International Policy Analysis Unit

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Work and Welfare in the Enlarging Euroland

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The map used for the cover illustration was provided by the European Commission.
It shows the unemployment rates by regions; the classes on the map are:

Dark green:	less than 4.45 %
Light green:	between 4.45 and 7.35%
Yellow:	between 7.35 and 10.25%
Orange:	between 10.25 and 13.15%
Purple:	more than 13.15%

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Preface

To combine full employment with social justice, without violating fiscal soundness – this is the "trilemma" policy-makers in the European welfare states are facing, and ultimately they have not been very successful.

Over the last decade or so, the leeway national policy-makers formerly enjoyed has been increasingly constrained, due to the new rules promulgated in the European integration process. This is most visible in the case of monetary policy, where those EU member states participating in monetary union no longer have any competences, but it is also true of economic policy. In employment and social policy, however, the most important decisions are still taken at the national level. As a consequence, national policies and reform proposals differ significantly, although active labour market policies and pension reform are high on the political agenda of most countries.

In spite of the adjustments made to it, the European Social Model – let us call it that, provisionally neglecting its many varieties – does not appear ready to cope with the challenges of the twenty-first century. For most major European countries (Germany, France, Italy, Spain), unemployment continues to be the most pressing socio-economic problem. The best solution would be to better integrate the unemployed and the working poor in the labour market – but how? Institutional rigidities will have to be removed, and some degree of pressure on the unemployed will be required. But this alone will not be sufficient until economic growth rates reach significantly higher levels or until economic policy is redirected towards a more "employment-friendly" approach.

In the coming years, when several very poor countries will become part of the EU, the scenario will be even more complicated. The success and legitimacy of this ongoing integration will depend crucially on a more equitable distribution of prosperity. Continued or rising unemployment and poverty would threaten its stability.

The question of how to guarantee social justice in a deepening and widening Europe has been a major concern for the International Policy Analysis Unit for quite some time. Last year, the main output of this project was a collection of working papers on the convergence of poorer countries and regions – or the lack of it (*Cohesive Growth in the Enlarging Euroland*). This year, we organised another experts' meeting on "European Integration and Social Justice" in Bonn, 18–19 July.

In this volume are published the main written contributions to this conference. The compilation starts with a summarising essay, briefly describing the present situation and the challenges arising with the deepening and widening of Europe. Then, we take a closer look at two country cases often portrayed as "success stories", the Netherlands and Denmark, with the focus on the labour market. In addition, we analyse how the new rules of the game affect fiscal policy and macroeconomic policy. Finally, we discuss how the introduction of European Monetary Union might have influenced the development of the welfare state and look ahead to the possible effects of Eastern enlargement on its future.

On behalf of the Friedrich Ebert Foundation, we would like to thank all participants in the conference for their contributions. We hope that this volume will contribute to the ongoing discussion among experts and policy-makers concerning adequate policies for social justice in a deepening and widening Europe.

Bonn, December 2002 *Michael Dauderstädt*

Lothar Witte

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Michael Dauderstädt °

The Enlarging Euroland: Deepening and Widening Unemployment and Inequality?

How does European integration affect social justice in Europe? This is the question we will try to answer in the following paper. Let us start with the pessimistic view, albeit already with some qualifications, whose elements we will then analyse in more depth.

Over the last few decades, unemployment, poverty and inequality have generally increased in Europe, although there have been periods (notably the late 1980s) and countries (for example, the Netherlands and Denmark) where social conditions have improved or at least not deteriorated. For many of these problems, the presumed causes are complex and manifold: the decline of global growth rates since 1972; the end of the Bretton-Woods system; the globalisation of international capital markets, investment, and production; the rise of low-wage competitors in the former Third World; deindustrialisation; technological and demographic changes; and – not least – the perverse effects of well developed welfare states themselves.

European integration as such has arguably contributed to those developments. The introduction of the Single Market and the euro has changed the regulatory and competitive environment of European economies. The association and imminent accession of eight to ten very poor post-communist transition countries to the European Union are increasing the adjustment pressures on labour markets and social policies. Low-skill jobs will become less and less competitive in the exposed tradables sector of the richer member states. The emergence of new jobs in the service industries could well depend on lower wages and less protective labour market regulations. The correction of those pressures on the primary distribution of incomes by redistributive public policies or active employment policies is increasingly constrained by the common monetary policy, the Stability and Growth Pact, and tax competition.

How do these arguments stand up to more searching empirical and theoretical scrutiny? We will start with the “facts” of social development in Europe during the last 10–20 years. We will then analyse possible explanations of that development and in particular possible causal relations in respect of European integration. Finally, we will try to forecast the impact of further integration, in particular Eastern enlargement, and discuss the politics and policy options needed to improve the social situation in Europe.

1. The dire state of Social Europe

Europe’s unemployment is high, its economic growth is slow, and the distribution of the little value added is increasingly unequal.

Unemployment rates have increased substantially since the 1970s (see Table 1). But while some countries have managed to halt and even reverse the rise (notably the Netherlands, Ireland and the UK), others could only achieve partial success that still leaves unemployment rates much higher than in the 1970s (for example, Sweden, Germany, France and Spain). While employment

° Friedrich Ebert Foundation, International Policy Analysis Unit.

rates have increased in many countries the share of "normal" work arrangements has decreased in most countries, Greece and Denmark being the exceptions (Hoffmann and Walwei 2002).

Table 1: Unemployment in Europe, 1960–2001 (%)

Year	1960	1961–70	1971–80	1981–90	1991–2000	2001
Belgium	2.3	1.9	4.6	9.7	8.7	6.5
Denmark	1.3	1.1	3.7	7.4	7.1	4.6
Germany	1.0	0.7	2.2	6.0	8.1	7.8
Greece	5.6	5.0	2.2	6.4	9.5	10.5
Spain	2.4	2.5	5.4	18.5	19.6	12.8
France	1.4	1.8	4.1	9.2	11.3	8.5
Ireland	5.8	5.4	7.7	14.7	11.1	3.8
Italy	5.7	4.8	6.1	8.7	10.7	9.8
Luxembourg	0	0	0.6	2.5	2.5	2.0
Netherlands	0.7	0.9	4.4	8.5	5.4	2.6
Austria	2.5	1.9	1.6	3.4	3.9	3.4
Portugal	1.7	2.5	5.1	7.3	5.6	4.6
Finland	1.8	2.4	4.1	4.7	12.5	9.1
Sweden	1.7	1.7	2.1	2.6	7.7	5.2
UK	1.4	1.7	3.8	9.8	8.1	5.3
EU average	*2.3*	*2.2*	*4.0*	*9.0*	*9.9*	*7.7*

Source: Eurostat.

The *share of wages in GDP* has declined in almost all member states since the first oil shock (see Table 2). The decline was most pronounced in Ireland, strong in the Netherlands and Portugal, and rather modest in Luxembourg and – surprisingly – the UK. That does not mean that real wages declined. With the exception of some years they grew by an average rate of 1% per year.

Table 2: Share of wages in Europe, 1960–2001 (% of GDP)

Year	1960	1961–70	1971–80	1981–90	1991–2000	2001
Belgium	69	69.5	74.8	73.9	72.4	70.5
Denmark	67.7	71.5	74.4	72.7	67.9	65.4
Germany	70.6	71.6	73.7	70.9	67.9	66.0
Greece	101.4	86.1	70.7	74.0	67.3	67.2
Spain	70.7	73.5	75.1	70.5	68.5	67.1
France	74.1	74.2	75.5	74.5	69.5	68.9
Ireland	78.0	77.9	75.9	71.3	62.0	53.9
Italy	76.6	75.0	76.6	74.3	70.3	66.8
Luxembourg	56.3	57.7	65.5	66.5	64.8	62.7
Netherlands	63.4	69.4	74.8	68.1	66.0	65.3
Austria	82.2	82.5	83.4	81.8	76.5	72.5
Portugal	73.7	72.9	87.3	79.6	76.5	72.5
Finland	73.7	73.1	72.5	71.9	66.1	59.8
Sweden	69.4	72.3	74.1	70.5	68.7	71.4
UK	71.7	73	73.7	73.2	73.3	73.6
EU average	*72.5*	*73.2*	*74.9*	*72.8*	*69.7*	*68.1*

Source: Eurostat.

Since wage figures include the incomes of both workers and top managers the share of wages does not reflect changes in wage differentials. Without further information on other potential sources of income (for example, from capital or transfers) it is an open question whether the share of the total household income of wage earner households has declined to the same degree. Still, the coincidence observed in several countries of declining wage shares with rising unemployment raises questions concerning the strategy of creating employment through wage restraint (Flassbeck 2000).

It is therefore better to look directly at the development of *income distribution*.[1] EU Gini coefficients present (Table 3) a small increase in the late 1990s, using the data of the Luxembourg Income Study. However, other empirical data (ECHP) show a decrease between 1994 and 1997. National data covering the period 1984–97 show an increase in inequality (measured by earnings differentials) in some countries (Austria, UK), but also improvements (for example, in Germany, Denmark, Belgium) and some fluctuations, as in Italy and Sweden, that do not confirm any long-term trends (see Scharpf and Schmidt 2000). An older study on the relation between wage differentials and integration shows only inconclusive or weak results with some convergence of wage levels between member states when measured in terms of purchasing power parity (van Mourik 1994).

Table 3: Income distribution in the European Union (Gini coefficients)

Country	**Gini LIS**													**Gini ECHP**	
Year	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**	**1994**	**1995**	**1997**		**1994**	**1997**
Belgium		**22.7**	22.7	22.7	**23.2**	23.2	23.2	23.2	**22.4**	22.4	22.4	**25.5**		36.0	34.0
Denmark				**25.4**	25.4	25.4	25.4	25.4	**23.6**	23.6	**26.3**	25.7		23.0	21.0
Germany	**24.9**	24.9	24.9	24.9	24.9	**24.7**	24.7	24.7	24.7	**26.1**	26.1	26.1		31.0	29.0
Greece														37.0	35.0
Spain							**30.3**	30.3	30.3	30.3	30.3	30.3		34.0	35.0
France	**29.8**	29.8	29.8	29.8	29.8	**28.7**	28.7	28.7	28.7	**28.8**	28.8	28.8		29.0	30.0
Ireland				**32.8**	32.8	32.8	32.8	32.8	32.8	32.8	32.8	32.8		33.0	33.0
Italy			**30.6**	30.6	30.6	30.6	30.6	**28.9**	28.9	28.9	**34.2**	34.2		33.0	32.0
Luxembourg		**23.7**	23.7	23.7	23.7	23.7	23.7	**24.0**	24.0	**23.5**	23.5	23.5			
Netherlands				**25.6**	25.6	25.6	25.6	**26.6**	26.6	**25.3**	25.3	25.3		27.0	28.0
Austria				**22.7**	22.7	22.7	22.7	22.7	22.7	22.7	**27.7**	27.7			25.0
Portugal														39.0	38.0
Finland				**20.9**	20.9	20.9	20.9	**21.0**	21.0	21.0	**22.6**	22.6			23.0
Sweden				**21.8**	21.8	21.8	21.8	21.8	**22.9**	22.9	**22.1**	22.1			23.0
UK			**30.3**	30.3	30.3	30.3	30.3	**33.6**	33.6	33.6	**34.4**	34.4		32.0	34.0
EU-Average	*27.4*	*25.3*	*27.0*	*25.9*	*26.0*	*25.9*	*26.2*	*26.4*	*26.3*	*26.3*	*27.4*	*27.6*		*32.2*	*30.0*

Sources: Luxembourg Income Study (bold figures only – other figures are reproduced to obtain estimated EU averages), and EU Commission for ECHP.

Household surveys on *social exclusion* show that the S80/S20 ratio, indicating the relation between the income of the poorest 20% of the population to that of the richest 20%, ranges from 3.1 (Finland) and 3.2 (Denmark) to 7.2 in Portugal, with an EU average of 5.0 (Eurostat 2000). From 1994 to 1998 the EU average increased from 5 to 5.4 (Eurostat and European Commission 2002). German national data show a steady rise in inequality since 1973. Inequality has also increased in both West and East Germany since unification, although unification led to more

1 We do not consider distribution between countries, although that is obviously a very important aspect of inequality within the EU, particularly after enlargement. This whole dimension has been analysed by our “predecessor” project Cohesive Growth in the Enlarging Euroland, ed. Dauderstädt and Witte (2001). Obviously we will introduce the findings of that project in the present analysis in so far as they affect social justice on a national scale.

equality within the unified Germany between 1993 and 1998 thanks to the convergence of income between East and West Germany (BMAS 2001).

Inequality would be much higher without the correcting influence of *redistributive and social policies*. Social expenditure as a percentage of GDP increased significantly in most countries between 1960 and 1980, and even between 1980 and 2000, due to aging populations and higher unemployment, it continued to rise, especially in the poorer Southern European countries – including Italy – as well as in France and Finland. As a consequence, the EU average continued to increase as well, in spite of relatively stable or even falling shares in some countries (Germany, Austria, Netherlands) (see Table 4).

Table 4: GDP share of social benefits in Europe, 1960–99 (%)

Year	1960	1969	1979	1989	1999
Austria	7.57	11.21	15.51	14.71	15.71
Belgium	11.35	13.70	20.85	20.62	21.16
Denmark	6.17	8.68	14.96	17.81	16.92
Germany	12.83	13.53	16.95	16.19	16.70
Greece	4.91	7.68	8.57	15.49	15.54
Spain	3.65	6.38	11.70	13.94	15.09
France	12.74	14.82	18.63	21.09	23.55
Ireland	4.07	7.76	11.64	14.62	13.64
Italy	9.50	11.93	14.08	17.61	19.70
Netherlands	7.17	12.92	19.93	18.26	17.75
Portugal	2.26	2.50	7.03	8.25	12.50
Finland	5.08	7.08	9.08	14.36	19.54
Sweden	6.09	8.19	14.28	16.29	15.82
UK	6.06	8.35	10.55	10.47	13.12
EU average	*7.17*	*9.70*	*13.75*	*15.53*	*16.91*

Source: Peter A. Cornelisse and Kees P. Goudswaard, "On the convergence of social protection systems in the European Union", *International Social Security Review*, **55**, No. 3 (2002), p. 10.

Since 1980, in the context of tighter fiscal policies and increasing demands, most governments have wanted to reduce social spending and/or improve its effectiveness. Some – such as Austria, Germany, the Netherlands, Sweden and the UK – succeeded partially and temporarily.

> During the 1980s and 1990s, conservative governments in Britain, the United States, and the other Anglo democracies have reduced the generosity of benefits, tightened program eligibility, implemented cost controls on service delivery, and encouraged privatisation of some social insurance and many social services. Neoliberal policy changes have not been confined to these right-of-center governments; Swedish, German, and other Western European governments of all ideological complexions have on occasion reduced pension and other social insurance benefits, limited benefit indexation, and restricted eligibility for unemployment compensation and social assistance. They have also imposed budget caps, user co-payments, and other cost-control measures for health and social services. Moreover, these efforts to restrain the welfare state have occurred at a time of rising need for social protection. (Swank 2002: 1–2)

A look at replacement rates (see Table 5) confirms the retrenchment efforts in Belgium, Germany, the Netherlands, the UK and Sweden, while at the same time reflecting the continuous rise of social protection in the "less developed" welfare states, such as Greece, Italy, Portugal, and Spain, or specific reform approaches, as in Denmark, that have increased replacement rates substantially while reducing job protection, so making labour markets more flexible.

Table 5: Replacement rates of unemployment benefits in Europe*

Year	1979	1989	1997
Austria	29.3	29.3	31.0
Belgium	46.3	42.1	39.8
Denmark	49.8	51.5	66.4
Germany	29.9	27.6	27.1
Greece	6.7	9.2	22.3
Spain	21.4	33.8	31.7
France	24.0	36.9	36.5
Ireland	28.1	26.9	30.0
Italy	1.0	2.7	18.3
Netherlands	47.5	53.2	46.9
Portugal	7.4	31.7	33.4
Finland	26.5	33.9	35.5
Sweden	25.1	28.9	27.6
UK	23.8	17.6	18.8
EU average	*26.2*	*30.4*	*33.2*

*The replacement rate refers to "benefits before tax as a percentage of previous earnings before tax as defined by the legislated entitlements averaged across the circumstances in which the unemployed person may find himself".
Source: Peter A. Cornelisse and Kees P. Goudswaard, "On the convergence of social protection systems in the European Union", *International Social Security Review*, **55**, No. 3 (2002), p. 8.

Finally, the developments described above might have contributed to an increase in Euroscepticism (see Table 6) since the late 1980s as European citizens started to blame "Brussels" for all major ills, in part because their national politicians were doing the same thing. It is not clear whether the decline in support for the EU is a result of the social "crisis", namely rising unemployment, welfare state retrenchment, and so on. However, it has coincided with the economic recession linked to the fiscal consolidation required by the Maastricht treaty (see Pochet 2002).

Table 6: Support for EU membership

Member states	**1983**	**1990**	**1996**	**2000**
EU membership "a good thing"	54	72	47	50
EU membership benefits my country	52	59	44	47
Applicant countries	–	**1992**	**1997**	**2001**
Support for accession	–	82	48	65

Source: Eurobarometer.

In the *applicant countries of Central and Eastern Europe* liberalisation and opening up to the world market have played a major role in the overall transition to a market economy. This has been accompanied by a strong increase in unemployment, inequality and poverty, although after 1995 poverty and, in some countries, unemployment fell somewhat (Milanovic 1998). The social crisis largely continued even after the post-transition recession had ended. Of course, there has been significant diversity between the countries of the region, with fast reformers (Central Europe) usually performing better than slow reformers (Bulgaria, Romania). Disappointment with transition and integration led, among other things, to a decline in public approval of EU accession in the late 1990s, although it has recovered recently (see Table 6).

To summarise: *Although there is always much diversity between member states, the general trend has been one of high unemployment, decreasing wage shares, mostly increasing inequality and welfare state retrenchment*. But can "Europe" – that is, European integration – be blamed for this dire state of affairs?

2. The impact of market integration

European integration is a complex process that combines market liberalisation with policy harmonisation. In the first aspect, it resembles "globalisation", with more limited scope (member states plus perhaps the associate members) but with a much more radical liberalisation through the Single Market, that has abolished not only tariffs and quotas, but also non-tariff barriers, fiscal and technical barriers, and similar measures, such as subsidies. In this way the EU is trying to promote freedom of movement of goods and services, workers, and capital. Moreover, monetary union has levelled the playing field even more by abolishing national currencies and exchange rates, so exposing national economies fully to external shocks. These developments have been called "negative integration" – by Fritz Scharpf and Wolfgang Streeck, among others – as they remove obstacles to the free play of markets (that is, for consumers, investors, enterprises, and so on). Regarding the second aspect – which might be called "positive integration" – it, too, constrains national policies by setting minimum standards, requiring compliance with EU rules and regulations, and subjecting national decisions to EU control, peer review, benchmarking, and/or the open method of coordination (OMC). Let us consider first the effect of market integration.

Liberalising and opening markets ("globalisation") affects employment and income distribution. However, many people fear that it also leads to a "race to the bottom" in terms of social protection. Let us focus first on different aspects of globalisation/integration that may also function as possible causes of rising unemployment and inequality within the enlarging EU:

- *Trade*: according to classical trade theory, international trade should increase welfare. It does so by fostering specialisation of production, resulting in an increase in productivity. If demand does not increase at the same time, unemployment will increase. Welfare gains can also be distributed differently between the countries participating in the exchange. Moreover, if trade occurs between countries with different endowments of production factors and hence different relations between factor prices (that is, income from utilisation of those factors), trade should increase demand (and hence the price, and so income) for relatively abundant factors and reduce demand for relatively scarcer factors. On the one hand, this would lead to lower wages for unskilled labour in rich countries that have, it is assumed, a greater supply of skilled labour and capital; on the other hand, it would improve the market position and income of highly skilled workers and of capital owners (see Wood 2002). In fact, unemployment and institutional "distortions" of labour market functioning delay and impede these effects.

- *Capital flows*: the impact of "free", that is, more liberalised trade will be reinforced by free movement of capital, in particular foreign direct investment (FDI). Together with international trade, which in any case consists increasingly of the intra-firm trade of multinationals, FDI creates transnational production networks that establish parts of the value-added chain at appropriate locations. Capital will generally look for low-cost and, particularly, low-wage locations with a productivity level which allows for lower unit labour costs. Relocating production to these locations will increase labour demand there and reduce it in the richer (?) investor countries.

- *Migration*: free movement of labour achieves the same effect by means of a "symmetrical" flow of human resources from poor countries with abundant labour to rich countries, also usually with surplus labour but paying higher wages. The increased supply of cheap labour will lead to lower wages, particularly for unskilled workers who have to compete with the immigrants. People may also migrate in order to benefit from better social protection. Without controls, such migration may overburden social security systems in the richer host countries and take pressure off systems in the poorer countries of origin until an "equilibrium" level – probably quite low – of social protection is reached (see Wildasin 1991).
- *Tax competition* may also force governments to collect more and more taxes from immobile (or less mobile) sources such as labour, consumption and property, while reducing the rates on mobile sources, particularly capital and corporations. This bias in the tax regime might contribute to a less equitable secondary income distribution (that is, after taxes and transfers), particularly in real terms given the regressive impact of higher indirect taxes (see Genschel 2002 and Wildasin 2001).

Taken together, these processes should lead to (or even impose) lower real unit labour costs; indeed, the latter have fallen within the EU from an index value of 107 in 1981 to 93 in 2001 (1991=100) (Europäische Kommission 2001). However, that does not imply a decline in real wages. As already mentioned, real wages have generally increased, though this increase sometimes conceals substantial sectoral, regional and employment category differences.

However, each of these potentially detrimental causal relations is disputed by a mass of *countervailing empirical evidence* (Cline 1996; Wood 1994) *and theoretical argument* (Krugman 1996) exculpating globalisation and integration (see Dauderstädt 2002b). Officially registered trade, capital and labour flows, particularly net flows, are often relatively small in comparison to the national income of the countries concerned and cannot explain the effects cited. Most of that exchange occurs among rich countries, above all within the EU, whose wages and regulatory standards do not differ that much. Regarding tax competition, empirical surveys (Ganghoff 2000; Genschel 2002) suggest that this has not occurred on a large scale. Tax authorities have combined the targeting of immobile sources with broadening the tax base; furthermore, immobile factors cannot be overburdened without the risk of pushing them into the shadow economy. Given the increasing need to maintain tax revenues due to high unemployment and aging populations, the relative stability of the tax intake might indicate limits imposed by the fear of tax competition.

Assuming ready adjustment by all workers, enterprises and governments, most negative effects would be transitory and small. Lower prices and/or higher investor incomes should lead to additional demand and so new jobs. However, in the meantime those out of work lose some of their purchasing power and deflationary pressures increase. In the real world of information and transaction costs, hysteresis, "ratchet effects", path dependencies, regulated markets, welfare states and slow learning processes, the effects are more lasting and substantial. Nevertheless, the variety of labour market outcomes among EU member states proves that there is no "iron law" of globalisation leading to unemployment. Even the seemingly more probable trade-off between unemployment and wage inequalities cannot be proven, as the examples of the Netherlands and Denmark show. At least as far as industrial earnings between 1970 and 1992 are concerned, unemployment and inequality were positively correlated (Conceição, Ferreira, and Galbraith 1999). There might, however, be a "trilemma" between wage equality, expansion of the service sector, and fiscal restraint (see Hemerijk 2002).

The main cause of *unemployment* is not international competition but structural change, that is, deindustrialisation. Productivity in agriculture and manufacturing industry has increased much more rapidly than demand for their products, leading to a decline of employment in those sectors. However, this rapid rise in productivity may be partly due to their character as exposed, traded goods sectors. While the surplus rural population of the 1930s–1960s was largely absorbed by the then still expanding manufacturing sector and is now protected by the Common Agricultural Policy, the industrial labour force surplus has to be employed in the service sector, which does not benefit from high productivity increases. Successful countries have, as a rule, either created jobs in public services financed by taxation (typically Sweden) or in a low-wage private service sector (typically the USA). The second option in particular will probably lead to greater inequality and, possibly, poverty if redistributive policies do not intervene.

This leads us to the causes of *welfare state retrenchment*. Again, contrary to widespread assumptions regarding the "malign workings of globalisation", many studies (Iversen 2001; Kitschelt 1999; Pierson 2001; Schwartz 2001; Swank 2002) consider other causes as more probable, such as deindustrialisation, rising unemployment, an aging population, changing family structures, and, most important, institutional legacies and political priorities. Openness to trade is even regarded by many analysts (Rieger and Leibfried 2001; Rodrik 1997; Rodrik 1998) as a cause of welfare state expansion rather than of retrenchment, though even the positive causal relationship has been disputed (Iversen 2001). The welfare state, which commands between 30 and 50% of national income, is a much more dominant influence on the distribution of income and life chances than foreign economic relations. It creates massive vested interests among a large part of the population. In the relatively affluent democracies of Europe, voters will protect these interests and thus the welfare state. So far, a range of political processes have defended the welfare state against new adjustment pressures. This explains the fact that government expenditure in general, and social spending in particular, has barely decreased, despite some retrenchment (see Table 4; see also Pochet and Vanhercke 1999 and Pochet 2002).

In much the same way, income distribution depends less on causes related to the world market than on domestic regulatory and redistributive policies that transform the price system, "distort" competition, protect some industries against new entrants, and limit access to certain skills. The structure of the education system, together with special labour market regulations, determines the skill profile of the labour force. Over time, most developed (knowledge rather than industrial) economies have evolved a symbiotic relationship between specific production and welfare regimes that determines wage and employment patterns (see Estevez-Abe, Iversen, and Soskice 2001 and Freeman and Schettkat 2000).

In the *transition countries of Central and Eastern Europe*, a number of which are also EU candidate countries, the causes of the social crisis are clearer. Here, the shock of trade liberalisation played a major role in increasing unemployment, due to the collapse of the old trade relations within COMECON, while trade with the EU helped these countries to overcome the recession. Inequality and poverty were caused by changes in the price system and by mismanaged privatisation rather than by external shocks. Previously subsidised prices of basic goods and services increased much faster than wages and transfer payments. None the less, social spending also increased as governments tried to mitigate the impact of these changes. In the long run, however, integration could contribute to inequality by locking the countries into a path of low-technology, low-skill specialisation.

To summarise: *Employment, income distribution, and the welfare state might be affected by economic integration and the increasing exposure of national economies to changes in other economies or the world economy. But these external shocks are translated and mitigated by a wide variety of institutions and policies, in short, by the welfare state. Only where political and institutional constellations allowed for radical change, as a rule in residual-liberal, Anglo-Saxon* *type welfare states with centralised majoritarian democracies where the number of beneficiaries is relatively small and less powerful, have there been substantial adjustments (see Huber and Stephens 2001 and Swank 2002). Otherwise, globalisation, and the "negative integration" of European markets as such, cannot be held responsible for the changes described in section 1.*

3. The impact of enlargement

The association and (later) accession of several post-communist countries has integrated a large pool of low-wage labour in the emerging pan-European economy which will affect employment, growth and income distribution through import competition, investment flows, relocation of production and migration. The candidate countries will not reach the levels of income and social security available in the richer countries for a long time (see Tables 7 and 8).

Table 7: Income gap of the accession countries relative to the EU

Country	**Level of GDP per capita in PPP** (EU-15=100)			**Years required to reach 75% of EU-15 average**
	1996	2000	2004	
Bulgaria	25	24	31	31
Czech Republic	65	60	68	15
Estonia	33	38	48	19
Hungary	47	52	64	11
Latvia	26	29	36	27
Lithuania	29	29	35	31
Poland	36	39	45	33
Romania	33	27	33	34
Slovakia	46	48	56	20
Slovenia	66	72	85	1

Source: UN–ECE, *Economic Survey of Europe*, No. 1 (2002), p. 183.

Enlargement adds more potential locations to the integrated European economy that are conveniently close to the industrial core regions of Europe. Moreover, Central and Eastern Europe has structures of income, skills, infrastructure, regulation, industrial relations, and social protection that are (still) very different from those of the present member states. These differences create opportunities for competitive advantage. The combination of lower transaction costs and higher cost differentials in the enlarged Euroland could produce a "globalisation-effect" within the larger Europe that would then exert adjustment pressures that dwarf those traditionally associated with the term "globalisation" and the competition of low-wage countries of the Third World (see Dauderstädt 2002a).

Table 8: Labour markets in the accession countries

Country	Unemployment rate		Average real monthly wage (€)	
	1994	1999	1994	1999
Bulgaria	20.5	17.0	77	65
Czech Republic	4.3	8.7	201	294
Estonia	7.6	11.7	116	217
Hungary	10.7	7.0	267	274
Latvia	18.9*	14.5	109	177
Lithuania	17.4	14.1	68	166
Poland	16.5	15.3	195	286
Romania	8.2	6.8	71	69
Slovakia	13.7	16.2	155	231
Slovenia	9.0	7.6	617	785

*1995
Source: Belke and Hebler, op. cit., pp. 40 and 60.

The *accession of the post-communist candidate countries* could also be seen as a means of reducing the differences between the socio-economic structures there and those in current member states. However, neoliberal critics of the enlargement in particular warn that the "premature welfare states" (to use a term coined by János Kornai) of the transition countries will render catch-up growth difficult if not impossible (see Belke and Hebler 2002). In fact, social spending in the transition countries is relatively high given their level of income.

