XII Riunione scientifica
POLITICA FISCALE, FLESSIBILITÀ DEI MERCATI E CRESCITA
Pavia, Collegio Ghislieri 6 - 7 ottobre 2000

TAXES AND SOCIAL POLICY IN THE EUROPEAN UNION: TRILEMMAS AND LABOUR MARKET IMPLICATIONS

Giuseppe Bertola

European University Institute, Università di Torino, CEPR

Società italiana di economia pubblica

Dipartimento di economia pubblica e territoriale – Università di Pavia

Taxes and social policy in the European union:
Trilemmas and Labour Market Implications

Giuseppe Bertola

(European University Institute, Università di Torino, CEPR)

Comunicazione alla XII Riunione scientifica SIEP, sessione su *Politica fiscale, flessibilità dei mercati e crescita*, Pavia, 6 ottobre 2000.
Much of this material is drawn from Bertola et al. (2000) and other joint work by the author.

Labor market and social policy: trilemmas at the national level

European social-policy models, while far from doomed, are troubled by increasingly unsustainable unemployment and fiscal problems (Ferrera et al., 2000, and references therein). While welfare systems are challenged by broadly similar domestic and international developments, the impact and implications of demographic, technological, and trade-related trends is quantitatively and qualitatively different across countries. This reflects both their heterogeneous economic and social structure and, more crucially, the different configuration of their systems of social protection, summarised by the classic distinction between Scandinavian, Anglo-Saxon, Continental, and Southern European Welfare States. Budget problems are the most pressing cause of distress for the public-employment-based Scandinavian Welfare State. The United Kingdom (like many non-European Anglo-Saxon countries) faces increasing social exclusion in the form of permanent “working poor” status. The Continental countries are troubled by low employment rates. Last, but not least, the Southern European countries also find it increasingly difficult to target poverty as their family- and pension-oriented social policies are challenged by demographic and labour-market trends.

A trade-off between employment and poverty reduction is to some extent unavoidable.. Incentives to work are needed to induce individuals to offer their labour, and they can only be reduced if assistance is made available to those in need, or high tax rates fund public employment and active labour market policies. A provocative (if oversimplified) picture may be worth many words. Figure 1 plots the long-run average unemployment rate against the reduction of poverty rates effected by each country's tax-and-transfer policies in a sample (of EU and non-EU countries) where the latter data are available. The relationship is positive, suggesting that – as economic theory would predict – more generous poverty-prevention schemes can hardly avoid lowering employment.

One may of course try and restore high employment levels by "active" policies, structuring subsidies so as to encourage work rather than non-employment. Such policies, however, tend to be expensive (as is particularly apparent in the extreme case where the public sector acts as an "employer of last resort" for workers who fail to obtain satisfactory employment in the private sector).

Interestingly, all systems of collective intervention in labour markets are finding it increasingly difficult to obtain achieve a satisfactory mix of equality, high employment, and sustainable public finances. Not only is the unemployment increase observed in recent decades inversely related to the increase in wage inequality (Figure 2), but the inverse relationship between levels of unemployment and of wage inequality (which only becomes apparent after removing country-specific effects) has been steadily moving away from the origin (Figure 3). Whether because of "globalization" or because of technological developments, it appears to become steadily more difficult over time to offer the combinations of equal and plentiful employment opportunities that would characterise an ideal labor market.

The need to reconsider systems of social protection and reconcile them with employment objectives is particularly pressing in Europe, where political interactions make it difficult to renounce traditional equality concerns even as changed economic conditions appear to make existing policies obsolete. Failing to confront the trade-off in its entirety may dangerously lead researchers (and, potentially, EU policy interactions) to unwittingly neglect one or the either side of it.

The problem facing European policy interventions in the relevant area has two interrelated faces. On the one hand, the current Member Countries are quite heterogeneous as regards economic structure and policy configurations. The most obvious and perhaps most important dimension of heterogeneity in both respects is that illustrated by Figure 4, namely the dispersion of per-capita income levels. Across EU members, social-protection spending increases more than proportionately with purchasing power corrected income levels (the elasticity is larger than 1.75). A log-linear regression explains over 85% of within-EU variability in 1996 and, while only Ireland's social expenditure falls somewhat short of the predicted value, the estimated relationship clearly misses the low social expenditure of the rich United States. This admittedly rough picture does identify a "European" social policy model, as distinct from an American one, within which social expenditure heterogeneity mainly reflects different and only slowly converging levels of economic development. It also suggests, however, that full economic integration and harmonisation of the member countries' Welfare States may prove a less than trivial task in practice. And, as mentioned, not only the intensity but also the "style" of labour market intervention differs substantially across countries, which make use of regulation (such as employment protection and wage constraints) and fiscal intervention (chiefly unemployment benefits and social assistance) in very different ways.

