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Are European Welfare States Sustainable?¹

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SOM-theme C

Coordination and growth in economies

Abstract

European welfare states face serious financial difficulties caused by persistent high levels of unemployment and demographic ageing. Serious organisational problems are accompanied by inefficiency. Fiercer international competition and closer European integration put pressure on social policy in the EU member states, and creates competition between national welfare states. Sustainable European welfare states in general and maintainable social security systems in particular require fundamental reform. In this paper a plan for a common EU-wide safety-net is presented. The current proposal differs considerably from previous proposals involving the establishment of a basic income, wage subsidies, an earned income tax credit or workfare. Simulations show that the proposal is both effective and efficient.

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1. Introduction

The present welfare state crisis is endogenous to its own growth in the postwar period. Inactivity is subsidised (Delsen, Van Gestel and Van Vugt, 2000). For millions of European citizens social assistance has become a relentless if well-intentioned trap. In some countries equally well-intentioned disability pensions schemes have become a hidden receptacle for people who, because of age or unemployability, are squeezed out of the labour market. From a macroeconomic point of view a huge amount of human capital remains unused while the financial burden and the work-pressure of the active part of the population have increased. Most of the risks the social security systems

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cover, depend on demographic factors. Naturally, this applies to child allowance and old-age provisions, which cover the demographic risks. However, disability, illness, medical expenses and unemployment are also age related, meaning that these risks increase with age. Moreover, there are serious organisational problems. European social security has developed piece-meal in the course of many decades. European social security systems have been subject to equally haphazard and ad hoc adaptations, improvements and cutbacks. As a result their legal structure, organisation and administration have become complex, inefficient and therefore expensive. Deficiencies in the political process have pushed welfare state spending beyond the optimum level where marginal benefits are equal to the marginal costs of public funds. Political coordination failures due to incrementalism in stead of simultaneous political decisions on all budget items, resulting from prohibitive transaction costs, can partly explain this overexpansion and overshooting of the welfare state (Lindbeck, 1994). A reduction in the social burden requires a reform of social security systems. Also the high and persistent levels of unemployment, partly caused by the social security systems, and the demographic ageing force to reconsider the European welfare state. Moreover, European welfare states have failed to develop an efficient instrument of income insurance on behalf of low-skilled workers (Drèze, 2002). As a result of the Economic and Monetary Union (EMU) the need for social protection is growing, while on the other hand EMU reduces the quality of the social environment and the resources (tax base) to finance this protection. EMU accelerates the present shift towards share-holder capitalism characterised by short-termism, and intensifies the growth of insecure temporary and marginal jobs. EMU also implies that the nation states suffer a considerable loss of macroeconomic policy sovereignty, without the European Union actually gaining anything of equivalence. This undermines the existing barriers against the “social dumping syndrome”. Social dumping has a major impact on national welfare states. Simultaneously, welfare shopping may be reinforced by increased transparency and the enlargement of the European Union (EU), that narrows the financial base. The ensuing race to the bottom may erode the welfare state, or at least result in the underprovision of insurance, and too low supply of public goods (Delsen, 2002a). The central question that will be answered in this paper is: Are European welfare states sustainable? To answer this question the implications of closer European integration for these welfare states will be established, as well as the role policy at the EU level can and should play in welfare state reform.

This paper is structured as follows. In Section 2 the welfare state is defined and four models of European welfare states are characterised. In Section 3 the theoretical relationship between positive and negative integration on the one hand and positive and negative policy competition on the other hand is established. The causes of policy competition, and its implications for European welfare systems are outlined. In the Sections 4, 5, and 6 respectively, the theoretical arguments and empirical evidence concerning social dumping, social tourism, and the race to the bottom in relation to the

European welfare states are established. It is argued that there are reasons to harmonise European welfare systems. In Section 7 a plan for a common EU-wide safety-net is outlined, that builds on the existing trends in national welfare state policy and is based on the European Councils' recommendations 92/441 and 92/442 related to European welfare states. In Section 8 simulations of the plan are presented. The concluding Section 9 summarises the main results of the paper.

2. Four models of national welfare states

A welfare state is a country with a democratic constitution, where production is largely governed by the price mechanism and where the government tries to guarantee its citizens an acceptable standard of living through a combination of consultation, regulation and activation of the budget mechanism. A welfare state is engaged in "social spending", and in "social investment". From an operational point of view, one can speak of a welfare state when the expenses towards social security, health care, education, and housing total a certain minimum percentage of the gross domestic product (GDP). The size of a welfare state may also be calculated by the share of income redistributed. The system of social care and security constitutes the backbone of the welfare state. Old-age pensions are the largest component of total expenditure on social protection in all EU countries. Health care is the second largest component in all EU countries. (For Ireland the rank order is reverse.) Together the two components constitute over half of all social expenditure (EC, 2002).

Industrialisation is an important determinant in the development of the welfare state. The continental European system can be considered a reaction to massive industrialisation and a protection against serious professional risks. However, apart from technological determinism also economic prosperity and ideology play an important part in the development of the national welfare states in Europe. Each welfare state is the product of a very specific national history and culture. In the European Union four models of welfare states can be distinguished: The Scandinavian model, the Anglo-Saxon model, the continental model, and the southern European model (See Table 1). The continental European system consists of employee insurances and health care for which both the premium and the wage replacing benefit are linked to the employees' earned wages. Social security in continental European countries still largely reflects the Bismarck model, featuring insurance and employment based benefits and provisions mainly aiming at maintaining employees' incomes. The Anglo-Saxon system is a national insurance against loss of income for all citizens, consisting of tax-financed basic benefits and health services. Social security in Anglo-Saxon countries in many ways reflects the Beveridge model, featuring relatively large social assistance of the last resort schemes. As for the other models, the Scandinavian model combined

elements of both the Bismarck and the Beveridge model, and added a stress on reintegration in the labour market. High levels of social protection expenditure and universal welfare provisions based on the citizenship principle characterise the Scandinavian model. Welfare states in the southern European countries appear to have followed a course of its own. Only southern European social security systems expressly aim to combat poverty.

Table 1: Welfare state models in the European Union

	<i>Scandinavian model</i>	<i>Anglo-Saxon model</i>	<i>Continental model</i>	<i>Southern European model</i>
1 Type	Aimed at full employment; welfare state in the first place “employer”, in the last place payer of benefits	Aimed at economic growth; welfare state in the last place payer of benefits, and strict focus on work on labour market	Aimed at economic growth; welfare state in the first place payer of benefits, in the last place employer	Economically aimed at catching up with northern states; welfare state is only a semi-institutionalised promise
2 Right to	Work	Transfer of income	Social security	Work and social security (only partly implemented)
3 Primary responsibility	The state	The state	Labour market	Family and church
4 Solidarity based on	Society	Individual (no solidarity)	Economic sector	Family
5 Redistributive effect	Large	Average	Restricted	Restricted
6 Support (reintegration etc.)	Extensive	Restricted	Average	Restricted
7 Level of benefit	Average/high	Average/high	Differentiated	Low
8 Scope	All residents	All residents	Employees	Aimed at the poor
9 Aim	Guarantee social protection	Guarantee social protection	Maintaining income	Combat poverty
10 Funding	Taxes	Taxes	Contributions	Contributions and other sources (church etc.)
11 Financial independence of labour market	High	Low	Average	High
12 Administration	Trade unions/ central	Central/state	Private	Private

Source: Delsen, Van Gestel and Pennings, 2000.

As to the policy dimension, since the early 1990s reintegration of beneficiaries appears to have become a more important policy objective for all European governments – at any rate at the ideological level. The objectives of all models of social security can now be found in a combination of providing social protection and of encouraging persons to re-enter work. In that context, benefit levels in Scandinavian and Anglo-Saxon countries, though still relatively high, have decreased and converged with benefit levels in continental countries. Also in order to solve budget problems and/or to satisfy the EMU criteria, in all models there have been restrictions in benefit levels, and a tightening of rules regarding eligibility for social security benefits. Incentives to search for work are given to those who are able to work. In several countries a right to work, although rather weak, exists for the young and for the long-term unemployed. In all models fairly large employment creation schemes have been organised, to help claimants and beneficiaries into work. However, while support of reintegration has become more important in the Anglo-Saxon, the continental and the southern European models, in the Scandinavian model it has decreased considerably in the process of convergence. Although work tests like in the Scandinavian model have become more prevalent in all EU social protection schemes, the social security systems in many EU countries still aim at exclusion rather than at transition towards employment. The various national social security systems in Europe still are largely designed to provide income rather than to reintegrate workers. Large quantities of money are spent on the condition that the beneficiaries do not work or do not earn. The replacement of labour income with public transfers is the dominant form of assistance (See Van Vugt and Peet, 2000; Corsetti et al., 2002).