Table 9: Inequality and social spending in accession countries

Country	Gini index		Social spending 1997 (% of GDP)	
	1987–90	1996–8	Pensions	Health and education
Bulgaria	0.23	0.41	6.2	7.4
Czech Republic	0.19	0.25	8.9	11.2
Estonia	0.24	0.37	n.d.	12.2
Hungary	0.21	0.25	9.4	11.4*
Latvia	0.24	0.32	10.7	9.5
Lithuania	0.23	0.34	7.0	9.7
Poland	0.28	0.33	15.1	11.2
Romania	0.23	0.30	n.d.	5.9
Slovakia	n.d.	n.d.	8.0	10.7
Slovenia	0.22	0.30	n.d.	13.3

*1996
Source: Gini index: World Bank, *The First Ten Years. Analysis and Lessons for Eastern Europe and the Former Soviet Union*, Washington (2002), p. 9; pensions: Nicholas Barr, "Reforming welfare states in post-communist countries", in Lucjan T. Orlowski (ed.), *Transition and Growth in Post-Communist Countries. The Ten-Year Experience*, Cheltenham (2001), p. 186; health and education: EBRD, *Transition Report 2001*, London (2001).

It is not yet completely clear which model or type of welfare state they will adopt. On the one hand, they show the characteristics of the continental type (financing social security by wage-related contributions), while on the other hand, they have established multi-pillar pension systems (Wagener 2002). Labour market flexibility is at the level of the most flexible EU member states (Belke and Hebler 2002:70). Although trade unions and industrial relations are well established in Central and Eastern Europe, they tend to be weak where it counts, namely in the new private sector. Trade unions and defenders of a strong welfare state in the present member states, in particular Germany and Austria, which are more exposed to developments in the East, hope that enlargement will prevent a "race to the bottom" by forcing the new members to adopt higher social standards.

Twelve years of opening up and transition have already created a highly integrated economy across Europe. The share of the EU in the external trade of the applicant countries is as high as it is within current EU member states. The same is largely true of foreign direct investment. Most analysts do not expect dramatic further increases after accession as gravity models of international trade show that the regional structure has already reached the levels to be expected given the geographical distance and relative income of the economies involved (see Dauderstädt 2000). Further strong increases in FDI are not very probable given the fact that privatisation is almost complete. Even successful catch-up growth based on EU regional assistance and strong FDI inflows will probably not reduce inequality in Central and Eastern Europe, though they may help to reduce unemployment, on the example of the unique success story of the Republic of Ireland (see O´Hearn 2001). But such success is hard to imagine for Central and Eastern Europe as a whole. Up to now, only Hungary has shown signs of following that strategy to some extent.

With regard to the present member states, the *effects of accession* and – in the future – enlargement are relatively weak due to the (absolute) small size of the applicant economies. Only particular regions, industries and skill groups in Germany and Austria have been or will be significantly affected (see Quaisser 2000). Eventually, the observations made above regarding globalisation also hold true with regard to the effects of enlargement.

4. The impact of EU policies

The third major cause to be considered is *European integration through common policies* rather than the abovementioned international flows and market processes. The EU has adopted a large body of community law, the *acquis communautaire,* which regulates the internal market, monetary union, and a wide range of other policies. Starting from our assumption that domestic institutions and policies rather than international competition determine social outcomes, the impact of integration on these institutions and policies could be of major importance. National economic and social policy-making is substantially constrained by EU membership. Although the EU certainly does not intend to aggravate the social situation in the member states, its structures and policies might well have that effect, at least indirectly.

- *Single market*: many effects discussed above regarding international economic interaction are exacerbated by the Single Market. The Single Market lowers or eliminates the barriers to trade, capital and labour movements and thus intensifies the competition between locations. However, the EU regulations covering the Single Market prohibit seeking particular types of competitive advantage through lower social protection (for example, regarding health and safety at the workplace), lower environmental standards, or poorer product quality.
- *Monetary union*: the common currency prevents the kind of exchange rate manipulation previously used to correct inflation and productivity differentials between member states. A loss of competitiveness cannot now be corrected by devaluation (thus protecting jobs) either, nor can the income level of successful, but poorer countries converge with the rich countries through the appreciation of their currency. Exchange rate changes distribute ad-

justment costs in a different way from protectionism through tariffs, subsidies or direct income adjustments. They affect other people and allow for some postponement of real adjustment even when, in the end, there is no escape from its painful effects (see Podkaminer 2001 and Orlowsky 2001). The specific policies adopted by the EU through the Maastricht Treaty constrain the fiscal policies of the member states, too (see Genschel 2002). The Stability and Growth Pact limits public deficits and debt, and so prevents or hinders employment policies using Keynesian demand management (see Heise 2002). It may also increase the pressure for budget consolidation, leading to lower social expenditure. According to the statutory bias towards stability, the European Central Bank (ECB) and ECOFIN have already strongly criticised some member states, notably Ireland, because of their above average inflation rate. Such a higher rate of inflation is needed for catch-up growth to reduce income gaps within the currency area (see Dauderstädt and Witte 2001).

- *Competition policy regarding public services*: EU competition policy in general and the Lisbon strategy in particular aim at an EU-wide market for services which – at least in the long run – might include public services that are essential for social welfare. Energy, transport and telecommunications are already affected by stronger domestic and European competition, which has been causing lay-offs in these sectors. Health and education are subject to the most redistributive policies in many countries. The market orientation and privatisation of such services could put low-income users/consumers at a disadvantage.
- *Economic and social policy coordination and harmonisation*: the EEC Treaty of Rome (1957) required some coordination and cooperation regarding social policy (Art.117-122). Acknowledging the competitive effect of many national policies, the EU has introduced regulations to prevent "unfair" competition. In some cases, such regulation might lead to higher standards in previously less regulated countries; but it could also cause a "race to the bottom", albeit a bottom defined by common minimum standards (although these might be lower than some current national ones). The Amsterdam Treaty, as well as the last couple of EU summits (in particular Lisbon, but also the Luxembourg, Cardiff and Cologne processes aimed at reforming social and economic policies), strengthened the EU's role in employment and social policy. Although most competences remained national, the EU will use processes such as the "open method of coordination", "benchmarking", the supervising of national action plans, the setting of targets, and so on, to promote best practice and reforms (see Hemerijk 2002).

Of the abovementioned processes and policies, enlargement, the Single Market, and, to some extent, Monetary Union work in the same way as the market integration dealt with in section 2. The Single Market has removed trade barriers and thus lowered transaction costs. Monetary Union has also reduced the risk of international transactions, in particular exchange rate risks. The latter might be even more important for transnational investment and production decisions than for trade. Taken together, both arrangements will accelerate the creation and deepening of transeuropean production networks whose internal supply-chains are represented as international trade.

As enlargement and Monetary Union reinforce competitive pressures in Europe, EU supranational policies and policy coordination add further pressure and constrain national reactions and adjustment options. The *Maastricht Treaty and the Stability and Growth Pact* not only level the playing field by removing exchange rate risks, but also limit the capacity of governments to deal with the consequences. But are these constraints really harmful, particularly in relation to social justice? There are at least two different views (for more details see Heise 2002 and Pochet 2002):

- The proponents of the Stability and Growth Pact hope that balanced budgets will lower interest rates and thus induce private investment that, in turn, will lead to stronger growth and employment. They do not believe in employment creation through deficit spending because households and enterprises will increase their savings (and reduce consumption and investment) in anticipation of higher taxes and/or in reaction to higher real interest rates. This conservative, neo-classical view would further expect that wage restraint (wage increases below productivity) would alleviate investment and create new jobs.
- The opponents see a bias towards stability that destroys jobs. They assume a Keynesian overhang of savings that private investment will not absorb. Wage restraint would only reduce demand further. A shift from capital-intensive to labour-intensive production can also not be taken for granted. As lower wages reduce all costs and prices, they do so for capital goods, too. Cheaper investment goods will reduce the expected cost advantage of more labour-intensive types of production.

Actual development over recent years supports the view of the opponents rather than the proponents but interpretation can obviously only be uncertain. The true indicator of success must be long-term growth in output and employment. The national long-term success stories (Netherlands, Denmark, UK, Sweden, Austria, Ireland, Portugal) are not conclusive. Although it is striking that three of these countries did not join Euroland, others have done so and have managed to achieve low unemployment. Ireland and Portugal might be discounted as high-growth peripheral countries benefiting from special circumstances (large foreign direct investment, falling interest rates, EU funds), but Austria and the Netherlands have adopted different strategies with strong employment growth in the latter and stable employment in the former.

Competition policy will possibly affect the welfare regimes in member states more profoundly. Competition policy determines structures of relative prices in the long run. Falling prices in more competitive sectors usually imply lower incomes, or at least stronger pressure on wages and profits which push productivity growth. In the end, more contested markets might be a source of unemployment and inequality, at least in the short run (see Schwartz 2001). In the long run, higher real incomes can shift demand towards new sectors and spurn growth. Different EU countries rely to different degrees on public services in order to ensure public welfare, particularly as regards insurance, health and education. In all sectors, clients/consumers rely increasingly on complementary private services and products. Those markets are already contested across Europe, as the corresponding public services will be, too, to the extent that they are privatised and deregulated. On the supply side, this can imply poorer working conditions and lower wages; on the user side, temporal and spatial coverage can also suffer with stronger regional inequalities and lacking surge capacities to cope with larger-scale emergencies such as epidemics or terrorist attacks. These "market failures" have to be corrected by regulation which in turn increases costs and puts the providers at a competitive disadvantage. If prices increase, poor clients will no longer be able to enjoy the full range of services.

Since these welfare-related policies are so sensitive they still belong overwhelmingly in the realm of national competences. But some European competences have always been subject to the Single Market. However, the coordination methods used by the EU provide for a strong role for the social partners (Art. 139) and the member states (open method of coordination or OMC). The OMC is theoretically open to civil-society involvement within the member states when targets are determined, quantitative benchmarks defined, National Plans of Action designed, and compliance checked. Generally, the EU has strengthened its role in the field of social and labour market policy, and this EU involvement has promoted social security and the participation of social partners, in particular workers. In the eyes of critics, these measures have increased costs and reduced flexibility. Their extension to the poorer new member states of Central and Eastern Europe is intended to protect the rigid labour markets and production systems of the old EU against competition from the candidate countries (Belke and Hebler 2002). In the eyes of trade unions and other sceptics (Streeck 1995), these policies constitute too low a barrier against the dynamic of a "race to the bottom" promoted by market integration. An additional dimension is the harmonisation of social security systems in the context of the free movement of workers, which should entail transferability of social entitlements.

The most important redistributive EU policies are the *Common Agricultural Policy* (CAP) and *cohesion policy* (that is, structural, regional and cohesion funds) that together account for about 80% of the EU budget. In the end, CAP has benefited mostly the richest and biggest farmers, ensured high prices and not prevented poor quality. Cohesion policy has not been able to prevent increasing regional disparities. Less divergence between poor and rich member states, in itself more due to the effects of Monetary Union than EU regional policy, has been accompanied by stronger disparities within member states (Dauderstädt 2001).

5. The complex interaction between economic integration and national strategies

National strategies are often less conscious choices between different options than the consequences of past choices, made under different circumstances, which exert a "ratchet effect" (Huber and Stephens 2001) through specific institutional arrangements and political coalitions. Regarding social justice, employment and inequality, the most important past choices concern the type of welfare state and production regimes (see Hall and Soskice 2001; Huber and Stephens 2001). They have led to different exchange rate and monetary policy regimes, distributions of productivity gains, labour market regimes, industrial relations, mixes of public and private supply of social services, and financing models for the welfare state. Add to these differences the more basic ones of structure of trade and production.

The socio-economic outcome is the result of a complex interaction of integration processes and these national adjustment regimes. The external causes (globalisation, European integration) create challenges that are different in the various countries because of different economic and social structures, policy legacies and power constellations. Oil price shocks affect Austria quite differently from oil-producing UK or nuclear France. The challenge of low-wage competition affects the countries with substantial tradable sectors if they are not exclusively focused on high-tech, high-price segments. Disinflationary policies are harder to swallow in countries like Greece or Italy than in traditionally hard-currency, tight-money countries such as Germany and Austria. Some problems are exacerbated by domestic developments as in the case of German unification which upset traditional West German policies completely.

Regarding social justice and inclusion, the most important structural differences between EU member states are their *different welfare states*. Following Esping-Andersen and others (Esping-Andersen 1990; Merkel 2001; Scharpf and Schmidt 2000), one usually differentiates between three types of welfare state: the Scandinavian or universalistic, the continental, and the Anglo-Saxon or marginal. They have different traditions of coverage, entitlement, funding and organisation. In the Scandinavian system, all citizens are entitled to coverage, social protection is financed by taxation, social services are run by the state and the participation of women in the labour market is high. In the continental system, benefits are linked to employment and families, and financed by contributions based on wages. The Anglo-Saxon system provides protection only for the poor and expects the rest to look after themselves by using market-oriented services. These systems have been variously affected by the challenges of globalisation and integration (see Scharpf and Schmidt 2000).

- *Employment and labour market policy*: hardly any member state was able to break the decline in employment in the exposed tradable sector, although the rates of decline varied – with the Netherlands and Denmark in relatively favourable positions (see Hoffmann and Walwei 2002; Walwei and Werner 2002). The Netherlands managed to reduce unemployment to a large extent by keeping wage rises under control (Wassenaar agreement) and by expanding part-time work. In common with Germany and France, it also resorted to early retirement in order to reduce the labour supply. France additionally reduced the working week to 35 hours. High employment in public services helped to keep unemployment relatively low in Sweden and Denmark. Making labour markets flexible fostered the creation of new jobs in the service sector, particularly in the UK. Unemployment benefits are tied to readiness to enter additional training schemes and/or accept jobs which are less well paid or located further away.
  Some effects can be seen in Table 10. They illustrate the trade-offs between income and employment and between employment and social protection. Getting people out of the labour market by means of generous social policies makes it possible for the remaining active workers to demand high wages. High wages require high productivity but the number of such jobs might be low.

Table 10: Productivity, work and incomes in Europe

Country	(1) GDP per hour worked	(2) Hours worked	(3) Unemployment	(4) Labour force as a % of working age population (15–64)	(5) Working age population as a share of total population	(6) GDP per person (1 to 5)*
Belgium	128	–5	–3	–19	–1	101
Denmark	92	0	1	9	1	103
Germany	105	–5	–3	–4	2	96
Finland	93	0	–7	2	0	88
France	123	–9	1	–6	–9	97
Greece	75	–4	–2	–11	1	58
Ireland	108	5	–4	–12	–3	95
Italy	106	–11	–5	–1	2	91
Netherlands	121	–26	2	–4	2	96
Austria	102	–4	3	–2	1	100
Portugal	56	2	0	1	1	60
Spain	84	13	–14	–13	2	71
UK	100	–9	0	3	–2	92
EU	103	–5	–4	–4	0	90
USA	120	–1	3	9	–2	128
Japan	82	10	4	6	4	106

* Values in columns 1 and 6 refer to the OECD average (=100); adding the values of column 1 through 5 gives the values of the last column.
Source: Bert van Ark und Robert H. McGuckin, "International comparisons of labor productivity and per capita income", in *Monthly Labor Review* (July 1999), p. 36.

- *Social policy*: most countries tightened eligibility criteria and reduced benefit levels for welfare payments. By doing this, they intended also to increase the gap between low wages and welfare benefits and create stronger incentives to accept low-paid jobs. Germany subsidised the pension system in order to limit social security contributions and thus non-wage labour costs. Pension reforms started to tighten rules on eligibility for disability pensions, as well as on early retirement. The retirement age for women has been increased with a view to equalisation with the male retirement age. Germany introduced a second pillar of state-subsidised capital-funded insurance. Most countries introduced measures to control health expenditure.

- *Tax and fiscal policy*: tax systems still vary substantially in Europe. Total tax revenue (as a percentage of GDP) has remained relatively stable although total state expenditure declined from 51.4% in 1995 to 45.8% in 2000. This reflects lower budget deficits in preparation for Monetary Union. Some countries introduced energy taxes, for example, Germany. Top rates on personal income and statutory corporate tax rates were lowered in many countries. The tax systems of Central and Eastern Europe add still more diversity, although the composition of their revenue sources is already relatively similar to that of the EU (see Table 11).

Table 11: Structure of state revenues, 2000 (% of GDP)

Country (EU-15)	**Current revenues**	**Indirect taxes**	**Direct taxes**	**Social security contributions**	**Other current revenue**
Belgium	49.0	13.0	17.5	15.9	2.7
Denmark	56.2	**17.3**	**29.6**	**3.5**	**5.8**
Germany	45.8	12.3	12.0	18.5	3.0
Greece	41.1	14.8	**8.7**	13.8	4.1
Spain	38.8	**11.9**	10.3	13.1	3.5
France	48.9	15.5	11.9	**18.4**	3.7
Ireland	**34.7**	13.9	13.3	5.7	2.5
Italy	45.4	15.3	14.6	12.6	3.2
Luxemburg	45.3	13.3	16.4	11.5	4.9
Netherlands	43.4	12.2	11.8	16.9	4.7
Austria	47.6	15.4	12.7	16.9	3.4
Portugal	44.3	16.0	10.8	12.6	4.5
Finland	50.9	14.0	18.8	13.0	5.7
Sweden	**57.5**	14.8	21.3	16.6	5.6
Great Britain	39.2	13.7	16.2	7.5	**2.0**
EU-15	**44.6**	**13.8**	**13.8**	**14.4**	**3.3**
Country (Central and Eastern Europe)	**Total current revenue and grants**	**Indirect taxes and customs duties**	**Taxes on income, profits and capital gains**	**Social security contributions**	**Non-tax revenue**
Bulgaria	42.1	13.8	6.9	11.2	**8.2**
Czech Republic	39.4	12.6	8.9	**14.7**	2.5
Estonia	35.4	13.0	8.7	9.9	3.3
Hungary	**45.0**	15.7	**9.4**	12.8	5.6
Latvia	35.0	11.9	7.7	10.7	3.0
Lithuania*	**31.5**	12.5	9.3	**6.8**	**1.7**
Poland*	40.3	13.2	7.9	11.3	6.5
Romania	31.4	**11.4**	**5.9**	10.9	1.9
Slovakia	36.2	13.0	7.6	11.2	3.7
Slovenia	42.5	**15.9**	7.7	13.7	2.4
CEE-10	**37.9**	**13.3**	**8**	**11.3**	**3.9**

*1999; bold figures indicate max and min values in each column.

Source: EU: Eurostat; CEE: UN-ECE, *Economic Survey of Europe*, No. 1 (2002), p. 61.

According to an analysis by Wolfgang Merkel (Merkel 2001), the outcome regarding social justice, differentiated in accordance with specific welfare state systems, has been best for Scandinavian welfare states and worst for Anglo-Saxon welfare states, though with substantial differences regarding different dimensions of welfare such as poverty, education, employment, social spending and income distribution (see Table 12).

Table 12: Ranking of welfare state systems according to social justice (values indicate deviations from international averages)

Type of welfare system	Poverty	Education	Employment	Social spending	Income distribution	Average
Anglo-Saxon	–0.3	–0.1	0.0	–0.3	–0.3	–0.2
Scandinavian	0.2	0.4	0.2	0.1	0.3	0.2
Continental	0.1	–0.2	–0.1	0.2	0.1	0.0

Source: Wolfgang Merkel (2001), "Soziale Gerechtigkeit und die drei Welten des Wohlfahrtskapitalismus", in *Berliner Journal für Soziologie*, **2** (2001), pp. 135–57.

In the end, the various member states weathered the challenges of the 1990s, but with *very different outcomes*. Even an apparent failure with regard to unemployment, such as Germany, looks quite different if one focuses on equality, which is quite high in Germany thanks to low wage differentials. In the 1990s, low unemployment seemed to be more difficult to achieve without sacrificing equality, although redistributive measures such as earned income tax credits, negative income tax, lower rates of social security contributions or wage subsidies can improve the lot of the "working poor". Politically, however, the search for scapegoats is now on. Governments unable to implement reforms tend to blame globalisation, global recession or Brussels for negative developments. While there is always at least an element of truth in this, the "whole truth" must include national public policies, not to mention societal attitudes, preferences and blocking tactics.

Very often, the real and *basic distributional conflicts* are quite simple. Higher social or environmental standards, earlier or easier retirement, generous leave rules and other "social goodies" reduce real national income by reducing either productivity or total labour input. These losses can be compensated by productivity growth due to the same processes (for example, firing or retiring the least productive workers) or other factors. But, all things being equal, somebody has to accept the loss. These losses can be allocated through inflationary processes, devaluation, public distribution of subsidies and taxes or direct nominal income changes. European integration prevents some of these types of adjustment. Within Euroland, inflation, devaluation and subsidies to producers are no longer an option. The remaining adjustment mechanisms are direct changes in nominal income, usually mitigated by redistributive policies (progressive tax regimes and social transfers).

6. Prospects, policies and politics in the enlarging Euroland

The currency union in combination with the Single Market has created a "level playing field" within Europe that will be extended to Central and Eastern Europe. But on this level playing field *very different national players* meet with different levels of income, endowments, preferences and strategies. With the accession of post-communist countries, these differences will substantially increase. Their per-capita income is lower, their social aspirations have been formed by decades of imposed egalitarianism (Delhey 2001), and their social and tax systems have only recently been reformed to cope with the new market economy, transition and integration. The resulting competition can be healthy for the purpose of improving national solutions and finding innovative responses to common challenges. But it could also turn out to be political dynamite when important social groups perceive that their interests are being endangered by European policies or rules. The rise of right-wing populism in some elections in Europe (Austria, the Netherlands, Denmark), with its attendant Euroscepticism, is one example of such a trend that is even more worrying because it has affected countries with relatively successful employment and social policies (see Ehrke 2002).

On the national level, the result of a more competitive environment and limited national sovereignty could be a *convergence of economic and social policies*. Up to now, convergence of social protection levels has been weak and mainly due to the expansion of social security in the poorer countries (Cornelisse and Goudswaard 2002). The traditional diversity of European welfare states may no longer be viable. The continental system could be forced to shift to tax-based social security in order to reduce labour costs. Scandinavian systems might be forced to lower the share of the state or at least to open up the system of public services to competition. Harmonising social policies would also ease the free movement of labour while at the same time discouraging migration in search of the best welfare-benefit deal. Pension systems will increasingly be integrated in euro capital markets. Obviously, such adjustments will be strongly rejected by national constituencies which fear (possibly with justification) income or entitlement losses. The political economy of social policy reform in welfare democracies makes radical changes very difficult, although they might be easier in some politico-institutional environments (for example, Westminster-style systems) than in others.

Sensibly, the EU has mostly chosen to adopt a loose coordinating and supervisory role in its approach to employment and social policy. The exceptions here are Monetary Union, with its centralised monetary and exchange rate policies and fiscal policy coordination, and the applicant countries, which are under much greater pressure from the EU to adopt particular structures and policies in order to conform with the *acquis communautaire*. After accession, however, these states will (re-)assert their national interest much more forcefully. Let us consider some central policy areas:

- *Monetary and fiscal policy*: EU monetary and national fiscal policies should target growth and employment as goals of equal importance with price stability. The size of the state, that is, the share of public revenue and expenditure in GDP, should remain a national decision. Expansion of demand in line with productivity growth should not be hindered by restrictive monetary policy. Higher inflation in poorer countries should be tolerated, as should higher budget deficits, when these are used to finance public investment. Flexibility has already provided for a variable geometry in the present EU regarding monetary integration. Accession countries should benefit as soon as possible from the reduced risk that comes from joining EMU, while being protected from excessively narrow constraints likely to hinder catch-up growth. The coordination of monetary, fiscal and incomes policy between member states and the relevant actors (ECB, governments, social partners) must ensure that the macroeconomic conditions for growth and unemployment are at least present, though they may not be sufficient to create the desired results.
- *Employment policy*: target levels of employment should be determined by national governments, parliaments and/or social partners. It is up to each society to decide if it wants to translate productivity growth into more output and higher income or less labour input. If they choose less labour input this reduction can again be distributed in various ways, such as shorter working hours, earlier retirement, or higher unemployment. The choice of higher

output requires higher demand that in turn has to be accommodated by macroeconomic policies, including wage and incomes policy.

- *Social policy*: in the case of earlier retirement or higher unemployment, income and leisure are redistributed and additional income transfers are required from the employed to the unemployed or retired. In continental welfare systems, this can lead to an "inactivity trap" where higher non-wage labour costs drive productivity growth and labour shedding (see Hemerijk 2002). Again, the EU should not get involved in these issues.
- *Competition policy*: exposing national enterprises to international or Europe-wide competition requires particular levels of productivity and wages in order to achieve unit labour costs more or less equal to those of major competitors. If national enterprises have been protected through trade and entry barriers (at the expense of the consumer) or through subsidies (at the expense of the taxpayer) they will have to adjust. Without fundamentally changing distributional patterns subsidies could be shifted towards the affected employees.
- *European redistributive policies*: a vigorous debate is already going on regarding the renationalisation of agricultural, structural and regional policies by limiting the transnational redistributive element. In the context of enlargement, reforms that make regional policy more effective are becoming very urgent (see Dauderstädt 2001). A radical alternative would consist of an "American Cure" introducing a European Social Security System, a progressive tax system including negative taxes, a European minimum wage and a growth-oriented monetary policy (see Conceição, Ferreira, and Galbraith 1999).

More flexibility could, however, distort the "level playing field" by offering some players more choices than others. It could even increase competitive pressures and undermine the whole integration process if more common policies come under fire. Critics of the flexible approach of the *open method of coordination* (OMC) fear that it will maintain the bias towards regime competition and therefore demand stricter supranational rules to protect society against the market (see Scharpf 2002). Another option could be still deeper integration. That would require a stronger EU "superstate" that not only regulates European markets and limits national choice, but is also able to alleviate the potential negative effects. Above all, this would require more resources, namely a larger EU budget that allows larger financial transfers to poorer or the most affected member states. This would imply another big step towards a federal Europe. It would also involve a significant redistribution on a European level which would certainly be met with hostility by the richer net contributors to the EU budget.

There are two basic justifications for the EU's supranational involvement in all these policy areas: first, the interdependence of action and outcomes across borders, and secondly, the cross-border enforcement of common European norms and values:

1. *Interdependence*: as argued above, interdependence, in particular the alleged harmful power of "globalisation", is often overestimated. In most cases, national societies would be worse off without international economic relations or integration. However, general welfare gains are usually accompanied by a new distribution of income and life chances between winners and losers. Welfare states usually take care of the losers and thus contribute to the realisation of overall benefits by easing the consequences of openness and liberalisation (see Riegel and Leibfried 2001). The painful adjustments in fact concern less the substance of income changes than the permitted mechanisms of adjustment and redistribution of gains and losses throughout the economy (tariff and non-tariff protection, devaluation, subsidies, and so on). If voters feel that their prosperity is threatened by integration, the already weakening support for European integration could be further undermined. It does not matter much whether that feeling is justified or merely the result of scapegoat strategies pursued by national governments or other players (see Pochet 2002).

If the citizens feel that the necessary adjustments might even require a change in such deep-rooted structures as national welfare or political systems, the arising conflicts could strengthen not only populist but also nationalist forces.

2. *Common European values*: the EU Treaties define a number of common goals, such as social cohesion, solidarity, and social progress (preamble and Art. 2 of the TEU). The Charter of Fundamental Rights has codified many social rights in Chapter IV on "Solidarity" (Art. 27–38). But the interpretation of those values and compliance differ significantly among national governments and other societal actors and in fact constitute a disputed issue. Compliance can be assured by different means (see Börzel and Risse 2002): In a "liberal-institutionalist" perspective, the legitimacy of the values can be assured by specific procedures of adoption, by embedding them in legitimate institutions, by making them enforceable by national law and by convincing the relevant actors. In a "realistic" perspective, compliance with possibly costly rules depends on the degree of surveillance and sanctions, the administrative and political capacity of states, the autonomy and power of political systems vis-à-vis societal actors and the relative power of the winners over the losers.

Given the fact that social justice is a highly contentious concept, particularly in an international context where winners and losers in the same game might be distributed across different nations – at least in appearance – politics play a decisive role. The current constitutional debate (Convention) in the EU is to a large extent concerned with the *power and legitimacy* of the institutions, procedures and decisions that affect the distribution of wealth, income and life chances within the enlarged union. The new members of Central and Eastern Europe will add a new dimension to the already complicated mix of welfare and production regimes in the EU. As already mentioned, they are at the same time more egalitarian in their aspirations (Delhey 1999) and economically and administratively less able to fulfil the expectations of their people. Hopes and fears in the applicant countries regarding the impact of EU membership on welfare and distribution are running high. The EU is trying to ensure the compliance of the applicant countries by using involvement (political dialogue, participation in the Convention) and aid to build capacities (PHARE and other programmes), as well as monitoring (screening) and sanctions (aid cuts, delayed accession).

In the end, *politics will be decisive*. There will not only be real winners and losers, but also those who consider themselves as belonging to one group or the other. Parties, media, and societal organisations shape those perceptions and organise the respective interests. The structure of political systems (electoral law, division of powers, centralism, and so on) will then determine which interests eventually shape political decisions and the design and outcome of policies. As past policies have already created powerful vested interests within the different types of welfare state, it is not probable that a common model will emerge through convergence (see Ebbinghaus 1999; Swank 2002). Continued and increasing diversity requires flexible institutions and procedures of integration in order to avoid widespread discontent and the revival of nationalism.

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Ulrich Walwei and Heinz Werner °

Back to Work: The Renaissance of the Dutch Labour Market

Compared with its main world trading partners, the USA and Japan, the European Union still has a huge employment problem. In terms of employment rates fewer Europeans than North Americans are in work – Europe also does less well in respect of unemployment.