On the other hand, many of the Member States' welfare systems fail to achieve uniformly satisfactory performance, especially as regards employment levels. Within the EU, different regimes also have different impacts on poverty reduction. It may also be worth pointing out that employment tends to be especially low, and unemployment highly regionally dispersed, in larger countries such as Italy, Germany, and Spain. This may be explained by the fact that relatively uniform social benefits, determined on the basis of national incomes as in Figure 4, tend to disproportionately reduce work incentives for residents of poorer regions. Further, internal labour mobility and regional competition are discouraged in Continental and Southern countries by such institutional features as centrally negotiated wages, job security provisions, unemployment benefits, and subsidies to less developed regions (Bertola, 1999). Needless to say, an extrapolation of the larger Member Countries' policy configuration to the EU level is unthinkable, especially in the absence of EU-level fiscal transfers.

EU objectives, instruments, and performance

Article 2 of the *Treaty on European Union* states as the EU's first objective the promotion of "economic and social progress and a high level of employment, [.] through the creation of an area without frontiers [.] and the strengthening of economic and social cohesion." "Free movement of persons" is an essential element of the "creation of an area of security and justice," another of the objectives to be pursued within the institutional framework of "subsidiarity" as defined in Article 5 of the *Treaty Establishing the European Union*: in areas which do not fall under its exclusive competence, the Community shall take action "[.] only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States."

Employment stands firm at disappointingly low levels in many of the Member Countries, and the Treaty's policy statements appear quite wishful. EU-level institutions have successfully dismantled protective barriers to free and efficient mobility of goods, services, and factors of production, thus indeed creating an area without economic frontiers. In the area of social policy, such a process of "negative integration" tends to enforce deregulation whenever existing policies conflict with desirable economic efficiency. Far from falling under the competence of EU-level supranational institutions, the social and labour market policy action advocated by the Treaty is almost completely subsidiary, left to intergovernmental negotiation, and subject to explicit unanimity requirements. Thus, official EU documents hopefully envision desirable social-policy convergence and co-ordination as the automatic result of European countries' sharing a common social model faced by common challenges at each national level, rather than of a process of "positive integration" through explicit collective agreement.

In the current EU context, achievement of social cohesion, employment, and co-ordination objectives is not only empirically wishful, but also theoretically dubious. Empirically, social and labour market policies are quite different across groups of member countries, reflecting the underlying heterogeneity of economic structures and social objectives as well as historically-determined features. Employment is obviously not high in general, and especially low in the larger and more heterogeneous Continental countries, where internal labour mobility and regional competition are discouraged by such institutional features as centrally negotiated wages, job security provisions, unemployment benefits, and subsidies to less developed regions. The institutional fabric of social and labour market policy is also remarkably stable within each country, and gives no indication of yielding to the wishful automatic coordination process envisioned by the "common challenges, common solutions" approach: social policy is heterogeneous across countries, and largely frozen within each country.

The EU trilemma

Theoretically, it is hardly possible to achieve social cohesion and full economic integration in the absence of centrally agreed social policy. Just like uncoordinated macroeconomic policies, fixed exchange rate, and free trade with capital mobility were mutually inconsistent before Economic and Monetary Union (see Padoa Schioppa, 1994), free mobility of goods and/or factors, local decision-making powers in the social protection area, and social inclusion cannot coexist consistently: pursuing two of the three necessarily implies forsaking the third. Rodrik (2000) identifies a somewhat similar trilemma, at the global level, involving the extent and character of policy choices and economic interactions beyond the borders of Europe and, indeed, of industrialized nations. National borders do matter for the intensity of economic interactions, even in the absence of formal barriers to trade and capital mobility, as long as contractual structures and legal enforcement are regulated and administered by national governments. Within the EU, enforcement of contracts and uniformity of legal restrictions is increasingly uniform, thanks to an extensive *acquis communataire* in fields such as quality standards, product liability, etc.; the resulting increasing intensity of product and factor market competition, however, is not accompanied by appropriate reforms of other public policy aspects.