The slowdown in social expenditure growth in the second half of the 1990s is related to rising employment and efforts of EU member states to consolidate public finances in the light of the Maastricht Treaty. However, real social expenditure per capita continued to rise. In the second half of the 1990s there has been a tendency in the EU member states to limit the contributions and taxes on employed labour, and to replace them by general taxation or earmarked taxes. In addition special reduction of employers' social contributions for taking on long-term unemployed and exemption of low earnings from social contributions have been introduced. In the first half of the 1990s the decline was concentrated on employers' contributions, in the second half of the 1990s on employees' contributions (See EC, 2000; 2002; Joumard, 2002; Bertola, Boeri and Nicolletti, 2001).

Table 1 also indicates that the respective roles and responsibilities of the state, of voluntary social organisations, and of households and individuals are still very different in the four welfare state models. As to the organisational dimension of change, in the 1990s two apparently conflicting tendencies can be identified (Delsen, Van Gestel and Van Vugt, 2000). On the one hand, primary responsibility for social security seems to have shifted to the state in those countries where the state did not already had that responsibility. On the other hand, a tendency can be seen in all models to increase

the responsibility of the employers and employees for themselves – generally, and also in organised solidarity and social security funding. Taken together, both developments may point in the direction of a new balance in the responsibility for social security all over Europe. There seems to be a creeping convergence towards a mixture of Beveridgean universal flat-rate low coverage and a Bismarckian supplementary system, mainly based on labour market participation.

The differences in social protection systems between the EU member countries are also reflected in social expenditure. In general, gross public expenditure on social protection is much higher in the North than in the South of the EU. Social security is often considered a luxury good: Income elasticity of the demand for social security exceeds one. The inter-countries differences are explained by the level of GDP per capita, i.e. the ability to pay (See Scharpf, 1997; Rayp and Meeus, 2002). For the total set of industrialised countries 1994 data indicate practically no correlation between wealth (GDP per capita) and social spending. This correlation becomes stronger for the 15 EU member countries (Scharpf, 1997). Data for 1999 show that in the EU the relationship between GDP per head and expenditure on social protection is not strong (EC, 2002). Apart from GDP per head also the age structure, the level of unemployment, and the share of private social services determine social spending. Taking account of differences in price levels between countries - measuring spending in terms of purchasing power standards (PPS) - four groups of countries can be considered (EC, 2002):

1. Around 3,500 PPS per capita: Greece, Spain, Ireland and Portugal;
2. Around 5,500 to 5,900 PPS: Italy, Finland and the United Kingdom;
3. Between 6,400 and 6,700 PPS: Belgium, Germany, France and Austria;
4. Above 6,900 PPS: Denmark, Luxembourg, the Netherlands and Sweden.

Also these data confirm higher public social expenditure in the North relative to the South, and lower expenditure in the Anglo-Saxon countries relative to the continental European countries. Gross figures overstate cross-country differences. Comparison of public expenditure levels is distorted as in some countries benefits are net of taxes, while in others they are gross and taxed. There is less variation between EU member states if taxes and social charges levied on benefits are taken into account. A net estimation diminishes public expenditures considerably in the high spending countries (Adema et al., 1996; EC, 2002). In 1999 the net expenditure on social protection to GDP ratio in Sweden (29%) is reduced below the level in Germany (30%). In Denmark (25%), the Netherlands (23%) and Finland (23%) these ratios are reduced below the level of the United Kingdom (27%). The Belgian level equals the United Kingdom level. In addition to net public expenditure, also net private social expenditure have to be taken into account in international comparison of social expenditure. In 1993, the total public and private net expenditure on social protection as a percentage of GDP in the Netherlands (24.9%) was equal to that of the United Kingdom (24.7%), and lower than that of Denmark (26.6%), Germany (28.2%) and Sweden (32.8%) (Adema et al.,

1996). The fact that the national total net expenditure on social security are more or less equal (See also OECD, 1999), shows that preferences in regard to social protection are quite homogenous. This means that privatisation of social security does not lead to a lower total expenditure, but to substitution effects.

3. Negative versus positive policy competition

The European economic union has mainly been the result of negative integration. Negative integration consists of an obligation which restricts the freedom of member states and does not involve the transfer of power to a supranational level. It requires no institutional development. Negative integration concerns the removal of national regulations, customs barriers, quotas and technical specifications, which can interfere with the free movement of capital, goods, services and labour. Scharpf (1997) refers to negative integration as the "market-making" processes. Positive integration occurs when in addition to national policies a number of common policies are developed on planning, controls, the fixing of priorities and consequences for re-distribution. Positive integration concerns the building up of welfare state arrangements - of the "in-kind" as well as the "in-cash" type - to compensate for the effects of negative integration. These positive integration policies involve the creation of regional institutions that limit the autonomy of national economic institutions. Public market-rule-making and policy-making powers are transferred from the national level to the union level. Scharpf (1997) refers to positive integration as the inner "market correcting" processes.² Measure of positive integration require explicit agreement of national government in the Council of Ministers. Hence, positive measures can only be achieved through coordinated decisions by the 15 member states according to their respective constitutions and political structures. In Europe conflicts are likely to arise taking into account the differences in the levels of economic development and wealth (productivity and GDP per capita), institutional differences (differences in cost of adjustment), and ideological differences among governments. Policy blockage of positive integration is quite likely. National problem-solving capacities are reduced by constraints of more intensive economic competition and the legal force of negative integration, while European action is constrained and often blocked by conflicts of interest under decision rules imposing very high levels of consensus. The non-existence of supranational welfare policies makes it more difficult to implement national welfare policies (Scharpf, 1997). Moreover, closer European integration may result in free-riding by national

² Positive economic integration is also referred to as deepening of integration. The implementation of the euro and the European central bank is the most recent example of institutional deepening. Also here "market making" is involved.

governments by shifting their structural inefficiencies onto other countries. As a result structural reform of the European welfare state systems is difficult to achieve.

In Europe less space is being allocated to a “demand-side policy”, which is becoming increasingly ineffective and restricted. The variability of exchange rates is an important balancing mechanism between economies which are at different stages of development and which have different economic and institutional structures. However, EMU implies that exchange rates as an automatic equaliser are no longer available. EMU also implies that the present 12 member states have lost their monetary sovereignty. Estimates from the European Commission (Buti and Sapir, 1998) show that if countries stick to the medium term objective of keeping their budget in balance, the Stability and Growth Pact offers substantial room for automatic stabilisers to function. De Grauwe (1998) argues that the pact restricts the budgetary policy. Government budgets are robbed of part of their automatic stabilisers (De Grauwe, 1998). Cutbacks and tax increases to balance the government budget aggravating the present downturn seem to confirm this. The most important impact of EMU on the welfare state is through its effect on national budgets and spending policy. As a result of negative integration and selective positive integration and institutional deepening in the EU policy competition via the supply side of the economy is becoming increasingly important. This implies that structural policy and institutions are increasingly becoming the national selling points of governments to attain competitive advantages.³ Unlike financial and monetary policy, social policy in Europe is mainly national policy. Authority is not substantially transferred to European decision-making. Considerable differences in the welfare states between the European Union member states are a cause for policy competition. Policy competition has two dimensions: Namely a positive and negative. Positive and negative policy competition are at odds with each other. Negative policy competition between governments who wish to attract or retain foreign investment and producing firms and to protect domestic jobs involves competitive deregulation and “flexibilisation”, tax cuts, and privatisation. Positive policy competition involves constructive measures aimed at improving the investment climate, such as investment in the material and immaterial infrastructure. Social cohesion and stability are conducive to the investment climate. Social spending is not just a cost factor: The income distribution effect of social security may have a positive effect on the accumulation of human capital, and economic growth through a greater degree of innovation. Businessmen simply consider national welfare state policies as one of many factors of production. In the Treaty of Rome differences in social protection were considered to reflect basically the income and productivity differentials between the member states. Social convergence had to follow from income convergence that was

³ Rees and Sonnenholzner (2000) argue that the introduction of the euro likely implies that competition for jobs and capital investment among (cross-border) regions increasingly replaces competition among individual EMU countries.

expected to result from the integration of the market (Rayp and Meeusen, 2002). Market integration and policy competition are supposed to generate economic growth and keep nations fit. A "benign neglect" of the downward harmonisation of social protection and working condition in Europe is the result. Since a large part of labour costs in Europe comprises taxes and premiums, there is a direct relationship between the macroeconomic competitive position and social protection. According to Scharpf (1997) it is remarkable that negative integration in the EU includes elaborate rules that prevent distortion in competition arising from subsidies, preferential public procurement and other forms of "affirmative action" favouring national producers, but non against the practices of competition deregulation and competitive tax reductions. The next three sections respectively deal with social dumping, welfare shopping, and the race to the bottom hypothesis.

