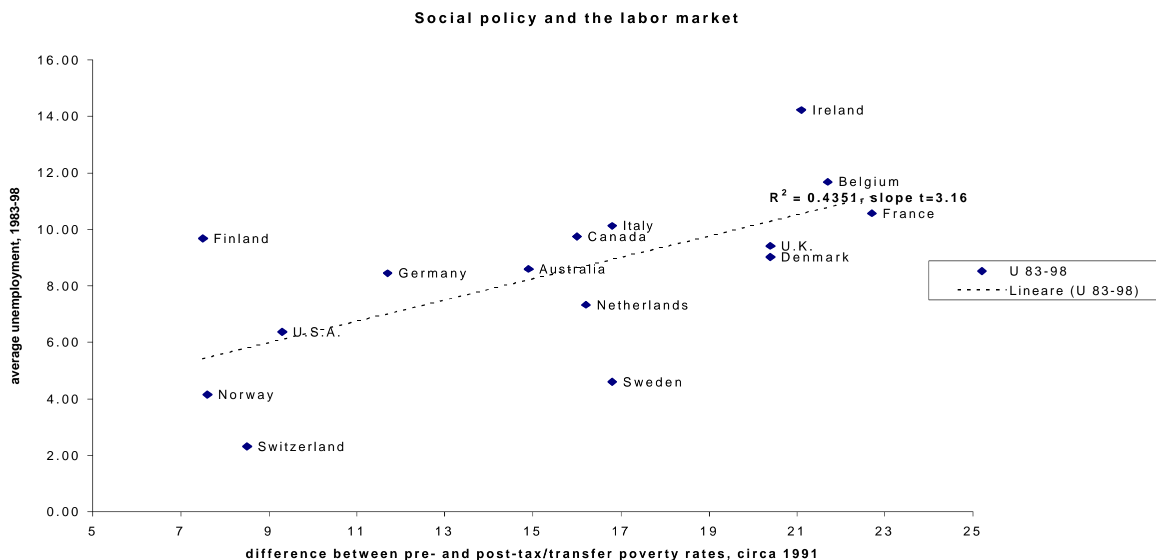

Figure 2.3. Sources: poverty rates, Kenworthy (1998); average unemployment, our computations on standardized data drawn from the OECD Unemployment Outlook database.

While the Welfare State appears to achieve its intended poverty-reduction purpose with no obvious adverse effects on income levels or growth rates, it would be naive to conclude on the basis of this simple evidence or of the more sophisticated statistics in Kenworthy (1998) or Perotti (1996) that redistribution has no negative effects on economic performance. And it would be especially naive to dismiss the economic challenges faced by the Welfare State in the EU context, where labor-market issues loom particularly large. In Figure 2.3, we plot the poverty-rate-based summary measure of Welfare State generosity against an equally rough summary measure of labor market performance, namely standardized unemployment rates, again averaged for each country over the 1983-96 period to eliminate cyclical effects and possible reverse-causation mechanisms.

When indicators of social-policy redistribution are considered jointly with unemployment, a thought-provoking positive relationship between poverty-reduction success and unemployment is readily apparent. A similar picture emerges in the two panels of Figure 2.4, where we investigate the interaction between family-based transfers and the labor market impact of social policies by plotting the poverty-based measure of the latter against household employment rates. Unfortunately, limited data availability prevents this exercise from providing much information, particularly as the relevant statistics are available only for Italy among the Mediterranean countries where our discussion of Section 1 found family

structure to be most relevant. The 1996 data indicate that social policy has a smaller and less statistically significant impact on family non-employment rates than on the individual unemployment rates considered in Figure 2.3. This might indicate that, quite intuitively, incentives to obtain market employment particularly affect young and female household members, but are not so strong as to induce non-employment of primary breadwinners. When we consider average 1996 and 1985 data for the (fewer) countries where both are available, however, family non- employment rates are just as significantly and positively related to Welfare State generosity as the individual unemployment rates of Figure 2.3.

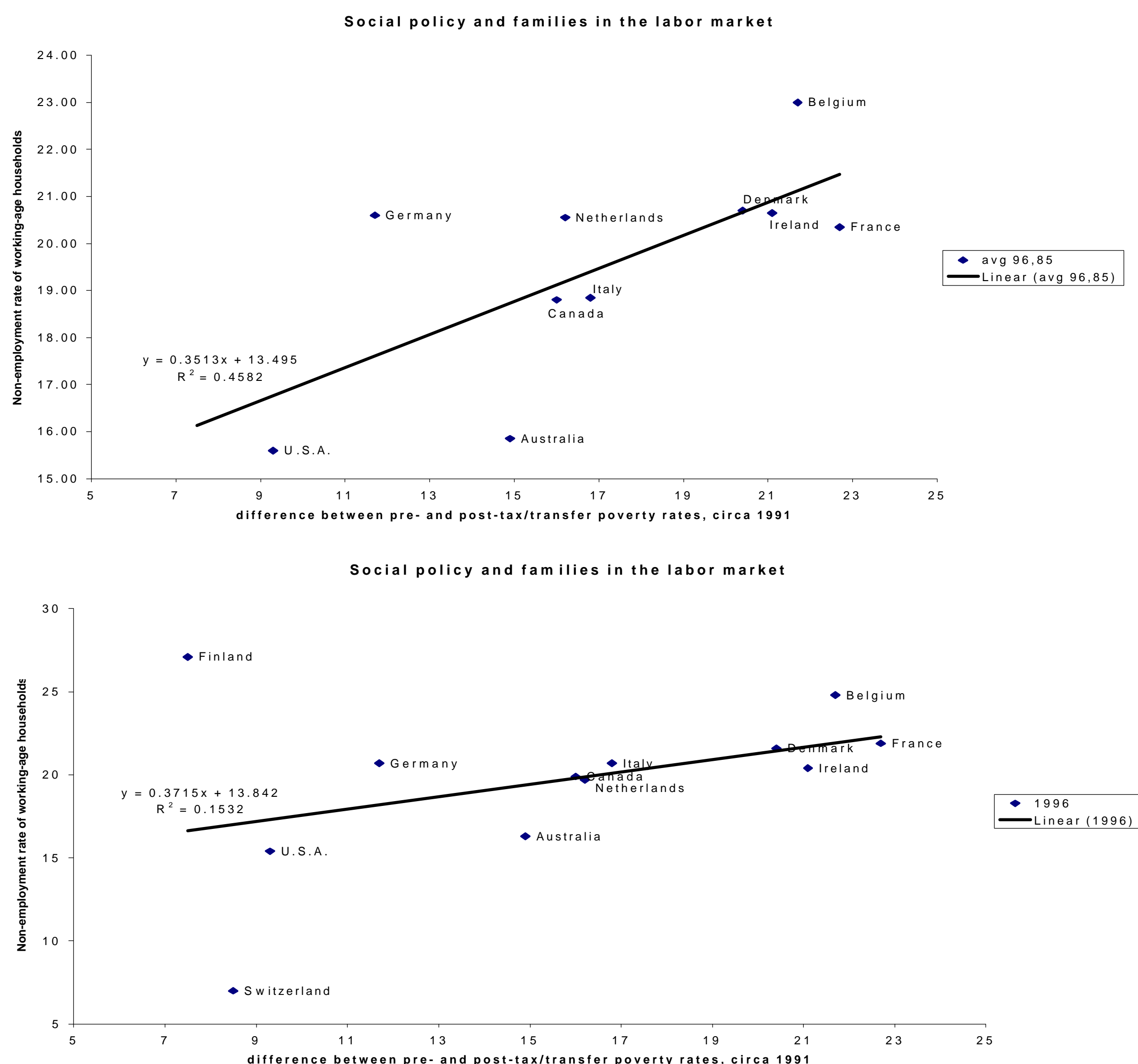

Figure 2.4. Sources: poverty rates, Kenworthy (1998); household non-employment rates, OECD Employment Outlook 1998, Table 1.7, all working-age households.

As in the other diagrams, the direction of causation between social-policy generosity and employment performance is far from fully clear: the variation in the data may be generated by a variety of country-specific factors affecting both variables. However, one can hardly deny that social policy is associated with high unemployment rates. In sharp contrast to the picture offered by GDP levels and growth rates, individual and family employment rates are negatively and rather significantly related to the generosity of welfare. We discuss next the relevant theoretical mechanisms and practical experiences.

2.3. Labor market issues: efficiency costs

We have argued that many Welfare State policies aim at mending free markets' failure to insure workers adequately against a variety of risks that cause income loss. Free markets fail to provide adequate insurance because of the efficiency costs associated with moral hazard and adverse selection. Compulsory universal coverage as exercised by governments may reduce some of those costs, or at least make the implementation of the policies feasible. It is our purpose in this section to discuss the main efficiency costs of social policies and discuss their relevance in EU countries.

From an economist's point of view, it is far from surprising that social policy should interfere with the workings of labor markets: after all, an important component of social policy aims at freeing individuals from the need to toil and work in order to survive. Political scientists point out that such "decommodification" can have important beneficial effects inasmuch as a credible option to refuse employment altogether helps workers obtain a better treatment from an otherwise too harsh labor market.[19] While families and rural communities made such options available in pre-industrial societies, and may still do so in some regions of Southern Europe, social policy fulfills a similar role in most modern market economies. Whether or not an economy may in fact generate the favorable employment opportunities that "decommodified" workers require is an open question: in equilibrium, high benefit levels may be taken up by workers, leading to lower employment rates while avoiding the existence of "working poor."

While policy cannot completely escape the trade-off between inequality reduction and high employment levels, the shape of the trade-off and an economy's position in relation to

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[19] "Decommodification" is defined in Esping-Andersen (1990) as the extent to which individuals can uphold a socially acceptable standard of living independently of market participation, and is measured taking into account rules governing access to pension, sickness, and unemployment benefits; the

the efficient frontier do depend on policy configurations. For example, universal benefits, such as family allowances, have only income effects – i.e. they reduce the overall need to seek gainful employment, but do not distort the choice between working and not working. Conversely, means-tested benefits – and the tax instruments used to finance all social benefits -- depend on market income. Hence, they decrease labor supply through both income and price effects, and may generate "poverty traps", i.e. situations where an individual's or a household's income is actually lower when working than when not working. In the case of social assistance measures, the general trend towards in-work benefits noted in Section 1 is meant to reduce or eliminate this effect. To achieve this desirable effect, however, low-wage employment opportunities must be available in the labor market, which may not be the case when working hours and wage rates are themselves regulated.

Unemployment benefits would "trap" workers out of employment only if they were higher than any wage the worker concerned could possibly earn. Their effects on employment are rather obvious also in less extreme cases, however: since their payment is contingent on *not* working, unemployment benefits can hardly be expected to increase incentives to work. For this reason, unemployment insurance schemes are very widely studied in the labor market context. In most countries' experiences, however, old-age and disability pensions have fulfilled much the same redistributive role, and have had similar employment effects. In the U.K., reductions in the generosity of unemployment benefits were accompanied by a spectacular increase of disability benefits, especially in industrial crisis areas. Old-age pensions have also been used by many countries to fulfil a social insurance role that would be more properly assigned to unemployment benefits: Italy, where unemployment insurance is practically non-existent, has one of the lowest labor market participation rates for men aged 55-65, who have been able to draw "exceptional" early-retirement benefits upon displacement from their jobs.[20] Clearly, workers whose labor market position is weak have more incentives to claim disability or lobby for early-retirement when unemployment benefits are not available, and obvious asymmetric information problems make it impossible to rely on objective medical criteria in awarding them. From this perspective, it is not surprising that the reduction not only of unemployment, but also of disability benefits was associated in the Netherlands with increased job creation and lower unemployment (Nickell

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amount of income replacement afforded by such benefits; and the range of entitlements they encompass.

[20] See Gruber and Wise (1997) for comprehensive evidence on the relationship between the generosity of pension arrangement and labor market participation of older men.

and van Ours, 1999).