Completely unfettered economic competition can only lead local constituencies to forego social objectives. The pursuit of equity always needs to be traded off decreased economic efficiency, and the trade-off is clearly worse when, for example, more generous subsidies and higher tax rates may lead to relocation of production rather than lower labour supply. In general, economic integration makes it easier for individuals to opt out of supposedly mandatory redistributive schemes. Foregoing the "protection" afforded by barriers to trade and labor mobility reduces the effectiveness of social policies and increases their cost, and theory predicts that as each decision maker privileges economic competitiveness over the pursuit of social inclusion uncoordinated policy choices by local constituencies should trigger race-to-the-bottom tensions. Thus, the EU can have complete economic integration and subsidiary social policies, but only by accepting lower levels of social protection.

The far from satisfactory performance of many member countries' social and labour market policies may lead some to favour such an outcome, but economic integration and subsidiary policy are not likely to be the chosen members of the trinity at the cost of social exclusion. Social inclusion is important for European countries, whose social policies are and are likely to remain remarkably stable and resistant to reform. It would be foolish, however, to use this evidence to dismiss the challenges posed to the current configuration of European social and labour market policies by the simple theoretical argument above. Rather, one should consider ways to reconcile the fundamentally inconsistent trinity without foregoing social objectives.

The EU could, of course, preserve both social protection and subsidiary political decisions by limiting the extent of economic integration. This scenario would reinstate barriers to fundamental economic freedoms, and especially thwart incipient labour mobility. In Europe, removal of economic freedoms from the trinity is not as inconceivable as an unfettered race to the bottom. Country-specific political decision processes do appear to privilege protection over economic efficiency. Hence, it is difficult to rule out a scenario of political agreement on social and labour market policies which would tend to reproduce at the EU level the current configuration of the many member countries, where institutions often reduce the intensity of interregional and interoccupational competition. It may not be a coincidence that employment performance is worse in the larger, more heterogeneous countries of Continental Europe than in Austria, Ireland, Portugal, the Netherlands (countries which display remarkably favorable combinations of equality and employment).

Just like resolving the inconsistent trinity by reducing social protection may appeal to some Europeans, a scenario of reduced international and inter-ethnic competition may be advocated by others. However, the choice need not be restricted to that between an Americanized or a frozen European Union. When resolving the inconsistent trinity, the EU should consider foregoing some fiscal and social policy subsidiarity in order to preserve economic freedoms and social protection. From an economic perspective, in fact, competition and social protection are both public goods. Competition between producers benefits efficiency (and consumers), competition among governments reduces efficiency, e.g., when it leads to subsidized production. The latter is appropriately outlawed by EU "negative integration" procedures, but appropriate policies should be agreed upon as a matter of collective rather than individual choice.

Agree to choose

Policy interventions meant to remedy market failures and/or to implement politically desirable redistribution should be designed and implemented at such a level as to ensure that all spillovers are correctly addressed. No individual can be rationally expected to use his or her own resources to remedy collective problems. So, no country or other local constituency can be expected to devote its tax revenues (and the dead-weight losses generated by tax distortions) to reduce inequality generated by economic interactions extending beyond its borders. Similarly, no individual producer and no organized lobby can be expected to welcome increased competition. Collective choice processes are needed to prevent “races to the bottom” in the provision of social policy. Economists can only point out that all such choices should be agreed upon through an appropriate political process (Sinn, 1998). Competition among atomistic agents is, of course, welcome from the economic point of view. For example, it is largely pointless to try and remedy economic inequality by restraining the extent to which wages may differ across regional entitities: rather, wages should be allowed to adjust to competitive and unemployment pressures. Competition among political systems, however, can hardly be decentralised to market mechanisms. If local policymakers were allowed to subsidise producers, for example, the equilibrium outcome would likely feature not only inefficiently, but in fact ineffectively high subsidization in all local constituencies. In this respect, the regulatory role of the European Commission, aimed at ensuring that subsidies at least pursue equity when implemented on a regional or individual basis, is quite essential to proper coordination of economic policies.