4. Social dumping

Social dumping refers to unfair competition between national systems caused by differential wage costs, working conditions and social costs. Mosley (1990) distinguishes three forms of dumping: Replacement of products, movement of capital and low wage policy, and policies to create a secondary labour market to obtain a competitive advantage. Sinn (2001) refers to wage dumping covering wages, working conditions and wage related fringe benefits that make up employers' labour costs, and welfare dumping concerning the redistribution of resources between different types of individuals, such as tax-financed transfers to the poor. The latter will suffer from tax competition. Countries are tempted to reduce claims of those groups - the young, the sick, the unemployed and the old - that most depend on public services and welfare transfers. A reduction in the social standards in the North is a form of social dumping. However, also a deliberate neglect by less-developed countries of the legislation for good social standards in terms of social fringe benefits, protection against injuries, pension schemes, codetermination rights and the like is a form of social dumping. They may stick to low social standards and do not care about low wages, because they know that competitive advantages for the domestic industries result (Sinn, 2001). However, reliance on low pay for jobs or competitive survival may imply falling into a low-productivity trap. Wages not only represent a cost factor, they are also a source for effective demand, and provide employers and employees with positive incentives to innovate and to increase productivity.

Increased private capital mobility induces fiscal policy competition. Adverse spill-over effects on other countries may result in a tendency towards inefficient low tax rates and an associated too low supply of public goods, and hence the erosion of welfare states. Financial capital mobility will lead to social dumping if the financing of the

social insurance system affects the return on capital. Countries have an incentive to lower these taxes in order to attract capital. However, this theory does not take into account the dynamic effects of capital accumulation. Low tax rates could stimulate growth and due to the transmission by the international capital market stimulate also economic growth in other countries (Lejour, 1995). Also lower trade barriers, and a better exploitation of economies of scale could exert a downward effect on prices, which stimulates production and employment. This broadens the tax base for social insurance contributions, and could have a positive effect on the benefit levels. It may also be argued that employers can not move their fixed physical capital easily to other countries. Real capital is less mobile than labour (Lejour, 1995; Sinn, 2001).

Whether tax competition is harmful depends on the relative size of the economic and political distortions. Harmonisation may be called for when economic allocative distortions are large and political decision-making distortions are small. In the reverse case tax competition may be welcomed to discipline ineffective governments (Eijffinger and De Haan, 2000). Also the country size matters. Small European states can actually gain from tax competition and may be reluctant to support cooperation: The tax base effect may swamp the tax rate effect (Genschel and Dehejia, 1999). It is the threat that matters: The differences in national systems act as an incentive for companies to practice social dumping. Jobs may be or threatened to be relocated to regions where labour is cheapest and least protected. Moreover, EMU intensifies competition and hence the growth of marginal jobs - flexible jobs (on-call employees, agency workers and fixed term contracts) and small part-time jobs - and is likely to result in more earnings below the minimum subsistence level. The threat of working poor and dependency is real. Moreover, the expected growth of flexible work will in the case of job loss result in an increase in the number of supplementary benefits up till the minimum level. The austerity of the social security system also contributes to this growth of insecure jobs. Workers may fall into unemployment and poverty traps (Delsen, 1999). Sinn (2001) argues that the income redistribution between the rich and the poor will indeed be eroded in systems competition, while refuting the artificial reduction in wages and fringe benefits in the transition process by less-developed small open economies: "The temporary lag of wages and social standards has nothing to do with social dumping; it is the result of the efficient working of the Invisible Hand in system competition". Welfare dumping is not wage dumping.

Countries with low social standards, and hence lower labour costs, have a comparative advantage. This comparative advantage gets more weight in EMU. The introduction of the euro makes social dumping more effective to improve the country's competitive position. For under EMU, the adjustments in the exchange rates of the participating countries and by differing rates of inflation, to compensate for the effects of social dumping is no longer available. Moreover, competition between national welfare state models will increase, for the euro increases transparency, and national labour costs, taxes, levies and other terms and conditions are now more readily

comparable (See Delsen, 2002a). So, social dumping is likely to get worse under EMU. Moreover, new information and communication technologies allows to exploit existing differences at low costs.

Table 2: Labour costs in manufacturing in European countries, 1999, (euros per working hour)

	Labour costs per hour in euros	Of which direct costs	Of which indirect costs
West Germany	25.5	55%	45%
Denmark	22.9	80%	20%
Belgium	22.0	51%	49%
Sweden	20.8	58%	42%
Finland	20.6	56%	44%
Netherlands	20.3	55%	45%
Austria	20.0	52%	48%
Luxembourg	19.7	66%	34%
France	17.3	53%	47%
United Kingdom	16.8	71%	29%
East Germany	15.9	60%	40%
Italy	15.5	51%	49%
Ireland	13.6	71%	29%
Spain	13.3	55%	45%
Greece	8.3	58%	42%
Portugal	6.1	55%	45%

Source: Calculated from Sinn (2001).

Gross hourly wage costs differ substantially among the European countries. Table 2 gives an overview of the hourly labour costs in manufacturing among European countries. In 1999 for EU-15 the average hourly wage costs were about 18 euros, varying from 6 euros in Portugal to 25 euros in West Germany. A further distinction is made between direct and indirect costs. Direct costs refer to gross wages per hour, i.e. the official annual pay divided by the number of working hours. The gross wages include the employees' social security contributions, overtime supplements, shift compensation, regularly paid premia, pay for vacation and national holidays, year-end bonuses and similar items. Indirect costs consist of employers' social security contributions, sick pay schemes, and other social expenses such as those for sports facilities, canteens medical services and vocational training. Indirect wage costs are part of the costs for social standards. These indirect costs are important determinants of the competitiveness of a single country. Table 2 shows that these indirect costs are substantial; 40% and over of the total wage costs for most EU countries, ranging from 49% of the total wage costs in Belgium and Italy to 20% in Denmark. Also the Anglo-

Saxon countries have relatively low indirect costs.⁴ Sinn (2001) concludes from this that there is a systematic relationship between direct wage costs and indirect wage costs: Countries with a high direct wage also tend to have a high indirect wage.

Table 3: Employers' and employees' contributions for social protection (% of labour costs, compensation of employees) in European countries, 1999

	Employers' Contribution	Employees' contribution	Total
Ireland	8	5	13
Denmark	5	10	15
Portugal	13	7	20
United Kingdom	12	11	23
Luxembourg	10	9	19
Sweden	20	5	25
Spain	20	3	23
Finland	21	5	26
EU-15	19	9	28
Austria	18	12	30
Germany	19	11	30
Italy	25	5	30
France	25	9	34
Netherlands	17	17	34
Belgium	25	10	35
Greece	27	12	39

Source: Calculated from EC (2002).

When we look at social contributions in particular a different picture emerges (See Table 3). The total level of contributions varies considerably between countries, ranging from 13% and 15% in Ireland and Denmark to 35% and 39% of the labour costs in Belgium and Greece. There is no systematic relationship with wages. Italy and Greece are confronted with high contribution levels. These are countries with relatively low levels of labour cost per hour. Also Spain and to a lesser extent Portugal have high contribution rates relative to their labour cost per hour (See Table 2). There also are considerable inter country differences in the level of contributions paid by employees and employers. The latter may cause difficulties for countries to catch up and is a cause for system competition. In most countries employers' contribution are considerably higher than employees' contribution. Exceptions being the Netherlands, Luxembourg, the United Kingdom where employers and employees contribute equally, and Denmark, where employees' contributions are higher.