The efficiency costs of unemployment insurance and similar policies are due to their wage effects and the disincentives that they create in job search. The discipline on union wage demands is usually the unemployment cost of high wages. With generous unemployment insurance unemployment is not as costly, so unions push for higher wages. Unemployment insurance also reduces the urgency with which unemployed workers look for a job and this increases the duration of unemployment.[21] The OECD in its *Jobs Study* (1994, chapter 8), after a careful review of the aggregate evidence, including much of its own, concluded that unemployment insurance has exerted substantial influence on unemployment. Scarpetta (1996) found that the rise in unemployment benefits can explain about 20 per cent of the rise in the average OECD unemployment rate between 1973 and 1993.

Unemployment insurance, however, also reduces wage inequality, partly because it acts as a wage floor and partly because low wages are likely to increase by more in proportional terms than high wages are when unemployment insurance benefits are introduced. In fact, as we saw in Section 1.1, the complex web of Welfare State policies in EU countries aims at decreasing inequality as well as at reducing poverty. Bargaining institutions have an important role in the pursuit of this goal, as well as in determining the impact of social policy interventions on labor costs and employment levels. For example, if there is a rise in labor costs because of a rise in the payroll tax, unions engaged in nation-wide wage bargaining may internalize the fact that unemployment would increase unless take-home pay concessions are made. Small, decentralized unions may instead resist changes in their members' take-home pay: if every union follows the same policy, the outcome would be too high wages at the macroeconomic level, with a bigger employment cost than with the corporatist union. This argument (on which see also Esping-Andersen, 1990) applies to social-policy interventions the familiar argument originally applied by Calmfors and Driffill (1988) to the labor-market effects of macroeconomic shocks.

As in that setting, a competitive market without unions would also yield favorable employment outcomes, as take-home pay would generally tend to adjust so as to ensure that labor costs are consistent with full employment (of a smaller labor force if, as is likely, lower take-home pay decreases labor market participation incentives). Thus, social policy intervention can be compatible with high employment and wage moderation in widely

[21] This can of course be beneficial to some extent if workers do not have adequate incentives to search in *laissez faire* equilibrium, as may be the case in matching models with two-sided heterogeneity (Marimon and Zilibotti, 1999).

different circumstances. On the one hand, if unions are weak -- as, for example, in the United Kingdom since the 1980s. On the other hand, in the presence of extensive consultation between unions, government and employers – as, for example, in the Netherlands' recent experience, where welfare reforms were facilitated by wage moderation on the part of "corporatist" unions (Nickell and van Ours, 1999).

Two aspects of the structure of the unemployment insurance system influence its efficiency cost: the duration of benefits, and the relation of unemployment benefits to the wage rate (the replacement rate). The theory of job search suggests that declining benefits during unemployment increase the incentives to look for work (Shavell and Weiss, 1979). Workers who expect their benefits to run out when they become unemployed try harder to find a job quickly to avoid the income drop. Incentives are maximized when the whole compensation is given before job search begins – but this would of course be less than fully satisfactory for insurance purposes, since the amount of compensation would be independent of how lucky or unlucky a worker may be while searching for a job. In practice, the duration of benefits varies across countries, and countries with longer-lasting benefits appear to have experienced a bigger rise in unemployment during the 1980s (Blanchard and Wolfers, 1999).

Active labor market policies are often implemented in Europe and, as we saw in Section 1.1, particularly in Nordic countries. From the perspective of this Section, these policies appear quite attractive: if social policy and income support decrease work incentives, what could be more advisable than "active" measures specifically aimed at remedying the labor-market effects of social protection? The record of active policies, however, is mixed (see Martin, 1998). Almost by definition, active labor market policies reduce the duration of unemployment, but they do have an important drawback: they are expensive (and, as we shall see, particularly so when the Welfare State is challenged by adverse exogenous developments). The most expensive kind of active policy, and consequently the most controversial, is the provision of public employment or subsidized training for targeted groups of unemployed workers. Training forms the backbone of Sweden's active labor market policies. Unemployed workers lose their entitlement to benefit after six months of unemployment and are transferred to a job with some training provision. Clearly, such a policy reduces unemployment both directly, because those on training programs become employed, and also indirectly by making those receiving training more employable after the end of subsidized employment. Britain's current "new deal" for young unemployed also has features of this program. The scheme, however, has been criticized on a number of grounds. It can be expensive when a large number of unemployed workers reach the end of six months

of job search without success. Also, it has been claimed by Swedish economists (e.g. Calmfors and Nymoen, 1990) that the availability of a job guarantee reduces the discipline effect that unemployment has on union wage demands and so, even though active labor market policies may speed up the transition to a job for those unemployed, they lead to less job creation because of their wage effects. Finally, it has been claimed that a large number of those trained return to unemployment after the end of subsidized employment, with little change in their employment prospects.

Employment protection legislation has been used extensively in Europe for the purpose of providing job security to the employed. But once again, there is an efficiency cost to the insurance. The efficiency costs of this policy, however, are not necessarily loss of employment. Dynamic labor market models imply that employment protection legislation reduces job destruction, but it also reduces job creation (Nickell, 1982; Bertola, 1990; Millard, 1996). The reason for the reduction in job destruction is obvious enough. Employment protection legislation is a firing cost imposed on the employer, so job destruction, which necessitates firing the employee, becomes more expensive. The reason for the fall in job creation is that since dismissal is now costlier, the firm creates a job and recruits an employee to it only if the revenue generated by this decision is sufficient to cover expected turnover costs. Thus, jobs that are not expected to have a long life are not created when there are stringent job destruction rules, and the policy is effective in reducing the risk of job loss of those in employment. Since both job creation and job destruction are reduced, the relation between employment protection and levels of unemployment is ambiguous, both in theory and in empirical data (Bertola, 1990; OECD, 1999a, Chapter 2). Not surprisingly, employment adjustments are lower in countries with stronger employment protection legislation, which are also countries where more people are out of the labor force (Scarpetta, 1996) and wages display lower cross-sectional variance and faster trend growth (Bertola, 1999a, and references therein).

The funding of social policies can also have efficiency implications. In competitive labor markets, where wages are determined by the aggregate supply and demand for labor and individual employers and workers do not have an influence on their rates of pay, the only tax variable that influences wages and unemployment is the size of the tax wedge (see Pissarides, 1998). The wedge increases labor costs at given real wages and so shifts the demand for labor down. Whether the effect is on wages or employment depends on the slope of the labor supply curve. If labor supply is inelastic, employment does not change but wages fall to reflect the tax. In this case, workers pay for the tax in equilibrium - there is what some

authors call no real wage resistance (see e.g. Tyrvainen, 1995). But if labor supply is elastic there is real wage resistance and more of the tax is passed on to employment. In general, the elasticity of take-home pay to tax and benefit levels depends on wage-setting institutions; the response of labor market participation to take-home pay and of employment to employers' labor costs depend, respectively, on the elasticity of labor supply and of labor demand.

If wages are determined by a bargain between employers and unions, the degree of progression of taxes also influences the wage outcome. When the tax is progressive, every time the union demands one more net Euro in wages, the employer has to pay a larger amount in pre-tax wages. That is, a given additional concession to the union with a progressive tax adds more to labor costs than the same concession with a proportional tax. For this reason, when taxation is progressive there is less real wage resistance: more of the tax should be absorbed by wages with a smaller effect on unemployment. Raising revenue with progressive taxes is likely to have a bigger impact on wages and less on employment than raising them with proportional or regressive taxes.[22]

2.4 Crisis factors

In light of the many theoretical channels through which social policies can hamper economic efficiency and, in particular, reduce employment, it is hardly surprising that Welfare State features are often blamed for the 'inflexibility' of European labor markets, with high unemployment and potential stagnation. Of course, such criticism can only too easily forget that some negative effects on employment are unavoidable, and that the Welfare State addresses real problems of *laissez-faire* market outcomes. Further, much of the current configuration of European Welfare States was already in place by the early 1970s, when the employment performance of European countries was quite satisfactory. The labor-market and other effects of social policies, however are not independent of the environment in which they are implemented: a variety of developments can explain the intensity of current debates on Welfare State "crises", and point to directions of reform.

In what follows, we focus on how exogenous changes in the economic environment may explain labor-market developments. It should be mentioned, however, that elements of the Welfare State "crisis" may be endogenous to its own phenomenal growth in the post-war period. Almost by definition, the Welfare State had to become too extensive and too complex before it stopped growing (Pierson, 1999); as individuals or organized groups learn to take advantage of the many loopholes present in real-life legislation (Lindbeck, 1997b) or to

manipulate decision processes on new legislation, social policy had to become less effective.

2.4.2 Macroeconomic and demographic trends

If the only shocks that affect an economy are cyclical, with mild recessions and booms, even poorly designed insurance policies will not put too much strain on the economy. Employment may on average be lower and fluctuations may have more amplitude with generous welfare policies but the fiscal strains from the extra financing needs in recession and the rise in unemployment are not likely to cause political problems. Such was the situation in the 1960s and early 1970s, when most of Europe's welfare systems were put in place. In addition, the economies of Europe were growing fast at the time, giving rise to more job creation and to wage gains beyond those expected a few years earlier.

What went wrong with the scenario which brought the Welfare States into being and what were the main strains? Three developments in the macroeconomic environment may be singled out as particularly relevant to the impact of labor market policies since the mid 1970s. First, the oil shocks of 1973-4 and 1979 increased production costs and necessitated wage reductions, especially in manufacturing. Second, productivity growth slowed down, in the United States at about the same time as the oil shocks and soon afterwards in the major European economies, making continued fast wage growth unsustainable. Third, the globalization and computerization of the 1980s and 1990s shifted the economic balance in favor of skilled workers. Further stress factors behind the Welfare State crisis are demographic in nature: lower birth rates, family-size changes, longer lifetimes, and increasing health-care costs tend to increase social expenditure within each country and for all developed countries as a whole.

The oil shocks of the 1970s and the skilled-biased shocks of the 1980s both required more flexibility in employment, especially of unskilled labor. The oil shocks necessitated across-the-board wage reductions and job loss in manufacturing, and structural shifts of employment towards the service sector in developed economies also exerted downward wage pressure: the wages afforded by employment in the service sector tend to be low, just because jobs are labor intensive. The skill-biased shocks required an increase in wage inequality and again some shifting of employment from low to high skill. Demographic trends magnified the effects of macroeconomic and technological shocks in making social policies increasingly difficult to implement. Slow productivity growth and aging populations have an obvious

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[22] For direct evidence on this issue see Lockwood and Manning (1993).

negative impact on pension arrangements. Single-parent households are more sensitive than standard nuclear families to work-incentives effects of non-employment benefits, and are more difficult to protect from poverty; similar considerations apply to single-elderly households which, especially in urban environments, are more likely to suffer old-age poverty than traditional extended families.

The welfare systems and methods of wage determination that European countries put in place before the mid 1970s proved unable to cope with the strains introduced by these shocks. Quite simply, the Welfare State was designed to insure principally against individual and cyclical risks. It is not – and should not – be used to insure workers against unfavourable economic conditions that are expected to last for a long time. When the oil shocks arrived, however, this distinction was not observed. Both governments and trade unions reacted to the unfavorable conditions created by the higher oil and material prices in the same way as they would have reacted to a normal recessionary shock. Wages were not allowed to fall, cushioned by union demands and the social insurance net, and there was pressure on governments to follow traditional Keynesian policies to expand the economy. The result was an increase in both unemployment and inflation.

European Welfare States and systems of industrial relations not only led to excessive real wage demands, but also had to cope with increasing dispersion of labor market outcomes across individuals. Whether due to globalization and the entry of low-cost producers in international markets or to computerization and other technological advances, structural changes in industrialized countries worsened the lot of unskilled workers relative to that of skilled ones during the 1980s and 1990s. There is more to do for social policy when more individuals are more severely disadvantaged, and the costs of social-policy intervention become more apparent at the same time as it becomes more desirable. To the extent that labor-market inequality is persistent across individuals, the insurance aspects of social policies are less apparent, while it redistributive aspects make them difficult to sustain politically.