In order to achieve an efficient combination of equity-motivated social policy and efficiency-enhancing competition, national and supranational policymaking authorities will need to face the challenges posed to their current of social and labour market policies by Economic and Monetary Union instead of relying on automatic convergence mechanisms of doubtful empirical relevance and limited theoretical appeal. Unfettered “competition among systems” need not produce appropriate configurations of social and labour market policies for each of the member countries, or indeed for regional entities within them. Political agreement is essential on both the social and economic aspects of integrated economic interactions.

What choices are needed?

The economist’s role is, of course, primarily that of outlining tradeoff between various possible objectives. The shape, if not the nature, of those trade-offs needs to be studied carefully in light of changing historical, technological, and social circumstances. Policies and institutions that work well within small, socially homogeneous, stable economic systems need not be suitable for the large and heterogeneous EU, especially when technological developments, trade with less developed countries, and the Single Market adjustment process itself disturb its economic system. The observation of wide-ranging heterogeneity in welfare “regimes” within the EU begs the question of which among the interrelated features of the Scandinavian, Continental, Anglo-Saxon, and Mediterranean Welfare States may be subject to more pressure in the EU policy environment. Economic and Monetary Union has undoubtedly increased the intensity of competition and labour mobility, without reforming somewhat cumbersome and poorly co-ordinated decisions processes in the social policy area. Policy pressures from such features of the "new" economy are probably not as important as those from many domestic technological and demographic developments. However, they are undoubtedly most important when focusing on the future of European and EU-level Welfare States.

Discussion, design, and implementation of a new social and labour market configuration for EU countries provides welcome opportunities to re-evaluate the effects of the current configuration of policy instruments. Policies should become more employment- and efficiency-oriented in an environment where life-long employment is unlikely to be even as efficient as it used to be, and financial-market development arguably reduces the desirability of labor-income stability. Moreover, policies should be reconfigured so as to encourage unsubsidized competition among economic regions, and to be consistent with unconstrained labour mobility within as well as across the member countries. Unemployment insurance, for example, should be designed to cover risks, not so as to reduce competitive pressure on employed workers (true in general, of course cannot be done perfectly, but must be done better when the cost of reduced competitiveness increases). The political appeal of social protection increases in a more efficient and turbulent economy, but so does its cost.

To preserve valuable social protection, coordination (not homogenization) is needed: it should be recognized that countries (and smaller entities within the larger ones) are substantially heterogeneous, chiefly in terms of income levels but also in terms of social and family structure. The same structural determinants are changing, however, and history-determined features of social protection systems should be revaluated, and experimentation should be welcome as long as spillover margins are controlled. Agreed policies should recognise explicitly the substantial heterogeneity of member countries' levels of economic development and social structure, resisting the temptation to extrapolate to the EU level any individual country's social policy configuration. The relevant collective-choice issues should be addressed through an explicit EU-level discussion of welfare system configuration criteria which, while respecting subsidiarity of social policies, appropriately take into account the constraints imposed by economic competition and by desirable actual and potential labour mobility.

Bertola et al (2000) outline how a sustainable, competition-friendly system of social protection could in principle be built around three levels of more or less coordinated policies. Accountable minimum levels of social protection for all EU citizens, and EU-level immigration policy, could and should eliminate incentives to engage in "welfare shopping." Accountable, actuarially fair social insurance schemes could be designed so as to ensure that competition and mobility are motivated by economic considerations instead. And minimum tax rates for mobile factors of production could ensure that resources are available to pursue whatever redistributional objectives appear politically desirable to local constituencies. Again in analogy to the macroeconomic inconsistent trinity, supranational interactions have an important role in possible resolutions of domestic political problems generated by the social policy trinity. As Esping-Andersen (2000) notes, a major overhaul of the status quo is difficult to imagine as a strictly national project. Where reforms are blocked, national governments have with some success managed to delegate necessary decisions (or at least the blame) to the EU level.

REFERENCES

Bean, Charles, Giuseppe Bertola, Samuel Bentolila, and J.J.Dolado (1998), *Social Europe: ...One for All?*, London: CEPR.

Bertola, Giuseppe (1999) “Labor Markets in the European Union,” Robert Schuman Centre working paper 99/24, European University Institute; *ifo Studien* 1/2000, pp.99-122; trad.it. ``Moneta unica e mercati del lavoro," *Biblioteca della libertà*, 152, Novembre-Dicembre 1999, pp.11-33.