⁴ The low percentages are probably related to the fact that in the Scandinavian model and in the Anglo-Saxon model, benefits are mainly financed from general taxation. In the other two models benefits are financed from payroll contributions (See Table 1).

There will be a tendency to increase wages in the economically weaker countries in the monetary union to the levels of those in the countries with stronger economies. Employers and employees in the richer countries will support this because they benefit from it. Trade unions and employees in the poorer countries will use the higher level of wages and social protection as the benchmark for their own wage claims. This convergence, i.e. upward harmonisation in social protection and wages may result in costs increasing more than productivity gains. Moreover, the desire for harmonisation will bring increased demands for transfer payments to the weaker countries. This will reward and stimulate inappropriate behaviour by trade unions (moral hazard). In the richer countries the taxes have to be raised to finance the increasing inter-country stabilisation transfer payments, reducing incentives, weakening growth and, finally, undermining the ability to make transfer payments to the poorer countries. Indeed, social expenditure as a percentage of GDP shows some upward convergence, despite the weak social protection programmes at the community level (See Alber and Standing, 2000; Delsen, Van Gestel and Van Vugt, 2000; EC, 1998; Rayp and Meeuw, 2002). Boeri (2002) on the other hand shows that for the OECD countries in the period 1980-1990 there is a low convergence rate (less than 0.2% per year) and is barely statistically significant. The same applies to the EU-15 countries, plus Iceland, Norway and Switzerland in the 1990-1999 period. He also concludes that there has not been an additional effect of European integration or EMU on the convergence of the size of the welfare state (Boeri, 2002). In the second half of the 1990s and in 2000 and 2001 productivity growth in the low-wage countries Portugal, Greece and notably Ireland was clearly above the EU average. Also nominal wage increases were well above the EU average in these countries. This indicates an upward convergence of productivity and wage levels in Euroland. However, as a result also the annual growth of unit labour costs in Greece, Ireland, Portugal as well as in Spain is above average, indicating a deterioration of competitiveness, which can result in a slower economic growth and job losses (Delsen, 2002a). The latter will burden the social security system and the social security ratio because the basis for financing is narrowed down (denominator effect), but also because the number of allowance recipients goes up (numerator effect). The reported convergence in social expenditure as well as the relatively high contribution rates in the South are mainly linked to the increased unemployment levels. Also the German unification is an example in this respect. Western employers and union representatives helped convince the government to impose west German work standards and the west German social security system on the east Germans (Sinn, 2001). In the case of Germany the transfer payments to the poorer east were massive. In the west Germany taxes had to be raised. Also the increase in contributions to the EC structural and agricultural funds by about 10 billion euros linked to the planned enlargement fits in here. These developments put pressure on the welfare states in both the South and the North, and a consequently call for structural reform of the European welfare state systems.

Rayp and Meeuws (2002) conclude from their simulations in a two-region - North-South - context that policy coordination would imply somewhat higher levels of social protection and welfare, and would enhance social convergence between the regions. There would appear to be no real threat of any downward adjustment in social protection within the EMU. The explanation for this is the large degree of homogeneity of the preferences related to social protection (See also Section 2). Strulik (2002) considers two countries each populated by workers and capitalists and equipped with a government that collects taxes to finance productive expenditure and income redistribution. Both groups in each country benefit from an abolition of the welfare state in the long run. Starting from autarky, free trade and capital mobility are introduced in a neoclassical growth model. Fiscal policy competition leads to a reduction of tax rates, a relative increase of productive expenditure by the government, and hence a reduction in the budget share of redistribution measures. The welfare state is largely reduced although not completely abolished. Lejour (1995) concludes that increasing integration exerts a downward pressure on the social insurance budget. In the EU social insurance policies are used as a competitive instrument. However, it is not clear whether these policies are more frequently used as an instrument for policy competition. The fulfilment of the EMU-criteria was a policy goal of social security reform in Belgium, Germany, Greece, Finland, Sweden, and the United Kingdom. Also the reduction of the costs of the social security system, of the state budget deficits, and the labour cost reduction were a cause for social security reform in the EU over the past years. It included a shift from universal and social insurance to selective means-tested social protection and a trend towards “residual” welfare states, i.e. the Anglo-Saxon model (See Alber and Standing, 2000; Delsen, 2002a; Delsen, Van Gestel and Van Vugt, 2000). This points towards negative policy competition and social dumping. European minimum standards of working conditions and social protection are necessary to counteract the incentive towards social dumping in EMU, and help to eliminate social inequalities across member states.

5. Welfare shopping

Within EMU, people could be attracted to emigrate by the prospect of either higher benefits or higher wages in other member countries. The euro makes it possible to directly compare the levels of social security benefits and contribution rates in different countries. This increase in transparency between national social protection systems might make social tourism easier and more attractive, and may be reinforced by the enlargement of EU. Social tourism – increased flows of labour to the richer regions – may have a major impact on social security in the EU. Related to this welfare shopping refers to migration from less generous to more generous welfare states. Free movement

of people makes it increasingly difficult to maintain relatively high protection standards. Citizens from member countries with low levels of social security benefits would decide to make use of their rights under European Community law to settle in other member countries with more generous welfare payments. Adverse selection would be the result: Countries with relatively high protection (benefit) levels would attract high-risk individuals, resulting in increasing costs to the social security system. High benefit levels imply high tax and premium rates, and the latter would induce people with low risks to leave their area or country. As a result, the basis to finance social security would become narrower. One may expect that in Europe low-risk workers are much more mobile than high-risk workers. Countries may fear immigration of subsidised low-skilled and emigration of taxed high-skilled. If each country acts independently to these migration externalities, i.e. takes the migration flow into account, but treats the benefit levels of the other countries as given, this will result in inefficiency, i.e. the underprovision of insurance (Drèze, 2002).

It is unlikely that social tourism will significantly increase under EMU, because access to benefit payments is still tightly circumscribed, the rights of EU citizens are still ineffective and restricted, and migration is not yet a socially-acceptable option for the greater part of the EU population and its government. To be more specific, free movement of people in the EU is limited to employed people, with the exception of family members. Citizens from EU member states that are not economically active are not free to settle in a member state. Recipients of unemployment benefits are only allowed to settle in another EU country to look for a job for less than three months, without loss of social security rights. The unemployment benefit is paid in local currency by the home country. This implies there is no incentive for unemployed people in a low benefit/low wage EU member state to look for a job in an expensive high benefit/high wage EU country. Temporary inverted social tourism from high benefit/high wage countries to less expensive low benefit/low wage countries is more likely. Inactive people without an unemployment benefit or without income are only allowed to settle in another EU member state when financial guaranties are given by a third party. Unlike in the United States, the vast majority of EU citizens are reluctant to leave their country in search for better living conditions. Differences in language and culture are the most important barriers limiting mobility. Labour migration affecting EU citizens is, therefore, not a significant phenomenon and is currently showing no signs of increasing. Nor is any significant increase in mobility within the EU expected for the future, with the exception of executives and specialists (Van den Broeck, 1996; Vandamme, 2000).

In theory low mobility indicates little divergence between regions. However, in the European Union there still are large and growing regional disparities. Rates of unemployment vary much markedly between regions in the EU than between countries (EC, 2001). Moreover, the regional and cohesion policies of the European Commission, which have strong political support, are expressly designed to avoid people having to

migrate to find work and to enable them to stay in their home region. Increasingly, the policy emphasis has been to reduce regional problems through structural programmes, rather than to encourage migration (EC, 1997). Large-scale intra-European migration is perceived as socially disruptive. According to Obstfeld and Peri (1998) EMU is likely to put in place incentives to remain at home. However, the recently approved extension of the EU towards eastern Europe, as well as a relaxation of the regulation of migration without work, will put pressure on the various social security systems. At present, several EU member states are adapting their migration policies to cope with specific deficits in labour market supply. With a very few exceptions internal EU migration decreased slightly in the 1990s, while international extra-EU migration recently increased during the 1990s: The level of net migration – the difference between inflows and outflows of migrants - in the EU is increasing (EC, 2001). There is some evidence of welfare shopping. Adoption of minimum standard, a common EU-wide safety-net, adjusted to reflect cross-country and cross-regional cost-of-living differentials, can avoid enlargement related migration over Europe, and prevent welfare shopping (Boeri, 2002; Bertolila, Boeri and Nicolletti, 2001).