Different Welfare State regimes have reacted differently to the new situation. Increasing wage inequality in the deregulated labor markets of the United States and the United Kingdom is, of course, one manifestation of the new economic environment. In these countries, social-policy provision conforms to Esping-Andersen's (1990) "liberal" Welfare State paradigm, where in-work benefits and targeted welfare provision manage to make some degree of social protection consistent with increasing low-wage employment in the private sector.

In other countries, better entrenched and differently designed systems of welfare provision have either created higher-wage employment in the public sector, or stifled service employment growth by extensive regulation of labor and product markets (Pierson, 1999). The former strategy has been adopted by Nordic "Social-Democratic" Welfare States; its sustainability over time, however, encounters fiscal constraints. Sweden in the 1990s is an example. Sweden outperformed other European countries up to the 1980s and its generous, active-policy-based Welfare State kept unemployment low when in other European countries it was rising fast. Fast economic growth, partly reflecting expansionary macroeconomic policies combined with devaluations, could support a generous welfare system that protected the individual from employment risks but also provided basic social services to all. When growth declined in the 1990s, however, the system reached near breaking point because of the high budgetary cost. The experience of Sweden and Finland in the 1990s has shown that active labor market policies cannot be used as an anti-cyclical device because of their high costs in recession.[23]

The second strategy is that of Continental European "Christian-Democratic" Welfare States, where high wages and stable employment for prime workers are ensured by binding wage floors and extensive regulation of employment relationships. In this case, sustainability is challenged by low employment rates (especially among female and older potential workers) and by high, persistent, long-term unemployment (especially among the youth). In Continental Europe, the wage setting institutions and the Welfare State did not allow a rise in inequality. Unemployment increased instead. This gave rise to the much-discussed unemployment-inequality trade-off and to several attempts to find out whether the trade-off is really as prominent a feature of the data as argued by the OECD and others.[24]

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[23] For analyses specifically dealing with Sweden see Calmfors (1993), Edin and Holmlund (1991), and Forslund and Krueger (1994).

[24] See the OECD *Jobs Study* (1994). Krugman (1994) neatly summarises the conventional view on the unemployment-inequality trade-off. For empirical studies of the rise in inequality see Katz and Murphy (1992), Freeman and Katz (1995), Blau and Kahn (1996), Nickell and Bell (1995).

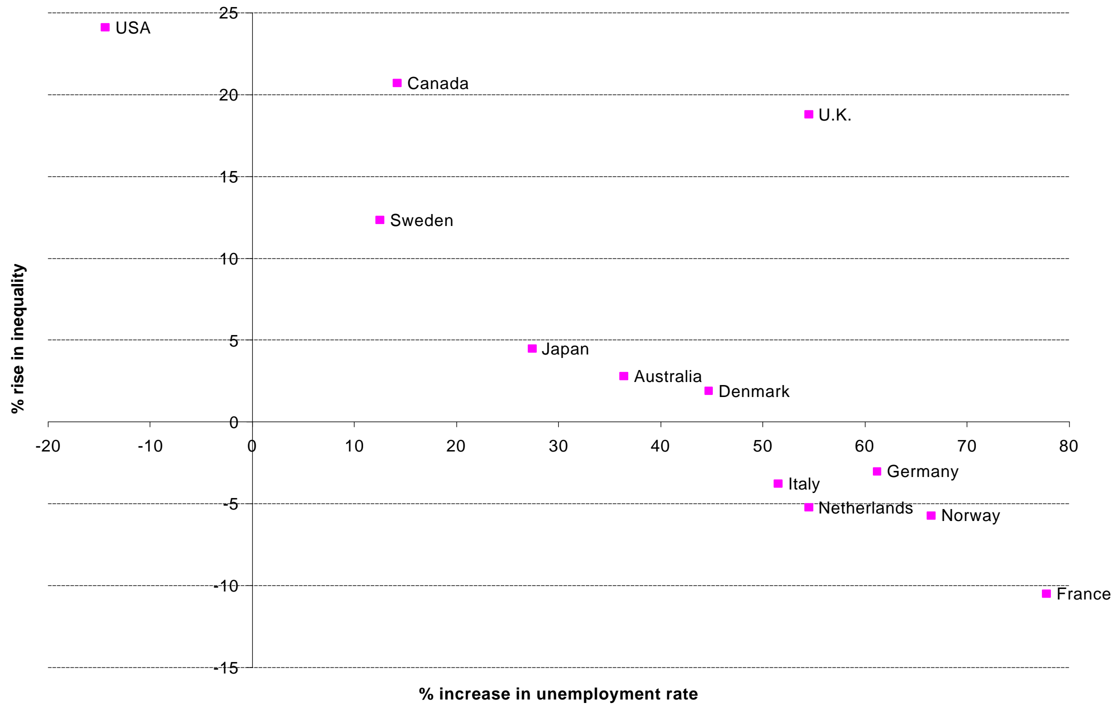

Figure 2.5. Definition and sources: horizontal axis, log difference between the average annual unemployment rate in 1986-90 and in 1974-79, from Layard et al (1991), Table 1, p.398. Vertical axis: log difference of the early 1990s and early 1980s ratios of earnings of men with the highest education qualification (E, usually university degree) and men with the lowest education qualification (A, usually compulsory schooling only), from *OECD Jobs Study,* part II, Table 7.A.1 (data for Italy are extrapolated from the wage distribution in Chart 5.1).

Figure 2.5 displays a clear trade-off between percentage changes in the ratio of earnings of the most educated group to the least educated group, and percentage changes in unemployment across countries. Like many of the other simple pieces of evidence we put forward, this is of course too blunt to capture all the nuances of real-life experience: taken at face value, in fact, the simple story would imply that the incidence of European unemployment should be mostly on low-skilled workers, which was not the case.[25] Still, the United States and Canada avoided the rise in unemployment and experienced big rises in wage inequality, while European countries experienced rises in unemployment but not in inequality.[26] The United Kingdom is an exception to this rule, having suffered over the period considered a rise in both unemployment and inequality: this, however, was a transitional phenomenon following the reforms of the 1980s, which weakened the power of unions and reduced the generosity of unemployment insurance, and moved the United Kingdom's institutional configuration from a position in the European cluster in the early 1980s to one closer to the North American cluster in the 1990s.

The increasingly dismal employment performance of mature Welfare States has, of course, spurred a flurry of reforms (see the Introduction to this volume for a review of these and other aspects of recent experience). Only in a handful of cases, however, reforms were consistent and fundamental, with significant and long-lasting effect. In many countries, the cumulative effect of marginal reforms seem to be that of decreasing generosity of non-employment benefits. As to employment protection legislation, a common element during the 1980s and 1990s was liberalization of "atypical" employment contracts (fixed-term contracts, part-time contracts, etc.), which typically differ not only in terms of job security but also in terms of social security coverage.

2.4.3 Economic integration and the provision of welfare

After the Great Depression and World War II, the boundaries of markets largely coincided with the boundaries of (national) social policy constituencies. On the one hand, this made it legitimate to consider each welfare system's motivation and performance in isolation

[25] Nickell and Bell (1995). See Bertola and Rogerson (1997) and Marimon and Zilibotti (1999) for a discussion of how dynamic labor-market interactions may explain this finding in light of realistic institutional differences across countries.

[26] Both unemployment and low-wage work, of course, are associated with poverty and "social exclusion." There is, however, very little relation between the increase of unemployment and that of poverty (Atkinson, 1998, Figure 2.4). This may indicate that the largest increases in unemployment occurred in countries where State and family transfers offer the most generous support to non-employed individuals.

when assessing its empirical implications, as we did briefly in Section 2.3. On the other hand, national welfare systems could try and mend market failures in splendid isolation, and enforce tax, subsidy, and regulation schemes without fear that their citizens could opt out of them. Alongside the broad productivity and demographic trends outlined above, however, significant changes have occurred in the extent to which industrialized economies interact with each other (especially in the context of European unification) and with less developed countries. Here, we briefly review how international spillovers may affect the economic and social impact of national social policies. In Section 3, we illustrate by example their relevance to the current European situation, and we discuss how institutions and reform processes may best cope with the issue.

Economic integration may reduce the need for social protection if local shocks are better buffered by more extensive market interactions. For example, workers face less income uncertainty if adverse labor demand shocks can be partly accommodated by migration rather than by lower wages and/or higher unemployment.[27] More importantly, the development of financial markets can reduce the need to provide social insurance within each country's borders at the same time as they make it possible for domestic residents to diversify away local sources of risk.

To the extent that markets remain incomplete and poverty is still possible within a larger integrated economic area, however, social policy meant to address insurance or solidarity issues is more difficult to implement effectively. By and large, the market failures that need to be mended by collective action and enforcement within a national economy cannot be addressed by uncoordinated policy actions by interacting economic systems. Each individual does not, by definition, participate voluntarily in the kind of transfer or regulation policies that are not supported by *laissez faire* markets, but would rather free ride on provision of social services and transfers. Similarly, local communities cannot be expected to voluntarily implement policies that reduce their competitiveness in economic interactions within a wider, possibly "global" economic system.

To illustrate this general insight, it is again helpful to focus on the particularly clear interaction featured by potential or actual migration. Broadly speaking, labor mobility increases the effective elasticity of local labor supply. As mentioned above, when labor supply is elastic then labor taxes may not be shifted to take-home wages, and has important

[27] See Wildasin (1995). Owners of immobile region-specific factors, however, likely face more income uncertainty in an integrated economy if land is complementary to labor, for example, land values are more sensitive to local shocks when labor is mobile.

employment effects instead. The effect is stronger if, in an effort to reduce the employment impact of social policies, their financing relies on progressive instruments. While the elasticity of labor supply may be higher at low skill levels when non-employment is the alternative to work, highly-skilled workers are also likely to be more mobile and take better advantage of tax-arbitrage opportunities.

Quite simply, a local economy that imposes high taxes on its workers but leaves them free to migrate will find it difficult to generate employment, and raise revenues, if taxes are lower elsewhere. On the other side of the coin, poor individuals are likely to be attracted by relatively generous welfare systems. There is some relevant evidence from the United States, where in 1969 the Supreme Court ruled that State-level welfare benefits could not be conditioned on previous residence, exposing States offering generous benefits to the danger of attracting welfare recipients.[28] Immigrants need not draw benefits themselves to trigger important consequences: when they compete with low-skilled workers, and the latters' wages fall below the non-work benefits, substitution of the indigenous poor by foreigners is effectively subsidized by the taxpayers of more generous constituencies. A classic example is given by the situation created in the German construction-worker market by economic integration with the rest of the EU in the early 1990s. The plentiful employment opportunities created by huge infrastructure investment in former East Germany were taken up by British, Portuguese, and Italian construction workers temporarily "posted" to Germany, while indigenous workers remained unemployed. Quite simply, the generous and essentially open-ended unemployment benefits granted to German workers were higher than the reservation wage of other European workers (though, of course, not higher than the German workers' own previous wages). Thus, the well-motivated "Bismarkian" institutions meant to protect construction workers from the highly cyclical character of their trade clashed with the essentially permanent character of their job loss in the newly integrated European economy. Like the oil shocks of the 1970s, such developments called for structural reform. In general, labor mobility cannot make it any easier to sustain high welfare safety nets. Rather, it may well excite race-to-the-bottom tensions in provision of welfare benefits, and resentment against new immigrants (we shall briefly discuss below how this tension was resolved in the case of German construction work; see also Bean et al, 1998, and their references).

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[28] The "welfare magnet" effect may explain why U.S. social policies are mostly implemented at the Federal level. Benefit-induced migration has modest relevance in the U.S.; see Meyer (1998). However, Borjas (1998) finds that the effects of welfare-system generosity differentials across States are quire relevant for new immigrants from outside the U.S.