However, comparisons of this kind hide the fact that the labour markets of the EU member states are far from being homogeneous. It is mainly the bigger countries (Germany, France and Italy – but not the United Kingdom) which face continuing employment problems. The importance of these countries within the EU makes them key contributors to the unfavourable situation of the European labour market as a whole. Notwithstanding these three "problem children", however, the European Union also has some remarkable success stories. EU member states such as Denmark, the Netherlands, the United Kingdom and the Republic of Ireland have managed to increase employment and sharply cut the number of those out of work. In-depth analysis of these "winners" confirms that an upturn in employment is not a pipe dream, but is in principle possible for other countries as well.[1]

Whereas the American way does not seem to be feasible for most European countries because of its negative consequences – such as an extremely unequal distribution of incomes – the Netherlands has probably found a European answer. The labour market results are remarkable: it is obviously possible to avoid the downside of US-style capitalism. The reforms were made with the agreement of the social partners and were accepted by broad sections of the population. It is therefore worth taking a look across the border and investigating what is behind this "employment miracle".

The paper begins with the development and structure of unemployment and employment. This is followed by a short account of the relationship between economic growth and employment and an overview of the reforms that have contributed to the success of the "Polder Model". Then the significance of the institutional framework for the upturn in employment in the Netherlands is discussed. Finally, the paper attempts to draw conclusions concerning the institutional aspects of the reform approach and its transferability.

1. Employment and unemployment in the Netherlands

Table 1 shows the development of economic growth, employment, and the unemployment rate for the Netherlands, Germany and the EU-15. For some time into the first half of the 1990s the economic indicators for Germany were no poorer than those for the Netherlands, but the Netherlands has always had a higher level of employment growth. The two countries did not begin to

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1 On this issue see Mitteilungen aus der Arbeitsmarkt- und Berufsforschung No. 2/1998, subject focus "Strategien für mehr Beschäftigung Internationale Erfahrungen" [Strategies for more employment – international experiences] and a series of country reports on the respective labour market situations under <www.iab.de>, in the series "IAB-Kurzberichte" (full text for downloading); Ulrich Walwei, Heinz Werner, and Ingeborg König 2001, "Lessons we can learn from other countries", IAB Topics No. 44 (for download from <www.iab.de>).

develop in opposite directions until the early 1990s as regards unemployment and employment. Moreover, the outlook for the Netherlands is still considered to be considerably better than for Germany, as the table shows.

Table 1:
Economic growth and development of employment and unemployment rates

	1986–1990	1991–1995	1996–2000	2000	2001*	2002*	2003*
	Netherlands						
Real GDP growth	3.3	2.1	3.7	3.5	1.1	1.5	2.7
Employment growth	2.3	1.1	2.6	2.4	2.1	0.6	0.9
Unemployment rate	7.4	6.1	4.1	2.8	2.4	3.0	3.5
	Germany**						
Real GDP growth	3.4	2.0	1.8	3.0	0.6	0.8	2.7
Employment growth	1.5	–0.1	0.7	1.6	0.2	–0.3	0.8
Unemployment rate	5.9	6.6	8.9	7.9	7.9	8.3	7.9
	EU-15						
Real GDP growth	3.3	1.6	2.6	3.3	1.7	1.5	2.9
Employment growth	1.4	–0.4	1.3	1.8	1.2	0.3	1.0
Unemployment rate	8.9	9.7	9.6	8.1	7.6	7.8	7.5

* 2001–3 estimates.
** Until 1991–2 western Germany only.

Source: European Commission (2002).

Unemployment

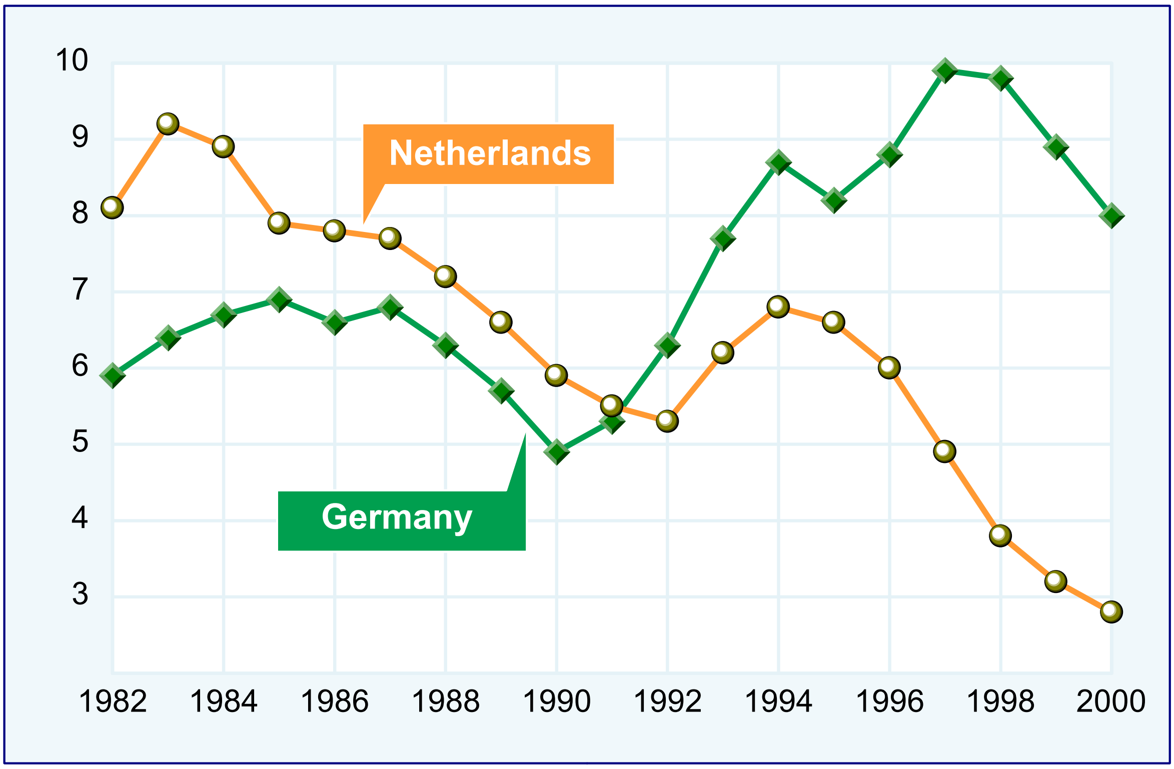
At the beginning of the 1980s the Netherlands had one of the highest unemployment rates among the European industrial nations. It was considerably higher than that of the Federal Republic of Germany (Figure 1). Subsequently, the Dutch rate dropped steadily until the early 1990s and, after a brief increase in 1994, has continued to fall ever since. At the current rate of below 3%, full employment has almost been achieved. This low unemployment rate is forecast to continue.

As regards the structure of unemployment it should be pointed out that the unemployment rates of Dutch women – as in most EU countries – are higher than those of men. Moreover, although youth unemployment in the Netherlands fell in parallel with the general decline in unemployment, it is still almost twice the level of average unemployment. In contrast, the unemployment rate of older workers has improved.[2] It must also be mentioned that the low-skilled and people belonging to ethnic minorities are affected by unemployment to a disproportionate extent. It can

2 This can be attributed, among other things, to early withdrawal from the workforce as a result of incapacity to work and early retirement. Both have been resorted to on a large scale in the Netherlands. See the remarks on the concept of the "broad unemployment rate" below.

also be observed that long-term unemployment (for a year or more) has remained high, at about 50% of total unemployment, and is becoming concentrated in particular groups of people who can only be placed in employment again with difficulty.

Figure 1:
Unemployment rates in the Netherlands and in Germany,*1982–2000 (%)

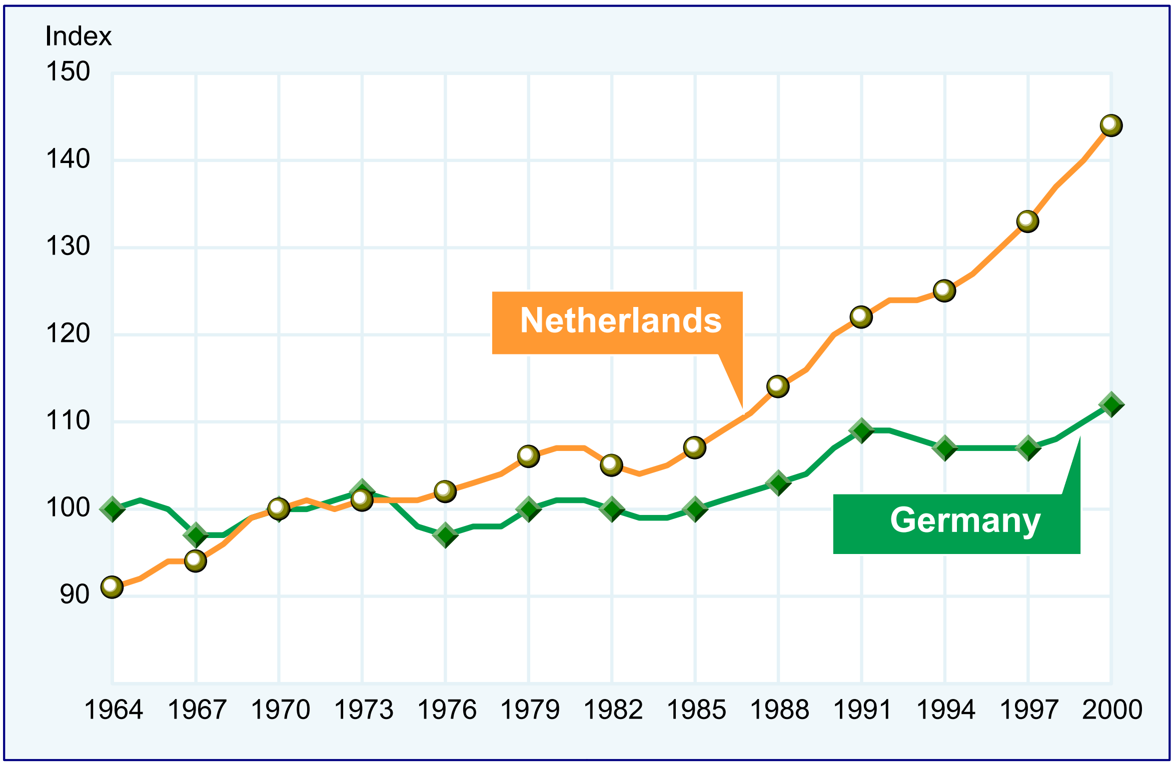


*from 1991 including eastern Germany.
Source: Eurostat, *Labour Force Survey*, various years; OECD, *Quarterly Labour Force Statistics 1/2002.*

Employment

Between 1983 and 1993 the Netherlands showed the highest employment growth among the countries of the European Union, with an annual average of 1.8% – this was exactly the same growth rate as the USA's for this period. After a slight dip in 1993 (–0.1%) the Netherlands subsequently achieved employment gains of more than 2% once again. The development of employment for the Netherlands and (western) Germany can be seen in Figure 2.

Figure 2: Employment in the Netherlands and in western Germany,1964–2000

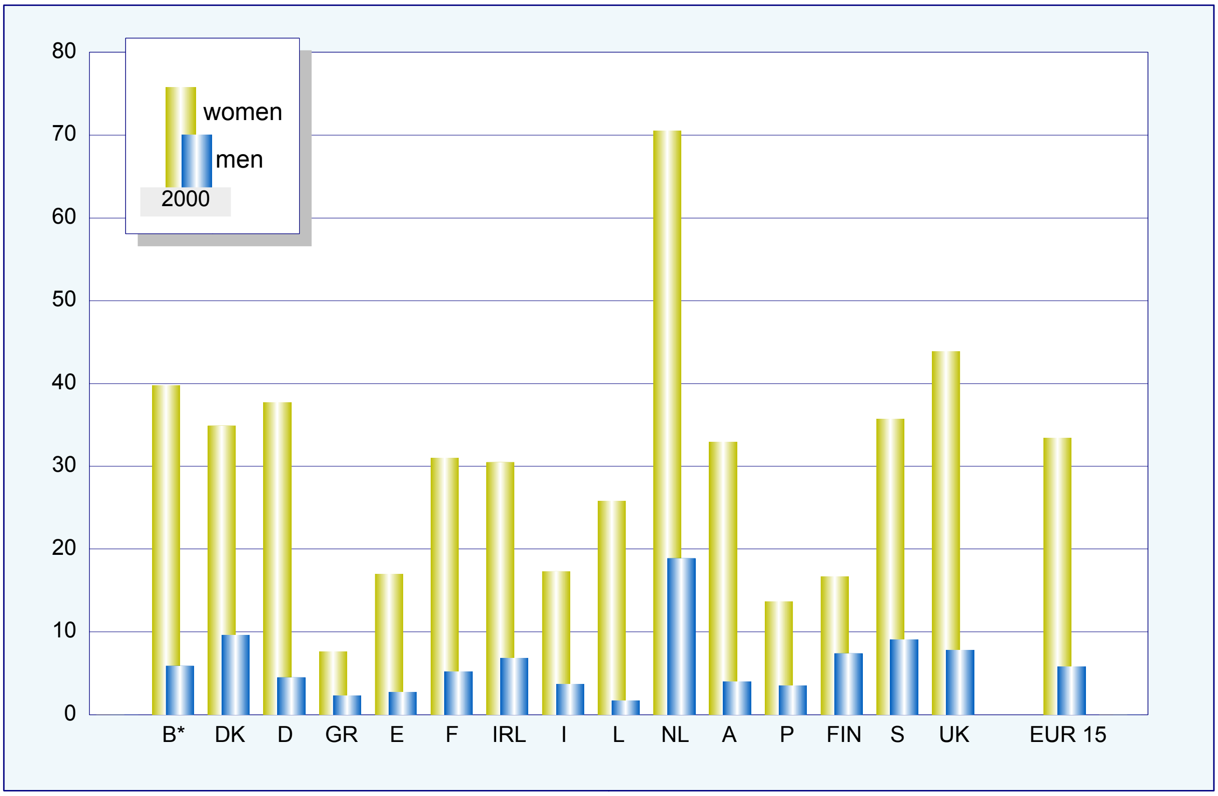


Index values, 1970=100
Source: OECD, *Labour Force Statistics*, various years; Centraal Bureau voor de Statistiek; own estimates for western Germany.

With a 41% share of the labour force in 2000 the Netherlands has by far the highest rate of part-time work in the Western world. Figure 3 shows the part-time rates for the 15 EU states. Almost 70% of all working women and nearly one-fifth of all men are in part-time employment. Since 1973 there has been an almost astronomical rise in the proportion of part-time work, increasing by more than 35 percentage points. This development was encouraged by the dynamic development of the service sector (with an employment share of 74%) and by the need to 'catch up' as regards female employment. Changes in the behaviour and preferences of the actors on the labour market were even more decisive than changes in the structural composition of the labour force (for example, by gender or sector) in explaining the dynamics of part-time employment in the Netherlands (see Walwei and Werner 1995: 365pp). The example of the Netherlands shows that what matters in the promotion of part-time work is not so much special support from the state (however: exclusion of discrimination),[3] but more a change in the attitude to part-time work on the part of everyone, employers, trade unions and society alike.

3 Dutch labour legislation has always been as neutral as possible with regard to working time. Part-time and full-time workers are treated as equal in legal terms. See Act on Part-time Employment in: European Commission 1996: 21.

Figure 3: Part-time rates in the EU states by gender, 2000 (%)



Belgium: only employees.

Source: Eurostat, Labour Force Survey 2000.

It is necessary to add that the part-time work is mainly performed voluntarily, in other words by those not seeking a full-time job. In 2000 only 3.5% of all part-timers were working part-time involuntarily. This is the lowest percentage of all the EU countries (Eurostat 2001:140–1). In the Netherlands it is not rare for well qualified workers, too, to work part-time. What is striking, however, is that the proportion of "marginal" part-time workers (fewer than 10 hours per week) is, at 25%, particularly high.[4] These workers are therefore probably already safeguarded elsewhere as regards subsistence or social insurance (via study/vocational training, by their spouse or receipt of social benefits).[5]

Against the background of the considerable increase in part-time employment it is interesting to examine the volume of work done. After all, it could be argued that employment growth – which is usually counted by the number of persons – is based above all on the expansion of part-time work and less on the creation of more employment. In these terms the employment success of the Netherlands would have to be relativised considerably. However, Figure 4 shows that the volume of work in the economy as a whole has also increased constantly.

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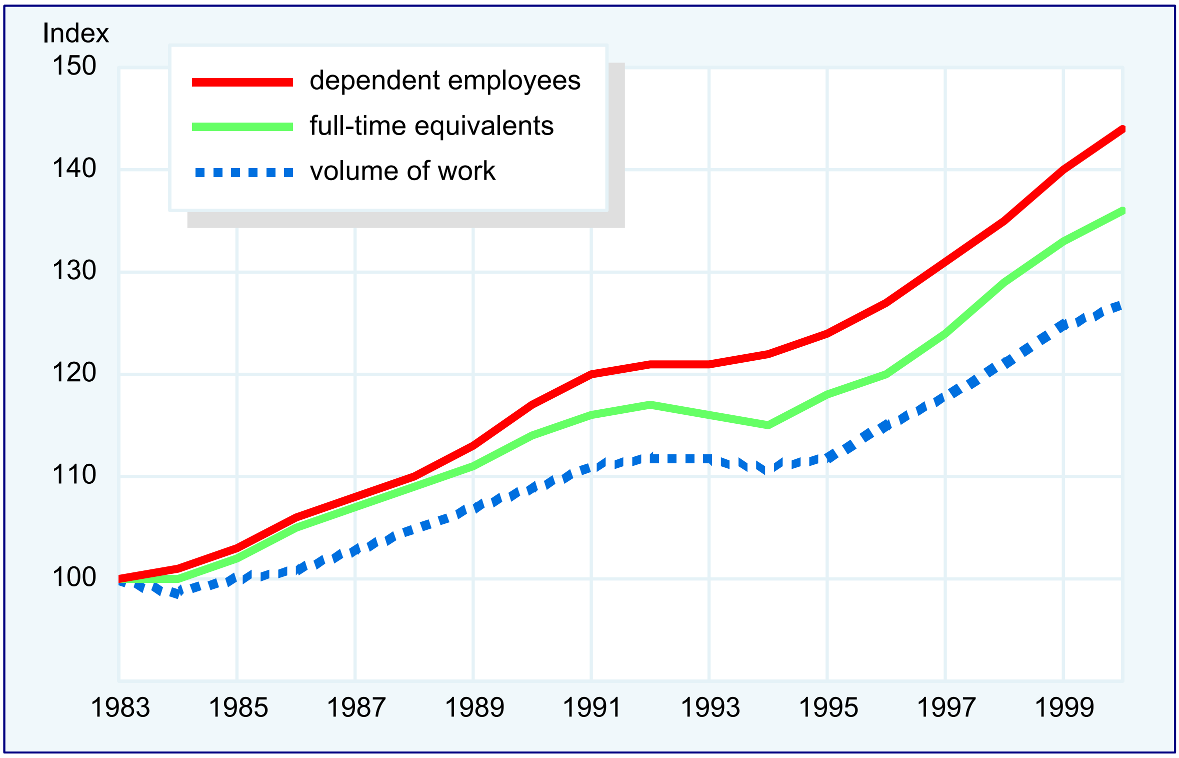
4 In Germany this proportion for 1998 was 15%. However, surveys such as the Socio-Economic Panel or the studies conducted by the Institut für Sozialforschung und Gesellschaftspolitik (Institute for Social Research and Social Policy) or also the IAB establishment panel find considerably higher values for so-called "marginal" part-time employment than the Eurostat microcensus used here. See: Kohler, Rudolph, and Spitznagel 1996.

5 What is certain to contribute to the large spread of these jobs with short working hours is the possibility to work a certain number of hours per week while continuing to receive social benefits in full (invalidity benefit, retirement pension).

Figure 4: Dependent employment in the Netherlands: employees, full-time equivalents and volume of work – index values (1983 = 100)



Source: Centraal Bureau voor de Statistiek.

A comparison of labour force participation rates is also revealing. Until the late 1980s, the Dutch male participation rates ran almost parallel to the German rates, having started out from a level that was about 4% lower (Figure 5). However, the downward trend in the Netherlands stopped in the 1990s; in fact, it even reversed, with the result that now the Netherlands shows higher labour force participation among men than Germany does. In comparison, the labour force participation rates of women in the Netherlands were far behind those in Germany at the beginning of the 1980s, although it must be noted that by international comparison Germany's rates are 'mid-table'. As is evident from Figure 5, Dutch women have in the meantime caught up with their German counterparts. The immense increase in employment can therefore be explained above all by the increasing economic activity of women – especially in part-time employment.

If one compares labour force participation rates by age group (Figure 6) it becomes clear that in the Netherlands older people have a decidedly low participation rate. This is associated with the various programmes aimed at older people's withdrawal from the labour market (for example, due to early retirement or invalidity). The reverse is true of young people, whose labour force participation rate is considerably higher. This indicates that young people work in addition to training.

Figure 5: Labour force participation rates in the Netherlands and in Germany, Men and women, 1980–2000 (%)

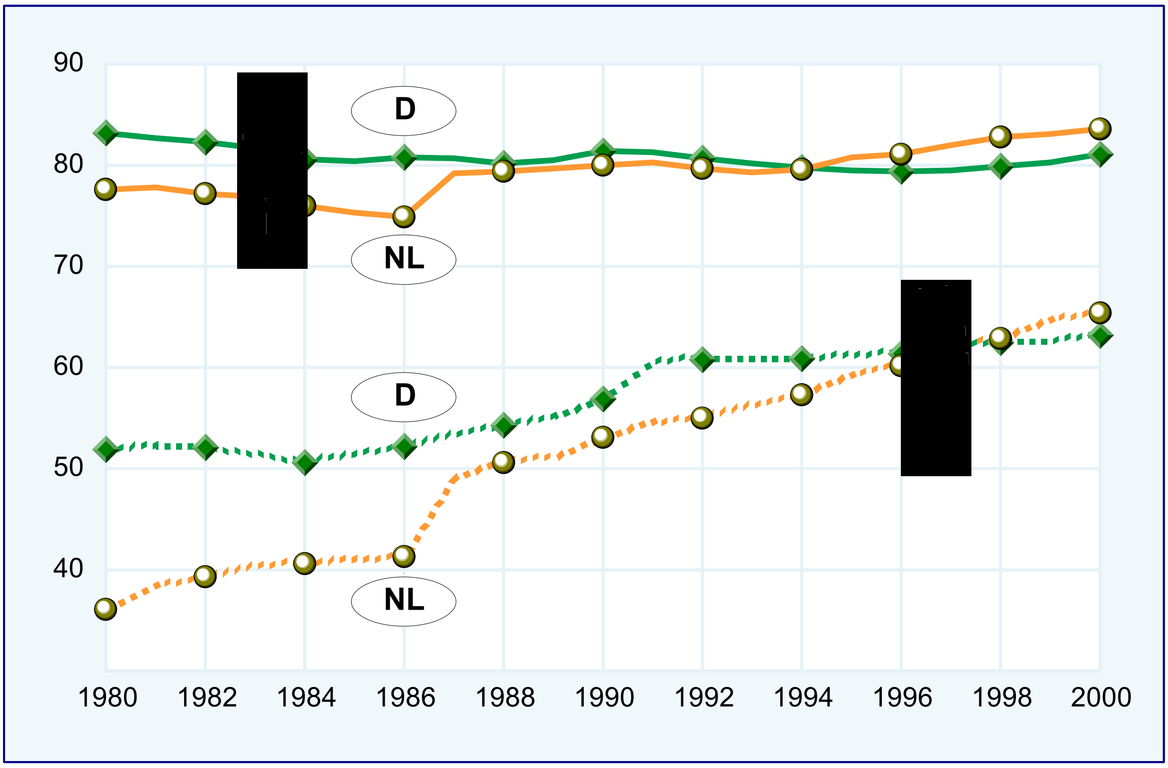
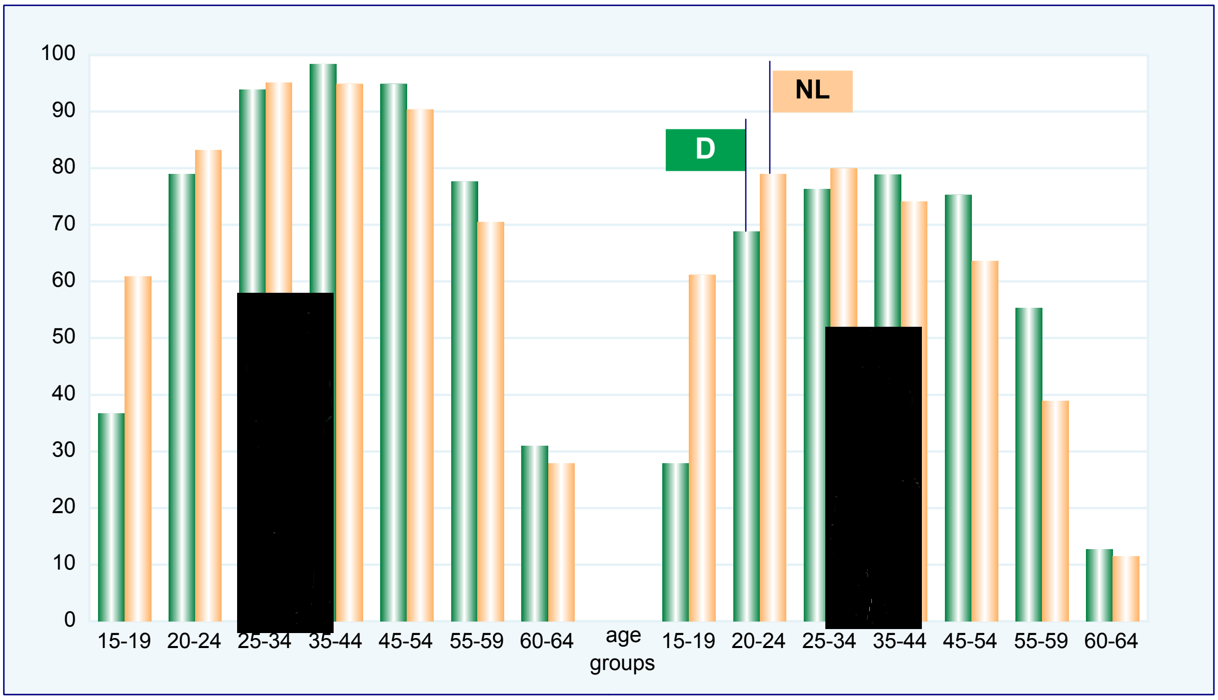


Figure 6: Labour force participation rates in the Netherlands and in Germany, Men and women by age group, 2000 (%)



Source: OECD, *Labour Force Statistics, 1981–2001* (2002).

2. Economic growth and employment

One of the reasons for the good economic results is that private consumption and investment remained high. The high level of consumption can be explained by the improved employment situation and the reductions in tax and social insurance contributions (OECD 1996: 11, and OECD 2000: 19pp). In this way domestic demand was supported and labour costs were reduced, which encouraged the policy of wage restraint pursued by the Netherlands since 1982. The moderate wage growth also had a positive effect on foreign trade. As the Dutch guilder was linked to the German mark (since 1983) this resulted in a cost advantage in the form of a "devaluation in real terms" compared with the German mark (Schmid 1997: 27). Investment, too, was a growth factor in the 1990s. It remained above the EU average until 1999, whereas in Germany it was below the EU average (European Commission 1997: 264pp; European Commission 2002: 113).

If economic growth (GDP) and employment are compared over time, it can be seen that in the Netherlands employment has followed the development of GDP more closely than it has in Germany (Figures 7 and 8). It has been particularly noticeable in recent years in the case of (western) Germany that a gap has opened up between economic growth and the development of employment. One might also add that labour productivity per capita was higher in Germany.

This has an effect on the so-called employment threshold, in other words the percentage of economic growth at which employment increases. The employment threshold can be portrayed in the form of a graph by comparing the changes in employment and the changes in GDP (Figures 9 and 10). The intersection of the regression lines with the abscissa (economic growth in percentage terms) depicts the employment threshold during the period under observation. In the Netherlands the level of economic growth at which employment begins to increase is close to zero: employment already begins to grow with a slight increase in GDP. In Germany this threshold averaged 1.5% to 2% for the years 1983–2000 and has risen in recent years.

Similarly to the case of the USA, the high level of employment growth in the Netherlands cannot be explained solely by more favourable economic development than in other West European countries. For instance, although average economic growth in the Netherlands was above the EU average of 2.3% between 1983 and 1993 – at 2.6% – it was below Germany's average growth rate of 2.8% and the USA's rate of 2.9%.[6] Since 1995 Dutch growth rates have been fluctuating above the EU average, however, and are considerably higher than the German average.

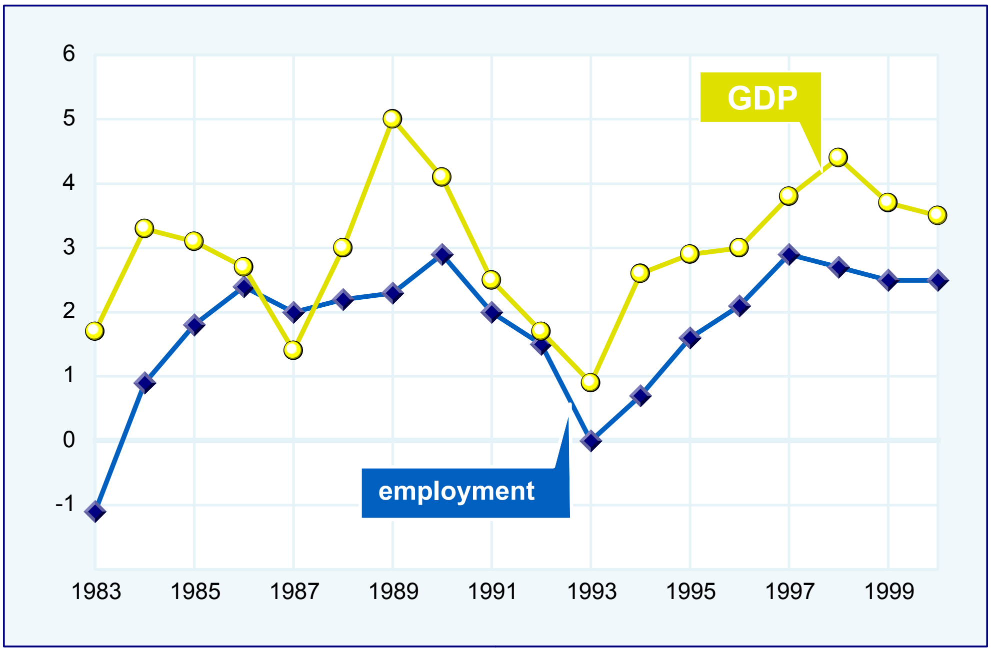
As there was little difference between Germany and the Netherlands as regards GDP growth rates until the mid-1990s, the positive employment trend must be attributable to other factors.