6. Race to the bottom

If an individual demands a high level of public care and schooling of his children, an extensive public social insurance, very good public transport facilities, etc. he is willing to pay a high tax or premium for such arrangements. EU citizens directly compare the public services they demanded and the level of taxation. This will generate in- and outflow of mobile labour and of the most mobile production factor capital. Not necessarily towards the country with the lowest tax rate. This does not imply a race to the bottom, but a race to the most efficient use of tax receipts. However, in a strongly competitive market with limited national macroeconomic policy autonomy individual countries are tempted to reduce their wage costs and level of social protection and taxes, and hence the welfare state in order to attract foreign investment and to make home-located firms more competitive. With no legal barriers to migration in the integrated EU labour market the forces of "fiscal competition" are at work. EU labour market integration entails migration externalities, resulting in underprovision of insurance and a race to the bottom (Drèze, 2002). Intensified by EMU, social dumping may *ceteris paribus* result in social convergence towards an ever lower level, and thus in a general deterioration of social protection within the EU. Other countries will be put under pressure by such competition to make corresponding cuts. A prisoner's dilemma occurs: Either a country improves its own competitive position if other countries refrain from doing so, or the country prevents a worsening of its own competitive position if similar measures are adopted abroad. Unemployment is exported. This "beggar-thy-

neighbour" policy results in the building down of the social model, because countries that resist will be confronted with an increasing competitive partner. None of the countries will actually bear the fruits of their restrictive social policy measures. There will be only losers. Competitive deregulation and tax cuts will for the competing countries result in less than desired wage levels and a lower than preferred level of social protection, i.e. undershooting of the welfare state (Agell, 1999). Strulik (2002) shows by a two-country model that if both countries coordinate their fiscal policy the reduction of taxes and income transfers is less pronounced. In a calibrated version this result is shown by calculating the Nash and Stackelberg equilibria solutions for two countries: The average Europe G-4 country (Germany, Italy, France and the United Kingdom) and the United States. Lower taxes and a higher share of productive expenditure by the governments cause a decrease of the welfare state. Globalisation does not induce the European to adopt the relatively low American share of welfare spending, but it does induce both countries to reduce the size of its welfare state. Although the United States remains the country with the relative smaller welfare state, the reform in Europe is much more pronounced, indicating a downward convergence.

Based on trends in social spending as a percentage of GDP the empirical support of social dumping and a race to the bottom threatening European social welfare states is weak (Boeri, 2002; De Grauwe and Polan, 2002; Rayp and Meeuw, 2002). Between 1985 and 1997 social security contributions have increased and does not support the race-to-the-bottom scenario. No large scale race-to-the-bottom tensions are apparent in recent European experience. National social policies display remarkable stability, stemming from well-rooted welfare state traditions. Related to the replacement rate of social assistance to the unemployed between 1985 and 1995 there has been a "race to the top". Cuts in social spending are not uniform but selective. Moreover existing provisions became more generous over time (See Bertola, Boeri and Nicolletti, 2001). Alber and Standing (2000) on the other hand conclude that compatible with the notion of race to the bottom there has been a trend to lower social spending relative to a given level of wealth.

During the second half of the 1980s and the 1990s unbridled tax competition between EU member states caused the average tax rates on the mobile factor of production, notable capital, to fall from 45% to 35%; the average tax rate on labour increased from 35% to 42%, having negative effects on the level of employment and growth in Europe, and hence on the levels of tax revenues (Eijffinger and De Haan, 2000). Welfare states are resilient. However, fiscal competition for capital income and for labour taxes on high-skill wages is already there, and will become more pressing after enlargement. The underprovision of income protection in an integrated labour market is an issue that cannot be ignored in the EU (Drèze, 2002). Joumard (2002) points out that although in the EU there is no clear evidence of a race to the bottom at corporate income tax level, a recent trend in capital income taxation and preferential tax treatment to non-residents by many EU countries may signal such a pressure to lower

taxes on highly mobile factors is at play. Also intra-cross-border shopping contributes to the tax base erosion. Here coordination of tax policy at the European level could moderate the tax base erosion pressure. A common tax rate is necessary to prevent free capital movements and tax arbitrage from creating a race to the bottom. Cooperation and coordination related to welfare state policies between countries is a solution to the prisoner's dilemma. However, significant differences in the size and the composition of public spending imply different financing needs, which may in turn warrant specific differences in tax systems. Diverging interests and linked to this the highly likely policy blockage of positive integration imply that the required unanimity for any decision on tax policy is difficult to reach (See Section 3).

Wage costs are not the only issue in international competition. In companies' decision-making concerning the location of their investments such factors as a well-organised national infrastructure, high education levels, a supportive banking system, state services and, last but not least, industrial peace are also taken into consideration. The quality of the public goods is of importance. The efficiency and cost-effectiveness of the public goods provision in the EU member states may be decisive for the location of companies (Eijffinger and De Haan, 2000). The welfare state plays a positive role in this respect. Apart from a social function, a welfare state also has an explicit economic function in capitalist economies. The welfare state is an investment and not just a cost factor. The welfare state, i.e. equality and efficiency are complements. The welfare state supplies with services that might not automatically be provided for in a satisfactory way by either the family or the market, such as education and health care. Compulsory insurance is a solution to market failures, i.e. may be motivated on efficiency grounds. Compulsory insurance mitigates the problem of adverse selection, exploits returns to scale, and it helps to solve the free-rider problem (Lindbeck, 1994). There is a positive relationship between social spending as a percentage of GDP and competitiveness.⁵ This implies that the race-to-the-bottom hypothesis is incorrect (De Grauwe and Polan, 2002). Strong national competitiveness is preceded by a period of high social spending. The latter implies that the causality goes from social spending towards competitiveness, and not reverse. High social security spending creates an environment with less social conflicts, and improves incentives to take risks and are a proxy for the willingness of societies to invest in the quality of human capital (See Delsen, 2002b; De Grauwe and Polan, 2002). In this context, relevant research has been conducted by Rodrik (1997) in an attempt to answer the question of why small, open economies have a larger government sector. There is complementarity between governments and markets: The provision of social insurance by governments protects against the effects of external

⁵ Competitiveness has many dimensions: "The degree to which a country can, under free and fair market conditions, produce goods and services which meet the test of international markets, while simultaneously maintaining and expanding the real incomes of its people over the long term."

economic risks, which include exchange rate instability and the product concentrations in exports. In developing countries, that do not have a system of social security, this role is performed by government consumption. So the government can actually act to absorb economic shocks and to reduce insecurity risk. The government makes growth of the markets possible. This is at odds with the traditional ideas behind the neoclassical economic theory, in which governments are detrimental to markets and their growth. Therefore, the discussion about reducing the welfare state should not be about the size of the welfare state so much as about its structure and its function in capitalist economies. Starting from this notion, in the next section a plan for an EU level welfare policy is presented that contributes to the sustainability of European welfare states.

7. The plan

Explicit coordination of social policy at the EU level does not go beyond declaration of principle. Related to the European welfare states the 1992 Recommendations no. 92/441 and no. 92/442 of the Council of the European Communities to the member states are relevant.⁶ These recommendations on minimum benefits and convergence of benefits mainly recommended:

- That employed persons be provided with a level of social security, sufficient to maintain their standard of living in the event of the materialisation of social risks;
- That all residents be provided with a minimum level of social assistance and protection, sufficient to cover their essential needs.

Generally, according to the 1992 Council's recommendations, social policy (and social security) should combat poverty and social exclusion, and should aim at integrating, economically and socially, those people who rely on social security provisions (Delsen, Van Gestel and Pennings, 2000). It is for member states to determine how their social protection schemes should be framed and the arrangements for financing and organising them. In 2000 the Lisbon European Council decided to intensify policy cooperation in crucial areas of social protection: The open method of coordination aims to encourage and facilitate to identify and exchange good practice and innovative approaches of common interest related to social inclusion, health care and pensions.