As a general principle, in an integrated economy a local constituency can easily end up providing welfare to strangers – and, in equilibrium, will have to restrain welfare provision to its own citizens. More generally, free trade of goods and services and free factor mobility (which have essentially the same implications in standard models where factor-prices are equalized in equilibrium) make it impossible to design and implement social policies on a local-constituency basis. The tax and subsidy arrangements of each integrated economic unit compete with the others' in maximizing their attractiveness for productive factors (and tax revenues), and minimizing their attractiveness for welfare recipients (and social transfers). To the extent that social policy is meant to redress market failures or to implement solidarity transfers, competition among systems will not lead to efficient outcomes when the elements of the relevant equations span the borders of policy-making constituencies. By definition, collective action is needed to eliminate inefficient or "unfair" economic interactions, and bringing back competition at the inter-constituency level defeats both purposes (see Sinn, 1998, for further discussion of the general "selection principle" that should allocate activities to collective decision rather than market interactions). We shall return below to evaluate such issues in the context of the current EU institutional framework.

"Globalization" and trade with less-developed countries may not a major source of Welfare State stress in advanced economies, where aging and family trends, sectoral shifts, and productivity developments play obvious and very important roles (Pierson, 1999). International spillovers of social policy, however, are an obvious issue in the European context, because within the European Union politico-economic resolution of reform pressures (whatever their source) shall unavoidably be influenced by international co-ordination of policy reactions across nations, or lack thereof. We turn to such issues in the next section.

3. Economic integration and political dynamics in the EU

Equipped with Section 1's review of EU welfare models and Section 2's broader discussion of theoretical and empirical issues, we now turn to analyze how national social policies may evolve in the future. Social policies are remarkably stable in each country, despite their more or less obvious shortcomings, and remain very different across countries in spite of essentially complete economic integration. While current and future reform pressures certainly reflect important country-specific factors, we especially focus on how economic and political interactions within the integrated (but not federal) institutional structure of the EU may rationalize the current patchwork of European social policies. Section 3.1 reviews the official EU approach to social policy issues. Section 3.2 argues that, despite conspicuous lack

of effective EU-level action in this field, EU institutions do affect the design and implementation of national policies in a variety of ways; and Section 3.3 shows how lack of EU-level action may be rationalized by the wide heterogeneity of economic and social circumstances within the EU, and illustrates the tradeoffs entailed by different degrees of centralization in the current EU institutional setting.

3.1 EU-level social policy: great principles and little practice

The institutional framework of the European Communities is keenly aware of social policy issues – and not surprisingly so, in light of the prominence of Welfare State intervention in each of the constituent Member States. Article 118 of the original Treaty of Rome tasked the Commission with "promoting close cooperation between the Member States in the social field." In practice, however, progress has been extremely slow in this respect, despite many declarations of principle. [29]

The Commission did use its supranational power to dismantle trade, labor mobility, and industrial regulation barriers (Scharpf, 1998,ab). The European Communities were formed by Nations, however, and members had no intention of "committing institutional suicide" (Pierson and Leibfried, 1995). Hence, introduction of coordinated market regulation was left to intergovernmental agreements at the Council level, where decisions were to be made on a unanimity basis. (Art 148 of the Treaty of Rome stipulated that the Council would act by a majority of its members, save as otherwise provided in the Treaty. The Luxembourg Agreement of 28-29 January 1966, however, made it official practice not to vote at all, but to continue deliberating until consensus is reached.) Only selected matters can be decided by qualified majority.[30] As regards social policy, the Single European Act of 1986 introduced qualified majority decisions in the field of "working environment, as regards the health and safety of workers" (Art. 118A). Art. 49, as amended, also allows directives to be issued by the Council *by qualified majority* "to bring about, by progressive stages, freedom of movements of workers." Art 49, para.1 states that the Council now has to operate in cooperation with the European Parliament: the Council adopts a common position by qualified majority on proposals from the Commission, after obtaining the Opinion of the

[29] See also the more extensive discussion in Bean et al (1998), Betten (ed.) et al. (1989), Ross (1995).

[30] Currently, a "qualified" majority requires 62 votes: France, Italy, Germany, and the U.K. have 10 votes each; Spain has 8; Belgium, Greece, the Netherlands, and Portugal have 5 votes; Austria and Sweden have 4; Denmark, Finland, Ireland have 3; and Luxembourg has 2. See Widgren and Kirman (1995) for a detailed discussion of voting rules and the implication of the national weights for the decision process.

European Parliament (but unanimity is required to amend Commission proposals). The Parliament can reject this common position within 3 months, and a second reading by the Council requires unanimity. The Parliament can also propose amendments which, after Commission review, result in a modified proposal to be re-examined by the Council. The Council can approve the Commission's proposal by qualified majority voting, or unanimously accept the Parliament's amendments in toto. The Single European Act of 1986 introduced qualified majority voting in the area of health and safety at work, singled out for ultimate harmonization through directives setting minimum requirements for gradual implementation. Together with gender equality in the labor market (a long-standing concern of European Treaties), the health-and-safety regulation area is the only one where EU-level initiatives have had an impact on member countries' social policies (see Bean et al, 1998, and Pierson, 1998). In other social policy areas, the European Commission was invited to promote dialogue between management and labor at the European level as an additional lever for harmonization. The pre-existent European Social Fund (art 123-128) was the subject of some new provisions, like the Agriculture Guidance and Guarantee Fund, the European Investment Bank, and other existing financial instruments in the new Part III added to Title V with provisions on economic and social cohesion.

The 1998 Amsterdam revision of the European Union Treaty (which is in force as of May, 1999) incorporated in the full 15-country Treaty the provisions of the Social Protocol signed in Maastricht by only 11 countries, and envisioned Community policies aimed at "a high level of employment and of social protection." Article 117 states more precise objectives: the Community and the Member States shall promote employment and "improved living and working conditions, so as to make possible their harmonisation [...], proper social protection, [...] and the combating of exclusion." Importantly, the Article states that these objectives may not be fulfilled by the functioning of the Common Market alone, and states the belief that appropriate developments will ensue from the Treaty's own provisions and "approximation of provisions laid down by law, regulation or administrative action." Article 118 lays down areas where Council directives are envisioned; at point 3, however, it specifies that such action requires unanimity when "social security and social protection of workers," and most other social-policy dimensions, are concerned. Some further social-policy matters to be decided by qualified majority voting are identified in the Treaty: working conditions; information and consultation of workers; equality between men and women in the labor

market; and the integration of persons excluded from the labor market.). Article 118b states the need for social dialogue: "The Commission shall endeavor to develop the dialogue between management and labor at the European level which could, if the two sides consider it desirable, lead to relations based on agreements." And Article 118c tasks the European Commission with encouraging cooperation and with monitoring of national social policies.

As we have seen, the side effects of social policy are particularly apparent in the labor market. Not surprisingly, the EU co-ordination process is focused on the need to spur employment creation. In November, 1997, at an Extraordinary European Council on Employment in Luxembourg the Member States agreed to co-ordinate and stimulate employment-oriented policies, even before ratification of the Amsterdam Treaty, around four "Pillars:"

I. "Improving Employability" (measures envisioned under this heading have an *active labor market policy* character, particularly targeted towards training of young and long-term unemployed persons);

II. "Developing Entrepreneurship" (chiefly through deregulation and simplification of market access and operations by small firms);

III. "Encouraging adaptability of businesses and their employees" (through union-negotiated work reorganization);

IV. "Strengthening the policies for equal opportunities" (mostly along gender lines – a long-standing concern of EU social policy intervention – but also as regards labor market participation of disabled individuals).

The nature of these guidelines and the character of the "Luxembourg process" by which they are implemented are quite interesting from our perspective. Taken at face value, the Luxembourg Process's employment guidelines are quite consistent with the perspective put forth in our own discussion of employment effects of social policy. The Pillars spell out a fairly coherent approach to Europe's employment problem, which is viewed as a structural problem – i.e., one that should be tackled by reform efforts, as Europe's old-fashioned Welfare States encounter unavoidable difficulties in a new macroeconomic environment.[31] The guidelines, however, communicate a clear unwillingness to sacrifice the social-protection

[31] This orthodox approach was challenged during Mr Lafontaine's brief tenure as Germany's chief economic policymaker, when an effort was made to create a consensus for coordinated demand and wage management at the EU level. A document signed under the German presidency of the EU at the Cologne meeting of the Council on 3-4 June, 1999, preserves some of the flavor of this alternative approach but, as in the case of structural policies, does no more than state general principles and set up a forum for macroeconomic policy discussions among the EU's social partners and policy-makers.

features of the current EU Welfare State. Not only does Pillar I largely conform to the "active" labor market policies of the Nordic and, to some extent, Anglo-Saxon tradition of social intervention – policies which, as we noted, try to reconcile the conflicting goals of generous social protection and high employment but encounter crippling fiscal constraints. Also, the concept of "adaptability" is quite different from the "flexibility" advocated, for example by the OECD *Jobs Study* to address the challenges posed to industrialized countries' Welfare States by a new environment of global economic interactions and fast, skill-biased technological developments. "Adaptability" is required of employers as well as employees and, rather than relying on market incentives, envisions intense consultation among workers' and employers' organizations.

As to the actual implementation of theoretical guidelines, the Luxembourg Process is essentially a forum for discussion and evaluation of country-level practices. Each Member State is required to submit annual Employment Action Plans, where its experience and policies are discussed within the framework proposed. In practice, the Plans make an effort to enlist the panoplies of nation-specific existing measures within the Luxembourg Pillars, typically without reference to their effectiveness (which, in most cases, has never been properly evaluated). Not surprisingly, and quite interestingly, the different national approaches to social and labor market problems are reflected in the various reports. In its Introduction, for example, the 1998 United Kingdom Employment Action Plan does mention "labor market *flexibility*" and, defining and discussing the notion, refers to the need for wages to "adjust sensibly to economic realities." This is certainly a guiding principle of U.K. labor market policy, as evidenced by the wide and increasing inequality of British wages. It is not, however, a principle that would be easy to trace in the Luxembourg guidelines, which would rather align reality (through training, for example) to workers' wage aspirations.

Country practices are then evaluated by the Commission's Services, with an eye to identifying national practices that, by adhering more strictly to the specific goals identified by the four Pillars, might provide examples for further reforms and adjustments (see European Commission, 1999). Thus, the Luxembourg Process essentially leaves employment-policy reforms in the hands of the member countries' governments. Its modest aim of creating consensus on "best practice" marginal reforms gives at most limited incentives to increase the expenditure on active labor market policies, and focuses attention on narrow performance criteria within the Pillars' framework rather than on broader evaluation of welfare-provision and labor market institutional systems within the EU.

Lack of effective policy action at the EU level is common in all social-policy fields.

In fact, the high consensus requirement of Council decisions has made it very difficult to introduce regulation on an EU-wide basis. The institutional asymmetry between "negative integration" (dismantling of national regulations, which proceeds at a supranational level) and "positive integration" (introduction of EU-wide regulations, which has to be negotiated at the international level) has shaped the development of EU social policy (see Scharpf, 1998a,b; the negative vs positive integration terminology was first introduced by Tinbergen in 1965). In the European Treaties, "general" social policies (such as tax rates or overall levels of social services) are largely left to nation-level, "subsidiary" decisions (indeed, only with the Amsterdam revision the possibility of some EU-level intervention in this field is of any practical relevance). "Specific" policies, i.e., those that affect different productive sectors differently within each Member State's economy, are instead subject to scrutiny because their effects could in practice be the same as those of explicit trade barriers. The distinction between "general" and "specific" social policies is hard to make precise – after all, regulation and redistribution do in general have different implications across producers (see Bean et al, 1998, for a fuller discussion). In practice, however, the European Commission can challenge national welfare policies whenever they may be suspected of distorting competition. Recent examples are the EC ruling against the Italian policy of subsidizing new employment through "Contratti di Formazione e Lavoro", which in the Commission's view benefit employers (rather than workers) when subsidies are granted in relatively strong regions or to relatively old workers. Similarly, the Commission is reluctant to approve local tax incentives – even in less-developed regions within each country – when the actual or potential concentration of some sector's production in privileged geographic units would effectively make it possible for the whole country, rather than only the region's residents, to enjoy competitive advantages.