As in the USA, more jobs are created in the Netherlands at a given level of economic growth than, for example, in Germany; in other words, the 'employment intensity' of economic growth was higher there than in Germany.[7] Explanations for this can be found, for example, in working time and wage developments, as explained below.

6 According to information from the OECD. Since 1992 the growth rate has also taken into account economic development in eastern Germany.

7 Employment intensity indicates the percentage by which employment increases (decreases) when economic growth rises (falls) by 1%.

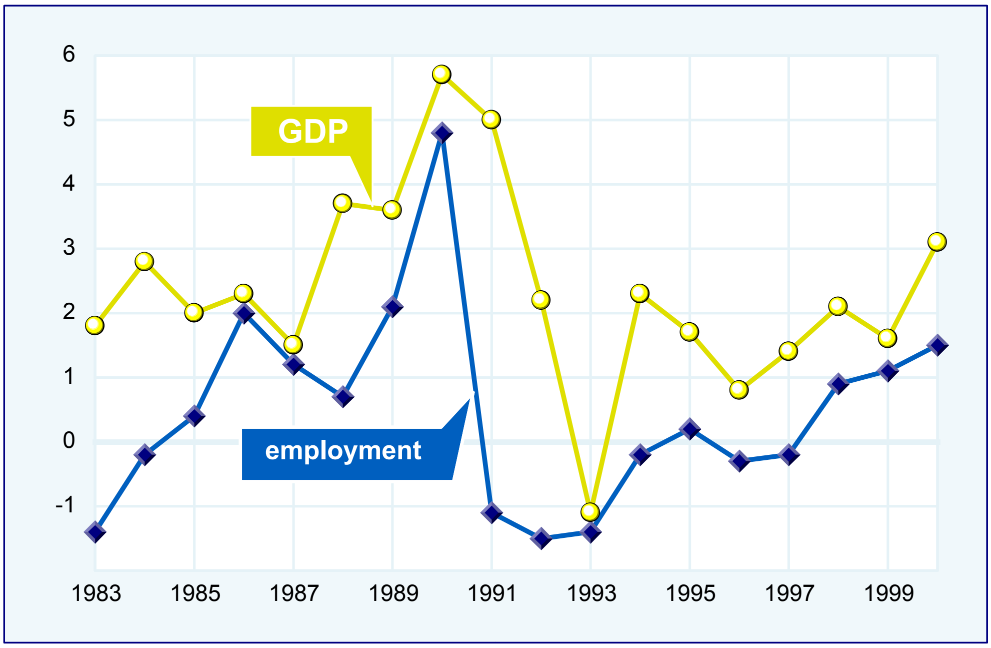
Figure 7: GDP* and employment in the Netherlands. Annual rates of change, 1983–2000 (%)



* Gross domestic product in terms of 1995 prices and purchasing power.

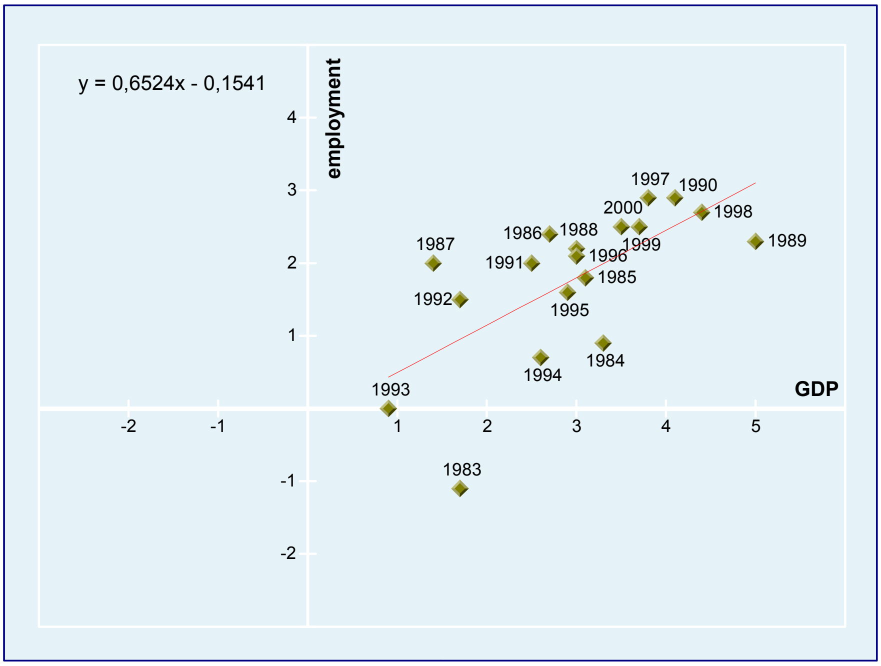
Source: Centraal Bureau voor de Statistiek; OECD, *National Accounts 1989–2000* (2002), Vol. I; own calculations.

Figure 8: GDP* and employment in Germany. Annual rates of change, 1983–2000 (%)**



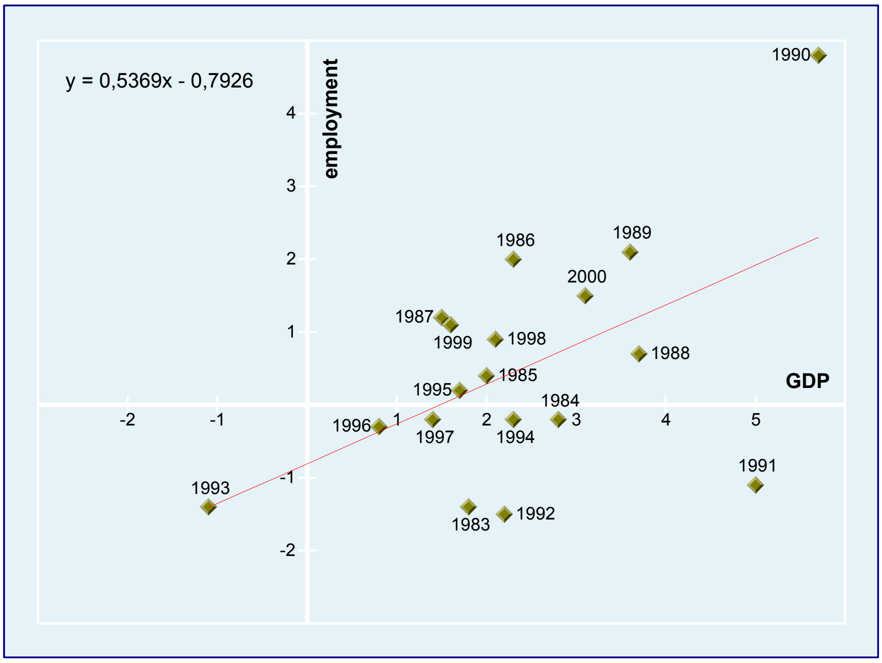
* Gross domestic product in terms of 1995 prices.
** until 1991 western Germany only.
Source: OECD, *Labour Force Statistics*, various years; Federal Statistical Office from 1991 (revised employment figures); European Commission, *Statistical Annex to European Economy* (spring 2002).

Figure 9: GDP* and employment in the Netherlands. Growth rates, 1983–2000 (%)



* Gross domestic product in terms of 1995 prices and purchasing power.
Source: Centraal Bureau voor de Statistiek; OECD, *National Accounts 1989–2000* (2002), Vol. I.

Figure 10: GDP* and employment in Germany. Annual change, 1983–2000 (%)**



* Gross domestic product in terms of 1995 prices.
** until 1991 western Germany only.
Source: OECD: *Labour Force Statistics*, various years; Federal Statistical Office from 1991 (revised employment figures); European Commission, *Statistical Annex to European Economy* (spring 2002).

Working time

Working time has shown a similar downward trend in the two countries. However, in the Netherlands this is due above all to the greater extension of part-time employment – another explanation of the Dutch "employment miracle" (see Table 2). But part-time work is only one pillar of the Dutch working time policy model. The second pillar has always been the reduction of labour supply by means of the early retirement of older workers or of those with a reduced earning capacity. That is why – as already mentioned – the labour force participation rates of older workers in the Netherlands are extraordinarily low by international comparison.

Table 2: Part-time rates* for Germany and the Netherlands, 1985–2000

	Germany			Netherlands		
	Total	Men	Women	Total	Men	Women
1985	12.4	1.6	29.3	22.3	7.3	51.0
1990	14.9	2.3	33.6	31.3	14.3	59.1
1995	16.0	3.2	33.6	37.0	16.1	67.2
2000	19.1	4.5	37.7	41.0	18.9	70.5

* people aged 15–64.

Source: Eurostat, *Labour Force Survey*.

If all forms of exclusion from the labour market, as well as participation in labour market schemes and highly subsidised forms of employment, are added up we get, according to the OECD, the so-called "broad" unemployment rate. This is made up of the unemployed, recipients of social transfers following unemployment (early retirement, social assistance, invalidity benefit) and participants in employment and training schemes. This "broad" unemployment rate comes to 27% for 1996 and has been falling only very slowly since then.[8] In comparison with this, the rate in Germany at that time stood at 22% (Schmid 1997: 30), a figure which already incorporates the more difficult situation in eastern Germany. The significant level of the so-called "broad" unemployment rate thus qualifies the Dutch "success story" somewhat. Nevertheless, the labour market policy performance of the Netherlands occupies a prime position in Europe because it has been able to maintain continuous employment creation, with employment growth rates like those in the USA.

Wage development and wage structures

The more favourable employment trend in the Netherlands compared with other EU countries can also be explained partly by the moderate wage growth. Since the mid-1980s the government has promoted a policy of wage restraint which has also had the support of the social partners. According to information from the OECD unit labour costs have grown far less in the Netherlands since 1983 than they have in neighbouring European countries (OECD 1999: Annex Table 13; Schmid 1997: 27).

8 OECD 2000: 25. Meanwhile the "broad" unemployment rate still stands at almost 20%. See OECD 2002: 27.

Are there wage structure differences that could explain the greater employment growth in the Netherlands? Whilst for example in the USA wage disparities have increased considerably, they have remained largely stable in the Netherlands.[9] A change in wage differentials must therefore be ruled out as a possible explanation. The ratio of the middle wage decile (D5) to the lowest decile (D1) remained constant at 1.6, whilst it fell from 1.6 to 1.4 in western Germany between 1983 and 1993, as OECD studies have shown. This means that in (western) Germany there was an above-average increase in the real income of workers in the lower wage groups (OECD 1997a: 7; Schmid 1997: 27). This involves the risk that the jobs in question will be cut as a part of streamlining efforts.

Owing to labour shortages it is possible to observe a considerable wage increase in the Netherlands from 2000 onwards, pushing up unit labour costs. This goes against the wage restraint that was pursued until the late 1990s. However, it can also be regarded as a "normal" adjustment process in the course of the business cycle (OECD 2002: 30; OECD 2002a: 146).

When seeking the reasons for the Dutch employment miracle one must begin by asking what factors could have encouraged the lower employment threshold. What is to be considered here is first and foremost changes in the institutional framework, in other words the labour market system. This is dealt with in the following section.

3. The significance of the institutional framework

Institutional changes have an impact on employment if they have a wage-moderating effect (such as longer term restraint as regards collectively agreed wages or measures aimed at activating the unemployed), if they help to reduce average annual working time per worker (such as flexible and individual forms of working time reduction), and if they increase the willingness of firms to hire new workers in an employment upswing (such as factors which promote the agreement of flexible employment relationships).

More decentralised wage determination and wage restraint

In the Netherlands there is a long tradition of negotiations between employers' associations, trade unions and the government. However, the state has a particularly strong position in the process of wage formation because it can intervene directly in wage negotiations and can even suspend them. However, no use has been made of this possibility since the beginning of the 1980s. As regards the organisation of wage determination there is an interesting mixture of centralisation and decentralisation. The platform for annual wage negotiations is the bilateral dialogue between the employers' associations and the trade unions at the "Foundation for Labour". The wage policy orientation determined here (the so-called "Centraal Akkoord") then forms the basis for the actual collective negotiations that take place at industry and enterprise level. These negotiations are orientated towards the Centraal Akkoord, but none the less take into account regional and sectoral differences.

Wage policy has been orientated towards wage restraint for more than 15 years now and has slowed down productivity growth as a result of its longer-term orientation. The increased flexibility of collective agreements has probably contributed to wage restraint. This can be seen, for example, from the fact that the wage agreements of individual industries increasingly contain more general outline provisions, thus leaving more freedom for enterprise-level negotiations. In

9 It should be noted that this comparison refers to full-time employees. See OECD 1996a: 60ff.

this way concrete wage agreements are linked more and more to the market development of individual firms. As already mentioned, significant wage growth can be identified from 2000, which could impair the competitiveness of the Dutch economy. The EU and OECD forecasts assume, however, that the economic development and labour market situation will continue to be favourable.

Activation of the unemployed

For a long time the Netherlands encouraged, on a grand scale, the early retirement of older people and the "clearing" from the labour market of people who declared unable to work. Thus the number of people receiving disability payments rose to 800,000 (total population: 15.8 million) at the beginning of the 1990s. This method was frequently resorted to when older workers or workers with health problems were laid off, as a measure to reduce the supply of labour. Early retirement greatly reduced the activity rate of older people, leading to a lower labour supply. However, in the past decade the public has increasingly become aware of the high level of unemployment and disability and the resulting social benefit burden.

In the course of the upswing in employment the course was set for activation and prevention. Incapacity for work is now checked at regular intervals. The method of financing invalidity benefits has also changed: now the employers pay contributions towards this, too. The intention is that employers be given an incentive to take positive measures to prevent invalidity. Two other moves in this direction are (i) that firms continue to pay wages in the event of sickness and (ii) that the private sector is entrusted with the administration of the health insurance funds. After this law came into force in 1994 the number of benefit recipients fell somewhat but then stabilised at a high level of approximately 800,000, as already mentioned.

In relation to social assistance, too, more emphasis has been placed on a return to working life. The employment office and local social services work closely together to reintegrate social assistance recipients into the labour market. The attitude of society has changed: whereas inactivity used to be tolerated and the payment of benefits used to be accepted, social assistance recipients are now urged to look for work, to retrain if necessary or to take part in further training – failing this, those concerned are threatened with sanctions. However, an improved labour market situation is ultimately required if such a policy is to work. It must also be mentioned that since 2001 unemployed people have received a one-off payment of EUR 1,815 if they cease to draw benefit early.

Other measures aimed at activation which should be mentioned are a moderate reduction in the (still generous) transfer payments in the event of unemployment and a tightening of the acceptability requirements related to placing the unemployed in new jobs. Active labour market policy reforms are also connected to this.

According to OECD information,[10] the Netherlands has always spent a relatively large amount on labour market policy measures – in 1998 more than 4% of GDP (as a comparison, the figure for Germany in 1998 was 3.6%). The proportion used to be even higher. As unemployment fell, expenditure on labour market policy measures also fell, to 3.7% in 2000. However, three-fifths (= 2.1%) of the expenditure on labour market policy measures is allotted to the payment of unemployment benefit.[11] One-third of the remaining 1.6% is needed for benefits paid in the event

10 See the OECD's Employment Outlook.

11 By international comparison wage-replacement benefits in the event of unemployment have remained high in the Netherlands.

of incapacity for work. The rest of the expenditure is spread over training measures (0.3%) and wage subsidies (0.41%); 0.25% is used for public labour administration (Germany: 0.23%).

Dutch labour market policy is increasingly focusing on particular target groups, such as job-seekers who are hard to place (especially the long-term unemployed), young people and ethnic minorities.[12] A further focus is the intensification of placement and advisory services via the public employment service and local or non-profit agencies. For this, placement pools or interim jobs are set up for the long-term unemployed. This is accompanied by considerable decentralisation, strict monitoring and budgeting related to results, in order to improve the effectiveness of the measures. An example of this is the payment to agencies of a flat rate per placement. Moreover, efforts are being made to facilitate the early recognition of the risks of long-term unemployment (so-called "profiling"), in order to start appropriate measures as soon as possible after the beginning of unemployment with the intention of preventing the individual from sliding into long-term unemployment. At a registration meeting unemployed people are classified according to their capacity to work and are accordingly looked after more or less intensively, and they are "activated" to look for work, to take up a subsidised job or to participate in a training scheme. It must also be pointed out that radical reform of the employment service has taken place – with a significant trend towards decentralisation and privatisation.

Wage subsidies for low-wage earners

In order to facilitate labour market access for low-skilled and long-term unemployed jobseekers, first the gap between the lowest collectively agreed wages and the statutory minimum wage (2002: EUR 1,207) has been steadily reduced by means of exemption clauses in collective agreements: the lowest collectively agreed wage groups are now only 5% above the minimum wage.[13] Secondly, in the case of low-wage earners, subsidies are paid towards the employer contributions to social insurance. In this way, effective labour costs can even be pushed below the minimum wage.

This support has two target groups. First, people who earn no more than 115% of the statutory minimum wage for a 36-hour week. The permanent annual subsidy to the employer amounts to EUR 1,806 (1999). Secondly, employers can receive a subsidy for long-term unemployed and hard-to-place individuals (1999: EUR 2,156) for a maximum of 4 years, as long as the newly hired worker does not earn more than 130% of the minimum wage. The different subsidies can be cumulated, thus reducing wage costs by up to 23%. In addition to this it is being considered to exempt employers temporarily from the statutory minimum wage if they take on a long-term unemployed person.

These still relatively new measures could increase wage differentiation (by qualifications) in the Netherlands, thus contributing to wage restraint in the economy as a whole.[14] The tax credit for low-earners that was introduced with the 2001 income tax reform works along the same lines.

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12 The non-profit temporary employment enterprise "Start" has served as a model for a number of European industrialised countries. Start hires out hard-to-place unemployed people to firms on a trial basis. Start funds itself from the income made from hiring out workers to employers. In 1994 Start made 130,000 placements in more or less short-term jobs. In addition to this it is necessary to mention non-profit agencies which place social assistance recipients in work above all on behalf of local authorities (for example, "Maatwerk"). Agencies in the context of Maatwerk, which means "tailor-made work", receive a flat-rate payment from the employment office for every successful placement.

13 However, they appear to have been rarely used by enterprises so far. In contrast, 300,000 or 5% of employees already receive the minimum wage. See OECD 2000: 57.

14 On this subject see the model calculations in OECD 2000: 56.

Individual and flexible forms of working time reduction

The reduction in average annual working time per worker can be put down, as already mentioned, in particular to the increasing significance of part-time employment. The majority of part-time employment relationships are voluntary, that is, a full-time job is not desired. Many part-time workers have a higher level of education or training, which says something about superior working conditions. In addition, there is an astonishingly large number of men in part-time employment. The large proportion of marginal part-time employment is also worth mentioning. This characterises part-time work as a possible secondary activity (for example, for housewives or recipients of transfer benefits) and as an instrument to make gainful employment compatible with other activities (for example, family commitments, training or further training).

The basic state retirement pension is seen as one reason for the large increase in part-time employment and flexible employment. This pension is independent of contribution payments and – depending on family circumstances – is only just higher than social assistance. The advantage of the basic pension is that it ensures subsistence level in old age even for people with low incomes or unstable phases of employment. Further reasons for the boom in part-time work are the increasing tendency for married women to work, the traditional acceptance of part-time employment by the trade unions, and the active role played by the state as a part-time employer.

More possibilities for flexible employment relationships

Whilst protection against dismissal in the Netherlands continues, according to the OECD, to be relatively restrictive (OECD 1999a: 66), there was a noticeable deregulation in the 1990s with regard to temporary forms of employment (hiring-out of labour, fixed-term employment). Particularly worthy of mention here are the greater possibilities for extending fixed-term employment and an extension of the duration of temporary work in the case of temporary workers.

Data from the European labour force survey emphasise that temporary employment has increased sharply in the Netherlands, where in 2002 it accounts for almost 14% of all workers, at the upper end of the EU scale.[15] It is used in particular to cover peaks in orders and to clear temporary staff bottlenecks. OECD analyses of the labour market effects of employment protection legislation show that the effects on the structure of employment – in other words, the distribution of employment opportunities and risks of unemployment – are considerably more significant than the effects on the level of unemployment (OECD 1999a: 49pp). Legislation also has an impact on the inflows into and outflows from unemployment or employment in the business cycle.

Another advantage of flexible labour markets is that they respond far more rapidly and more strongly to changes in fundamental economic conditions. This could have encouraged the linking of the upturns in the economy and in employment in the Netherlands.

4. Lessons learnt: ways to gain more labour market flexibility

In the early 1980s economic growth in the Netherlands almost came to a standstill, unemployment shot up to about 11%, and the national debt and budget deficits reached record levels. Against this background the government, the employers and the unions decided to conclude an alliance for work, the main component of which was wage restraint (Wassenaar Agreement of 1983). The government took this to heart and cut the salaries of civil servants and pensions by

15 Germany, too, is in the upper group of countries with a large proportion (13%) of fixed-term employment.

3%. Furthermore, the national deficit was curbed. Subsidies for endangered industries ceased to be the guiding principle of structural policy, being replaced by policies to strengthen technological change, research and training. Since then the Netherlands has had considerable success in its growth policy. Besides the consistent supply policy (for example, moderate wage policy, budgetary consolidation), the real devaluation of the guilder and the resulting activation of the trade balance and the balance of payments have had a positive effect on development (see Pohl and Volz 1997). However, (eventual) strong economic growth alone does not explain the spectacular increase in employment, which had already begun.

"Flexicurity"

In the Netherlands it is generally accepted that external flexibility (inflows and outflows of staff) is an increasingly important precondition for the ability of labour markets to function. If flexibility increases, however, deficits in the area of social security can result where occupational histories are less straightforward. In order to alleviate this increasingly clear conflict of aims the Dutch government passed the Law on Flexibility and Security (valid as of 1 January 1999). The aim of this approach, which is known as "flexicurity" for short, is to foster a greater adjustment capacity in the labour market – if possible by dismantling labour market segmentation into core workforce and peripheral workers. This occurs first by the facilitation of atypical employment or the strengthening of its legal standing. Secondly, the employment security of "regular workers" was reduced. In this way labour market segmentation is reduced and transitions become easier, and the overall flexibility of the labour market improves.

The "flexicurity" approach in the Netherlands consists of three components:

- *more contractual freedom in the case of fixed-term employment (for example, by facilitating consecutive short-term contracts) and in the use of temporary workers (for example, by abolishing both the obligation to obtain permission and the maximum limit on the period of hiring-out by an agency; temporary work is now also permitted in the construction sector);*
- *strengthening of the legal position of people in atypical employment (for example, temporary agency workers were given the right to the same working time as permanent employees and entitlement to continued wage payments in periods when the worker is not being hired out and to dismissal protection after at least 18 months of employment); and*
- *fewer protective rights for so-called "regular workers" (for example, extended probationary periods, shorter notice periods).*

International comparative analyses suggest that strict employment protection is negatively correlated with labour mobility. However, for everyone involved labour mobility at industry and macroeconomic level is associated with exertion of effort (for example, friction owing to the search for and settling into a new job) and corresponding benefits (for example, new ideas and better labour allocation). It is clear that an evaluation of the pros and cons (in the sense of a cost-benefit analysis) of labour mobility cannot be done solely with the aid of scientific analyses. In conclusion, some employment-policy arguments should therefore be brought forward. Particularly in view of the increasing persistence of unemployment, any revisions of labour legislation would have to take the interests of outsiders (the unemployed and peripheral workers) more into account (see Ichino 1998). More mobility due to labour-law reforms would not only open up more entry possibilities to outsiders, however, but would also direct public interest away from the preservation of existing employment and towards the creation of new employment, thus promoting structural change.

In order, first, to take into account the growing need for scope for action in personnel policy and, secondly, to be able to avoid social exclusion there are two conceivable ways of arranging the labour market order: in the first one, hardly any change in the substance of employment security *de jure* would be necessary – apart from a partial modernisation of the legal norms – if the existing freedom for flexibility in wages and working time were consistently made full use of or were expanded, for example, by means of exemption clauses in collective agreements. If the second method were chosen, the effective level of employment security *de jure* would come into question. More freedom in the termination of employment relationships, so putting more of the “market” into the labour market, seems to be possible if – like the Dutch “flexicurity” concept – there were acceptable exchange deals: if the workers are expected to accept less employment stability, their social security should not be neglected in the reforms of the tax and transfer systems.

Before we finish, let us take a final look at another lesson from the “Dutch miracle”, a lesson that could be applied to Germany and to other countries facing similar employment problems. The main message is that what is needed is a comprehensive reform, in which a consistent policy mix has to be applied simultaneously, incorporating the following three components:[16]

- reductions in working time, which should be arranged in such a way that it would not incur any additional expense and would be individual, flexible and reversible – for example, more part-time work and less overtime;
- moderate increases in nominal wages at macroeconomic level, which would initially have to be below productivity growth; and
- fiscal-policy impulses – for example, delayed consolidation, restructuring in public budgets in favour of investment and the reduction of direct taxes.

The implementation of this set of strategies will depend not only upon technical expertise, but also upon political will and social consensus. The precondition for the reversal of the employment trend in the Netherlands was the desire to act in concert and the view that labour market flexibility plus security is the order of the day.

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16 This proposal was elaborated in more detail by Klauder, Schnur, and Zika 1996, Schnur, Walwei, and Zika 1998, and Schnur, Walwei and Zika 2000. An international comparison comes to similar conclusions; see Werner 1998: 324ff., Walwei 1998: 334ff. and Walwei, Werner, and König 2001.

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Edeltraud Hoffmann and Ulrich Walwei °

Against the Tide: Why Permanent, Full-Time Jobs Are Still Standard in Denmark[1]

In all industrial countries the composition of work arrangements is in a state of flux (Delsen 1995; Meulders et al. 1996; De Grip et al. 1997). The "standard work arrangement", based on a permanent full-time relationship with the status of employee and subject to basic social security, is losing ground compared to non-standard work arrangements, such as temporary work, part-time work, homework, on-call work, freelancing, and so on.

For a first approximation of the diversity of work arrangements Table 1, based upon the European Labour Force Survey (ELFS), presents an overview of the changing importance of self-employment, part-time employment and temporary employment during the 1990s.[2]

Table 1:
Selected work arrangements in Europe 1988 and 1998 (% of total employment)

Member States	Total employment (in thousands)		Self-employment (incl. family workers)		Part-time employment		Temporary Employment 1)	
	1988	1998	1988	1998	1988	1998	1988	1998
Denmark	2683	2679	11.0	9.7	23.7	22.3	10.2	9.1
Germany		35537		11.0		18.3		10.9
– West	26999	29077	11.5	11.5	13.2	20.0	10.1	10.0
– East		6459		8.5		12.0		17.0
Austria		3626		13.8		15.8		6.8
Belgium	3483	3857	18.0	17.4	9.8	15.7	4.5	6.4
Spain	11709	13161	29.1	23.0	5.4	8.1	15.8	25.3
Finland		2179		14.6		11.7		15.1
France	21503	22469	16.2	12.5	12.0	17.3	6.6	12.2
Greece	3651	3967	49.5	43.4	5.5	6.0	8.8	7.4
Ireland	1090	1496	25.3	20.2	8.0	16.7	6.8	6.1
Italy	21085	20357	29.5	28.7	5.6	7.4	4.1	6.1
Luxembourg	152	171	11.2	9.4	6.6	9.4	3.3	2.4
Netherlands	5903	7402	12.1	11.6	30.3	38.8	7.7	11.2
Portugal	4427	4764	30.9	28.2	6.5	11.1	12.6	12.4
Sweden		3946		11.4		23.9		11.4
United Kingdom	25660	26883	12.7	12.5	21.9	24.9	5.2	6.1
European Union	128345	152494	19.1	16.6	13.2	17.4	7.8	10.6

1) Dependent employees incl. apprentices, trainees, research assistants, etc.

Source: Eurostat, Labour Force Survey.