Social policy at a European level demands positive integration (See Section 3). Economic convergence is a necessary condition for social convergence. From previous sections it can be concluded that a European minimum standard is an answer to social

⁶ 'Council Recommendation of 24 June 1992 on common criteria concerning sufficient resources and social assistance in social protection systems' (92/441/EEC, published in: *Official Journal of the European Communities*, L 245, 26.8.92, p. 46-48), and 'Council Recommendation of 27 July 1992 on the convergence of social protection objectives and policies' (92/442/EEC, published in: *Official Journal of the European Communities*, L 245, 26.8.92, p. 49-52).

dumping, a race to the bottom, as well as welfare shopping. In case of considerable economic differences between member states, harmonisation of social protection at a high level will imply a relative increase in costs and a deterioration of the competitiveness of the weaker countries, and a reduction of the ability of lower-income countries in the EU to make full use of their comparative cost advantages, and thereby to catch up with more advanced economies. Within EMU minimum standards and social harmonisation clash with productivity differences between EU countries. A uniform European social dimension may result in economic divergence; a widening of the regional income gap, while the aim of EMU is to promote convergence of economic performance (Delsen, 2002a). In an integrated economy, uniform minimum absolute welfare levels are likely to have the most negative employment effects in the relative poor countries and regions. Hence, minimum standards should be specified on a relative basis (Bertolila, Boeri and Nicolletti, 2001). Moreover, these standards will help the established, incumbent workers (insiders) at the expense of the outsiders (the long-term unemployed, the school leavers, and the temporary workers). Hence, social minimum standards may hurt precisely the people whom it was meant to help.

Are there options for reorganising European welfare states that could reduce mass unemployment and maintain aspirations of social justice, even under the conditions of an internationalised economy? Full employment and a high activity rate are conditions *sine qua non* for a sustainable welfare state in general and a maintainable social security system in particular. Vandebroucke (1998) refers to “egalitarian employment policies” as the future of the welfare state. Employment is the core issue for the future of the welfare state, both for fundamental reasons of social cohesion and individual self-esteem and for reasons of economic sustainability. The question, then, arises, as to which policy mix or institutional arrangements will allow for more individual choice and will make the best use of the available labour resources both in the short and long term, and that produce both efficiency and equality, i.e. full employment and a fair distribution of jobs and earnings. The target of full employment depends upon assumptions or goals regarding labour force participation rates, the length of the workweek and the frictional unemployment. Whether these conditions have been met depends on the economic situation and on the welfare state system itself. The conditions under which the welfare state delivers its benefits are crucial. If the system fails to adequately encourage those dependant on benefits to resume work, the safety net will turn into a hammock. There is a moral hazard. In the European Union social security, health care, education and old age pension schemes still are largely framed on the basis of the traditional family and the close link of its single (male) earner with regular employment. By offering all breadwinners the opportunity to support their families, full employment ensured that mass poverty was largely eliminated (See Van Vugt and Peet, 2000). The search for independence has led to greater number of single-person households and resulted in a diversity of employment patterns. A new full employment concept, based on the complementarity of equality and efficiency (See Section 6), is

needed; a concept that fits the desire to improve the labour utilisation rates and that contributes to, not hampers, the flexibility of the labour market. According to the European Advisory Group at CESifo the welfare state should not replace labour income, but supplement it when it is inadequate. This implies a new definition of poverty: A person who does not work (welfare state replaces labour income) is replaced by someone who is working to his physical and mental capacity and is nevertheless unable to earn a sufficient income (welfare state supplements labour income). This group advocates an earned income tax credit system as practised in the United States (Corsetti et al., 2002). As pointed out by Drèze (2002) tax credits accrue after a substantial delay after the income has been earned and the credits only operate on the supply side. Moreover, tax credits must be accompanied by reductions of gross wages, of unemployment benefits, if low-productive workers are to become employable.

The core of my proposal is a new concept of full employment consisting of the introduction at the EU level of the legal right to a basic amount of work, the right to at least a part-time job for all people in the workforce, combined with the stipulated right to a (partial) basic income guaranteed by the government. Hence, the public sector acts as the employer of last resort. Acceptance of part-time work is obligatory. Unjustified unwillingness to work will be punished by a withdrawal of the tax and premium free basic income amount. In this way, the current proposal differs considerably from previous proposals involving the establishment of a basic income or workfare in the form of individualised social assistance benefits with a job guarantee and an obligation to carry out paid work. The advantages of both systems are combined. The right to a basic amount of work and the obligation to work part-time – the carrot and the stick – increase the feasibility of a partial basic income. A stipulated partial basic income and a basic amount of work are two sides of the same medal: Both are complementary. From the point of view of European integration, the scenario will not in itself prevent social dumping practices between European countries but it will establish a floor under the national security provisions beneath which they will not, and can not, drop. The EU wide safety net may not prevent a general lowering of social security standards but it will prevent the undershooting of the welfare state and the race to the bottom. It also contributes to the sustainability of national welfare states,.

Four arguments are generally mentioned for the introduction of a basic income: Redistribution of employment, levelling of incomes, simplification of the social security system and flexibilisation of the labour market (Delsen 1997). A basic income gives employees greater control over working hours and entails a definite right to income independence. It also gives individual employees a certain bargaining power. A basic income enables a significant number of requisite new jobs to be created at lower levels for a salary below subsistence level while maintaining the minimal social standard. A basic income encourages risk-taking and innovation by individuals. It also implies an incentive for employment-intensive activities and entrepreneurship by encouraging the setting up of small businesses. It encourages part-time employment, freelance

employment and on-the-job training since the entire income no longer depends on the number of working hours. This is especially relevant to individuals with a low income. The social protection of the growing number of atypical employees in the EU improves considerably. The unemployed are always financially rewarded if they seek paid work. A basic income can act as a social safety net, providing protection against social exclusion. Due to the absence of a means test, a basic income actually helps the low and unskilled and the long-term unemployed to escape the poverty and unemployment trap. This is because it provides an incentive to find a job to supplement this basic income. The productivity and pension traps are also eliminated. Segmentation is therefore avoided. This is an important reason for politics to embrace the basic income. Moreover, it makes training and parental leave more attractive. Another advantage of the basic income is that the income risk associated with changing jobs decreases. This improves employment mobility and economic dynamics increase. Dynamic efficiency increases as well. Flexibility in wage costs also increases. It enables employers to adapt employee numbers as well as wages to changing market circumstances since there is less resistance among employees than when their income guarantee would be threatened. Reaching market clearing wages improves the allocative efficiency and leads to full employment and greater economic growth. The current pensionable age is meaningless: There is no longer a difference between 65+ and 65-. Drèze (2002) considers wage subsidies an efficient instrument to generate employment and to provide for income protection for low-skilled workers. He proposes an EU-level scheme of matching grants for low-skilled workers, whereby a share of national wage subsidies would be financed by the EU under suitable funding, i.e. levies from member states. Avoiding the moral hazard and free-riding accompanying his proposal may result in prohibitive high transaction costs. The introduction of a basic income can replace specific measures such as work experience projects, wage cost subsidies and working while retaining a benefit. The basic income can be "paid out" in cash, or as a reduction in taxable income or in the form of a tax credit. Tax and premium free cash payments, for instance on a monthly basis, are to be preferred; they can be used instantly, and are relatively easy to implement and to operate. Distortion of budgets or competition should not be feared. After all, the employed will also receive this basic income. Also the environment may profit from a basic income. Once the well-being of the neediest is divorced from the question of economic growth, and with it the moral justification of economic expansion, society can begin to concentrate on questions of sustainability. The following two options are available for financing the basic income: Abolishing part of government subsidies, abolishing the social security system, increasing direct and/or indirect fees and introducing a levy on business capital. Employment will be stimulated if added value is taxed instead of employment. Figures issued by the Social and Cultural Planning Office of the Netherlands (*Sociaal en Cultureel Planbureau – SCP*) in 1993 (See Table 4) indicate that a large majority (65%) of Dutch people oppose the basic income.