Bertola, Giuseppe, Juan Francisco Jimeno, Ramon Marimon, and C.Pissarides (2000) “Welfare Systems and Labour Markets in Europe: Heterogeneous in the past, integrated in the future?” G.Bertola, T.Boeri, G.Nicoletti (eds.), *Welfare and Employment in a United Europe*, Cambridge (Mass.): MIT Press.

Esping Andersen, Jøsta (2000) “Comments to Bertola et al.”

Ferrera, Maurizio, Anton Hemerijck, Martin Rhodes (2000) “The Future of Social Europe: Recasting work and welfare in the new economy,” Lisbon: Celta Editora.

Padoa Schioppa, Tommaso (1994) *The Road to Monetary Union in Europe*, Oxford: Clarendon Press.

Rodrik, Dani (2000) “How Far Will International Economic Integration Go?” *Journal of Economic Perspectives* 14(1), Winter 2000, pages 177-86.

Sinn, Hans-Werner (1998) “European Integration and the Future of the Welfare State” CEPR D.P. 1871; *Swedish Economic Policy Review* 5(1), 113-32.

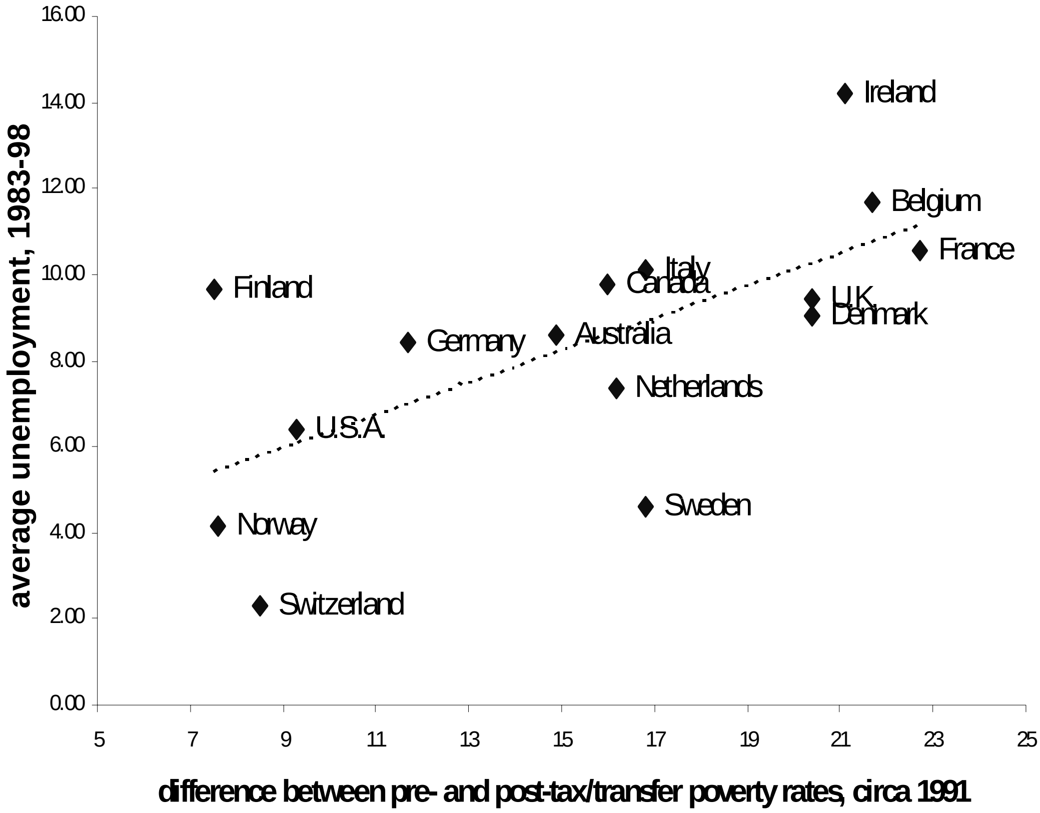

Figure 1 Reproduced from Bertola et al. (2000, Fig. 2.3.); data source: Luxembourg Income Study, OECD.