Conversely, the complexity of international co-ordination and of the relevant decision processes paralyzes "positive" integration. In practice, the EU is reduced to envisioning social-policy convergence on the basis of the idea that all European countries share a common "social model faced by common challenges at each national level," rather than on the basis of explicit collective action. In light of the wide heterogeneity of economic circumstances and social-policy models documented in Section 1 above, however, it is far from clear that the challenges are indeed "common," or that solutions and reforms implemented at the national levels should lead to convergence. Article 117, in fact, does recognize that diversity of national practices must be taken into account. The process of convergence is complicated by the heterogeneity of Welfare State models within the

European Union, which we documented in Section 1. As mentioned in Section 2.4, each of these models encounters different problems in the face of common national trends, and problems and possible solutions also differ in the face of increasing economic integration.

In summary, social-policy problems (especially as regards their employment implications) feature quite prominently in the EU agenda. Yet, supra-national policy-making is not well developed in this field. EU institutions offer, at most, a forum for discussion of social policy while leaving its implementation to national or regional governments, on a subsidiarity principle basis, even as economic integration and supranational interference constrain its operation.[32] Next, we examine in some detail the challenges posed by EU integration to various dimensions of the member countries' Welfare States, and we discuss how the structure of political decision processes may address the relevant issues.

3.2 Challenges for social policy in an integrated but diverse EU economy

In order to flesh out an interpretation of the resulting ambiguous situation, we bring themes from the previous sections to bear on specific examples drawn from EU experience. The national systems of welfare provision discussed in Section 1 feature many interacting instruments, all of which rely essentially on legal restrictions: national legislation imposes taxes and contributions, identifies individual entitlements to transfers and social services, and regulates employment contracts and other market interactions. In Section 2, we briefly discussed how economic integration, by increasing opportunities to "opt out" for individuals, generally makes it more difficult to specify and enforce binding legal restrictions.

The first and most obvious challenge to national welfare systems in the EU is indeed posed by such opting-out opportunities. Free mobility of goods, capital and labor in the single market undoubtedly makes it easier to circumvent some of the existing legal restrictions. Incentives to escape taxation are, of course, stronger at the high end of the income distribution, where the burden of social-policy funding is by definition highest and benefits are lowest. Clearly, social policies could not be financed by a well-defined "national" tax base if firms and individuals were completely free to choose whether to pay taxes, or opt-out of supposedly mandatory arrangements. As we mentioned in the general discussion at the end of Section 2, participation in social security schemes (unlike private insurance contracts)

[32] The principle of subsidiarity is defined in Article 3b of the Treaty of the European Union: "The Community shall take action... only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community."

needs to be enforced. Tax competition among systems unavoidably tends to replicate the imperfect market interactions that at least some social policies are meant to correct, and this is an issue in the EU context as well as in the broader context of "global" economic interactions. In general, and in the EU, the same factors that are more heavily taxed by progressive schemes (capital and skilled labor) are also highly mobile, and their mobility can only decrease the tax base of social policies.

Such tensions, of course, arise on the wider arena of global economic interactions as well as within Europe's Single Market, and may not yet be so strong as to put much pressure on national social policies. As we saw in Section 1, in fact, national social policies are remarkably stable in recent experience within each of the EU countries. The development of a new legal framework and new institutions at the Community level, however, dilutes national law-making and enforcement powers, and this poses a second, different, and EU-specific challenge to the existing system of welfare provision. While essentially all fiscal legislation is allocated to national authorities on a subsidiarity basis, the European Court of Justice is empowered with striking down national legal restrictions that discriminate among European citizens. Thus, not only the tax base, but also the beneficiaries of social policies are not under complete control of national policy-makers. Such interference, however motivated, can only reduce and never increase the "national" character of welfare systems. In particular, even if national tax rates were harmonized (through competition or co-ordination), potential access to each nation's social services by any European citizen dilutes the identification of taxpayers and recipients. Contributions and benefits need not balance for all individuals *ex ante*, and certainly do not balance *ex post* if social policy provides insurance within each national welfare system. The extent of *ex ante* and *ex post* redistribution, however, is part of the system's design: the identity of taxpayers and recipients is a necessary element of any (national) social contract. By denying to national policy-makers the power to decide the extent and width of the redistribution's scope, legal restrictions within the EU endanger all redistributive schemes.

Furthermore, the introduction of EU-wide legal restrictions redefines the scope of existing national welfare systems. In spite of strongly voiced statements such as the one by Jacques Delors that opens this Chapter, EU legal restrictions in the social policy field have been very minor, but other EU policies do have an impact on national welfare systems. For example, the EU-level "legal restrictions" underlying the Stability and Growth Pact and Monetary Union itself are not directly concerned with social policies. As we saw in Section 1, fiscal consolidations needed to achieve the Maastricht convergence criteria were not

achieved at the expense of social policies. To the extent that public deficits and inflation have distribution as well as macroeconomic implications, however, supranational constraints have undeniable indirect effects on national welfare systems and on their reforms. For example, a transition from a pay-as-you go to a fully-funded system cannot avoid harming either current contributors or current recipients if governments cannot borrow.[33] The Stability Pact's parameters may be too stringent to make a smoother transition possible, and it may be advisable to relax them when deficits are explicitly linked to Welfare State reforms. Similarly, and more generally, fiscal discipline translates the tax-competition pressure noted above into immediate expenditure constraints, and makes it impossible to dilute redistributive tensions to future generations. Fiscal discipline is welcome, of course, if it can prevent the excessive "social" spending that is only too familiar from the past experience of many EU countries. Still, it does present a challenge to policy-making institutions.

The other challenges are also familiar to European citizens and law-makers. In fact, as the following examples make clear, very similar tensions arise within each of their countries whenever social policies are shared among multi-tiered jurisdictions:

- *Shopping for services.* When local social services are subsidized with local taxes and citizens from outside cannot be discriminated against, there is an obvious tendency to shop for services. Consider, for example, the case of hospitals price policies in Germany (Pierson and Leibfried, 1995). Investment costs, covered by the Länder and by the federal government of Germany, are not reflected in the price of services. Clearly, nearby Länder should be tempted to free-ride on provision of health services to their citizens. Similar issues arise in higher education, which is funded at the Länder level within the Federal Republic of Germany, and is open to students from other Länder. In practice, only the poorest Länder under-provide such free-access services: presumably, richer local governments are relatively immune to free-riding temptations, because their choices are to some extent inspired by Pan-German solidarity. Free-riding, however, may of course become irresistible in times of fiscal tightening. More ominously, current EU law forces German hospitals to charge the same price to all EU citizens. In practice, this may make it necessary for German hospital construction costs to be covered by the price of services – effectively eliminating an instrument of public subsidization. The problem arises because the current definition of "European citizenship" applies to the citizen-consumer of services, but largely neglects the fact that citizens are also taxpayers. The

[33] See, for example, Huang et al. (1997).

lack of coincidence between the tax-paying and service-consuming sets of European citizens is further complicated by the European Court of Justice view that the health service fees (subsidized or not) should be covered by the citizen's national plan regardless of where in the EU services are performed.[34]

- *The mobility of the unemployed.* If mobility has to enhance efficiency this should be particularly true regarding the mobility of the unemployed, who should be encouraged to move from depressed regions to more productive ones. This is very far from being the case within each European nation: in Southern Italy, Southern Spain, and East Germany extraordinarily high local unemployment is supported by a variety of explicit and implicit transfers, which effectively prevent mobility towards tighter regional labor markets and sustain high-wage equilibria in each country's better-developed regions. The strong anti-mobility bias of national regulators' and social partners' attitudes is compounded at the EU level where, if anything, institutional arrangements are even less favorable to mobility. The duration of unemployment benefits is limited to a maximum of three months if an unemployed person moves away from the country where the job was lost (European Commission, 1997). This is meant to prevent "vacationing" by the unemployed – a real danger, since German unemployment benefits could clearly finance a very pleasant life in Ireland or in Portugal. As we have seen in Section 1, however, national unemployment benefits typically last much longer than three months: hence, current arrangements discourage international mobility even more strongly than within-nation mobility.

- *The level of social security contributions*. Social security systems differ across EU countries (see, for example, European Commission, 1997), but also within each of them. Individuals working in different professions and under different employment contracts are subject to very different contributions, and are entitled to benefits that differ not only from each other, but also from standard actuarial accruals of their contributions. The extent of such heterogeneity may increase, as we noted above, if "marginal" labor market reforms introduce new, non-standard forms of employment contracts. Space does not allow us to discuss such arrangements in any detail. From our perspective, however, it

[34] Traditionally, previous approval by the patient's health authorities was required for non-emergency health care, a provision used for example by Italian citizens to pay for surgical procedures performed in France (and, presumably, charged at marginal cost by the French hospitals). However, the right of any European citizen to receive health care anywhere in the EU and charge the expense to their country's Social Health plan is asserted by two recent sentences of the European Court of Justice

is important to note that the coexistence of different old-age pension schemes poses very important challenges to the sustainability of national retirement systems. Until recently, for example, Italian workers could pay no pension contributions if their employment contract was configured as a *Collaborazione coordinata e continuativa,* i.e., as nominal self-employment, rather than as a regular dependent-labor contract. Similarly, in Germany many young workers escape social security coverage by drawing from each employer less than the minimum income above which contributions are mandatory. In many countries, the occupation-specific pension schemes of declining professions need to impose high contributions on active workers – and can only accelerate their own demise as individual workers choose different professions to escape contribution burdens. As we repeatedly mentioned above, social policy interventions can hardly survive unless participation is mandatory and coverage is comprehensive. Hence, each European country addresses pension sustainability issues by eliminating the possibility of "opting out" (Italian *Collaborazione* workers now pay contributions, if only at about a third of the standard rate) and/or by reducing contributions and benefits for covered workers. At the EU level, the interaction of complex social security arrangements multiplies opportunities to "opt out." Existing arrangements attempt to ensure that individuals are not penalized by mobility across national boundaries. In the case of defined-benefit public pensions, workers' entitlements accrue in proportion to the length of working careers in each of possibly many countries (see Bean et al, 1998, for a discussion of the details of the scheme). Appropriate mobility incentives are, of course, easier to provide in the case of defined-contribution schemes, especially if fully funded, at least if similar returns accrue to pension wealth in each country's scheme (as should but need not be the case, since national constraints may be imposed on pension fund portfolios). Thus, the current tendency to reform pensions in the direction of actuarial fairness (i.e., to equate benefits to the market return of contributions) favors mobility across EU countries. But even if national systems were fully funded, legal restriction stipulating minimum contributions could hardly be binding if they are different across countries. Within the EU, workers are currently bound by the rules of the country where they work. Alternatively, workers could be bound by the rules of the country of origin (as is sometimes the case, on the basis of bilateral treaties, for non-EU immigrants –such as Turks working in Germany, who often make contributions to and mature benefits in the social security scheme of

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regarding dental work done in Germany on Mr Raymond Kohl and optician services performed on

Turkey rather than Germany). As long as contributions are not voluntary (i.e., as long as we are talking about "policy" rather than about market arrangements), however, workers would move to constituencies where contributions are low, or employers would prefer workers bound to lower social security payments, in both cases initiating a "race to the bottom" and eroding the sustainability of high contribution, high benefit configurations.

Unfortunately, the familiar character of these problems does not imply that we know how to deal with them. What is new in the EU context is the scope of interactions and, especially, the unclear standing of "solidarity" feelings that might support redistribution across the national boundaries of member countries. Any attempt to deal with the complex and difficult challenges posed by EU interactions to national welfare systems needs to take into account three classes of problems.

First, as we already stressed, it should be recognized that *markets cannot provide adequate protection.* Clearly, social policy would be rather trivial if markets could provide adequate levels of insurance and services: "social" policy would just need to remove legal restrictions that prevent markets from functioning. In a way, this is the rationale of "negative" integration measures, i.e., executive elimination of heterogeneous policies and unfair barriers to trade and labor mobility. But social policy, as we know, does address market failures, and implements transfers and redistribution that could never be achieved except through collective action.