Table 4: Judgement of several social security systems in the Netherlands, 1993 (percentages)

	Basic income	Workfare
Proponents	19	59
Opponents	65	29
No preference, do not know	15	12
Total	100	100

Source: Koopmans et al., 1997, p. 132.

The level of the basic income must be pegged with delicacy: High enough to provide a decent living and real social security for those who have to depend upon it, but not so high as to deaden all ambition to earn more. Whether the scenario will indeed result in a flexibilisation of the labour market largely depends on the level of the basic income. If it is pegged too low, no positive effects will be achieved and social problems will increase. On the other hand, if it is pegged too high it will result in a stiffening of the labour market because for many people the incentive to work will prove too weak. Even if the basic income is fixed with discernment, it may still act as a break on labour mobility. Particularly low income earners (for whom the basic income represents a large percentage of their total income) may feel little incentive to search for new jobs which will improve their income only marginally.

The introduction of a basic income would mean that policymakers should acknowledge that it is no longer possible to offer the entire labour force a paid (full-time) job. It also means abolishment of the obligation to look for employment and the end of the right to work. In my opinion, this right to work – a component of the United Nations' Universal Declaration of Human Rights – should be upheld, no matter what. The government should guarantee a basic amount of work, in other words a part-time job for everyone in the labour force. Unemployment is defined in relation to this guaranteed amount of part-time work. The basic income is not subject to personal income and/or wealth. Here, the obligation to carry out a minimum amount of paid work is explicitly chosen. Part-time employment – part day, month and/or year – will become the new norm. The government guarantees a part-time job, which in combination with the basic income amounts to the subsistence level for an individual. Those unwilling to accept a part-time job in the private or public sector forego their right to the partial basic income. A supplement amounting to 100% of the subsistence level for single people is applicable to people who cannot work (elderly and disabled people). Other people will receive less, for example a partial basic income of 50 – 60% of the social subsistence level. They will have to earn their own income or receive financial support from other family members. This can be realised by accepting a part-time job. Family values are encouraged. There should be an explicit equalisation of regular paid work and unpaid socially useful activities. Rearing young children, taking care of elderly or ill relatives, or performing voluntary community services could be

considered real jobs which provide an income. In this way a sound basis may be created for solidarity of care, for the extension and improvement of primary social care which so far has always depended on moral obligations and unpaid charity. The plan thus offers a real perspective on realising solidarity as to income, work and care – which is more than the current welfare states can do.

Providing an individual with a basic amount of work – at least part-time – is advantageous to employees, companies and society as a whole. The individual has an opportunity to participate socially and economically. Social exclusion is prevented and the right to work is maintained. Financing the basic income is made simpler. International research has shown that part-time employment leads to higher participation among men and women, has a positive effect on the degree to which the production factor labour is used and has a significantly positive effect on productivity (Delsen, 1995). Fewer financial sources are required for people that are excluded. The burden of taxation and labour costs will decrease, which will have a positive effect on employment.

If benefits are (too) generous and/or too easily accessible, they will have a “magnetic” effect. The right to social security should be accompanied by the obligation to work. Unemployed and disabled individuals who receive benefits and who can carry out work adapted to their situation are used to satisfy the unfulfillable needs of society. Individuals who refuse work offered to them are not entitled to claim benefit. Workfare appears to be an important way to deploy large groups of people at the bottom of the labour market in the short term (Koopmans et al. 1997: 132). The poverty trap, the unemployment trap and social exclusion will be avoided. The concealed unemployment reserve in the early retirement schemes, the disability insurance and the unemployment insurance can be activated. Workfare has not convinced the social partners. Employers are wary of the extension of the collective sector and competitive distortion. Unions point towards increasing competition on the labour market, which is exerting pressure on conditions of employment. On the other hand, a considerable group is and will remain dependent on benefits without workfare, resulting in substantial costs. Workfare is clearly supported by 59% of the Dutch population (See Table 4). Workfare was defined as the unemployed and disabled being obliged to carry out work that is beneficial to society, and are paid the minimum wage. Workfare fits in the policy trend present in all national welfare states in the EU (See Section 3).

8. Simulations

Simulations of the proposal have been carried out by the new Applied General Equilibrium (AGE) model of the Dutch CPB National Bureau for Economic Policy Analysis. The AGE model is the stripped down version of MIMIC, the applied general

equilibrium model of CPB. MIMIC is the abbreviation of Micro Macro model to analyse the Institutional Context (See Gelauff and Graafland, 1994). The main simplifications of the MIMIC-model concern the exogenous labour supply, no (physical) capital, no schooling decision, and no division by sector. The stripped down version of MIMIC allows researchers to keep the results tractable and to focus on the crucial mechanisms that play a role in the impact of active labour market policies (ALMP) (See Jongen, Van Gameren and Graafland, 2000). The AGE model features equilibrium unemployment, i.e. at any point of time part of the workers is searching for a job, and part of the jobs is searching for a worker. Even in the absence of costly search by firms and workers the labour market will be characterised by equilibrium unemployment as wages are determined by unions and employers' federations in a right to management bargaining structure. Unions maximise their utility by demanding above market clearing wage levels.

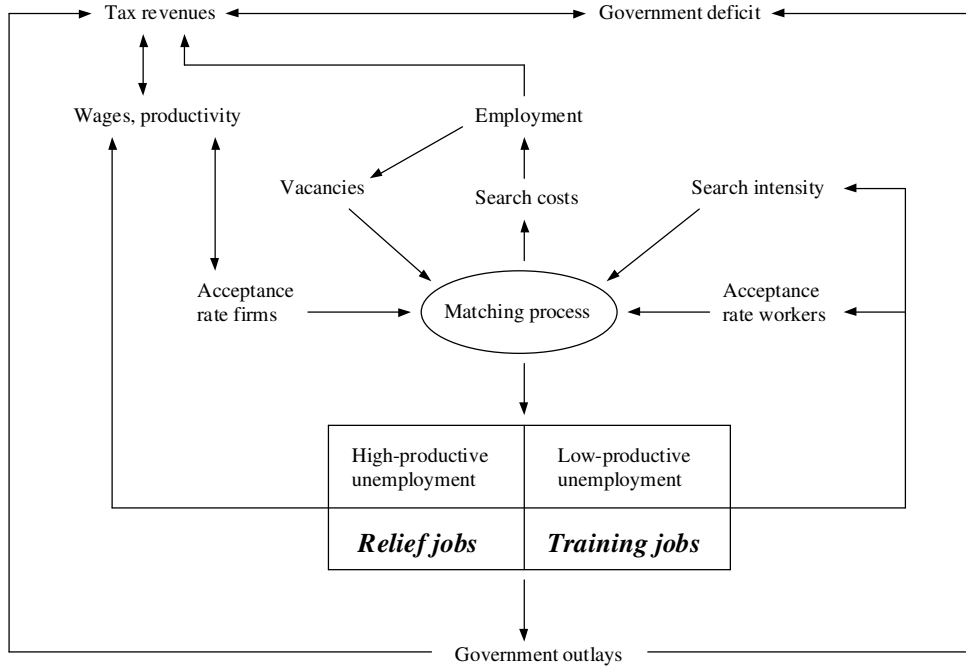


Figure 1: The model - an overview

The core of the AGE-model is the so-called “matching process”. The “matching process” concerns the number of vacancies, the number of job seekers and their search effort, and the acceptance rates of firms and workers (See Figure 1). In the labour market firms decide on the profit maximising level of employment (and the associated optimal number of vacancies), and they decide on which workers to accept. Some productivity realisations will be unprofitable to the firm due to the presence of minimum wage legislation. In this respect the acceptance rate of firms refers to the share of contracts with workers that is profitable to the firm. Workers choose the time they devote to job search (the search intensity) and which jobs to accept (the acceptance rate of workers). Some wage offers fall short of their reservation wage. Wages and productivity, combined with search costs for vacancies, feed back into the optimal employment decision by firms.⁷ A distinction is made between workers in low-productivity unemployment (stock of individuals on welfare) that are obliged to search for a job and workers in high-productivity unemployment (stock of individuals on unemployment benefits). The first concerns individuals that have lost part of their skills. They differ in their search and acceptance behaviour. Individuals may regain their lost skills in regular employment or in training jobs at minimum wage level supplied by the government. The volume of these relief jobs and training jobs is limited. The treatment effect (positive effect on search effort + increased attractiveness for firms) may dominate the lock-in effects. As a result search costs for firms fall. Outside regular employment, low-productivity individuals can participate in relief jobs provided and paid by the government. Compensation equals minimum wage. It is assumed that individuals do not regain their lost skills in relief jobs. Production by relief jobs does only cover 25% their compensation. Participants in training jobs are not productive. As a result of the higher compensation for participants in relief jobs it is optimal to reduce their search effort for locating private sector vacancies, and they become more selective towards job offers from the private sector. Search effort also suffers from the fact that participants devote valuable leisure time to working (“lock-in effect”). Search costs for firms rise, and the relatively high compensation level increases wage pressure. As a result relief jobs crowd out private sector employment. The relative shares of individuals in regular employment and in the various states outside regular employment determine the wage outcome via the fall-back position of workers in wage bargain. The model is scale independent: The unemployment rate and all other shares do not depend on labour supply. Labour supply determines the size of the market. The government transfers unemployment benefits to the unemployed. Combined with subsidies to the private sector, these transfers determine government outlays. To keep a balanced budget the government levies taxes on all workers, both employed and unemployed.