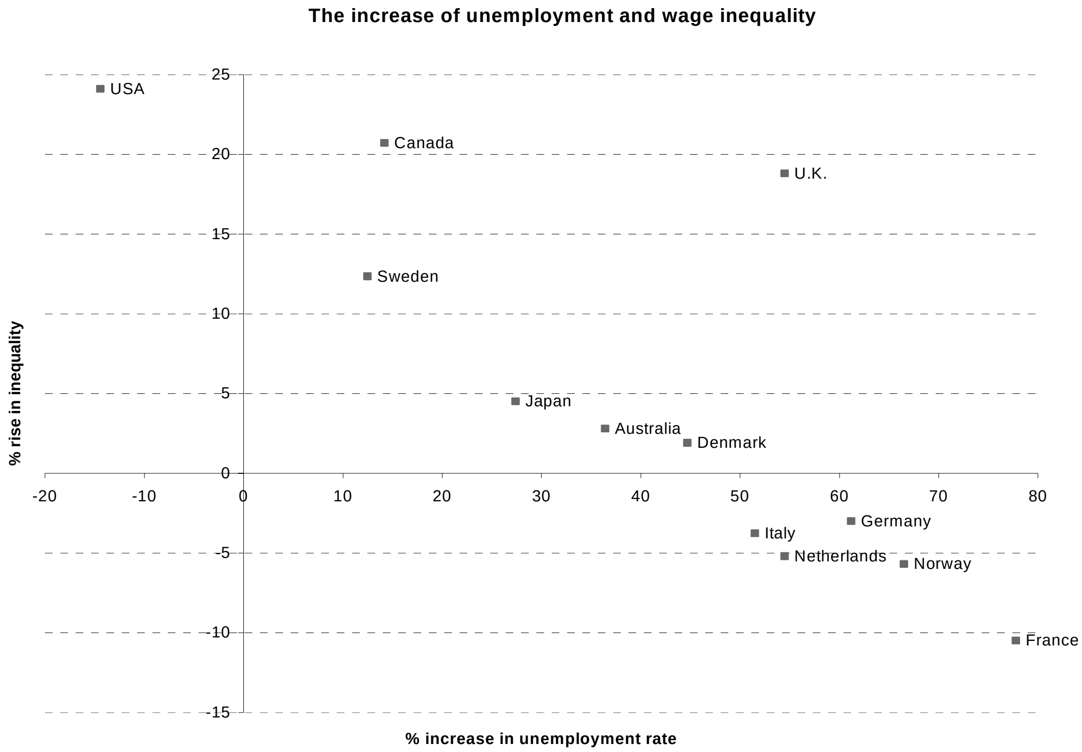

Figure 2: reproduced from Bertola et al, 2000. Definition and sources: horizontal axis, log difference between the average annual unemployment rate in 1986-90 and in 1974-79, from Layard et al (1991), Table 1, p.398. Vertical axis: log difference of the early 1990s and early 1980s ratios of earnings 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).