Second, it is necessary to *commit* to (and enforce) social policies. Of course, individuals would always want to free ride on each other in the provision of welfare (or public goods), no matter how attractive social-policy arrangements might be from a collective point of view. Given enough *commitment* to enforcement of a common set of legal restrictions, however, a homogeneous society should find it easy to design collectively an agreeable set of social policies, and enforce them at whatever jurisdictional tier is most suitable to their implementation.

The design and implementation of social policies is further complicated by *heterogeneity of preferences for and consequences of social policies***.** Unfortunately, the European Union is very heterogeneous: both in the "social" problems to be addressed -- which in turn reflect different levels of economic development and different social and family structures; and in the solutions devised in the various countries -- which, as we saw in Section

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Nicolas Decker in Belgium (La Vanguardia, 27-5-99).

1, feature a bewilderingly diverse array of policies and institutions. Only if the European Union could be viewed as a "fractal society", in the sense that the same social patterns (i.e., of employment, inequality, etc.) were present at all different levels, then agreement would clearly be possible: at the level of regions, nations, or EU, the problems to be addressed by collective intervention would be similar, and so should the solution.

Not surprisingly, the current configuration of EU supranational institutions and national policy-making authorities deals with this challenging situation in rather complex and often less than completely satisfactory ways. The basic tension arises from the coexistence of generous but increasingly less sustainable national welfare systems with their own peculiarities on the one hand, and increasingly integrated economic interactions on the other. The difficulty of reconciling these broad trends, and the likely resolution of the current conundrum, are sometimes quite apparent. The resolution of the peculiar situation faced by the German construction industry in the aftermath of the Single Market's implementation is a case in point: as we mentioned above, the generous unemployment scheme covering German construction workers was clearly incompatible with free labor mobility, since Portuguese, British, and Italian "posted workers" were willing to work at wages lower than German unemployment benefits. The issue was resolved by a mix of labor market deregulation and limits to economic integration. German unemployment benefits were reduced and, at the same time, a binding minimum wage was introduced for all construction work on German soil, effectively imposing a quota on German imports of construction services. After a long and politically complicated process, a Directive stated that, despite its obvious contrast with the European Union's Single Market ethos, such national legislation was allowed. This small-scale example illustrates neatly the tension between labor market regulation and economic integration. Its outcome indicates that national deregulation is a natural response when increased market pressure makes national policies too expensive. While the very limited extent and character of State and local social policies within the U.S. is evidence of the practical relevance of such "welfare magnet" effects (see, e.g., Bean et al., 1998, for a discussion and further references), neither "globalization" nor EU economic integration appear to put much pressure yet on European national welfare systems. The posted-worker example, however, also indicates how EU-level regulation may play a role in the broader European politico-economic arena.

Similar tensions are apparent in the other examples encountered above, such as Länder-

level provision of health services in Germany. Unfortunately, if the tensions arising from desirable European mobility are not properly addressed, mobility of contributors and beneficiaries of (national) social polices would unavoidably reduce social policy to a minimum common factor, all the more undesirably in the absence of an EU-wide safety net even remotely comparable to that provided by Federal programs in the US.

Currently, EU-wide legal restrictions do not recognize this danger. In particular, it is common practice of the European Court of Justice (ECJ) to consider that "EU citizens – service consumers- are free to consume (social) services in any member state" (Leibfried and Pierson, 1995).[35] Given this, preservation of national or regional welfare systems may need to rely on more or less implicit limitations of mobility – for example, by emphasizing linguistic and ethnic barriers to mobility so as to delimit clearly, if along far from justifiable lines, the scope of "solidarity." Such undesirable developments would not only hamper economic efficiency, much like the minimum-wage provision that alleviated pressures on the German construction workers' unemployment insurance scheme: they would also effectively increase social exclusion, in possibly much more effective and certainly less expensive ways than in the case of poor-region subsidization along Italian, German, or Spanish lines.

How well is the EU institutional structure equipped to deal with the twin dangers of excessive "race to the bottom" tensions and equally unwelcome limits to economic integration and social cohesion? To answer, we need to recall that *shared decision-making* is a crucial feature of the current social-policy configuration in the EU. Despite the stated subsidiarity of social policies at the national level, both economic-integration constraints and explicit "negative integration" supranational powers of intervention have deprived national governments of full control of their welfare systems. Hence, we proceed to discuss theoretical perspective on suitable decision process in the EU framework.

3.3 Sharing decisions on social policy

The analysis of the decision process is a central element in understanding social policies and their possible reforms in Europe. On the one hand, it is no longer possible to think of national welfare systems as independent entities: national governments are far from free to decide autonomously their preferred welfare policies. On the other hand, no central

[35] Social policies other than direct service provision may or may not be affected by similar mechanisms. In France and Germany, access to social assistance is conditional on the impossibility of obtaining support from ascendant and descendant relatives (Atkinson, 1998, p.105, and references

EU government is or is even envisioned to be responsible for a European welfare system. Furthermore, the current decision process cannot possibly be viewed as a stable arrangement – if only because the *EU Consolidated Treaties* themselves contain provisions for a transition to qualified majority voting on many issues in the next few years (European Commission, 1998a). It is more appropriate to view the current configuration as a temporary stage in an evolutionary process that may hopefully converge towards a stable and rational arrangement sometime in the next century. Hence, we need to understand which institutional arrangements are more suitable for a positive *evolution* of social-policy provision in the EU. We start our discussion of the decision process by summarizing some traditional and more recent views on how policies should be decentralized. We then confront these views with the current EU institutional framework, with an eye to identifying its strengths and weaknesses.

Traditional fiscal federalism theory (e.g., Oates, 1972) assigns different public policies to different tiers of government following an efficiency principle for internalizing economic externalities. For example, public goods with large economies of scale (like military defence expenditure) or with important spillovers across jurisdictions (like those affecting labor mobility incentives) are assigned to the central government. Local public goods, conversely, are better assigned to local governments, to ensure that they are better tailored to local needs.[36] Under these classical principles, many social welfare policies are more efficiently decided at the central level, so as to appropriately internalize spillovers, and/or implemented centrally to pursue economies of scale. In particular, redistributional policies should be agreed at the central level to avoid "welfare shopping" and race-to-the-bottom tensions. And, since risks are better pooled on a larger scale, it should be more efficient to implement social insurance policies at the EU level. By the same principles, some social services may be more efficiently provided at a sub-national level.

In summary, traditional fiscal federalism theory would call for a radical change from the current status quo of European national welfare systems. Policies now left to national governments may be more efficiently decided either at the EU level or, possibly, at a more local levels – as is the case in the US, where basic safety-net provisions are decided and financed at the Federal level while other social services are provided at the State or lower

therein). In the United Kingdom, there is no such "liability to maintain" and all EU nationals might in principle draw the (limited) social assistance benefits available to British citizens.

[36] On standard fiscal externalities arising in the provision of public goods to heterogeneous constituencies, and on possible solutions in a traditional federalist context, see Piketty (1996), Wellish and Wildasin (1996), other contributions to the same special issue, Persson and Tabellini (1999a), and references therein.

levels.

This view, however, is questionable. Recent estimates show that the economies-of-scale benefits of an EU-wide social insurance and tax system may be fairly small (see Fatas, 1998).[37] As to theoretical arguments based on policy spillovers, new theories of federalism emphasize that it may be naïve to model each tier of government as a benevolent social planner who efficiently implements the corresponding policy.[38] When there are multiple tiers of government, voters *delegate* the choice and enforcement of policies to representatives, and the process by which representatives are selected and interact is an important component of the design and implementation policy.

These aspects appear particularly relevant in the EU context, in light of three peculiarities of its institutional framework. First, as we noted above, it assigns a predominant role to national representation and national institutions, according to the subsidiarity principle. Second, Member States feature very different institutions, in particular with respect to the degree of within-country federalism. This makes it undesirable, if at all possible, to prescribe EU-wide norms as to how policies should be decided at lower-than-national levels. Third, the central EU authority does not reside with a President or with a Parliament. The European Parliament is gaining more prominence over time, at the expense of the agenda-setting powers of the European Commission. Much of the executive power, however, is in the hands of the European Council, which is not under the control of the European Parliament. The members of the European Council are national Ministers: hence, they are neither elected by the European citizens at large (as in presidential systems), nor by elected European representatives in the parliament (as in parliamentary systems). In this respect, the EU conforms to a model of *cooperative federalism,*[39] such as Switzerland's unique national democracy with a collegiate executive that does not depend on legislative confidence.[40]

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[37] In several policy areas, of course, the benefits of centralization are quite apparent, and well recognized by public opinion. In the Commission's Eurobarometer survey results, over 65% of respondents think that "policy should be decided jointly within the European Community" in the areas of "Cooperation with developing countries," Scientific and technological research," Foreign policy towards non-EU countries," and "Protection of the environment." In social policy areas, conversely, agreement is in general below 50% (see Dalton and Eichenberg, 1998).

[38] See, for example, Qian and Weingast (1997) for a perspective of the new federalism view and Besley and Coate (1999) for an analysis of fiscal federalism prescriptions taking into account the political economy process.

[39] See Inman and Rubinfeld (1997) for a comparison of different forms of federalism.

[40] See, for example, Lijphart (1992) for a comparative study of parliamentary vs. presidential systems.

3.3.1 The EU as cooperative federalism: strengths and weaknesses

In fact, the EU institutional structure can be rationalized on the basis of the principle of *cooperative federalism*, that is of *"preferring the most decentralized structure of government capable of internalizing all externalities, subject to the constitutional constraint that all central government policies are agreed unanimously by the elected representatives from each of the lower-tier governments"* (Inman and Rubinfeld, 1997). As a matter of fact, inasmuch as some decisions can be taken by majority-rule, the EU can also be said to follow the principle of *majority-rule federalism.* Regarding social policies, however, the *Consolidated Treaties* (European Commission, 1998a, Art. 137) dictate that the European Council should act *unanimously*, that is, according to the principle of cooperative federalism. It follows that the EU design features the strengths and weaknesses of a cooperative federalist model with extensive policy-making authority across many government tiers.

Accordingly, as we proceed to discuss some of the problems that democracies face in deciding and implementing social policies, we shall focus on how a cooperative federalist structure may address or aggravate these problems, and on whether the current structure of policy delegation within the EU is appropriate from this perspective.

The traditional federalist view would call for redistributional policy choices to be made at the central level, supposedly by policymakers elected through a federation-wide democratic election. Redistribution, however, typically features both winners and losers. When the status of winners and losers is clearly associated to well-defined groups within a society, decision rules based on simple majority would violate the basic principle that constitutions must be self-enforcing (see Ordeshook, 1991). This simple insight, and the substantial heterogeneity among EU member countries, rationalize the unanimity principle applied to social-policy decisions at the EU level. Allowing EU social policies to be decided by majority rule within the European Council could easily force a "losing" country to transfer resources to "winning" countries and, to the extent that heterogeneity is both wide and persistent, to do so permanently. Thus, unanimity requirements do prevent central EU institutions from engaging in substantial social-policy action, but they also play an essential role in guaranteeing the stability EU-level policy.

The discussions of new EU budgets agreements in 1999 (Agenda 2000) are a good illustration of the fact that net-contributor countries are unwilling to play the role of permanent losers. Rich countries showed their unwillingness to support the existing configuration of regional and agricultural policies, while some of the current net-recipient

countries were unwilling to apply the same rules in the aftermath of EU accession by poor Eastern countries. Centralized decision-making by some form of majority rule would lead to permanent winners and losers, threatening the stability of the EU. Under the current unanimity principle, this danger was avoided but the discussion did not lead to decisive action on either reforms of current schemes, or on the exact timing of accession. This is a typical example of EU decision processes in the social-policy area. It would be futile to complain about its indeciseveness without realizing that lack of action does not result from unanimity rules *per se*, but rather from the underlying conflict of interest that rationalizes them.