⁷ The AGE-model is calibrated on data for the Dutch labor market in 1993. The flow model is calibrated for three levels of education: high-skilled, low-skilled and unskilled.

The results of the simulation concern a combination of the following measures (Graafland and Jongen, 2000):

1. A 25% reduction in social assistance benefits for recipients who are, in principle, capable of working;
2. Pay cut in job-creation posts in the public sector (relief jobs) from the minimum wage to the “old” subsistence level. Working hours in such jobs also reduced from full-time to part-time (average 16 hours a week);
3. A tax credit of 25% of the subsistence level;
4. A major increase in the number of job-creation posts available in the public sector for those entitled to social assistance who are required to seek employment;
5. Reduction in the gross minimum wage, without affecting the guaranteed minimum income, so that the net income at the minimum level inclusive of the tax credit is equal to the “old” net minimum wage;
6. Compensatory taxes, with the government varying the average tax base in order to maintain a balanced budget.

Measures 1-3 increase the gap between income from regular work and income on social security assistance and in relief jobs. This will encourage those entitled to social security and those in relief jobs to actively seek (regular) employment. The remainder of those entitled to social security assistance will be given the opportunity to take a relief job in the public sector (a 13-hour so-called “Melkert” job (providing job-experience for the long-term unemployed)) (measure 4). This measure once again limits the difference in income and prevents social exclusion. The gross minimum wage may be cut as a result of the reduction in contributions (measure 5). Employers will be encouraged to take on job seekers more quickly. The measures will be funded from compensatory taxation (measure 6).

The simulated measures differs on a number of point from my original plan:

- The social assistance benefit for people who are capable of working are replaced by a basis income of 50% of the "old" social assistance benefit. In the simulations the reduction is only 25%. This implies that also the tax credit equals 25% of the social assistance level in stead of 50%, and the reduction of the minimum wage is 25% of the social assistance level in stead of 50%;
- In the simulations only the social assistance benefit is lowered for people who are able to accept a job. In my plan also the unemployment benefit is reduced;
- The availability of relief jobs is limited, and only low productive job seekers are considers for these jobs.

As a result of these differences and the far reaching assumptions related to training, skills and productivity in the AGE model the simulations underestimate the effects of the proposal.

Table 5: Simulation-results of the proposed welfare state reform

	<i>Percentage changes</i>		<i>Absolute changes</i>
Prices		Ratio's	
Labour cost (1)	0.88	Unemployment rate	-1.63
-unskilled	-4.16	-unskilled	-6.06
-low-skilled	-0.47	-low-skilled	-1.69
-high-skilled	0.02	-high-skilled	-0.81
Labour productivity	-0.46	incl. additional jobs (4)	-1.17
Production price	-0.65	-unskilled	-6.99
Consumption price	-0.49	-low-skilled	-1.13
		-high-skilled	-0.12
Volumes		Taxes	
Production (2)	0.98	Average rate	-0.40
Employment (total) (3)	1.74	-unskilled	-8.13
-unskilled	6.81	-low-skilled	-1.46
-low-skilled	1.82	-high-skilled	0.51
-high-skilled	0.85		
Employment (firms)	1.44	Government expenditures (5)	0.21
-unskilled	8.31	Wage bill	0.19
-low-skilled	1.30	Search costs	0.57
-high-skilled	0.15	Unemployment insurance	-1.81
Net real income		Welfare benefits	-0.85
-minimum wage	0.03	Total	
-unskilled	9.47		
-low-skilled	2.64	Government receipts (5)	-0.85
-high-skilled	-0.45	Taxes	
-additional jobs	-34.20		
-welfare benefits	-22.90		

- (1) Gross labour cost per unit of labour, excluding search costs.
- (2) Production in the private sector.
- (3) Employment including additional jobs (in persons)
- (4) The stock of unemployment plus the stock of additional jobs divided by the labour force.
- (5) In billions of guilders.

The results of the simulations are presented in Table 5. The impact of the plan on some key macroeconomic variables and government expenditure are presented. The equilibrium stemming from measures of my plan (simulations) are compared with the

initial equilibrium (base projection), i.e. the induced changes. The simulations indicate that unemployment will fall substantially and production will increase considerably. Also the inflation rate drops. The unskilled and low skilled workers in particular will benefit from the plan both in terms of job growth and in their purchasing power. Private sector employment of unskilled workers increases by over 8%. Their unemployment rate drops by 6 percentage-points. The net real income of the unskilled improves by more than 9%. The simulations also show that the proposal is budgetary neutral. In fact the average tax burden will fall. The proposal turns out to be in its effects a kind of “Robin Hood” type of income and tax policy: The lower end of the labour market benefits considerably more than the upper end of the labour market.

9. Conclusions

Social policy at a European level demands positive integration. Social policy at a European level has not (yet) been given shape since national governments still have to transfer substantial powers to the European decision-making structure. Almost all European social security systems are beset by serious financial difficulties caused by persistently high levels of unemployment (although these levels vary considerably between various countries), and by adverse demographic developments (in most European countries the median age of the population is rising rapidly). Moreover, there are serious organisational problems caused by political coordination failures. As a result of EMU and the internationalisation of the economies the need for social protection is growing, while on the other hand these developments reduce the quality of the social environment and the resources to finance this protection. The fears of social tourism, social dumping, and the race to the bottom are theoretically and empirically founded. Undershooting of the national welfare state is the result, that can only be avoided by policy coordination at EU level and a certain amount of convergence towards some commonly defined goals. European minimum standards of social protection are necessary to counteract the undershooting. Full employment and a high activity rate are conditions *sine qua non* for the survival of the welfare state in general and a tenable social security system in particular. The social security systems in many EU countries, however, aim at exclusion rather than at transition towards employment. Apart from the aim, the structural characteristics of the social security system are important for its effectiveness.

In this paper a new concept of full employment is proposed consisting of the introduction of the legal right to a basic amount of work, the right to at least a part-time job for adults, combined with the stipulated right to a (partial) basic income guaranteed by the government. In this way, the current proposal differs considerably from previous proposals involving the establishment of a basic income, an earned income tax credit,

subsidised jobs, or workfare in the form of individualised social assistance benefits with a job guarantee and an obligation to carry out paid work. Simulation results show that the common EU-wide safety-net presented in this paper is both effective and efficient. It improves the position of those groups that are permanently excluded from paid work due to the current social security system. The resulting “Robin Hood” type of income and tax policy is budget neutral. It creates substantial additional economic and employment growth. The unemployment rate drops considerably and production increases substantially. It improves the labour utilisation rates and it contributes to the flexibility of the labour market. Notably the employment position and the purchasing power of the unskilled and the low skilled improve. It stimulates flexibility in companies and in the labour market. However, from a policy point of view, it is even more important that the right to part-time work in combination with the right to a basic income increases employment and that social and economic exclusion is neutralised. The plan offers a real perspective on realising solidarity as to income, work and care, which is more than the current welfare states can do. In other words, the proposed plan can be considered a form of active labour market policy and activating social security designed to improve the position of individuals who have been excluded from paid work due to the current social security system, the power of insiders at decentralised level and current employment policy.

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