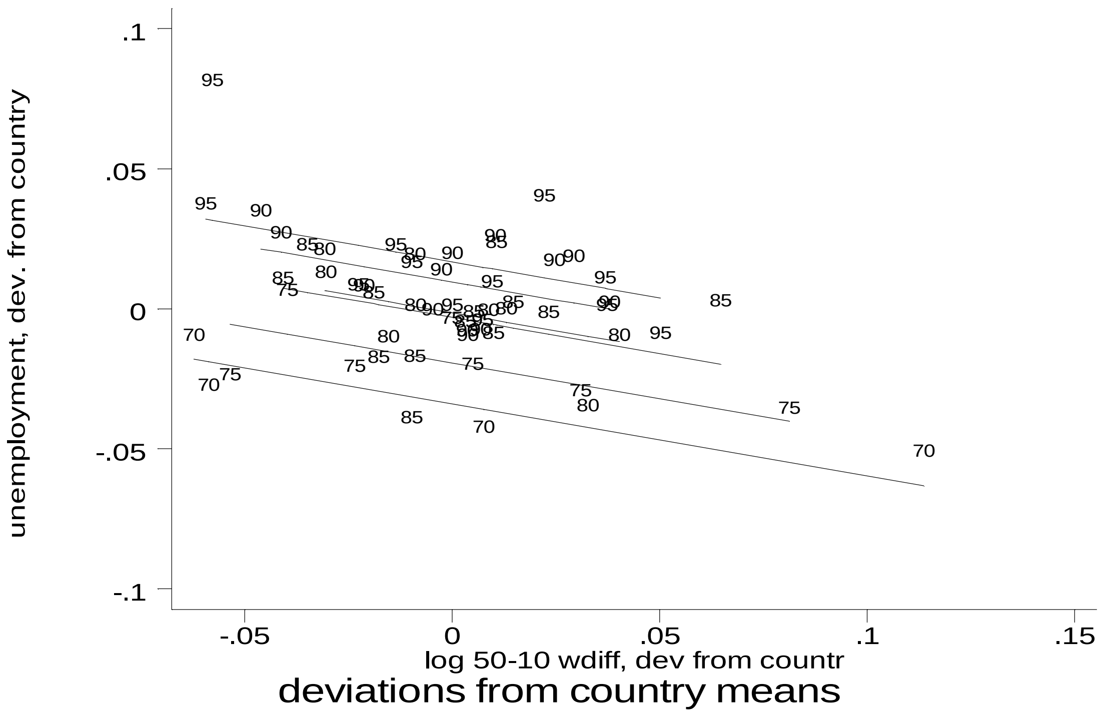

Figure 3: Unemployment and wage inequality: deviations from country means, lines plot regression lines estimated on all data allowing for period effects. Work in progress (with F.Blau and L.Kahn).

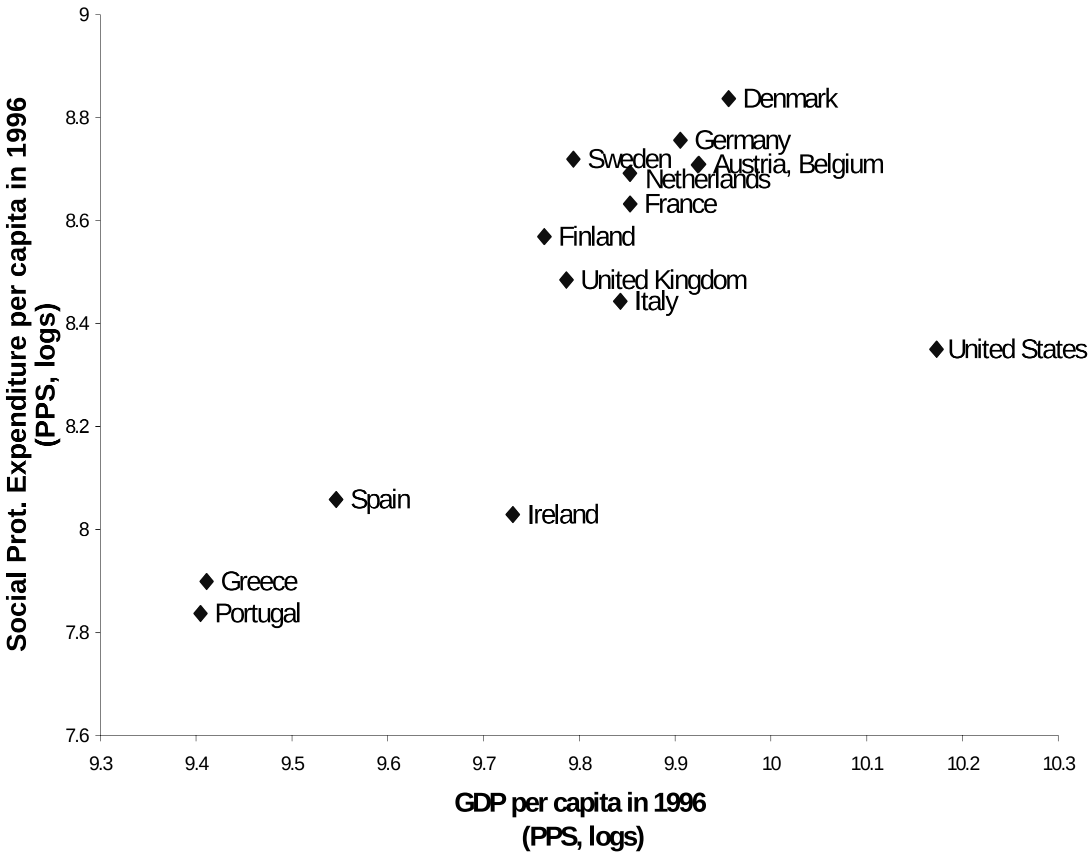

Figure 4: Reproduced from Bertola et al. (2000, Fig.1.1.a); data source: ESSPROS (Eurostat).