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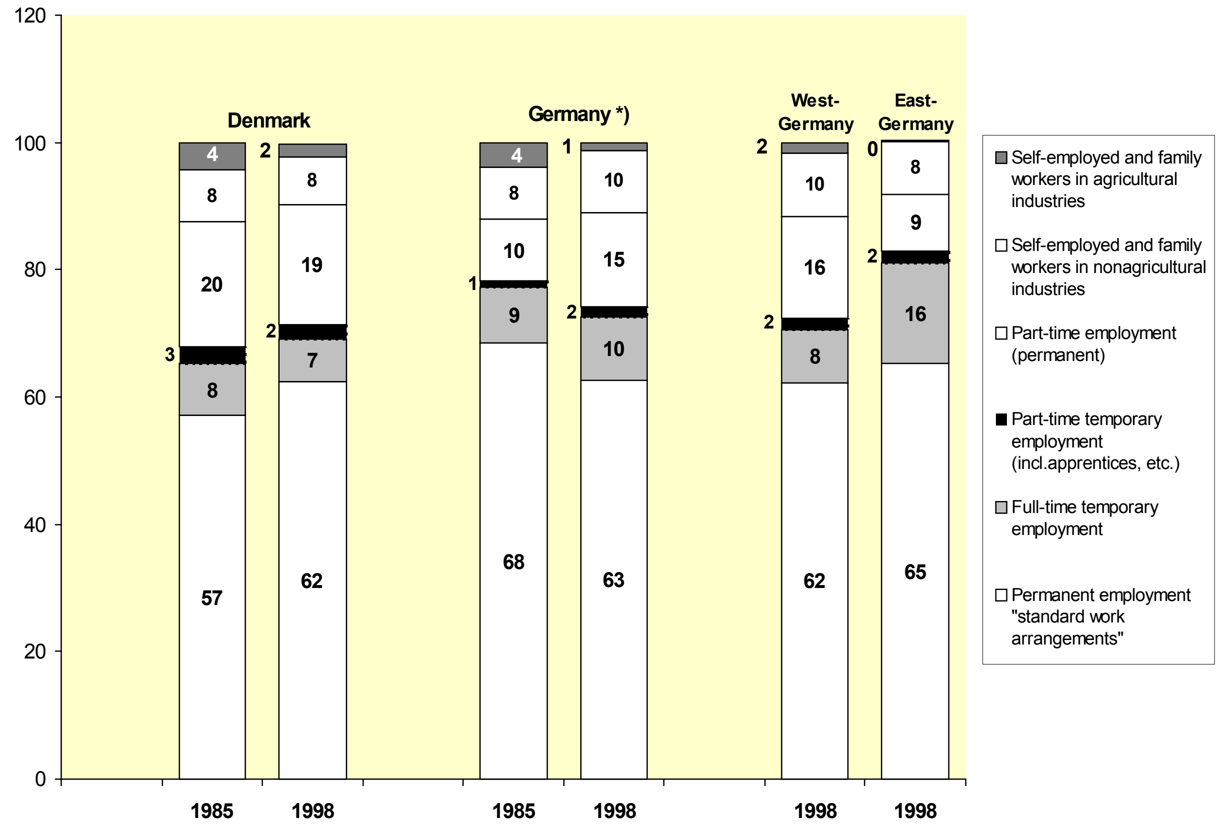
1 A more elaborated version of this paper will be published in a forthcoming book Non-Standard Work Arrangements in Japan, Europe, and the United States, ed. Susan Houseman and Machiko Osawa. We thank the European Foundation for the Improvement of Living and Working Conditions in Dublin for providing us with data from the recent survey "Employment Options of the Future".

2 The data used in this paper are taken from special tabulations of the ELFS for the years 1983 to 1998 provided by Eurostat. See the appendix for more information on the data and definitions of wage arrangements.

The data show that the share of self-employment (including family workers) is decreasing; nevertheless, self-employment is still significant in Southern European countries such as Greece, Italy, Portugal and Spain, mainly due to the importance of traditional agriculture. Quite the opposite is true of part-time and temporary employment: in almost all EU countries, their proportion of total employment has increased. Part-time employment is especially widespread in the Netherlands, the United Kingdom, Sweden and Denmark, temporary employment in Spain, Finland, and France.[3]

However, there is one country that stands out among all EU countries, showing a decrease in the share of all non-standard work arrangements included in the table: in Denmark, not only did self-employment lose importance, but also the share of part-time and temporary employment decreased over the last decade, albeit from a relatively high level. By contrast, the share of standard work arrangements had increased by roughly 5 percentage points since 1985. Figure 1 gives a detailed overview of the development of work arrangements in Denmark and Germany.[4]

Figure 1: Change in work arrangements in Denmark and Germany
(% of total employment in 1985 and 1998)



Source: Eurostat, *Labour Force Survey; Mikrozensus* (national survey); *) 1985 West-Germany

3 In interpreting the figures presented in Table 1 account has to be taken of the fact that non-standard work arrangements are not clear-cut. For example, self-employed persons can either work full-time or part-time, and part-time and temporary employment can coincide. Moreover, temporary workers may include apprentices, agency workers or participants in active labour market measures. Part-time work consists of a wide range of employment relationships, from marginal employment (a few hours of work) to jobs just below full-time level. In addition, self-employment rates include self-employed workers with or without employees.

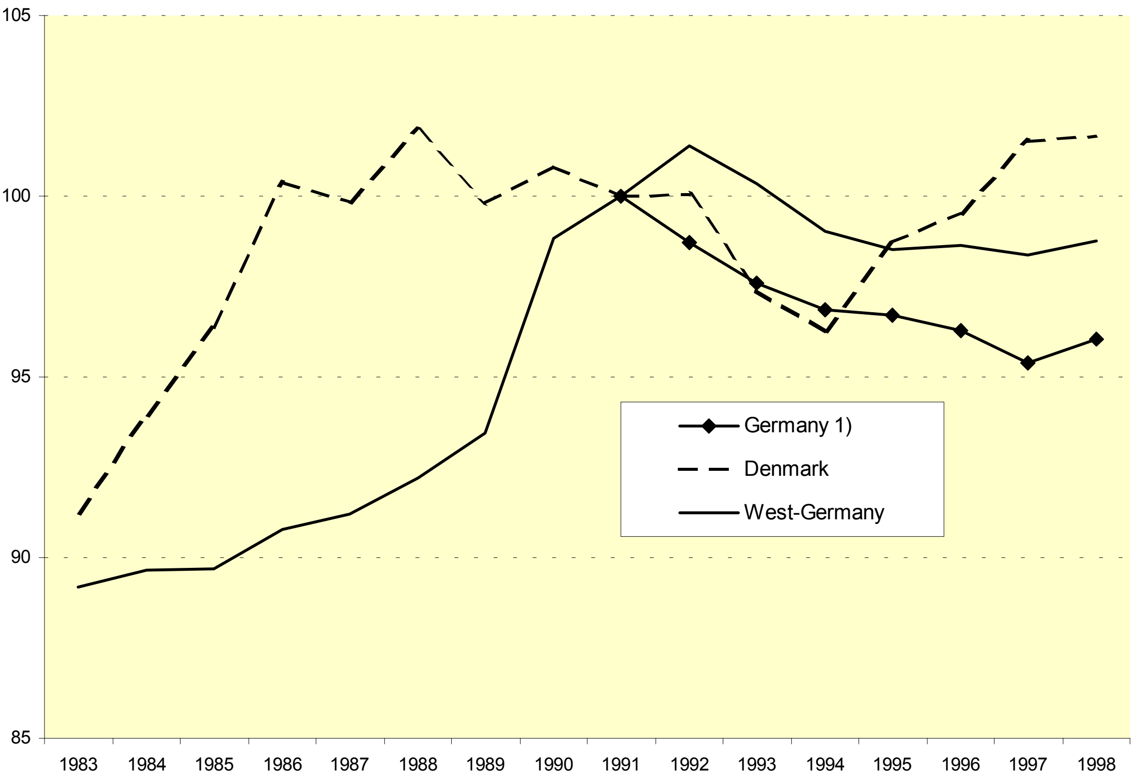
4 Germany will be used as a “negative benchmark” throughout this paper as an example of the ‘continental European welfare states’ where the bulk of the European employment problem is concentrated.

How can we explain this atypical behaviour of the Danish labour market? One possible answer is the availability of options for employers and employees. For both, the choice of work arrangements depends upon the alternatives. Labour market performance and institutional setting particularly influence scope of action. The relevance of labour market performance is obvious from the viewpoint of an employee, since standard work arrangements are still first choice for most of them. The institutional framework also influences the costs and benefits of various alternative arrangements of the work relationship for those involved: for example, an institutional setting implying high costs for employers can make full-time arrangements less attractive to them and so reduce their prevalence.

Labour market performance

For decades Denmark has shown one of the highest labour force participation rates in the Western world. In 1998, the labour force participation rate reached 79%, while the corresponding German rate stood at 71%. The difference is even greater if one compares employment rates: in 1998, in Denmark 75% of the working-age population was employed, in Germany only 64%. Figure 2 illustrates the variations in employment since 1983 for both countries.

Figure 2: Employment Indexes in Denmark and Germany, 1983–98 (1991 = 100)

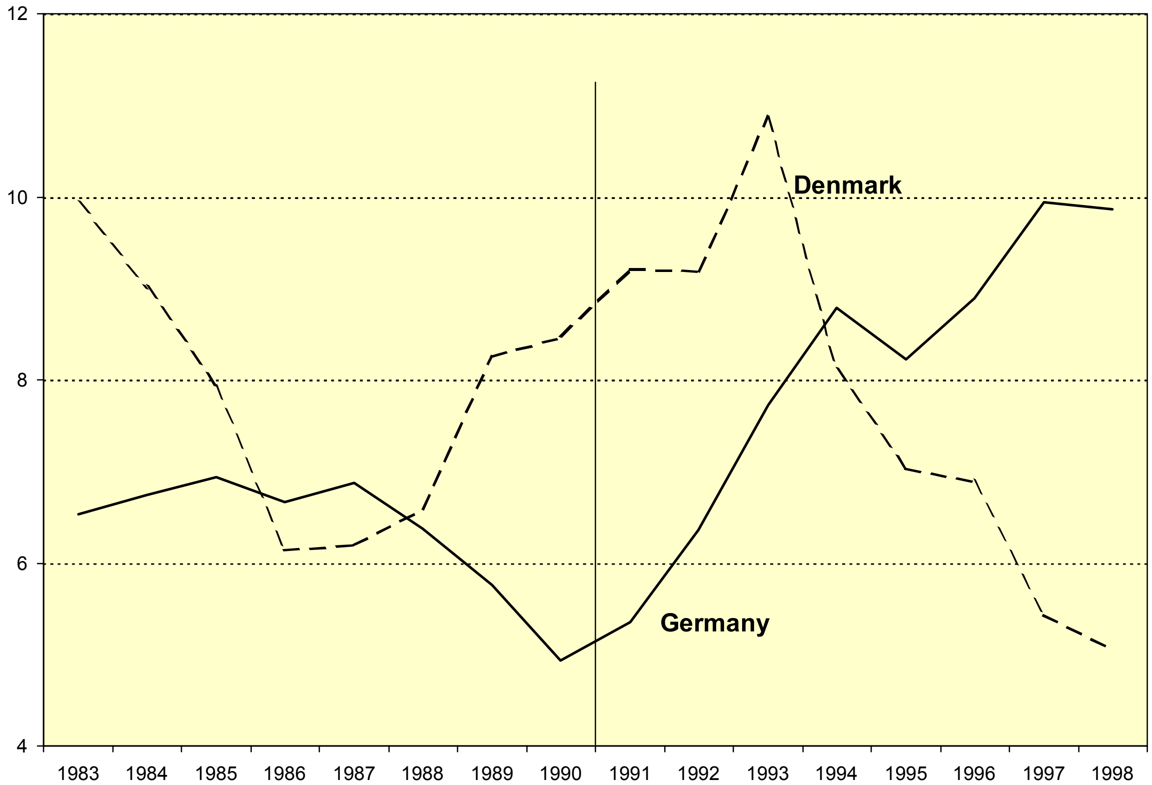


1) Germany 1991–8 incl. new German *Länder.*

Source: Eurostat, *Labour Force Survey*; *West Germany – Mikrozensus.*

Not surprisingly, differences between Denmark and Germany are also visible regarding level and development of unemployment (Figure 3). In 1996, the standardised unemployment rate in Denmark was 6.9%, compared to 9.6% in Germany. If we use the OECD concept of “broad unemployment" – which includes registered unemployed, participants in active labour measures (such as training, job creation schemes and short-time work), people in early retirement and those in paid leave schemes (such as child care or training) – the proportion of the unemployed was considerably higher (20.5%), only slightly lower than in Germany (22%). Recent Danish studies show that the usual unemployment rate and the broad unemployment rate fell in the second half of the 1990s, indicating a "real" improvement of the labour market situation (Madsen 1999).

Figure 3: Unemployment rates in Germany[1)] and Denmark, 1983–98 (% share of labour force)



1) 1983–90 excl., 1991–8 incl. the new German *Länder.*

Source: Eurostat, *Labour Force Survey.*

The recent employment boom can be attributed to several factors, including a sustained economic improvement, fiscal impulses through tax cuts, and changes in active and passive labour market policies aiming at activation of the jobless by both offering targeted measures and imposing sanctions (PLS Consult and Peter Jensen 1997; Madsen 1999). The high Danish employment rate gives less competitive workers more opportunities to enter the labour market. All age groups, all qualification levels and both sexes were able to profit at least partly from high levels of employment. As a consequence, the share of long-term unemployment in total unemployment decreased from 39% in 1985 to 29% in 1998, and the youth unemployment rate (up to 25 years of age) sank from 11% to 7%.[5]

5 In the same period the proportion of long-term unemployment in Germany went up from 48% to 52% and the unemployment rate of young people in the age group 15–24 remained at about 10%.

Institutional setting

The choice of work arrangements is influenced by the options employers and employees have at their disposal; the institutional framework defines the labour market actors' scope of action; and regulations influence the costs and benefits of the various alternatives for those involved.

Among the regulations which affect the composition and development of different work arrangements, social security systems and particular incentives or disincentives resulting from them, the type of income taxation, the provision of child care facilities, the level and significance of active labour market measures, the existence of particular institutions facilitating the school-to-work transition and the strictness of employment protection regulations seem to be of particular importance.

The Danish *social security system* provides generous social protection (for example, in the case of unemployment). It is mainly financed by general tax revenues (European Commission 1999). The pension system consists of a basic pension for all citizens, financed by general tax revenues, and a supplementary pension mainly financed by employer contributions. In 1997, the share of social security contributions amounted to only 10% of labour costs (defined as gross salary plus social security contributions paid by the employer), the lowest in the EU. Accordingly, the negative labour market effects often attributed to high social security contributions in countries such as Germany, where the corresponding share was 34%, could be avoided in Denmark, where the social security system does not create major incentives to opt for non-standard work arrangements.

However, some regulations in Denmark do produce *incentives to take up marginal employment*. For instance, in the case of part-time employment relationships with a monthly working time of no more than 39 hours, no contributions to the supplementary pension system are due.

The *type of income taxation* may also influence the quantity of labour supply and the associated choice concerning wage arrangements. In Denmark, a system of separate income taxation is in place (see Dingeldey 2000), avoiding the discouraging effect that joint taxation, which creates an incentive towards tax-free marginal employment for secondary earners, can have on the labour supply. This is particularly important for married women, since with separate taxation the low wages of part-time working wives are taxed at a correspondingly low rate and not at the high marginal rate applying to their husbands, as would be the case with joint taxation.

In addition to the type of income taxation the employment rates of women are positively related to the provision of *child care facilities*. Denmark is at the upper end of the scale as regards the provision of publicly funded care facilities for children up to three years of age (see Thenner 2000). Accordingly, Danish women do not face the considerable obstacles to work on a full-time basis or even on a regular part-time basis observed especially in Germany.

Denmark also stands out in the Western world as the country that spends the most on *active and passive labour market policies*, according to OECD data. In 1998, the share of total expenditure on labour market policies amounted to 5.63% of GDP (Germany: 3.56%). Of particular interest in this context are schemes that enable unemployed people to start up new businesses or job creation schemes that are associated with fixed-term contracts. Leave programmes (for example, for training purposes or child care) can favour fixed-term contracts because such measures often lead to a temporary replacement.

Denmark changed the emphasis of its labour market policies in 1993. One part of the reform consisted of additional measures to reduce labour supply (for example, early retirement, sabbaticals and paid leave arrangements). The number of participants in labour market programmes and the composition of expenditure in Denmark reveal a shift in recent years from demand side measures (especially wage subsidies) towards supply side measures (mostly training programmes).

In many countries a close relationship exists between standard labour market programmes for young people and institutions facilitating the *school-to-work transition*. The Danish vocational education and training programmes are sandwich-type programmes, in which a separate theoretical education at a vocational school (one-third of total duration) alternates with practical training on a full-time or part-time basis in a business enterprise (two-thirds of total duration). A characteristic feature of the system is fixed-term contracts between the young employees and the employers offering practical or occupational training (excl. vocational school). Nevertheless, the existing institutions fail to reach all school leavers to whom standard labour market programmes are offered.

Finally, *employment protection regulations* may also influence the composition of work arrangements. The stricter dismissal protection is, the more it can act as an incentive for enterprises to select above all those forms of employment with little or no dismissal protection (for example, fixed-term contracts, use of agency workers, or contracting out work to the self-employed). According to the OECD indicator measuring the strictness of employment protection regulations of 26 countries in the Western world, where a higher ranking implies fewer legal restrictions,[6] Denmark is in sixth place, Germany in twentieth (OECD 1999). In other words, compared to Germany, standard work arrangements are low-risk options from an employer's point of view.

At this stage we can summarise as follows: Denmark is different. It is different from many other European countries, especially the continental welfare states exemplified by Germany, with regard to its (positive) labour market performance, its (high) labour market flexibility, its social security system (financed and designed in a way that does not create incentives to non-standard work arrangements), its (positive) institutional incentives for female employment, and the (high) significance of active labour market programmes.

Self-employment

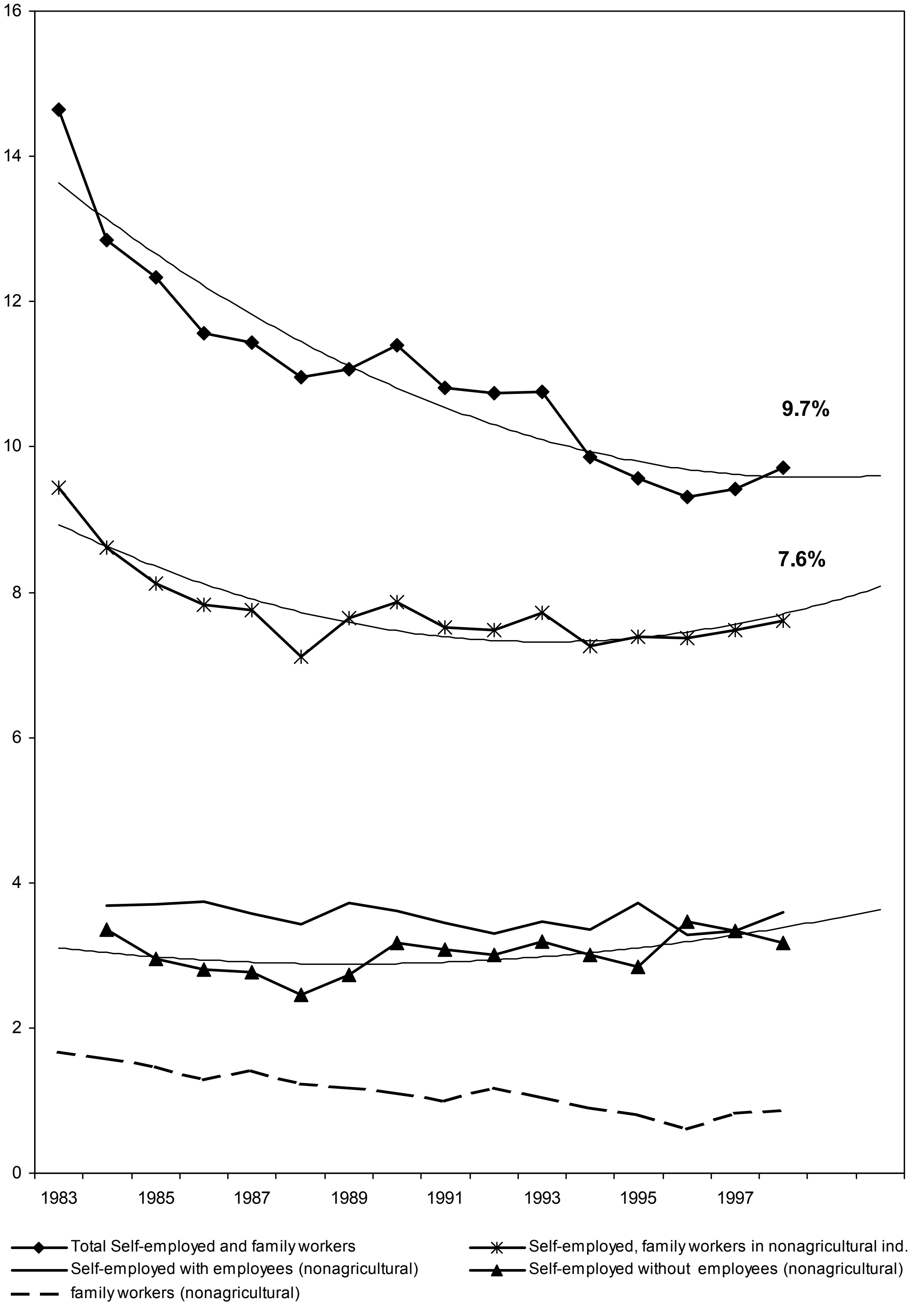
In 1998, Denmark, Germany, Sweden and the Netherlands (as well as Luxembourg) were the countries with the lowest share of self-employed persons in total employment in the European Union, while southern European countries showed the highest share. What lies behind these differences?

The first argument relates to *structural change*. Agriculture-dominated societies are generally characterised by a high degree of self-employment. In more developed countries contrary effects can be observed from industrialisation on the one hand and from a higher share of services on the other. Industrialisation leads to increased capital accumulation and business concentration and a higher share of services leads to business start-ups.

The level of self-employment also depends on the *level of prosperity*. The share of self-employment is high in countries with low average incomes, while self-employment rates are comparably lower in countries with a high living standard. Responsible for this are productivity effects resulting from a growing capital stock which induce relative improvements of wages compared to incomes from self-employment. Higher levels of economic development offer more alternatives for earning a living. Incentives to become self-employed are hence reduced.

6 The indicator takes into account regulations concerning individual and mass dismissal, as well as temporary employment (for example, fixed-term contracts and the use of agency workers).

Figure 4: Denmark – Self-employed and family workers, 1983–98 (% share of total employment [quadratic trend])



Source: Eurostat, *Labour Force Survey*.

The *size and composition of the labour force* may also influence the level of self-employment. If we assume the same density of self-employed (that is, the number of self-employed related to the working population) in two countries or at two points of time, the self-employment rate (as part of total employment) will decrease with a higher or growing employment rate. This is because a higher utilisation of the labour force is in general accompanied by the higher labour force participation of women, who are less likely to become self-employed (Blanchflower 1999; Huijgen 1999).

The *situation on the labour market* as well as *labour market institutions* can also play a role in determining the level of self-employment. Both aspects are considered to be "push factors". High unemployment rates induce higher inflows into self-employment due to the lack of jobs in dependent employment. Self-employment programmes aiming at the reintegration of the unemployed can reinforce such a development. "Push factors" can also become effective because of strict employment protection, high social security contributions and, not least, deregulated product markets with low barriers to entry.

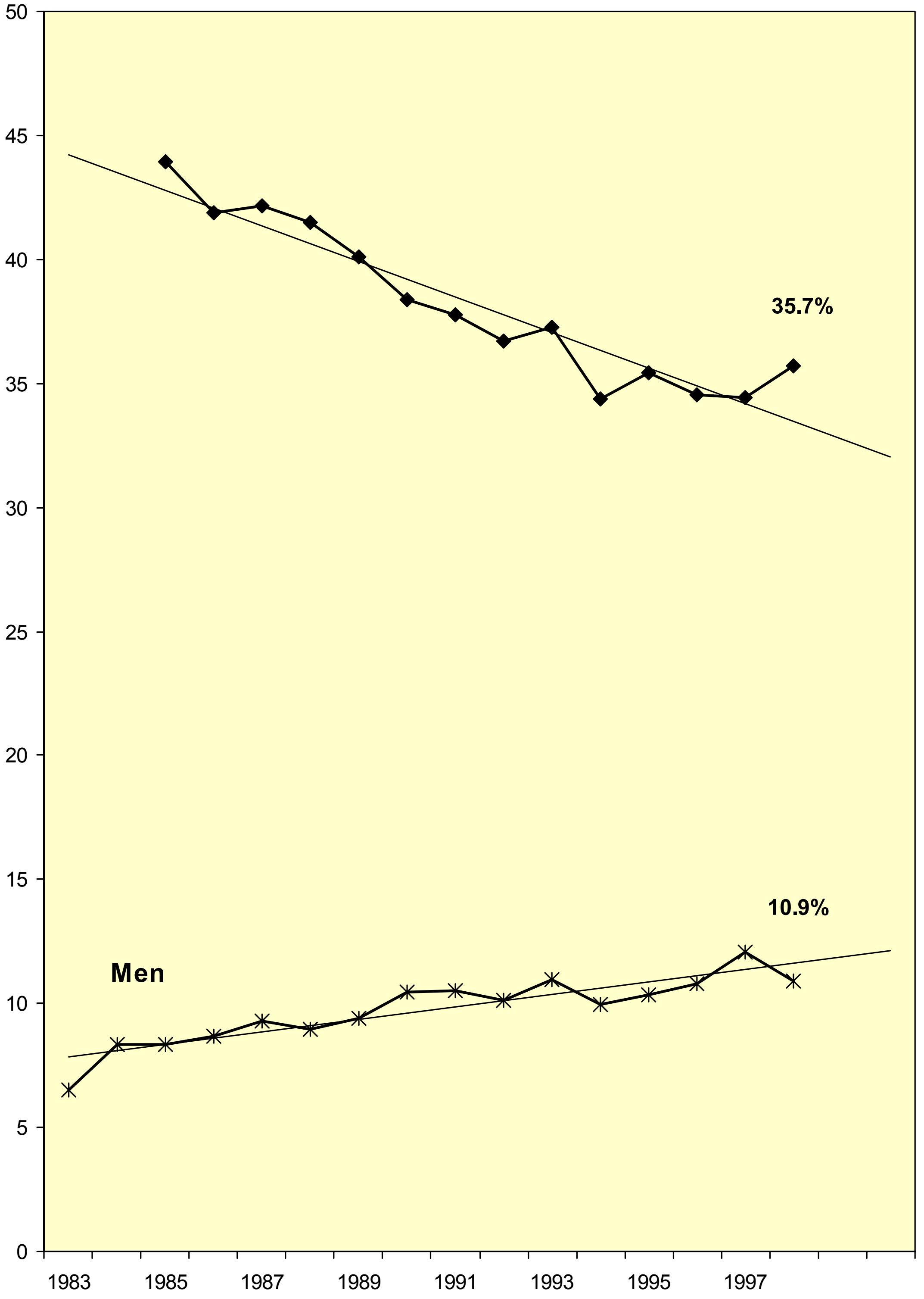
High living standards on the one hand and structural change to the detriment of the agricultural sector on the other hand offer a plausible explanation for the comparatively low self-employment rates in Denmark, as well as in Germany, Sweden, the Netherlands and Luxembourg. The particularly low share of self-employed and family workers in Danish employment may in addition be attributed to a number of factors such as a higher participation rate of – also married – women, a more favourable labour market development since 1994, less emphasis on labour market policy programmes promoting the start-up of businesses, and less strict labour market regulations. Figure 4 reveals that self-employment rates fell in Denmark from 1983 to 1998. But the development is largely influenced by the closing of small businesses in agriculture leading to decreasing numbers of self-employed workers. Outside the agricultural sector one can observe a contrary picture: the decrease of the share of self-employed persons (not including agriculture) was halted in the late 1980s, and as a consequence, increasing levels of self-employment (especially outside agriculture) can be expected, as shown by trend extrapolations.

The share of self-employed with employees was slightly higher than the share of self-employed without employees in 1998. But differences between the two rates diminished in the course of time, since the increase of self-employment without employees was above average. A possible explanation for the increase of one-person businesses may be that market entry became more feasible for small enterprises because of the rapid diffusion of information and communication technologies. Due to stronger international competition and increasing labour cost pressures a more intensive contracting out of work and concepts of lean management may also have contributed to this development.

Part-time employment

Besides the Netherlands, with a part-time rate of almost 40% in 1998, there are three countries in the European Union with a share of over 20%: the United Kingdom, Sweden, and Denmark. But Denmark is the only EU country where the share of part-time work has decreased over the last decade (see Table 1). This decline was mainly caused by women and is concentrated in voluntary employment contracts with an average weekly working time of between 15 and 35 hours. However, the diminution of female part-time employment in Denmark is not a new phenomenon. The development was already there in the 1980s but less striking. Then, the downward trend of female part-time work in Denmark was compensated by the increase in the number of men working part-time. However, in the 1990s this was no longer the case, with male part-time work remaining relatively constant (see Figure 5).

Figure 5: Part-time rates by gender in Denmark, 1983–98 (linear trend)



Source: Eurostat, *Labour Force Survey*.

The long-lasting decline of part-time work among Danish women seems largely to be associated with an institutional setting favouring their full-time employment, including comprehensive child care facilities and separate income taxation. The reduction of involuntary part-time employment during the economic upswing in Denmark contributed to the general decline and is associated with improving labour market conditions.

While part-time work with long hours (more than 14 hours a week) decreased, marginal part-time work (up to 14 hours per week) increased, due to a number of institutional incentives. In 1998, 8.1% of the employed (women 9.9%, men 6.5%) had a regular working time of less than 15 hours per week. This is probably due to the fact that many young Danes work part-time: youngsters account for 74% of marginal employment in Denmark (part-time employment with weekly working time of between 1 and 9 hours), which may come as a surprise in a country with high participation rates in education.[7] There are two reasons for this surprising fact. First, part-time work (or alternatively, full-time work) may be an integral part of the Danish vocational system, in which young people switch between education and learning at a workplace. Secondly, part-time work is often done by pupils or students who seek to improve their standard of living by means of marginal employment.[8]

Temporary employment

Compared to other EU countries, temporary employment rates in Denmark are somewhat below average. Apprentices account for a good deal of such employment, albeit with a declining tendency (see Figure 6), and in many cases, temporary employment is also associated with part-time work.