The Agenda 2000 discussions also offer a good illustration of another important feature of EU "cooperative-federalist" decision processes. European Council members do not represent EU-wide constituencies, but act as "country advocates." The conservative Spanish representatives were in favor of regional redistribution because funds would flow to Spain; German social democrats rallied against EU-wide redistribution because Germany is a net contributor. The fact that, within each country, redistribution would favor relatively poor citizens was immaterial: representatives acted as advocates of their countries' interests, regardless of their own ideology.

In a cooperative federalist model, in fact, the central government is a committee of representatives. While cooperative federalism reduces the risk of having permanent winners and losers, it may aggravate the tendency of elected representatives from each of the lower-tier governments to *trade policies* (or engage in *log-rolling*). Further, voters have incentives to behave strategically when electing their representatives to such committees, and "pork-barrel"[41] distortions may be very strong when representatives act as advocates of local interests.

"Log-rolling" distortions may be particularly important in the case of subsidy or regulation policies that are meant to affect a specific jurisdiction but, through spill-over of their economic effects or through inter-jurisdictional transfers, are not purely local policies. The traditional federalist view suggests that the choice of such policies should be centralized. A distorted decision process, however, may well eliminate the advantages of centralization. For example, policies aimed at guaranteeing minimum welfare standards can hardly avoid

[41] The term "Pork-barrel" politics comes from Colonial America. It was a custom for the store of a typical village to have a barrel of pork and shoppers were allowed to take as much pork as they could get with one hand. Therefore, families should send to the store whoever had the largest hands to "bring home the bacon."

subsidizing relatively poor regions or countries: their representatives may convince richer countries' representatives to support such subsidies by agreeing to support policies favored by the median voters in rich countries. Clearly, such log-rolling need not take into account the EU-wide repercussions of the overall policy package.

As to "pork-barrel" distortions, it is only natural that voters choose *extreme advocates* as their delegates in cooperative federalist committees or councils – i.e., those who are better at "bringing home the bacon." For example, voters may not particularly like subsidies when they are granted and financed in their own jurisdictions. Nevertheless, they may choose a representative who supports subsidies if the subsidy to local agriculture is financed by all jurisdictions.[42] As a result, interactions among committee members may feature log-rolling of *expensive* policies, since as all elected representatives are those inclined to spend.

Log-rolling and strategic delegation problems are not unique to cooperative federalism. They are present, for example, in the legislatures of presidential systems (see, for example, Ferejohn, 1983). However, in other institutional frameworks a balance of power between "popular" representation and "locally based" representation (for example, between the legislature of locally elected representatives and the President in the US) tends to reduce the possible inefficiencies that these distortions can typically generate.[43]

In the context of the EU, as we have emphasized, such a balance of power does not exist: for the European Council and European Parliament, elected through national political processes, it is far from natural to aggregate and represent the preferences of European citizens. As regards redistributional policies, a balance of power exists though unanimity requirements. Nevertheless, decision processes could only too easily lead to excessive intervention and spending regarding other policies.

To prevent overspending and other decision-making inefficiencies, the scope of central policies can be credibly limited *ex ante*. In fact, overspending is severely constrained in the EU by the commitment to maintain the EU budget (hence, *a fortiori*, the socially-oriented expenditure funds in Title V, Part III of the EU treaties) below 1.27% of the EU GDP. Such a low level contrasts sharply with the size and scope of public expenditures at national and regional levels, and certainly does not correspond to what might be an efficient distribution of public expenditures across government tiers from the "traditional federalist"

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[42] On this issue of 'strategic delegation' see: Chari, Jones and Marimon (1997), Besley and Coate (1999) and Brueckner (1999).
[43] Persson and Tabellini (1999b) provide evidence that presidential systems tend to have lower public expenditure. This may indicate the relevance of overspending distortions in parliamentary systems.

view. The limited budget of the EU, however, is easy to rationalize in light of the weaknesses and strengths of its cooperative federalist model. On the one hand, an overall budget cap is advisable if a decision process prone to "pork-barrel" and other distortions discussed above would otherwise have free rein. On the other hand, pre-commitment to low levels of spending and policy activity is indeed credible, inasmuch as it is enforced by unanimity requirements and checks-and-balances throughout the complex co-decision process of the European Parliament, the European Council, and the European Commission.

Rather than constraining the overall budget, distortions may also be reduced when decision processes on different policies are isolated. This is well understood by economists as regards monetary policy: for example, a high degree of commitment is ensured by the European Central Bank's high degree of independence. In effect, Central Bank independence isolates a specific line item in the overall government budget and a specific issue within the wider scope of macroeconomic policies, and in doing so aims at eliminating unwelcome spill-over influences between fiscal and monetary policies. The same principle applies to other policies, and is particularly relevant for policies that redistribute resources across identifiable groups of "winners" and "losers." If such policies must be discussed separately from other inclination of the winners' representatives to over-spend can be balanced by opposition by the losers' representatives. Therefore, decision-process distortions may be minimized if social policies cannot be traded with other policies.

3.2.4 Advantages and disadvantages of centralization and decentralization

In summary, without a centrally-elected executive, as in presidential or parliamentary systems, it is difficult to argue that all social policies can be democratically decided by majority vote within the European Council. Unanimity requirements are readily rationalized from this perspective. Their main weakness, of course, is the difficulty of reaching decisions. In the context of European integration, this does not amount to freezing the *status quo*. Rather, it reinforces the dualism between *negative* and *positive* integration briefly discussed above. While unanimity is not necessary to enhance market integration and allow tax competition across jurisdictions (negative integration), implementation of some social policies at the EU level (positive integration) is difficult because of unanimity requirements which, in turn, reflect the persistent heterogeneity of Member countries.

The structure of representation of citizens' interests also matters in this context. In most democracies, forms of direct "popular" representation typically coexist with forms of indirect or "local" representation, by which citizens of a jurisdiction (or social group) are

jointly represented by a delegate or institution. As we have seen, a characteristic feature of the EU is the predominance of "national" representation (rather than, for example, aggregation of voters' interest around other, non-national lines).[44] We take this feature as given, and do not explore issues of EU constitutional design. For our purposes, it suffices to emphasize the implications that the current configuration of EU institutions is likely to have in deciding and implementing social policies.

This form of representation has two main advantages. First, it makes it possible to identify clearly the preferences to be represented (and defended) by local advocates. Second, with a well-defined local jurisdiction, representatives become more responsive and more accountable. Both of these features may allow a smooth evolution from a system of sovereign states and cultures towards a more integrated EU. Besides the strategic delegation problems discussed above, however, a system of national representation also implies that decisions almost never correspond to "one-citizen-one-vote" principles. Typically, citizens from smaller jurisdictions tend to be over-represented in central institutions (and decisions).[45] Regarding social policies, this asymmetry has not played an important role up to now. Poor and rich countries have their own share of small and large representatives. Social welfare models – with the exception of the Scandinavian model – are not associated with size. In the future, however, the size asymmetry problem may become more relevant. First, because EU enlargement is expected to bring in poor and relatively small countries. Second, because the difference between large regions and small countries is only historical and if European regions gain predominance the asymmetry may become an issue.[46]

Advantages and disadvantages of different degrees of centralization are also apparent as regards the ability of different government tiers to commit. A problem with shared decision-making is that a particular decision may never be important enough in any particular government tier, even if it should be implemented from an overall point of view. For example, spending on minimum social protection or on family support measures may be crowded out by policies receiving stronger support at each decision level, despite its desirability from an *ex ante* point of view. In such cases (as in the case of monetary policy

[44] This feature may itself limit the central EU institutions' power to decide: a majority of a committee elected by national constituencies, rather than by European citizens at large, should not be allowed to impose decisions on a minority that has not lost an election on the basis of *ex ante* democratic rules.

[45] Such asymmetries may accentuate strategic delegation problems. See, for example, Brueckner (1999).

[46] As a matter of fact, regions with institutional representation are starting to develop their own initiatives independently of the *Committee of the Regions*, which also includes cities and does not have a well defined democratic status of their members.

delegated to an accountable and independent central bank), the government tier or institution with the highest degree of commitment should be identified at an equally *ex ante* constitutional stage, and receive a clear mandate to target a specific problem.

Finally, social policy decentralization is desirable to the extent that it allows local governments to adapt to local conditions, creating competition among jurisdictions and allowing people to "vote with their feet" (Tiebout, 1956, Bewley, 1981). While policies designed through a centralized process are often uniform, decentralized decision-making allows for diversity. In the European Union there is wide diversity in social and economic conditions at the local level, hence experimentation and adaptation of social policies is desirable. Co-ordination of social policies may address obvious spillovers across jurisdictions, but moves towards harmonisation tend to diminish experimentation. Unfortunately, the strengths and weaknesses of the EU's cooperative federalism are very intimately related. The main strength, namely the responsiveness of decision-making to national peculiarities, is achieved at the expense of a lack of commitment at the supra-national level, resulting in potential policy distortions. Next, we take up our discussion of welfare policies taking these political economy aspects into consideration.

4. A framework for welfare-provision co-ordination and competition in Europe

Our discussion of desirable and undesirable social-policy effects has identified a variety of evaluation criteria, such as *social protection, equity, efficiency* (especially as regards *labor market participation, labor mobility,* and *full economic integration*), *democratic representation* and *accountability*. It has also highlighted obvious and less obvious trade-offs along these dimensions, especially as regards the complex decision process in the "cooperative-federalist" configuration of the EU. Additionally, EU social policy provision would be greatly enhanced if it could achieve the *simplicity* and *stability* envisioned by Madison's quote at the head of this Chapter.

On the basis of our previous discussion, we can outline a *framework* for discussion of EU social policy reform. Our aim is not that of discussing a detailed "ideal" list of EU social policies, but rather that of identifying clearly a configuration of decision processes that may lead to coherent assignment of policy choices among the current EU institutions. For this purpose, we shall regroup the social policy instruments listed in Section 1, and consider in turn:

a) Transfers and services guaranteeing a minimum welfare level to citizens, configured

as basic security benefits (entitlement to which is granted as a right of citizenship) and those among targeted benefits (aimed at providing assistance to those in proven need) that can be considered part of the basic safety net;

b) Contingent insurance provisions (pensions, unemployment and certain forms of health insurance). That is, most corporatist benefits (for which eligibility is based on previous employment, and which are paid in relation to previous income)

c) Other social services, namely most encompassing benefits (for which eligibility is determined by both citizenship and employment, and benefits are paid on a flat-rate and income-related basis) and those among targeted benefits that are not directly aimed at preventing extreme poverty.

This classification of social policies and elements of social welfare provision systems is somewhat different from, though of course intimately related to, those we and our references found useful in discussing past historical experiences and current Welfare State configurations. It recommends itself, however, for the purpose of a constructive discussion of crucial politico-economic tensions in the EU. As we shall see, in fact, the complexity of the political-economic interactions in the EU context – and the need, in the cooperative-federalist spirit, to reach unanimous agreement in order to prevent externalities– is decreasing as we move from (a) to (c).

a) Transfers and services guaranteeing a minimum welfare level to citizens

This aspect of welfare systems easily generates inter-jurisdictional spillovers. When the relevant policy instruments are implemented and financed locally, poor people have incentives to move towards more generous jurisdictions, rich tax-payers have incentives to move out of them, and competition among jurisdictions is unavoidable. Labor mobility is limited in current EU experience. Capital is already quite mobile, however, and goods-market integration has much the same implications as factor mobility inasmuch as factor-price equalisation holds. Most importantly, a central aim of European Union policy is that of facilitating mobility of European citizens. From this perspective, the danger of a "race to the bottom" cannot be disregarded: despite current immobility, policies must be configured *as if* Europeans were already completely mobile. The relevant issues need to be addressed explicitly, and the minimum social rights of European citizens must be defined and guaranteed by EU policies. Leaving the relevant choices to local jurisdictions can only result in either unacceptably low levels of welfare provision and social cohesion, or in more or less

implicit limitations of economic integration as local constituencies try to defend their welfare systems.