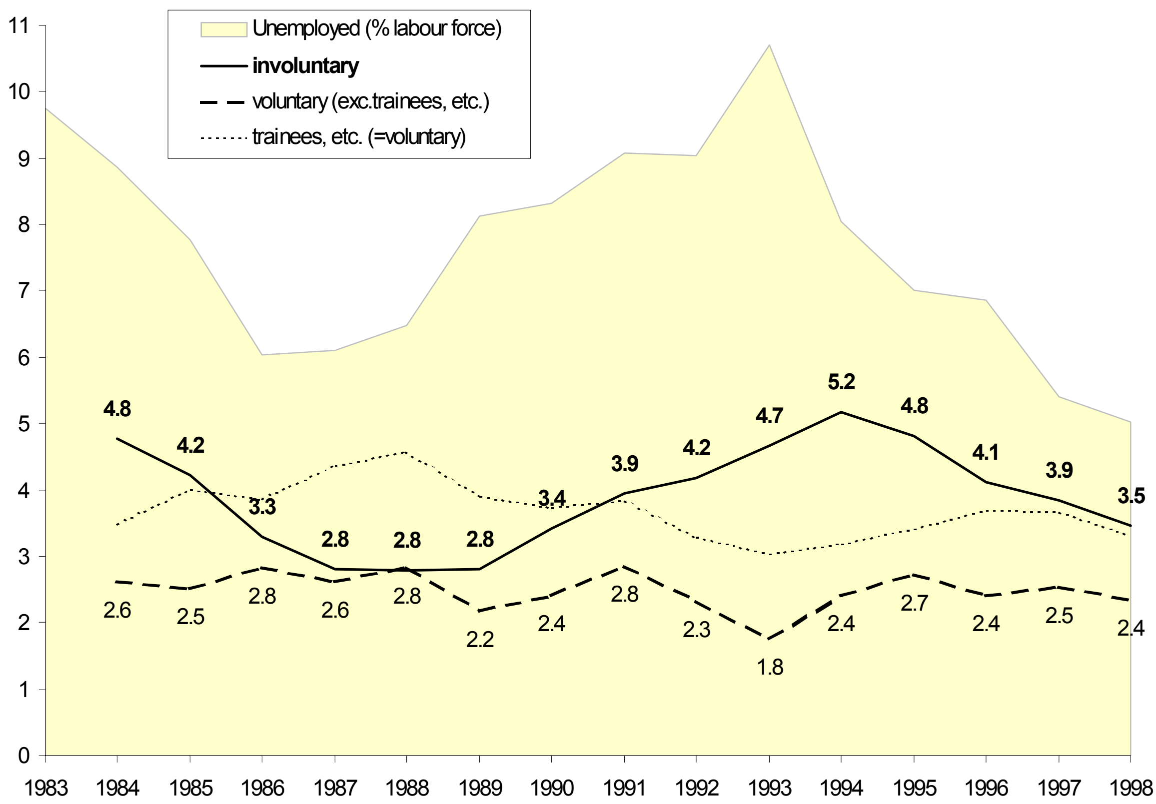
During the last decade, no significant changes took place in Denmark with regard to the relative importance of temporary work. If we take into account the fact that the overall employment record is very good in Denmark and that Danish labour market regulations provide a relatively high level of flexibility, not creating major incentives for non-standard work arrangements, we would expect lower temporary employment rates (excl. apprentices) in Denmark. Possible explanations for this counterintuitive result may be identified by taking a closer look at structural features of temporary employment, labour market performance and institutional issues.

Temporary work arrangements are in general not the first choice for the majority of workers employed on a fixed-term basis. In Denmark, however, “voluntary” temporary employment is relatively significant, with 2.4% of total employment (Germany: 0.2%). This is related to the fact that permanent contracts are not necessarily the first choice for employees for whom the disadvantages of a temporary contract (for example, the higher risk of being jobless after expiry of the contract) are less relevant. This might apply to persons who are not interested in a permanent job (pupils or students) or persons who would anyway leave dependent employment (for example, because of retirement or due to the starting up of a business). The relatively high number of “voluntary” temporary contracts in Denmark seems to correspond to the importance of marginal work carried out by pupils and students.

7 In Denmark 71.9% of persons between 15 and 25 years were in education in 1998 (in Germany 68.4%).

8 This is also due to the fact that students at a higher educational level are allowed to earn only a certain amount of money (maximum income ceiling) every year. However, the size of the grant makes some supplementary income necessary for most students. Full-time work would lead to loss of the study grant.

Figure 6: Temporary employment in Denmark, 1984–98 (% of total unemployed)



Involuntary: "could not find a permanent job"; "no reason given"; "contract for a probationary period".
Voluntary: "did not want a permanent job".
Source: Eurostat, *Labour Force Survey.*

The business cycle is one possible determinant of changes in temporary employment rates. But the relationship between unemployment and temporary employment can be pro-cyclical as well as anti-cyclical. Increasing unemployment may induce pressure that promotes the diffusion of temporary contracts; decreasing unemployment may reduce the number of temporary contracts (as in Denmark – see Figure 6 for temporary employment, excluding apprentices, and so on). A contrary relationship can instead be expected when temporary employment is used as an employment buffer that is widened in cyclical upswings and reduced in cyclical downswings (as seems to be the case in Germany).

In Denmark neither employment protection regulations nor temporary employment rates have changed significantly. The relatively high temporary employment rate in Denmark – although employment protection regulations are less strict than in Germany – can probably be attributed to two factors: the comparatively high volume of "voluntary" temporary employment and the still significant level of active labour market policy programmes (for example, subsidised employment and paid leave arrangements) leading to numerous fixed-term contracts.

Finally, regulations concerning temporary work agencies may also be important for the utilisation of temporary employment. The use of agency workers is a potential alternative to the hiring of permanent or fixed-term employees. Contracts concerning agency workers are also often signed for a fixed duration only. In Denmark, regulations concerning temporary work agencies were abolished in 1990. Therefore, the duration of the employment contract of an agency worker depends on the individual agreement between agency and temporary worker. Consistent information about the extent of agency work in EU countries is not available. Estimates made by the World Federation of Temporary Work show that the importance of temporary work agencies is relatively low in Denmark (0.3% of dependent employment) and in Germany (0.7% of dependent employment), compared, for example, with the Netherlands (4.6%) and France (2.2%) (see Klös 2000; De Koning et al. 1999). In spite of significant deregulation, the spread of agency work is still weak in Denmark, a fact that, again, must be seen in the context of the availability of other flexibility options.

In general, we can assume that decisions on the use of work arrangements at the firm level are considered carefully. Recent studies illustrate that temporary work arrangements are used as a complement to the core workforce in order to reduce adjustment (for example, to business fluctuations) costs by means of more flexibility (see Rudolph and Schröder 1997). Furthermore, the possibility of using temporary employment as a probationary period (without any obligation) is also a reason for temporary work arrangements because it provides an opportunity to improve the selection of staff (see Farber 1999; Rogowski and Schömann 1996). From this point of view, relatively constant rates of temporary employment over time are compatible with high levels of fluctuation in temporary work arrangements.

Conclusions: More diversity or new standards?

Analyses based on the ELFS have shown that over the 1983–98 period the proportion of standard work arrangements increased in Denmark, while it declined in Germany and in most other EU countries. The renaissance of standard work arrangements in Denmark – that is, permanent full-time work with employee status – is especially due to the decrease in part-time employment as well as the small decline in self-employment and the almost stagnant level of temporary employment.

Despite the general trend, even in Denmark amongst young employees the ELFS data indicate growth in non-standard work arrangements. Non-standard work arrangements are obviously playing an increasing role as a bridge to standard work. This is because they can reduce the difficulties of subsequent integration in the labour market. In addition to the role of non-standard work arrangements as a means of transition the increase in the number of young employees affected by employment of this kind also reflects the fact that many of them combine education and work (for example, apprenticeships and other types of learning at the workplace, as well as marginal employment which acts as a supplement to study grants). All in all, there are no hints that the growing number of non-standard work arrangements affecting young employees are a reflection of growing social exclusion among them.

Trend extrapolations suggest that the downward trend of standard work arrangements in Germany, taken here as representative of most EU countries, and the opposite trend in Denmark may continue further because of the important role of part-time employment. But analyses suggest that care must be taken to avoid determinism when interpreting the development of work arrangements. Two factors – normally not explicitly taken into account in the utilisation of trend extrapolations – have been identified as relevant to the direction and even the strength of some changes in the composition of work arrangements: labour market performance and institutional incentives.

The changes in work arrangements, particularly the diverging development of non-standard work arrangements in Denmark and Germany, reflect different labour market performances. Whereas in Denmark – as a country with traditionally high labour market participation – employment has gone up and unemployment down since 1994, Germany – as a country with significantly lower labour market participation than Denmark – experienced a severe labour market crisis for most of the 1990s. The continuing reduction in the amount of female part-time employment with weekly hours between 15 and 35 hours in Denmark can at least partly be seen as the exploitation of already scarce human resources. Supply side restrictions did not exist to a large extent because of comprehensive child care facilities and significant incentives to work due to the system of separate income taxation. Moreover, self-employment (especially, since 1995, outside the agricultural sector) did not increase, largely due to the positive overall development of the labour market which absorbed more women in full-time jobs.

The institutional setting seems to be at least an equally important factor in the diverging trends. However, it is important to note that standard work arrangements in Denmark and Germany are not comparable in qualitative terms. The standard work arrangement in Denmark is less burdened by social security contributions and strict regulations than typical continental welfare states such as Germany. Therefore, the present erosion of standard work arrangements in Germany need not necessarily lead to a situation characterised by greater diversity of such arrangements in the future; but this erosion may indicate the need for reform of the standard work arrangement.

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Appendix: The Database of the Eurostat Labour Force Survey (ELFS)

The survey is carried out annually in spring. The labour force characteristics of each person interviewed refer to their situation in a particular reference week.

Eurostat covers the resident population living in private households. The population living in collective households (homes, boarding schools, hospitals, and so on) in particular and persons doing compulsory military service are excluded.

Definitions and Explanatory Notes

"Standard work arrangements" are based on a permanent full-time relationship with employee status and subject to basic social security; included are manual and non-manual employees and civil servants, including career military personnel.

Permanence of the job. This question is addressed only to employees. The termination of a fixed-term job or work contract is determined by objective conditions (for example, reaching a given date, completion of an assignment, return of another employee who has been temporarily absent); included are persons with a contract covering a period of training – such as apprentices, trainees, research assistants, and so on – or for a probationary period, and persons with a seasonal job.

Active labour market programmes influence the number of temporary employed. The ELFS does not distinguish between participants in these programmes from other temporary employees. Furthermore, temporary agency workers cannot be accounted for in the ELFS; besides, persons engaged by an employment agency may have a work contract of unlimited duration.

The distinction between *full-time and part-time work* is made on the basis of a spontaneous answer given by the respondent. Comparing the answers with the number of "hours usually worked" shows for both Denmark and Germany that "part-time" rarely exceeds 35 hours, while "full-time" usually starts at about 35 hours.

Self-employed are subdivided into employers (who employ at least one other person) and self-employed without employees (who do not employ another person).

Arne Heise°

Boosting Employment through Coordinated Macro Policies: A Viable Option for the EU?

1. The policy agenda

Ever since European integration was put on the political agenda, and particularly with European Monetary Union (EMU), one of the major arguments in its favour has been that it would help to boost economic growth and employment. However, deepening integration over the decades has been accompanied by growing unemployment, slack economic growth and the cutting back of social systems almost everywhere in the European Union (EU).

Although there is no direct link between these developments, it nevertheless explains why unemployment ranks so high, not only on the political agendas of individual EU member countries but also on the common policy agenda. It has become increasingly obvious that not European integration per se, but only European integration with a particular economic policy orientation will be able to deliver the desired outcomes.

The inclusion of an "Employment Chapter" in the 1997 Amsterdam Treaty closed an important loophole in the Maastricht Treaty, signed six years earlier. Even after the path-breaking agreement on a single currency, critics of European integration had still been able to complain – with some justification – that the convergence criteria set for participation in European Monetary Union (EMU) placed too much weight on price stability in the new euro area, and too little on the employment situation. Indeed, it could be said that the Maastricht Treaty still bore the hallmarks of the economic – and political – priorities of the 1980s, the "monetarist decade". As importance was increasingly attached to combating the rising trend in unemployment, a pressing need became apparent: the European Central Bank's remit to ensure price stability in the future eurozone had to be balanced by assigning the EU explicit responsibilities for employment. In this way a new field of EU policy was opened up.

Without doubt this development was due in part to the constant political pressure applied by those member states which have traditionally had more active labour market and employment policies, namely Sweden and Austria. But it can also be attributed to the EU's gradual "social-democratisation", a process whose crucial moment was the coming to power of Lionel Jospin in France and Gerhard Schröder in Germany.

Yet the EU's assumption of employment policy responsibilities in the Amsterdam Treaty was merely the beginning of a conceptual process which shaped the three pillars of current EU employment policy (see Figure 1). These are:

- The "*Luxembourg Process*", initiated at the 1997 Luxembourg Summit, which established that member states would coordinate their labour market policies.
- The "*Cardiff Process*", named after the Cardiff Summit of 1998, which embodies the hope that liberalisation of product and financial markets can stimulate the structural changes and dynamism required to create knowledge-based economies in the various European countries, while simultaneously deepening European integration.

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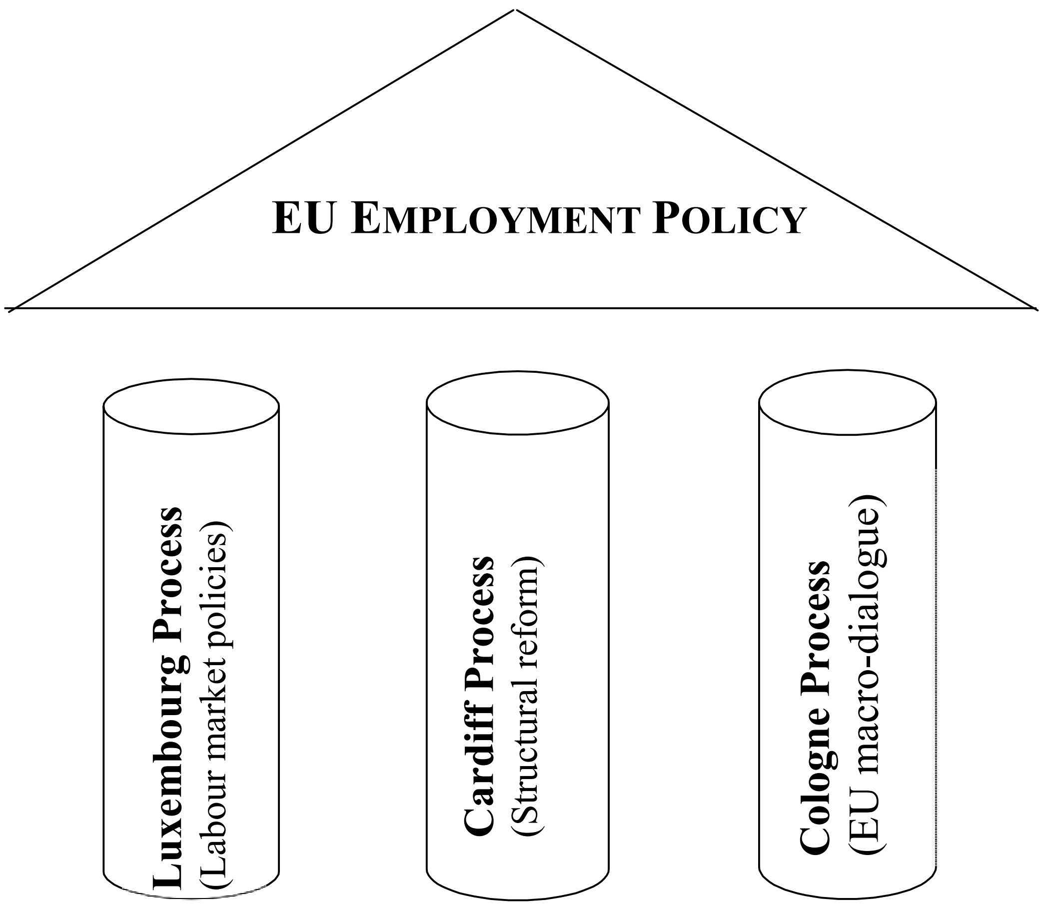
- The "*Cologne Process*", the most recent of the three. Agreed at the 1999 Cologne Summit, it recognises that a favourable macroeconomic situation is the prerequisite for lasting improvements in growth and employment, and that coordination of budgetary, monetary and incomes policy – so-called "EU macro-dialogue" – is therefore desirable. For the first time the ECB's activities have been set in an employment policy context, and the European social partners tied in to the process.

Figure 1: European employment strategies



Both the Luxembourg and the Cardiff processes stress the importance of functioning markets, and are thus unmistakably based on microeconomic considerations of allocation theory and supply-side policy; they are concerned with improving "employability" rather than purely quantitative "employment". By contrast, the Cologne Process is founded on macroeconomic, demand-theory notions, so that it can also be seen as part of a "Euro-Keynesian" strategy (see Aust 2000).

Because the European Union does not have the financial resources to pursue an employment policy on its own account – it has only 1.27% of EU GDP at its disposal – employment policy as established in the Cologne Process can be merely "economic governance" in the sense of coordination of national policies. The concentration on the Cologne Process and the neglect of the Luxembourg and Cardiff processes in the following analysis is not an arbitrary decision but results from my belief (see Heise 1998, 1999, 1999/2000) that a lasting improvement in economic growth and employment can be achieved only by macroeconomic policies.

There are two distinct levels of coordination and also two distinct coordination procedures. First, we must distinguish between *horizontal coordination* of national policies within a given policy field, such as the Stability and Growth Pact (SGP) coordinating national fiscal policies, and *vertical coordination* of monetary, fiscal and incomes policies in order to create a coherent policy mix. Secondly, we must distinguish between *hard coordination*, implying clear rules and sanctions, and *soft coordination*, which has to rely on peer pressure. Before taking a closer look at these policy coordination levels and procedures, let us first establish the need for policy coordination within EMU.

2. Economic policy coordination in the euro-zone: what is the issue?

2.1. Horizontal coordination

The rationale for policy coordination within some policy fields is the need to provide a public good (for a survey of the literature see Mooslechner and Schuerz 2001). This is best explained in terms of the example of fiscal policy, which is mentioned in the European treaties.[1]

In a monetary union, national risk premia on interest rates, which governments have to pay according to their (expected) fiscal behaviour, are levelled out. In other words, the cost of an overly expansionary fiscal policy can be externalised to all EMU members, while the benefits of such a policy – growth effects or social policy spending – can largely be internalised. This, it has been argued, creates an incentive for member countries to neglect fiscal restraint or, even worse, forces member countries into an overly expansionary fiscal policy in order not to end up as a "willing victim". Therefore, coordination must impose clear restrictive rules and sanctions if the European Central Bank (ECB) is not to be left to combat inflationary pressures – which may arise in the case of overly expansionary fiscal policies – alone.

Although this reasoning cannot be rejected outright, its validity has often been exaggerated: on the one hand, the possibility of externalisation exists only if national governments bail each other out in times of financial trouble. Accordingly, the European treatises include a *"non-bail out clause"* which is perfectly credible as national governments retain powers of taxation and so are in a position to determine public revenues to a significant degree.[2] On the other hand, fiscal policy will not be pursued simply and predominantly with regard to the possibility of externalisation but rather with regard to a trade-off between today's and tomorrow's fiscal room for manoeuvre – and this depends much more on the level of public debt than on interest rates (see Heise 2001a). These caveats at least reduce the risk of running into a situation of overly expansionary fiscal policies within EMU.

There is another, almost contradictory reason for coordination, given the possibility of "free riding". EMU members may act as "free riders" – that is, "opt out" of stabilisation policy – if they expect the other members to accomplish the task without them (particularly in the case of a small country), or, on the contrary, if they expect the others to behave as "free riders" themselves (particularly in the case of a big country). Under such circumstances, only clear rules and sanctions will provide an expansionary fiscal policy which is able to stabilise the euro-zone.

These lines of reasoning – the first, coordination for *restrictive purposes* in order to prevent excessive public deficits, the second, coordination for *expansionary purposes* in order to provide effective stabilisation policies – seem to contradict each other. However, this constitutes only a

1 It could also be established for incomes policies. Monetary policy, however, has not had to be horizontally coordinated in the euro-zone since monetary unification in 1999.

2 In this respect they are quite different from German Länder or US states.

vague representation of the different positions of EU members: larger and more closed economies cannot profit very much from free riding but may be induced to externalise the interest rate effects of expansionary fiscal policy; smaller and more open economies, on the other hand, are unable to internalise the positive growth effects of fiscal stimuli but may want to free ride if they can. In both cases, without effective policy coordination the provision of public goods will be difficult to achieve: fiscal discipline on the one hand and stabilisation policy on the other (see Jacquet and Pisani-Ferry 2001).

2.2 Vertical coordination

The interdependence of the various policy areas – that is, monetary, fiscal and incomes policies – can be shown by the construction of a Phillips curve, on which those responsible for them pursue the *common goal* of a given combination of price stability and labour market parameters, but display *differing preferences* with respect to inflation and unemployment.

Using a formal model (see, for example, Carlin and Soskice 1990; Layard, Nickell and Jackman 1991; Nordhaus 1994) it can be shown that, if behaviour is not coordinated, none of the political actors can reach their desired utility, expressed by a position on the Phillips curve. In that case all actors – central bank, government and social partners – must accept a loss of utility relative to the situation in which cooperation occurs. Specifically, it transpires that monetary policy is tighter than would be required merely on price stability grounds, while budgetary policy is subject to "hegemonic coordination" by the independent central bank, the result being higher borrowing and reduced room for manoeuvre on the part of public authorities. Meanwhile, incomes policy, and in particular the unions, must accept increased unemployment with no compensating distributional improvements.

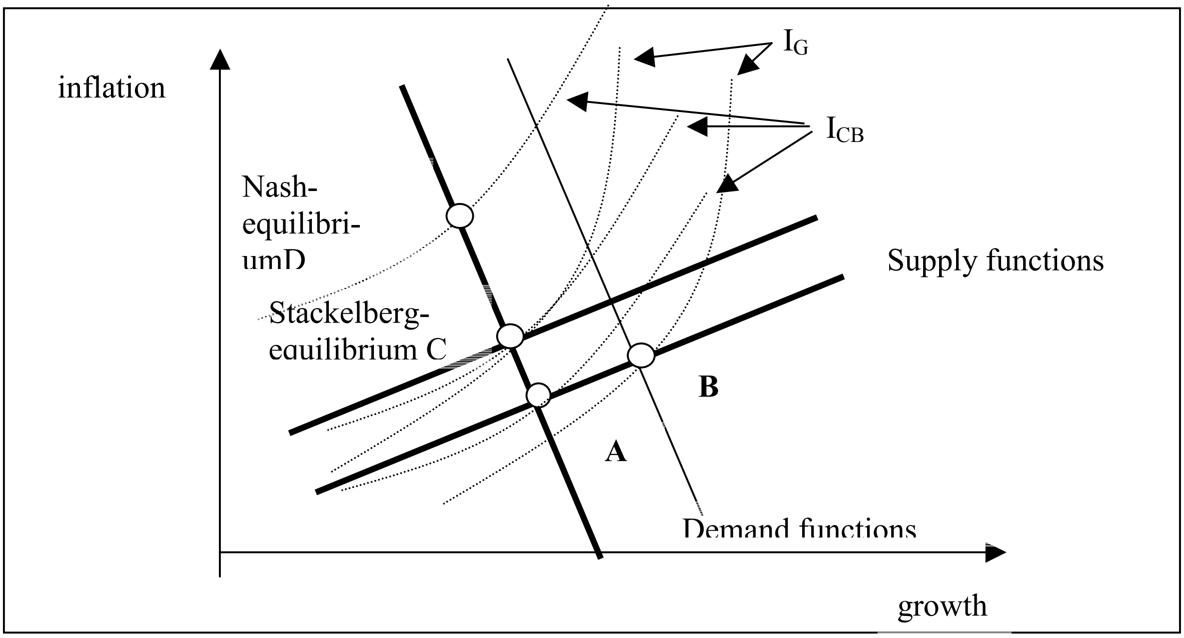
If it were possible to compare an economy with horizontal coordination with another which lacks it, the latter would display not only higher interest rates and higher prices (or inflation), but also higher unemployment and more public debt (see Heise 2001b: 61ff.) This is shown in Figure 2 which portrays – for the sake of simplicity – the preferences of two actors only (the central bank and the government) in a growth–inflation space. Non-coordination results in a Nash-equilibrium position D, or, if one actor is taken to be what is called a Stackelberg-leader, in position C (both of which are clearly inferior to either A or B or some point of coordination in between).

Cooperation therefore seems desirable in that it increases utility – and not just for the individual actors but also for the economy as a whole. It might therefore be expected to arise spontaneously. Yet empirical studies clearly indicate that coordinated behaviour occurs by chance, if at all. That does not mean that actors are ignorant, ill-directed or downright malicious, however. Rather they are both rational (that is, they pursue defined goals in a consistent manner) and selfish (that is, they value increases in their own utility more highly than those of other actors). Under these circumstances, actors will be caught in the classic Prisoner's Dilemma unless it is somehow assured that all the actors concerned will play their part in cooperation (in the case of macroeconomic coordination, that would involve the central bank permitting a more expansionary monetary policy, the government adopting a less restrictive, but sustainable budgetary policy,[3] and the social partners agreeing to a non-inflationary incomes policy which seeks distribu-

3 This should certainly not be understood to mean an undifferentiated policy of deficit spending. The notion is rather that the empirically established positive long-term effects – on growth and employment – of expansionary budgetary policy should be combined with the requirement for sustainability, that is, the maintenance of a level of public debt perceived as optimal, for example, 60%, as under the Stability and Growth Pact (see Heise 2001a). Such an approach to budgetary policy requires a coordinated policy mix, however, if it is not to fall into the debt trap (see Rankin 1998).

tional stability). Otherwise, it remains preferable, and indeed necessary, for the individual actors to accept a macroeconomically inferior outcome in a situation of general non-cooperation. For the alternative is to become a "willing victim" who makes the concessions required by cooperation and is exploited by other actors who do not.

Figure 2: Uncoordinated monetary and fiscal policy "game" in a growth–inflation space



Game theory considerations do not warn us merely against unjustified assumptions of "spontaneous cooperation", however. They also point to the conditions which must be fulfilled if the Prisoner's Dilemma is to be resolved and cooperation occur. The most elegant option would be to bind the actors contractually, making non-cooperation sanctionable, but that is effectively ruled out in the case of macro-dialogue. A binding agreement of this type would involve dependence on a third party to decide whether the actors had, in fact, fulfilled their contractual obligations, and is in any case barely conceivable for independent actors.

The alternative is an implicit agreement under which sanctions take the form of non-cooperation costs (the so-called "long shadow of the future"). In this case institutional structures must be devised to minimise the danger of "willing victims" being exploited.

(1) The first essential is that the actors must be willing and able to *communicate* with each other; without communication a "cooperative game" is unthinkable. However, "communication" must go beyond the mere exchange of information which could in any case be gleaned from the actors' own relevant material or press statements. Rather, communication here implies exchanges about cooperation itself, about potential gains and the costs of non-cooperation, about a cooperative strategy and about anything which might increase actors' trust that cooperation on their part will be reciprocated by others.

(2) Communication is a necessary, but not a sufficient condition for cooperation. It must also be possible to specify and *monitor* actors' individual contributions to cooperation. Only when it is clearly and generally accepted that all such contributions have been made can behaviour in "the next round" – that is, in future interactions – be determined. That means that *guidelines* must be established to enable contributions to be verified.

(3) To avoid the first-mover trap, a *sequence* – that is, a succession of cooperative actions and responses – must be established. That also addresses the problems arising from the fact that, in pursuing their policies, individual actors may have to consider other market players as well as the other policy actors involved in the "game". Specifically, a central bank cannot ignore the financial markets if it wishes to have any chance of achieving its goals. Indeed, the markets may demand complete central bank independence as a prerequisite for its credibility. In that case the bank cannot be a "follower" – an actor which responds to the cooperative contributions of others – but must be a "leader", setting the cooperation agenda.

(4) Finally, a "*game strategy*" is required that minimises the utility losses for an actor who none the less becomes a "willing victim". Here game theory prescribes "tit-for-tat" as the ideal strategy. Simple and unsophisticated, it signals a willingness to cooperate while punishing non-cooperation mercilessly.

To enable lasting cooperation between macroeconomic actors, these parameters must be set in an *institutional context* (so-called "structural embeddedness"). This gives actors security and confidence and so underpins cooperation. In particular, communication must occur within a stable institutional framework. Monitoring of actors' behaviour and establishment of generally accepted guidelines requires a "neutral" authority which must be equally respected by central bank, government and social partners – only then will its decisions be effectively binding.[4]

All in all, the prerequisites for successful vertical coordination of macroeconomic actors' behaviour in the context of a macro-dialogue are numerous. Yet the underlying conditions are clearly favourable. Since all actors can profit from cooperation by approaching their desired position on the Phillips curve more closely, the game has a positive sum. Unlike in a zero-sum game, such as the situation of "antagonistic cooperation", there is no need for them to be constantly on guard against losing out in the process of give-and-take. That should make it relatively easy for actors to obtain the internal legitimation necessary to participate in macro-dialogue, either from their members (in the case of the social partners) or from voters (the government).

3. …and what has been achieved?

In the Maastricht Treaty, as well as in its revision, the Amsterdam Treaty, EU members agreed upon coordinating economic policies. But what was the underlying rationale for this agreement and what is its purpose?

"Multilateral surveillance" is the nucleus of economic policy coordination in the euro-zone, in which broad economic policy guidelines (BEPG) are being issued by the European Commission. Over recent years, these guidelines have been of an orthodox neo-liberal orientation: they have persistently recommended fiscal parsimony, wage moderation and labour market deregulation. National governments are required to take the recommendations of the BEPG into account and to respond to them in their annual economic reports. Although the BEPG are merely general statements, this type of "soft coordination" – which includes the employment policy guidelines (EPG) of the Luxembourg Process and, additionally, the annual reports of the Cardiff Process –

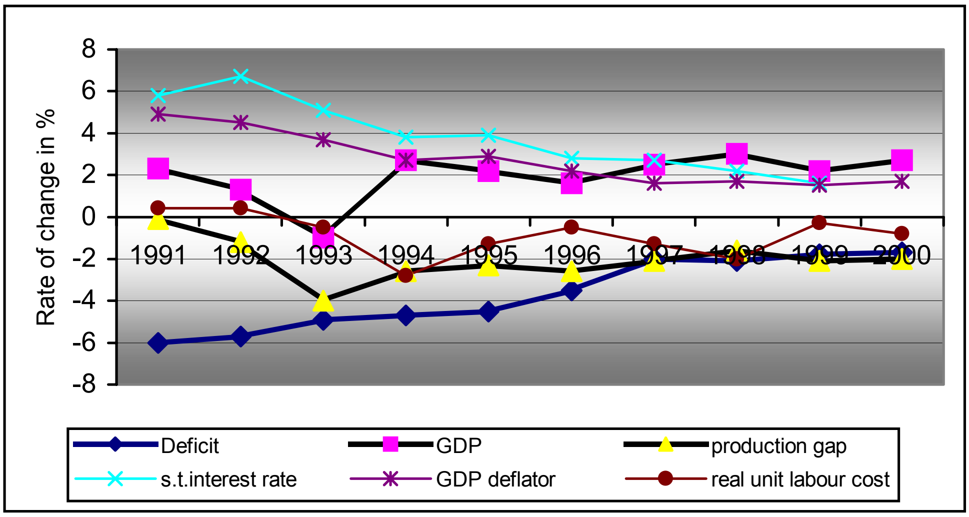
4 Elsewhere I have proposed (Heise 2001b: 98ff.) a "Socio-Economic Committee" (SEC), composed of representatives of the various policy actors, and an "Expert Committee" (ExC), made up of academics enjoying the relevant actors' trust (closer to the Austrian "Advisory Committee on Economic and Social Issues" than to the German "Expert Committee on Macroeconomic Performance"), which together could serve as the institutional framework for macro-dialogue. The ExC would take on the monitoring role, working on the "papal" principle: at specified points in time it would be required to issue unanimous recommendations. That would prevent individual members' views from being imposed upon by a majority, while creating pressure for agreement. The results of the monitoring process would be communicated in the SEC, which would discuss and communicate sanctions.

is far from being ineffective: even without clearly established sanctions, peer reviewing and peer pressure may be very effective in enforcing a common (neo-liberal) policy outlook.

"Hard coordination" – that is, clear rules of conduct and sanctions in case of misbehaviour (see Canzoneri and Diba 2001) – has been reserved for horizontal coordination of national fiscal policies, euphemistically called the Stability and Growth Pact (SGP). The purposes of the SGP are evident: on the one hand, it aims at fiscal constraint, tying members by issuing zero-deficit guidelines (see Buti et al. 1998); the negative growth effects of such fiscal constraint are rejected outright. On the other hand, binding policy guidelines are expected to lend the newly established European Central Bank more credibility in exclusively pursuing a policy of price stability (see Artis and Winkler 1998). Finally, the SGP enacts a type of vertical coordination which has been called "assignment" and implies a strict separation of policy responsibilities.

In other words – and to clarify – the SGP serves to *substitute* the vertical cooperation of the different policy actors (see Artis and Winkler 1998; Gatti and Wijnbergen 1999). The SGP was invented for the very purpose of rendering unnecessary cooperation proper and to avoid "exploitation" of the ECB by the budgetary policies of (some) EU members. Using a "hard coordination" procedure in the horizontal coordination of national fiscal policies ensures that new orientations – probably extracted from alternative macroeconomic paradigms – will have no chance of infiltrating the practise of European economic policy.[5] Against this background, vertical policy coordination of the Cologne Process – the so-called "macro-dialogue" – becomes futile. Not surprisingly, the Cologne Process is characterised neither by any form of "hard coordination" nor by "soft coordination" of the "multilateral surveillance" variety.

Figure 3: Euro-zone, selected indicators



Notes: Deficit = structural public deficit; GDP = rate of change of real GDP; production gap = difference between production capacity and production potential; s.t. interest rate = short-term nominal interest rate; GDP deflator; data for 2000 are estimates.

Source: *European Economy*, No. 68 (1999).

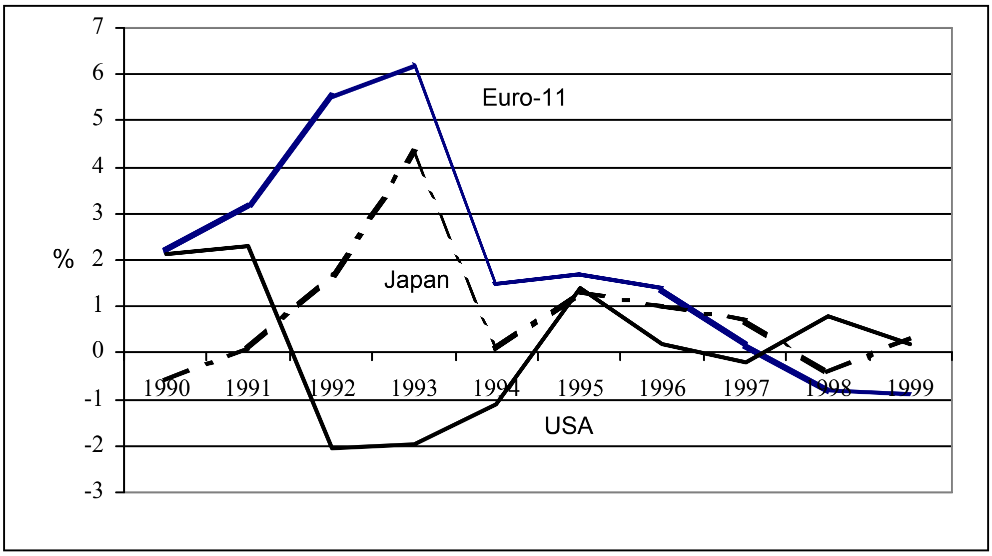
5 Severe floods causing widespread devastation in eastern Germany, in combination with a dull economic situation at the end of 2002, provoked a debate on the feasibility of the SGP. Although the case against SGP compliance 'come what may' was not a theoretical but purely a practical one, the dispute was terminated by simply referring to an alleged 'credibility effect', which holds only if the SGP is strictly adhered to.

Has this peculiar type of coordination already left its mark on the economic situation and development of the euro-zone? The reduction of public deficits from an average 4.8% of EU GDP over the period 1990–5 to 2.2% over the period 1996–2000 seems to be in accordance with the objectives of the SGP (and its forerunner, the Maastricht convergence criteria), but could also be attributed to a coincidental upturn in the business cycle. However, if the public deficit is controlled for business cycle distortions, the result is virtually the same: structural deficits were cut from 5.3% on average between 1990 and 1995 to 1.9% on average between 1996 and 2000, indicating that this restriction was accompanied by a slump in the second half of the 1990s (see Figure 3). Also, the huge divergence in national deficits had been drastically narrowed: while in 1991 the highest deficit was Greece's 11.5% of GDP – in contrast with Luxembourg's 1.9% surplus – the differential was down to –2.4% (in France) and +2.8 (in Denmark) in 1999.

The directly negative demand impact of such a restrictive budgetary policy could have been counterbalanced only if monetary and incomes policy had switched to an expansionary mode. However, Figure 3 arouses the suspicion that this was unsuccessful in terms of closing the production gap which opened up during the recession in the early 1990s. Although short-term (real) interest rates came down from 7% in 1992 to 2% in 2000, this only matched falling inflation rates which were the result of reduced (real) unit labour costs. However, if fiscal and incomes policies are constrained, monetary policy has to carry the whole burden of stabilising the economy – and this includes much stronger monetary pushes than the Bundesbank (until 1998) and the ECB (since 1999) were willing to give: while the short-term real interest rate (as an indicator of the central bank's policy orientation) was close to zero on average during the 1970s, it never fell below 2% during the 1990s (and GDP growth rates were higher during the 1970s than during the 1990s).

To summarise, it seems evident that slack economic growth in the European Union is, at least partly, due to unsuccessful vertical macroeconomic policy coordination – a result which is supported by a comparison with the prosperous development in the USA during the second half of the 1990s (see Flassbeck 2001; Lombard 2000; Semmler 2000), which becomes obvious when interest rate–growth differentials in both regions are contrasted (see Figure 4).

Figure 4: USA, Japan, EU; interest rate–growth differentials



Source: Flassbeck (2001).

Notwithstanding the fact that the available experience of macroeconomic policy coordination under the Cologne Process is still too limited for us to be able to draw final conclusions, it is clear that expectations should not be too high:

- Macro-dialogue was established in reaction to the Stability and Growth Pact, and – it may be surmised – as something of a concession. Only when a "window of opportunity" opened after the election of social-democratic governments in Germany and France, and an outspoken "policy-maker" took office in the person of the German finance minister Oskar Lafontaine, was it possible to embed the ECB in a macroeconomic employment policy strategy. After the resignation of Lafontaine early in 1999, however, the macro-dialogue lost momentum as a policy orientation.
- Macro-dialogue was forced into a straitjacket of requirements (acceptance of the provisions of the SGP and of the autonomy of the policy actors involved) which eroded its feasibility and secured the dominance of (restrictive) horizontal coordination.

Finally, the institutional framework of the Cologne Process – a "technical level" at which information and "points of view" are exchanged and a "political level" of mutual confidence building – is insufficient to overcome the "Prisoner's Dilemma" of vertical cooperation (see Heise 2002).

4. … what should be done?

Prior to the search for better coordination of macroeconomic policies a paradigm shift in economic policy must be acknowledged – the established problems of coordination within the euro-zone are no "technical" faults but are due to a misconception of what coordination is supposed to be. Therefore, what is needed is no less than a conceptually new orientation – or rather, a re-orientation as the SGP's domination of fiscal restrictions and the ECB's domination of monetary policy revert to a pre-Keynesian state.

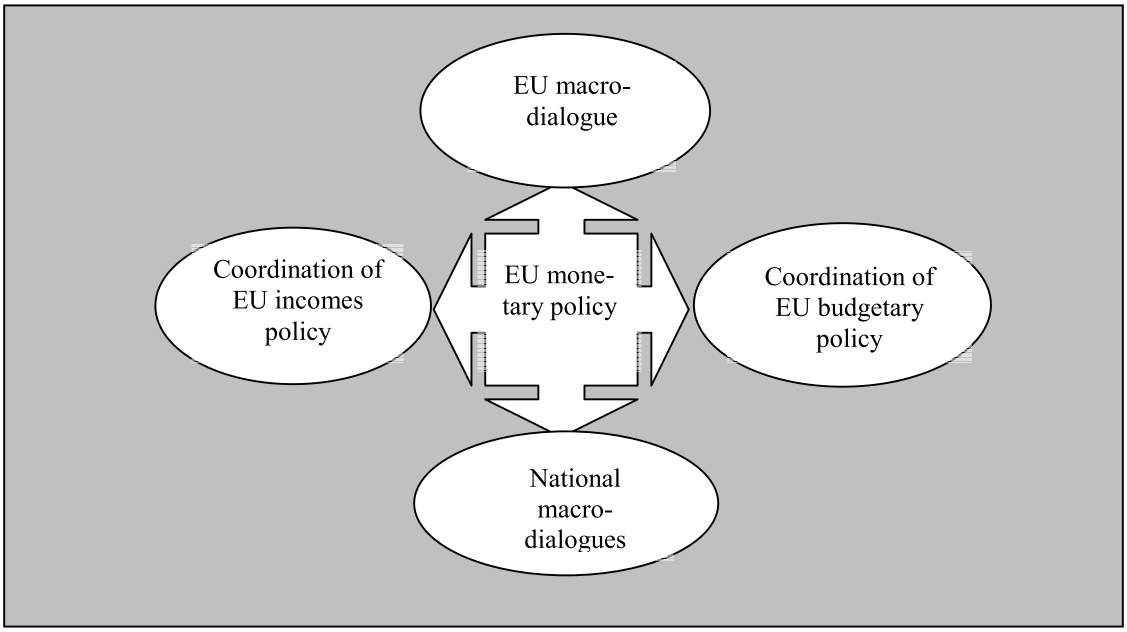
Having said that, neither political agony nor an uncritical revival of the "Keynesian revolution" is to be hoped for. Political agony is misplaced because the border of restrictive horizontal coordination and vertical assignment is not as closed as it sometimes appears to be: the political elites of some other EU member countries (for example, France) are much more critical of the established EMU architecture than the Germans dare to be – remember that it was the German finance minister Theo Waigel who "imposed" restrictive fiscal coordination. Furthermore, due to the debt problem resulting from German unification, expansionary fiscal policy – however necessary – is still a non-issue in German politics. However, a very slow redirection of the discussion seems to be under way; and the UK, although not an EMU member, has established budgetary rules which go far beyond the stabilisation potential of the SGP (HM Treasury 1997). An uncritical return to bastard-Keynesian ideas (to use the slightly unkind expression attributed to the late Joan Robinson) of the 1960s is unwarranted as the blind spots in "bastard-Keynesianism" – particularly the twin perils of inflation and public debt – are at the roots of the renaissance of pre-Keynesian myths in the 1970s and 1980s.

A proper shift in economic policy must take the concept of EU macro-dialogue seriously – which involves an institutional strengthening of the Cologne Process, as well as a re-interpretation of the SGP:

- The division of macro-dialogue into technical and political levels has so far impeded creation of an institution which could draw up binding, generally accepted policy rules, and make it possible to monitor the behaviour of the various policy actors. If such an institution is to emerge, the technical level will have to be markedly upgraded and its subordinate remit correspondingly extended.

- It should not be forgotten that an actor genuinely capable of decisive action at EU level exists only in the monetary policy field, namely the ECB. For budgetary and, above all, incomes policy, such actors are lacking. Macro-dialogue would therefore require multi-level coordination between the various policy areas, and the relevant national actors in the fields of budgetary and incomes policy (see Figure 5). As a result it is in danger of falling into Scharpf's (1993) notorious "interwoven policies trap" (*Politikverflechtungsfalle*). Without doubt EU macro-dialogue could be more easily initiated, and later consolidated, if it could build on national macro-dialogues at member state level; then it could be restricted essentially to coordination within policy fields and to providing feedback for the various national dialogues, with a common monetary policy providing the necessary binding element. Certainly, the establishment of national dialogues would itself require a spillover process from the EU level, as experienced during the discussion on monetary and budgetary policy in the run-up to EMU.

Figure 5: Multi-level policy in the European Union



- The SGP must be re-interpreted in a way which allows for coordination of budgetary policy beyond a zero-deficit orientation (see Arestis et al. 2001) without neglecting the need for sustainability. After long political discussions, 60% of (national) GDP has been accepted as the level of sustainability within EMU. This is important as it determines another benchmark which is more important in year-by-year budgetary decision-making, namely the public deficit. Assuming an annual nominal GDP growth rate of 5% (on average), a budgetary deficit of 3% will be sufficient to stabilise a debt of 60% of GDP. Of course, this is a measure of structural (that is, taking account of business cycle distortions) deficits which may be surpassed in times of recession and undercut in boom times. Shifting this benchmark towards a zero-deficit and re-interpreting the 3% margin as the sanction-free maximum can be economically harmful in terms of growth prospects and definitely contradicts its initial purpose of stabilising a sustainable debt. It is in this sense that the SGP must be put back onto economic foundations.

Sometimes, the demand for changes in the neoclassical–monetarist orientation of the EU architecture is rejected with the argument that international financial markets would "punish" such a strategy shift because the various players would fear for the credibility and independence of the

European Central Bank, resulting in capital outflows (if not flight), interest rate increases and euro depreciation. However, developments since the 9-11 terrorist attacks can be read quite differently: responsible action taken to secure economic growth may keep institutional investors on board. Hence, financial markets are interested not only in (expected) inflation differentials but also in (expected) growth differentials.

Both vertical and horizontal policy coordination within the euro-zone are vital for Europe's growth and employment prospects. The experience of the past decade – during preparations for and the first few years of EMU – shows that an optimal policy mix has not yet been found; theoretically grounded speculation suggests that we must not expect changes for the better as long as the architecture of European integration and the institutions of EU economic governance are not thoroughly challenged. How realistic is such a development? On the one hand, the fragility of multi-level coordination procedures, such as the macro-dialogue suggested here, must be admitted. However, as long as there are no European political actors able and with the legitimacy to form a European (economic) government, there is no alternative to economic governance of the proposed kind. More important than the institutional peculiarities seems to be the fundamental lack of political support for the necessary changes: the "political cycle" has still not bid farewell to neoclassical–monetarist views and there is no "policy-maker" at hand who could build an alternative agenda and give the macro-dialogue new momentum. However, until things change, the Cologne Process and its macro-dialogue will be an empty shell, and EU growth and employment prospects will remain poor.

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Philipp Genschel °

Tax Competition in the Single Market: A Policy Constraint for the European Welfare State[1]

1. The conventional wisdom and its critics

During the 1990s, there was a lot of concern in Europe that globalization in general and the Single Market Program in particular would undermine the fiscal basis of the welfare state. Newspapers were full of dire warnings from policy makers who saw the coming of "cut throat tax competition" (Maystadt 1994:2) and bemoaned the loss of "billions of Euro" to unfair tax poaching (Lafontaine and Strauss-Kahn 1999:18). G-7 summits, the European Commission, and the OECD issued alarmist reports on "harmful tax competition" (European Commission 1996; OECD 1998b). Scholars warned of "beggar-thy-neighbor policies" (Tanzi and Bovenberg 1990) and an impending "race to the bottom" that would force "down the share of total government revenue generated by taxes on business and capital income" (Scharpf 1997:531). "In equilibrium, the tax rate on capital in each state will be driven to zero" (Frey 1990:89) with potentially serious consequences for public goods provision and distributional equality (CEPR 1993; Sinn 1997). "The end of redistribution" (Steinmo 1994) seemed near. Doomsday for the welfare state.

Recently, a group of scholars has challenged this view. They maintain that there is little evidence for a close relationship between economic integration and national tax policy and no indication that tax competition is eroding the mobile capital tax base or depressing tax revenues. Even sophisticated empirical analyses fail to hint of a race to the bottom in capital taxation. The "conventional wisdom," so it seems, "is too simple and considerably overdrawn" (Garrett 1995:682; see also Garrett 1998a, Garrett 1998c, Kirchgässner and Pommerehne 1996, Quinn 1997, Swank 1998).

Who is wrong? Don't policy makers know what they are talking about? Do they suffer from 'false consciousness' concerning tax competition, or are Geoffrey Garrett et al. looking at the wrong data or drawing the wrong conclusions? Probably both. As I will show in the next section of this paper, the critics are right in claiming that the evidence on tax competition does not fit the conventional *race to the bottom* scenario. Over the 1990s, the average OECD country has neither suffered a dramatic decrease in total tax revenue nor experienced a clear shift of the tax burden from mobile to immobile bases (section 2). However, the critics are wrong in concluding from this that tax competition is not a serious constraint on national tax policy. As I will show, tax competition has systematically reduced national tax autonomy by preventing governments from raising taxes in response to higher spending requirements and from detaxing labor in response to high levels of unemployment.

I do not contend that tax levels and tax ratios have remained stable. I do contend that this does not prove tax competition to be impotent. There have been countervailing pressures that neutralized its impact. Globalization was not the only challenge facing the welfare state during the 1980s and 1990s. There was also slow growth, high unemployment, high levels of pre-

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1 An earlier version of this paper was published as a working paper by the Max-Planck-Institute for the Studies of Societies (MPIfG Working Paper 01/1, May 2001). It has profited a great deal from the ideas and suggestions of Steffen Ganghof.

committed spending, and mounting public debt. The handling of these problems, which were not directly linked to globalization, compromised the adjustment to tax competition: The reduction of tax revenue was not an option given high levels of spending and debt (section 3). Governments had to maintain tax revenue even though tax competition increased the difficulties of taxing capital (section 4). At the same time, high levels of unemployment limited how far the tax burden could be shifted to immobile tax bases such as labor and consumption. Labor and consumption may not normally flee abroad to avoid high taxes. But they 'evade' them through unemployment or the shadow economy (section 5). In conclusion, the conventional wisdom is correct: Tax competition is a constraint on national tax policy. But this constraint makes itself felt differently than the conventional wisdom assumes. It does not force the welfare state into a race to the bottom, but traps it in between external pressures to reduce the tax burden on capital and internal pressures to maintain revenue levels and relieve the tax burden on labor. The result is more austerity, more deficit finance, and a less employment-friendly tax mix than would have prevailed in a world without tax competition (section 6).

2. Did tax competition change the structure of taxation?

The national tax systems of OECD countries are products and symptoms of economic closure.[2] Their main components were conceived when national borders were relatively closed to economic transactions. The progressive income tax made its breakthrough during the huge fiscal expansion of the First World War. Turnover taxation was introduced in most countries during the interwar years when first inflation and then depression cut into income tax revenues. Corporate taxes and social security contributions also made their debut during this period. After World War II, social security contributions were expanded massively to finance the build-up of the welfare state. All this occurred in a context of separated national markets. Trade barriers and capital controls restricted tax-base mobility to national markets and prevented any international spillover effects of national tax-policy choices. Taxation was a purely national affair. The governments' fiscal sovereignty went unchallenged.

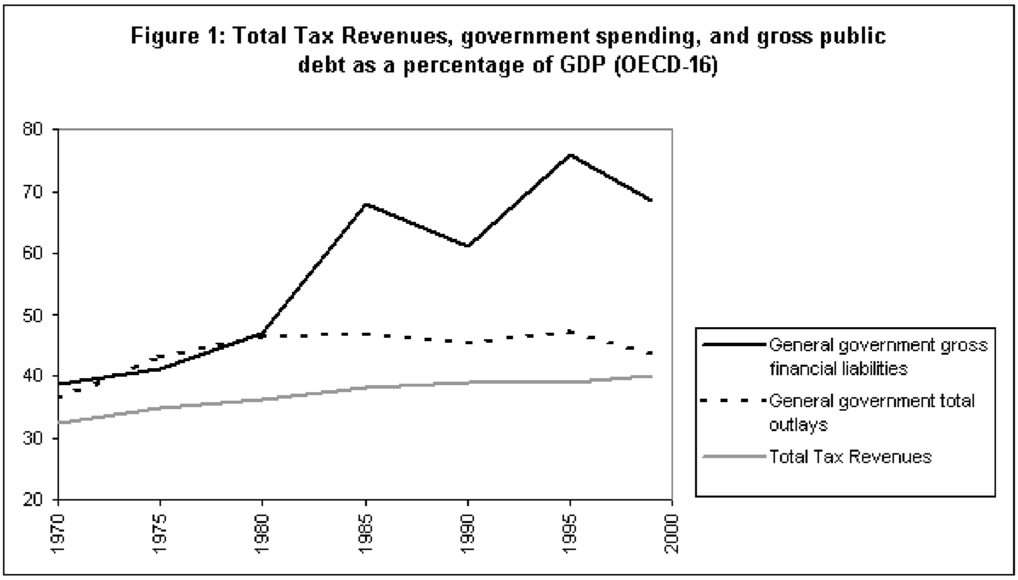
As the fences separating national markets were coming down during the 1980s and 1990s, many observers feared that this sovereignty might drain away. The elimination of trade barriers and capital controls made exit a viable option for mobile factors, such as human, physical, or financial capital. Governments would have to compete for these factors and could no longer turn a fiscal profit on them. As a consequence, it was feared that the welfare state would shrink in scale and its power to redistribute would be diminished. The scale would shrink because high tax levels were believed to be unsustainable if tax levels were significantly lower elsewhere. Redistribution would decrease because capital and other mobile tax bases would no longer pay high taxes - if they paid any tax at all. In short, two consequences were predicted:

- the level of total taxation would decline (see European Commission 1996, Steinmo 1996, Tanzi 1998, Hagen / Norrman / Sørensen 1998), and
- the tax burden would shift from mobile tax bases, most importantly capital, to immobile bases, such as labor, consumption, and real estate (see Sinn 1990, CEPR 1993, Steinmo 1996, Hagen / Norrman / Sørensen 1998, Schulze and Ursprung 1999).

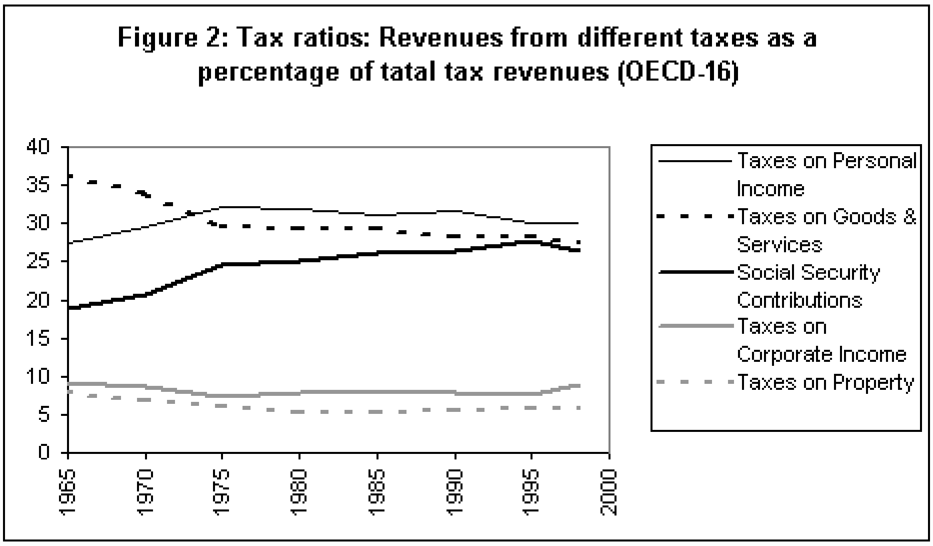
These predictions have become the conventional wisdom on tax competition (see Radaelli 1998). But are they also true? There is reason for doubt.

2 On the evolution of the modern tax system see, for example, Neumark 1948, Webber and Wildavsky 1986, Steinmo 1993.

Figure 1 shows how total tax receipts, averaged across sixteen OECD countries,[3] have developed since 1970. So far there is no evidence of a decline in tax revenues. In fact, the share of tax revenues in GDP has risen by eight percentage points from roughly 32 percent in 1970 to about 40 percent in 1998.



Are changes in the composition of the tax burden more in line with conventional wisdom? Figure 2 presents the revenues of various types of taxes as percentages of the total tax revenue (tax ratios) and shows how these percentages have changed in the average OECD-16 country since 1965.



Interestingly, the most obvious changes occurred before 1975, when national borders were still fairly closed. After the mid-1970s, tax ratios changed remarkably little. The changes that

3 Austria, Australia, Belgium, Canada, Germany, Denmark, France, Finland, Italy, Ireland, Japan, Norway, the Netherlands, Sweden, United Kingdom, and the United States of America.

did occur make little sense in terms of the conventional wisdom. Revenue from taxes on property and consumption has decreased rather than increased since the mid-1970s. Corporate tax revenues have gone up rather than down. Only the rising percentage of social security contributions suggests that the tax burden on immobile wage earners has increased.[4]

However, there may be more shifting of the tax burden taking place than is immediately apparent from figure 2 (Ganghoff 2000). The nearly constant percentage of the personal income tax in total tax revenue may mask a shift of the tax burden from mobile to immobile sources of personal income, i.e. from capital to labor income. The constancy of the tax ratios may conceal changes in the size of the underlying tax bases. If unchanging proportions of tax revenue derive from tax bases of changing proportion, then clearly a redistribution of the tax burden has occurred. National account data suggest that the relative weight of the major macroeconomic tax bases has changed during recent years (Kramer 1998). Michael Webb claims that the share of corporate profits in GDP has increased significantly since the early 1980s. Hence, the slight increase of the corporate tax ratio reported in figure 2 may actually conceal a decrease of the effective tax burden per unit of corporate profit (Webb 1998).