We are certainly not the first to make the point that *harmonization of minimum welfare standards* is needed (see e.g. Bean et al., 1998, and their references), or that there are a variety of reasons to advocate an EU-wide minimum welfare floor (see Atkinson, 1998). Our discussion of political decision-making in the cooperative-federalism framework of a still very heterogeneous EU suggests, however, that minimum EU-wide welfare levels should be defined as explicitly as possible. The very diverse levels of economic development and welfare systems among current and prospective EU members have two implications in this context.

First, to prevent welfare-shopping from distorting mobility incentives and reducing the political feasibility of welfare provision, the minimum standard needs to be specified in absolute terms (rather than in relation to local incomes). It cannot, however, take the form of a uniform cash amount in all of Europe: "harmonization" efforts should be targeted to the effects of policy instruments, not to the details of their implementation. Hence, cost-of-living differentials and the character of social-service provision should be taken into account by the definition of country- and region-specific minimum levels of welfare provision. The definition of such minima is essentially a technical problem, albeit a very difficult one: it would be necessary to account for cost-of-living differentials in large cities or in the countryside, even within each country, and to take a stand on whether individual or family welfare levels should be protected from falling below minimum standards.. The definition and specification of minimum-welfare policies might however be a suitable task for the European Commission's technocratic structure, which should be tasked with monitoring local welfare programs to ensure that no European citizen, regardless of his or her residency, employment history, and nationality is allowed to fall through the cracks of an EU-wide safety net. Our discussion of the labor-market impact of social policies suggests that guidelines should be specified and implementation should be monitored so as to encourage labor-market participation and labor mobility. It also makes clear, however, that the fundamental conflict between social protection and high employment can in general be solved only by "active" measures whose costs can hardly be sustained by independent fiscal constituencies within an integrated economic area. Unconditional levels of support, such as negative income taxes or "basic income" proposals, cannot avoid negative labor-supply effects if they are generous; work-tested benefits, such as the US *Temporary Assistance for Needy Families* (TANF), clearly reduce poverty prevention at the same time as they increase

work incentives.[47]

Second, the very different income levels of EU countries and regions imply that 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. In light of the limited amounts needed to prevent social exclusion within each National welfare system (see Section 1), the size of the relevant budget line could be smaller than that of the current Structural, Cohesion, or Common Agricultural Policy funds. Unlike these programs, the EU minimum welfare program should be clearly targeted at avoiding European poverty with the least possible negative impact on employment.

As we know, the level of support and its employment side-effects are intimately related. Were non-employment and access to social assistance the only alternative to labor market participation, a uniform minimum absolute welfare levels would likely have the most negative employment effects in relatively poor countries or regions, and minimum assistance levels should be specified on a relative basis. Inasmuch as full labor mobility is an essential component of EU design, however, benefits should be specified so as to prevent absolute (PPP-adjusted) poverty at the EU-wide level, in order to prevent "welfare shopping." These considerations may suggest that income support levels be specified as an average of local and EU-wide relative poverty levels (see Atkinson, 1998, p. 29). From our labor-market perspective, the weight of local average incomes should reflect the extent of personal mobility across the boundaries of local labor markets (that need not correspond to those of Nations or regions). It should tend to zero as labor mobility becomes perfect, however: as we argued above, in the interest of clarity and stability it may be advisable to configure this and other policies *as if* desirably perfect labor mobility already characterized the EU.

The location of the EU-wide poverty prevention programs along the fundamental trade-off between poverty prevention and employment is an essentially political decision. As argued by Atkinson (1998, Sect.3.1) a clear commitment to an official policy in this respect would have beneficial politico-economic implications within each country. Inasmuch as unhindered mobility of persons is a basic building block of the EU, however, the issue must be discussed at the central level: to ensure that actual or potential problems are addressed

[47] Adults receiving TANF funds must "engage in work" within two years. Inman and Rubinfeld (1997) discuss the Welfare Reform Act of 1996 and the introduction of TANF as an example of *cooperative federalism* in the current US system. With the Welfare Reform Act, the U.S. moved from a central policy of matching grants to states for different conditional minimum welfare policies (families, job training, and homeless children) to a decentralized policy (with a single central block grant: TANF).

clearly and to minimize 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 paper (just like the current declarations of principle) if would-be free rider constituencies were allowed to circumvent them by lax means-testing procedures. As in the US TANF program, the availability of central matching funds should be conditional on satisfactory implementation of minimum welfare provisions, and the enforcement power afforded by this financial lever should be exercised by central supervisory bodies. It is also essential in this context to reach agreement on the definition of EU citizenship, especially as regards entitlements of non-EU immigrants and refugees. In the spirit of social cohesion, all EU legal residents should be fully integrated in the minimal, centrally co-funded welfare program envisioned here. To address the obvious co-ordination problems arising when EU-wide citizenship entitlements are granted by local constituencies,[48] entry into the EU should be centrally regulated, as is envisioned (albeit after a long transition process) by the provisions added in Amsterdam under Title IV of the EU Consolidated Treaties (European Commission, 1998a).

b) Contingent insurance provision

Programs meant to cover workers against income losses due to old-age, disability, and unemployment are a more or less important component of all Welfare States. These "corporatist" programs, like programs that provide health insurance to citizens at large as well as to workers specifically, specify benefits contingent on verifiable conditions (such as health, age, or employment loss) and on past contributions (which, like benefits, depend in turn on employment histories and income levels). Hence, they differ from the minimum-welfare policies envisioned under (a) because they are supposed to increase productivity, and because they do not necessarily redistribute resources *ex ante.* In terms of Section 2's general framework, this class of social policy is meant to address market failures and, in principle, they could be fully financed by appropriately designed contributions. Thus, even in a very heterogeneous EU, no central-budget line item need be devoted to financing these policies.

As made clear by our discussion of subsidized German hospital prices and of regional effects of unemployment insurance schemes, however, the quasi-market nature of such arrangements is very often intertwined with redistributive aspects. Efficient provision of

[48] See, e.g., Wellish and Wildasin (1996).

collective insurance in the EU context must emphasize the link between contributions and benefits that is currently too often relaxed by solidarity-based or political redistribution of resources. In other words, individual entitlement to benefits should be explicitly based on past and potential contributions, emphasizing the quasi-contractual character of these schemes and reinstating the link between citizen-taxpayers and citizen-beneficiaries that is essential to ensure the continued political legitimacy of this class of policies. One might for example address the German hospital problem by applying different prices to patients who are citizens of the constituency on which taxes are levied and those who are not. Just as patients' expenses are typically covered only partially by private insurance companies, so could "national health plans" be configured as insurance contracts for the mobile European citizen.

More generally, EU-wide arrangements in this field should be reformed in the direction of actuarial fairness. This, of course, is desirable even in country-specific contexts, inasmuch as each national welfare scheme is hardly sustainable when "insurance" contracts are inappropriately used as vehicles for unfettered redistribution. It is even more desirable in the EU context, where country-specific sustainability problems can have systemic effects in the case of pensions just as much as in the case of public debt, and where distributional tensions can distort location and mobility decisions within the integrated economy unless appropriately addressed in the context of policies discussed under (a) above. Again, we are certainly not the first to point out that actuarial fairness is necessary to prevent collective insurance programs from distorting individual decisions, and that efficiency properties are particularly desirable in the EU context. Atkinson (1998, p.144) points out that social insurance need not be subject to downward pressure from fiscal competition when there is a clear link between contributions and benefits. And Orszag and Snower (1997) propose the introduction of European welfare accounts (for retirement, unemployment, education, and health purposes) with mandatory contributions and contingent withdrawals, but allow for redistribution through income-contingent transfers into and out of welfare accounts. The political interactions entailed by redistribution, however, are quite complex within the very diverse integrated economy of the EU, and are arguably better addressed by minimum welfare programs envisioned under (a) above, or perhaps through the local arrangements discussed under (c) below.

A proper configuration of contingent insurance programs does need to be discussed at the EU level, though along different lines from those relevant to the minimum-welfare schemes under (a) above. Participation in such schemes, as we know, must be mandatory whenever

they are meant to address a real market imperfection. Hence, agreement must be reached at the central EU level as to minimum required contributions, because – no matter how close to actuarial fairness are the schemes – some individuals would always have incentives to "opt out" and generate "race to the bottom" tensions unless the scope of mandatory programs spans the Single Market. Besides minimum contribution levels, broad EU guidelines should be specified for the character of non-mandatory programs to be made available by appropriately accountable authorities within each country, which - continuing current efforts in the old-age pension field – should ensure that individuals who move across national programs or participate in multiple programs are not penalized.

Central interference, however, should not go beyond the specification of minimum contribution rates and regulation of the overall character of collective contingent-insurance schemes – more specifically, central co-financing of expenditures is not desirable in this context. Rather, an appropriate definition of "local" financing should ensure that social benefits preserve economic incentives. Importantly, the scheme should *not* be contingent on an individual's nationality, nor on his residency *unless* it bears on economic incentives. For example, unemployment insurance policies could be "harmonized" through minimum contribution rates, but their financing should not be centralized. Rather, their budgets should balance locally on a cyclical basis. This would avoid inter-jurisdictional redistribution through the scheme, leaving it to more appropriate policy instruments, and introduce appropriate mobility incentives for local governments, firms and unemployed workers: persistently high unemployment would imply low average benefits, downward wage pressure, and out-migration. Clearly, such a scheme would be quite different from that currently in force within EU countries, where regional subsidies ensure low-migration, high-wage configuration in all (rich and poor) regions. It is equally clear, however, that the current configuration of regional unemployment rates could not possibly be extrapolated to the whole EU without implementing politically unpalatable cross-national transfers. Importantly, the definition of "local" budgets would not necessarily coincide with the current regional boundaries of EU nations, nor should it be allowed to conform to ethnic and linguistic divides. Rather, the boundaries of "local" economic interactions should be defined with reference to desirable interregional and inter-occupational labor mobility.

c) Other social policies: services and labor market institutions

A proper definition of local economic interactions also identifies a broad class of collective "social" policies whose effects are closely confined within "local" boundaries. For example,

preferences and resources may justify very heterogeneous provision of such social services as child, old-age, and health care. As in the case of local public goods outside the narrow scope of "social" policies, such collective non-market intervention should be completely deregulated, but also completely financed at the local level and allowed to be contingent on residence-to-date, so as to reap the advantages of decentralization and competition. Even with complete integration, local tax rates and local public services can very well be heterogeneous, as is the case within the US. Local financing would allow individuals to "vote with their feet" and select the configuration of local social policies that best conforms to their preferences, resources, and comparative advantage.[49] Local social policy intervention may best take the form of regulation of private provisions, blurring the boundaries of public and private economic interactions.[50]

As we emphasized in Section 1, labor-market institutions may pursue the same goals as other social policies without a direct impact on public budgets. The poor performance of most European labor markets is evidence of the need of reforms in this policy area. The heterogeneous character and pervasive nature of labor market institutions in EU member countries, however, suggests that their reform might best be pursued by allowing "competition among systems" rather than by central interference. The wide variety of *status quo* policies and reform proposals suggest that there is ample room for experimentation and adaptation to local conditions. Active labor market policies, for example, need not be equally advisable for all EU countries. Some features of each institutional setting will certainly be made obsolete by enhanced competitive pressure within the Single Market. Others, however, may survive, and possible remain heterogeneous if their effects on efficiency and distribution grounds depend on industrial structure, on the structure of family interactions, or on other local specificities.

With respect to these local policies, the role of central EU institutions is limited, but far from irrelevant in two respects. First, in order to exploit fully the advantages of experimentation, central institutions should not specify uniform guidelines, but should play a role in monitoring local policies and disseminating clear information as to their experiences. Second, it may be advisable to specify minimum EU-wide tax rates on the income of mobile factors of production in each local constituency. Mobility is of course desirable, but it should

[49] Of course, accommodating heterogeneity may requires decentralization to very low levels of government, which may in turn reintroduce inter-jurisdictional externalities See Bewley (1981) for a formal critique to Tiebout's argument along these lines.
[50] See, eg., Buti (1998) and his references.

not be driven by tax differentials. Otherwise, race-to-the-bottom tensions would make it necessary to fund local public expenditures with property taxes only (i.e. taxes on land, the immobile factor of production).

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