It has become fashionable, therefore, to look at *average effective tax rates* as a better indicator of potential shifts in the tax burden (Mendoza / Razin / Tesar 1994; Mendoza / Milesi-Ferreti / Asea 1997). Average effective tax rates are calculated by classifying tax revenues according to the macro-economic tax base from which they derive – capital, labor, or consumption – and then expressing them as a share of this tax base. This ensures that personal tax revenues are considered according to the tax base from which they derive, and that tax base effects are controlled for. However, even this does not yield convincing evidence for a race to the bottom in taxation. As table 1 shows, the tax burden on (immobile) labor has increased significantly since the 1965-1974 period, but so has the burden on (mobile) capital, while the effective tax rate on (immobile) consumption has stagnated.[5]

Table 1: Average Effective Tax Rates

	Capital			Labor			Consumption		
	1965–75	1975–85	1985–94	1965–75	1975–85	1985–94	1965–75	1975–85	1985–94
Austria	0.17	0.20	0.21	0.33	0.38	0.41	0.17	0.19	0.18
Australia	0.34	0.42	0.45	0.13	0.18	0.19	0.08	0.10	0.09
Belgium	0.26	0.35	0.33	0.31	0.37	0.40	0.15	0.15	0.14
Canada	0.41	0.38	0.44	0.17	0.22	0.28	0.11	0.11	0.11
Denmark	–	0.42	0.42	–	0.35	0.41	0.21	0.24	0.26
Finland	0.22	0.32	0.41	0.23	0.31	0.38	0.17	0.20	0.22
France	0.17	0.25	0.25	0.29	0.37	0.43	0.19	0.18	0.17
Germany	0.21	0.29	0.26	0.29	0.35	0.37	0.14	0.13	0.15
Italy	–	0.22	0.28	–	0.28	0.32	0.11	0.10	0.13
Japan	0.23	0.35	0.44	0.12	0.17	0.21	0.05	0.05	0.05
Netherlands	–	0.30	0.31	–	0.43	0.46	0.14	0.15	0.16
Norway	0.25	0.38	0.37	0.33	0.34	0.35	0.21	0.25	0.24
Sweden	–	0.45	0.58	–	0.46	0.48	0.16	0.17	0.20
Switzerland	0.17	0.24	0.25	0.19	0.26	0.26	0.065	0.07	0.08
UK	0.50	0.60	0.52	0.24	0.25	0.21	0.12	0.13	0.14
United States	0.42	0.42	0.40	0.17	0.21	0.23	0.06	0.05	0.05
Average	0.28	0.35	0.37	0.23	0.31	0.34	0.13	0.14	0.15
Standard deviation	0.11	0.10	0.11	0.07	0.08	0.09	0.05	0.06	0.06

Source: OECD Revenue Statistics, OECD National Accounts, Leibfritz et al. (1997).

4 For a thorough analysis of tax structures in OECD countries, see Messere 1993 and Wagschal 2001.

5 Reproducing table 1 on the basis of Eurostat data and Eurostat's implicit tax rate indicator – the same concept as average effective tax rate but a slightly different operationalization – yields substantially similar results. See Ganghof 2000, Table 13.6.

In short then, the critics have a point when they argue that the conventional rhetoric on a "policy race to the neoliberal bottom" is at variance with the available data. Tax revenues in OECD countries have not declined but increased since the 1970s, and the tax burden on capital has not eroded visibly. Are they also right to conclude that tax competition does not seriously constrain national tax autonomy? That governments "wishing to expand the public economy for political reasons may do so (including increasing taxes on capital to pay for new spending)" (Garrett 1998a:823)? That they "have room to pursue their preferred policy goals" (Swank 1998:691) and may even find their governmental capacity enhanced (Quinn 1997:541)? This is, perhaps, more difficult to believe. In any event, such conclusions cannot be drawn from the lack of evidence for a race to the bottom in capital taxation.

To argue that tax competition does not constrain national tax policy implies that the observed tax policy choices and outcomes would have been the same in the absence of tax competition. In other words, it assumes that the slow increase of total tax revenues since the 1980s, the constancy of tax ratios, and the increase of the effective tax burden on labor would have occurred in any event because they reflected government preferences rather than the structural constraints imposed by economic integration. As I am going to show next, this is not a very plausible assumption. There is good reason to believe that in a counterfactual world without tax competition the level of total taxation would be higher,[6] capital taxation would generate more revenue, and the tax burden on labor income and consumption would be lower.

3. Would total taxation be higher without tax competition?

The level of total taxation would indeed be higher in a world without tax competition because the growth of public expenditure is hard to contain and even harder to reverse, and because large deficits are not a long-term solution for bridging the gap between stagnating revenues and increasing expenditures (Ganghoff 2000; Steinmo and Swank 1999.) While total tax revenues have risen since the 1970s, public spending has risen even further, leaving most OECD countries with a mounting burden of public debt (see figure 1).

The high levels of public expenditure during the 1980s and 1990s were rooted in decisions made in the 1960s and early 1970s to create and expand welfare state programs in old-age pensions, health care, unemployment, and other areas of social protection. These entitlement programs created expenditure obligations that proved hard to control. Once legislators had stipulated who was to be eligible for transfer payments of what size, then the number of households receiving such payments and, consequently, the amount of transfers paid, depended on factors largely beyond legislative control: demographic trends, health status of the population, labor market developments, growth rates, etc. (Cordes 1996; Pierson 1996).

Most of the new or expanded welfare programs were based on the assumption that the high growth rates and low unemployment levels of the 1960s would continue into the future (Kawai and Onitsuka 1996). Yet, after the first oil crisis in 1973, growth rates slumped, and unemployment began to rise. Initially, governments reactioned to these developments in Keynesian fashion: benefit levels were maintained, the range of beneficiaries was increased,

6 This assumes that there are no domestic downward pressures on taxation which could prevent such a rise. Given dramatic cases of tax payer revolt such as the California property tax revolt of the late 1970s, this may appear heroic. Note, however, that even the California revolt did not result in any lasting reduction of tax levels. See Gold 1990:90. Less dramatic 'revolts', such as recent protests against eco-taxes on petrol in Germany, did not even have a short term effect.

new welfare programs were established, and the level of public expenditure was raised in an effort to shorten the recession, dampen its social impact, and fight unemployment (Stephens / Huber / Ray 1999). The revenue shortfall was met through large fiscal deficits. Deficit finance was an inexpensive option, since long-term real interest rates were low. Despite sizeable deficits, the public debt grew only slowly during the 1970s (figure 1). Also, deficits seemed to be a temporary expedient only. It was thought that, once the recession was over and OECD economies returned to the high growth rates and high employment levels of the period preceding the oil crisis, governments would reduce fiscal imbalances. As it turned out, however, the economic difficulties represented more than just a cyclical downturn. Slow growth continued, and unemployment rose even further in the wake of the second oil crisis. Long-term interest rates began to rise, and the level of public debt began to escalate (figure 1). The net debt service doubled between 1980 and 1985 from 1.7 percent of GDP to 3.4 percent (table 2). Higher interest payments meant more precommitted spending and less budgetary flexibility; they thus contributed to the fiscal predicament of the welfare state.

Table 2
Government Spending, Social Expenditure, Public Debt Service and Public Investment as a Percentage of GDP (OECD-16)

	Government Spending	Social Expenditure	Public Debt Service	Public Investment
1970	36.0	14.0 [1]	1.4 [1]	-
1980	46.2	19.9	1.7	3.5
1985	46.4	21.8	3.4	3.0
1990	45.2	22.6	3.3	2.8
1995	47.1	24.7	3.7	2.7
2000	41.6	23.5 [2]	2.5	2.6 [3]

[1] all OECD countries
[2] 1998
[3] USA not included

Source: OECD National Accounts; OECD Economic Outlook; OECD National Accounts; Adema 1998 Social Expenditure Statistics of OECD Member Countries.

When it slowly dawned on policy makers and public opinion alike that the logic of the economic game had changed in a fundamental way, the expansive fiscal policy of the 1970s came to be regarded as a mistake. Leftist governments were replaced by conservative, supply-side-minded ones in many countries, and fiscal consolidation and expenditure restraint became top priorities throughout the OECD. Most attention and political energy focused on welfare retrenchment. But cuts in entitlement programs actually contributed little to the consolidation process (Pierson 1996; Stephens / Huber / Ray 1999). Social expenditures continued to rise and were only partly compensated by cuts in public investment (table 2). An economic boom helped to improve appearances during the second half of the 1980s. Deficits were reduced, and some countries managed to balance their budgets, including Denmark, Germany, the UK, and Sweden. Yet the debt level remained high. Interest payments continued to tie up 3 percent of GDP in the average OECD country and more than 5 percent in EC member states. The structural discrepancy between spending requirements and tax revenues continued.

When economic conditions worsened in the 1990s, levels of public expenditure immediately shot up again. Large deficits reoccurred and pulled upward the level of gross public debt and the cost of debt service. Governments were in for another round of expenditure containment.

Again, the focus was on welfare retrenchment. As a result, the welfare state has undoubtedly become meaner and less generous (Clayton and Pontusson 1998). Still, social expenditures continued to rise. In part, this was due to the character of the reforms, which were often incremental rather than radical and reduced future rather than current spending. Yet other factors also played a role in this rise of social expenditure: rising levels of unemployment that sustained high spending even as social rights and benefits were curtailed,[7] growing health care costs related to an aging population, and increased spending on public pensions due to early retirement schemes and population aging. As before, the only real savings came from cuts in public investment (OECD 1998a:152). By the mid-1990s, public investment had reached the "lowest level since the beginning of the century" (Tanzi and Schuknecht 2000:47).

One business cycle later, the situation does not look markedly different. Growth was low in 2002, unemployment high, and public spending overshot tax revenues by a considerable margin. Portugal and Germany missed the Maastricht 3 percent deficit criteria, and other countries look set to do so in 2003. Yet, expenditure containment gets ever more difficult. The continual cuts in capital spending have raised concerns that public investment may be too low and may jeopardize long-term growth (OECD 1998a; Sturm 1998). The process of social security reform is becoming increasingly painful. All the 'easy' changes have been implemented. Most slack has been reduced. The cuts start to affect the core of the system and the reform process becomes correspondingly controversial – just witness the recent debates in Germany on cost containment in health care and the pension system.

During the past 20 years, austerity has not been enough to achieve fiscal consolidation in advanced welfare states. This goal also required tax increases. A survey of fifteen episodes of significant fiscal consolidation[8] in OECD countries shows that all cases but one were based on an increase of total taxation, while only ten cases involved a cut in expenditure. "Overall, more than half of the consolidation episodes under review relied more on revenue increases than on expenditure cuts" (OECD 1996:36). Evidence from the consolidation efforts in the EU during the period leading up to the establishment of the monetary union confirms this result (OECD 1998a). Sound public finances were predicated on higher taxes.

In fact, many countries made conscious efforts to raise government revenue. During the 1980s, these attempts were still modest. The most visible feature of the supply-side-inspired reforms of this decade was the reduction of headline tax rates. Almost everywhere, governments cut, at times significantly, the top rates on personal and corporate income (Hallerberg and Basinger 1998). Yet simultaneously, they broadened the tax base. They curtailed interest deductions, cut savings and investment incentives, eliminated tax shelters, tightened capital gains taxation, and intensified the enforcement of tax laws. As a consequence, the reforms were usually at least revenue neutral (Steinmo and Swank 1999). The tax policy of the 1990s was more overtly "budget driven" (Sunley and Stotsky 1998:426). In the Euro-area, in particular, it was sometimes difficult to see any rationale behind policy initiatives "apart from getting more revenue in the short term" (Castellucci 1998:159). The base-broadening continued. Social security contributions, VAT rates, and – in some instances – excises increased. A few governments, including the Netherlands, Denmark, and Sweden, introduced new 'green

7 OECD simulations suggest that the effect of unemployment on the fiscal balance is very strong. In some countries, including Italy, Belgium, and Sweden, an increase in unemployment by one percentage point is estimated to deteriorate the fiscal balance by as much as roughly one percentage point of GDP. See OECD 1998a.

8 Significant fiscal consolidation, according to the OECD definition, is an improvement in the general government structural (i.e. cyclically-adjusted) fiscal balance that is equivalent to at least three percentage points of GDP, and which takes place continuously over consecutive years (two years minimum).

taxes' on energy and the consumption of other natural resources. Germany, France, Italy, and Sweden levied temporary surcharges on gross personal and corporate income.

The increase in total tax revenue (figure 1) and the rise of average tax rates on labor and capital (tables 1) show that these efforts were not without effect. However, revenue gains would have been larger in the absence of tax competition. As I will demonstrate in the following, tax competition prevented governments from tapping into important sources of capital tax revenue and forced them to rely more on labor taxation to meet revenue targets. This had detrimental repercussions on employment and growth, and eventually on tax revenues.

4. Would capital tax revenues be higher without tax competition?

The critics of the conventional wisdom doubt that capital tax revenues would be higher in a world without tax competition. According to Garrett, the observed increase in average effective tax rates on capital (table 1) "should give ... pause" to those who assume that tax competition bids down capital taxation (Garrett 1998b:87; see also Swank 1998). Yet, the reasoning is not entirely clear. If capital owners shift capital out of high-tax jurisdictions, this does not necessarily reduce the effective tax burden on the remaining capital. On the contrary, governments may be forced to increase the effective tax burden in order to maintain the same revenue from an eroding tax base (Hagen / Norrman / Sørensen 1998:166). Given tax-base mobility, an increase in effective tax rates may indicate intense tax competition and revenue losses rather than the reverse. Hence, the highly aggregated data on effective tax rates, tax ratios, and total tax revenues are a poor guide for assessing if and how deeply tax competition cuts into the mobile capital tax base. To get a better picture, it is necessary to look at the behavior of taxpayers at the microlevel. Do individual and corporate capital owners make efforts to avoid or evade taxation, and how widespread and effective are these efforts? Obviously, the answer is hard to quantify: "if we could measure it, we could tax it" (Perez-Navarro 1999:18). But still, some instructive evidence exists.

4.1. Corporate taxes

The most obvious way in which corporations can reduce their corporate tax bill is by setting up shop in a low-tax country. Econometric evidence confirms that, by and large, foreign direct investment reacts negatively to high effective tax rates (Leibfritz / Thornton / Bibbee 1997:31; Sørensen 1992; Hines 1999). But the estimated effects are often weak in terms of size and statistical significance.This is hardly surprising because taxation is but one factor in the locational calculus of business enterprises. Companies want low taxes. But they also want good public infrastructure, a well-educated labor force, easy access to markets, clustering economies with relevant other firms, etc. When it comes to locating real activities, tax policy is hardly ever the critical factor.

However, there is also a second, less obvious reason why business shows so little concern for taxation: Locating in low-tax jurisdictions is not the only way in which companies can avoid high taxes. Multinationals can also shift profits artificially from high tax to low tax countries by manipulating commercial and financial exchanges within the company. For example, to reduce the taxable profits of a subsidiary in a high-tax country, affiliates in less tax-heavy locations will charge inflated prices for deliveries to this subsidiary and pay deflated prices for deliveries they receive from it (*transfer pricing)*. To increase deductible expenses in the high-tax country, affiliates will finance the subsidiary through intracompany loans rather than equity, because interest payments are tax-deductible while dividend payments are not (*thin* *capitalization*). To reduce the tax burden on the resulting interest income, they will collect the interest income through a holding company in a low-tax environment (*base company*), where it is taxed lightly, if at all (European Commission 1992; Hines and Rice 1994; Radaelli and Gammie 2000).

As long as profits can be moved artificially between high- and low-tax jurisdictions, there is no need to also move the underlying profit-generating activities. Companies are free to place location-specific business functions in countries featuring the best local conditions, irrespective of tax, as long as they take the tax factor into special consideration when deciding where to place business functions that are not location-specific. Therefore, while foreign direct investment in general is not very sensitive to tax differentials, the investment in location-unspecific activities, such as intragroup finance, the management of intangible assets, headquarter administration, and other overhead services, tends to be extremely sensitive to tax differentials. Because these functions provide the strategic nodes for successful international tax planning, it matters a lot that they are placed in a favorable tax environment. This, in turn, makes it attractive for governments to specifically target these functions through preferential tax regimes.

This is not a new phenomenon. Luxembourg passed its first law on holding companies in the late 1920s. But the importance of preferential tax regimes has increased in step with the multinationalization of production. During the 1980s, a large number of new regimes were set up in the EU. Ireland, for example, established the so-called *International Financial Services Center* in Dublin – a regime that awards a special, reduced corporate tax rate of only 10 percent to companies providing financial services to non-residents. Belgium has a similar tax regime for trade in intangibles. So-called *coordination centers* that sell finance, consultancy, marketing, R&D, and other services to affiliated companies are allowed to submit only a fraction of their profits to corporate tax. Other preferential tax regimes have been established in the Netherlands (favorable tax treatment for financial service companies), Luxembourg (new rules for holding companies), Italy (Trieste off-shore financial and insurance services center), and France (preferential tax treatment of headquarter services) (Valenduc 1994; Pinto 1999).

Multinationals use preferential tax regimes as a platform for international tax planning. A coordination center in Belgium, for example, may help to reduce the corporate tax burden of a German subsidiary belonging to the same multinational company. To this end, the coordination center sells, say, a brand name to the subsidiary, which also receives a loan from the coordination center to pay for the brand name. This transaction reduces taxable profits in Germany in two ways: The – probably inflated – transfer price for the brand name cuts into the subsidiary's operating surplus, while the interest payments on the loan create deductible expenses. The corresponding profits are collected by the coordination center, where they remain largely tax-exempt. As a result, the tax bill of the overarching multinational company is reduced (European Commission 1992; Schreiber 1998; Owens 1993).

Preferential tax regimes have become popular because they boost the financial service industry, provide high-quality employment for professionals, and generate additional tax revenue. The problem is that they do so by undermining the ability of foreign governments to collect corporate taxes. Research on large German companies shows that the share of foreign income in total company income has increased greatly since the 1980s. In part, this reflects the surge of foreign acquisitions in the wake of the initiative for a Single European Market. It also reflects increased incentives for profit shifting. Since a sizeable share of the new acquisitions was in countries with preferential tax regimes – Ireland, Belgium, the Netherlands – international tax planning has become easier. As a consequence, the corporate tax burden on large multinational companies in Germany has fallen considerably, compared with that on nationally based, small- and medium-sized companies that do not enjoy the same international options to avoid taxes (Jacobs and Spengel 1997 and 1998; Weichenrieder 1996; von

Wuntsch 1998). In 2001, for example, some large and profitable companies, including Deutsche Bank, EON, and BMW, hardly paid any tax in Germany. It is impossible to give an exact number for the size of the attendant revenue loss. But experts suggest that it may be significant (OECD 1995; Grigat 1997; Deutsche Bundesbank 1997).

Similar evidence is available for the United States. A House of Representatives study claimed in 1990 that half of a sample consisting of almost forty foreign companies had paid virtually no US taxes over a ten-year period. The revenue lost through transfer-price manipulations was estimated at US $35 billion (Dicken 1998:247). Another study discovered a significant relationship between the income reported by US subsidiaries abroad and the tax rate in the host country. Reported profits were found to be lower in high-tax countries, confirming that multinational enterprises shift profits to low-tax countries (Hines and Rice 1994:162; see also Hines 1999, Caves 1996, Radaelli 1998). This is also consistent with the observation that foreign-controlled companies in the United States report significantly less taxable income than their domestically owned counterparts, which is at least partly attributable to international tax planning (Grubert / Goodspeed / Swenson 1993). In general, market-based methods of transfer pricing seem to be less common in international transactions within US multinationals than in domestic transactions, for which tax avoidance incentives for price manipulation do not exist (Benvignati 1985). Considering this evidence, it seems fair to conclude that, even though corporate tax revenue has slightly increased as a share of total tax revenue in recent years (recall figure 2), the increase would have been larger in the absence of tax competition.

4.2. Taxes on financial income

Despite the attention that political scientists pay to them, corporate taxes have not been a major revenue source in recent decades for "funding the welfare state" (Swank 1998). The personal income tax has always been much more important (see figure 2). Is there any evidence that tax competition weakens the grip of the personal income tax on capital income?

Two types of capital income are taxed under the personal income tax: profits from unincorporated business and private financial income. Small, unincorporated businesses typically lack the channels for international tax planning that multinational companies have. Hence, the taxation of their profits is not threatened much by international tax avoidance. Financial income, by contrast, is very vulnerable. Financial assets such as bank accounts, bonds, or equity are highly mobile and easy to relocate. This often allows taxpayers to reduce their tax bill by simply moving their assets across the border. Just to get an idea of the dimension of the potential revenue loss, Kramer has added the interest payments on government bonds and bank deposits in the fifteen EU member states. Assuming an effective taxation of 20 percent,[9] the resulting revenue would, according to Kramer, be almost double the corporate tax revenue (Kramer 1998:61). Tax competition has largely prevented governments from tapping into this revenue source.

In the past, almost all OECD countries taxed financial income under the global personal income tax. Nevertheless, the tax burden on financial income was significantly lower than on other sources of personal income. First, financial income enjoyed large tax privileges. Throughout the OECD, governments granted generous tax breaks for specific types of investment in order to stimulate long-term savings and to channel it into specific savings instruments such as government bonds. Second, financial income was easy to hide. Unlike wage

9 Note that an effective tax rate of 20 percent is rather low if compared with the average effective/implicit tax rates that tables 1 and 2 report for capital taxation in general.

income, from which tax was withheld at source, financial income was taxed on the basis of taxpayer self-assessment. If taxpayers did not declare their financial income, it usually went untaxed. Given high levels of top marginal tax rates and inflation rates that sometimes ran into double digits during the 1970s, the incentive to exploit this opportunity was large. It was sometimes the only way to prevent interest income from being confiscated by a combination of personal income tax and inflation (Vanistendael 1988; Robson 1996).[10] Since governments understood this problem and did not want to choke off private savings, they often turned a blind eye to this type of evasion. As a result, a large share of the tax base for interest income went untapped. Estimates suggest that only between 10 and 50 percent of private interest income was reported for income tax purposes in advanced OECD countries (see Kazemier 1992: 240, Ishi 1993:141, Steuerle 1992:27, Schlesinger 1985:240, Vanistendael 1988:160).

During the 1980s, governments became more assertive in taxing financial income. Inflation rates were coming down, and personal income tax rates were cut, so that there was less reason for leniency with tax evasion. More importantly, increased taxation of financial income appeared to be an elegant way to ease the budgetary strain. Since, formally, this type of income was already taxed, no new tax was necessary. It was sufficient to enforce and extend the tax that was already in place. Finally, this move also promised to improve distributional equity, presumably because the lax treatment of financial earnings favored (wealthy) capital owners over (poor) wage earners (Ishi 1993).

To tighten the tax grip on financial income, governments reduced or eliminated tax privileges and improved the collection of taxes that were theoretically due but often went unpaid. They introduced withholding taxes in order to make sure that at least a fraction of the tax due was collected at source.[11] Some countries also set up automatic reporting systems obliging banks to inform the tax administration about taxpayers' interest earnings. With the sole exception of Luxembourg, all OECD countries now use at least one such protective measure against domestic tax evasion.

To the chagrin of national treasuries, the introduction of these protections generated little additional revenue. Many investors reacted to withholding taxes or reporting systems not by paying more taxes but by switching from domestic to international tax evasion.

- When Belgium introduced a withholding tax of 25 percent in 1983, many investors moved their assets to withholding-tax-free Luxembourg and the Netherlands. As a consequence, the competitiveness of the Belgian financial services industry declined. Interest rates rose. In 1990, the government reduced the withholding tax rate to once again attract financial assets and financial intermediation to Belgium(Brean / Bird / Krauss 1991).
- Austria went through much of the same experience in 1984, when it introduced a withholding tax on financial income: Savings flew to Germany, where no such withholding tax existed, and the volume of the securities market contracted significantly (Schuster 1999).
- In the Netherlands, the introduction of an automatic reporting system in 1988 induced a drop in domestic savings deposits and prompted a major flight of capital. Short-term capital exports increased by 1.4 percent of GDP in the period following the announcement of the reporting system in July 1987 (Gardner 1992:68).
- After an aborted attempt in 1989, Germany introduced a withholding tax of 30 percent in 1993. The result was a massive outflow of funds and a banking boom in Luxembourg.

10 As Vito Tanzi shows, even a combination of moderate inflation rates and moderate personal income tax rates can translate into an effective marginal tax rate on real interest income close to or in excess of 100 percent. See Tanzi 1995.

11 Technically, withholding taxes are prepayments on the income tax that are withheld at the source of the income. In case of financial income, this is often the bank, which pays out interest or dividends.

> The loss for the German treasury was considerable. Instead of the projected receipts of DM 24 billion, the new measure generated only DM 11 billion in 1993. The yield did not significantly improve in later years (Deutsche Bundesbank 1994).

To be sure, governments could stop international tax evasion through international cooperation. Since the late 1980s, the European Commission has continually attempted to bring the member states to agree on a European reporting system through which each government would inform the others about the foreign investments of their citizens, or, alternatively, to introduce a harmonized withholding tax on financial income. Both measures would substantially reduce the incentives for international tax evasion within the Single European Market. The problem is, however, that small countries often have no interest in stopping evasion. They have little domestic tax base to lose but a lot of foreign tax base to win from tax competition. For them, tax competition may actually be a very attractive proposition. Luxembourg is an excellent example. Hence, the negotiations on tax cooperation are progressing rather slowly, if at all (Dehejia and Genschel 1999; Bernauer 2000). Meanwhile, the member states compete for foreign tax evaders. Some countries, including Austria and Luxembourg, introduced or strengthened bank secrecy laws to provide foreign evaders better protection against investigations by authorities from their home countries. Others have reduced or eliminated withholding taxes on non-resident financial income to increase the advantages of evasion (OECD 1994). Only a small minority of OECD countries still levy such taxes (see Bundesministerium der Finanzen). In effect, unless the investor is scrupulously honest, interest receipts from abroad go tax free (Owens 1993).

To reduce their vulnerability to international tax evasion, many countries have lowered their tax claims on resident financial income. Top marginal income tax rates were cut practically everywhere, and some countries even decided to exempt financial income completely from the global income tax. Norway, Sweden, and Finland turned to so-called dual income tax systems, in which capital income is taxed at low proportional rates while labor income continues to be taxed at progressive rates (Ganghoff 2000:619). Others only exempted financial income from progressive taxation by turning the withholding tax on this income into the final tax. Table 4 indicates the trend. While in 1985, only two out of eighteen OECD countries taxed financial income outside the general income tax, by 1998 the number had risen to eight. Anecdotal evidence suggests that the exemption from progressive taxation has occasionally been successful at attracting financial investment back home that had fled abroad (see Gardner 1992 and Schuster 1999). This required, however, that governments scale down their tax claims on financial income.

The willingness to take financial income out of the scope of the global income tax represents a remarkable break with past traditions. Until recently, a schedular approach to income taxation, in which each source of income is taxed separately at flat rates, was considered to be a second-best choice for countries that lacked the administrative skills and capacity to operate a global income tax. Global income taxation was believed to be superior because it promised to tax income from all sources equally without discrimination (horizontal equity), and because it could tax individuals at progressive rates according to their individual ability to pay (vertical equity) (see Tanzi 1995). By moving back in the direction of schedular taxation, governments implicitly admit that they no longer have the power to enforce a global income tax in a globalized economy (Slemrod 1995:145). Schedular taxation sacrifices both horizontal and vertical equity. But it seems to be governments' best bet to collect at least some revenue from financial income.

5. Would taxes on labor and consumption be lower without tax competition?

In contrast to corporate and financial capital, labor and consumption are fairly immobile tax bases. In border regions, some people may work, live, and shop across the border for tax reasons. But these are exceptions. Usually people don't move to another country just because income taxes and social security contributions are lower. Cross-border shopping is more common. Still its impact on national tax policy is very limited (Hagen / Norrman / Sørensen 1998:171). Even in the EU, there is no indication of any tax competition in the area of consumption taxes (Ratzinger 1997:469).

Nevertheless, the tax burden on consumption has increased very little over the past twenty years (recall figure 2, and table 1). While many governments raised general consumption taxes, especially VAT, the receipts from special excises fell. Operating on specific tax rates, excises are liable to negative fiscal drag. Their real value declines with inflation unless governments adjust the rates, which they rarely did during the 1970s and 1980s (Messere 1997:306). The effective tax burden on labor, by contrast, has increased sharply, higher social security contributions being the main driving force (figure 2). As table 1 shows, the effective tax rate on labor has gone up in recent decades almost continually in nearly every country. Now workers frequently receive only half of the total wage bill to the employer; the rest is paid to the government (OECD 1995:96). Would that be different in a world without tax competition? Would governments use additional revenues from capital taxation to reduce the tax burden on labor?

5.1. Labor taxes

There is widespread agreement in Europe that the tax burden on labor is too high and should be reduced for three reasons: the shadow economy, distributive equity, and, most importantly, unemployment.

High taxes on labor tend to increase unemployment if trade unions manage to shift the tax burden forward onto employers via higher gross wages. The employers may try to pass the cost increase on to consumers. But in a globalized economy, the scope for price increases is limited. Therefore, they reduce the demand for labor instead. Unemployment increases. The evidence "is, with some exceptions, reasonably convincing" that taxes on labor increase pre-tax wages, and, hence, unemployment (OECD 1995:68). Daveri and Tabellini find that the association between high labor taxes and high unemployment is particularly strong in continental Europe. They estimate that the rise of ten percentage points in the average effective tax rate on labor since the 1965-1975 period (table 1) may account for as much as four percentage points of the increase in European unemployment. The relation is less pronounced in the USA, Japan, and Scandinavia (Daveri and Tabellini 2000).[12]

High tax rates on labor are also considered a major factor behind the shadow economy (European Commission 1996; Schneider and Enste 2000:82). If an average production worker's marginal after-tax wage equals only 50 percent of his marginal pre-tax wage, as is often the case in OECD countries (OECD 1995:96), he could offer his labor at half the price and still earn the same amount in a marginal hour of work in the untaxed shadow economy. This leaves a fairly wide range for mutually beneficial agreements between sellers and buyers of labor at the expense of the tax authorities. High tax wedges make it particularly hard for labor-intensive industries such as agriculture, construction, or hotels and restaurants to stay

12 Daveri and Tabellini's finding is controversial, however. See Bertolila 2000.

clear of shadow employment practices (Scharpf 2000:205). Faced with price-elastic demand, they often hire labor off-the-books to reduce costs. High labor taxes also tend to crowd out markets for certain household services, encourage unreported economic activity such as baby-sitting, gardening, house repair, and private lessons, and cause in general "excessive self-production" and do-it-yourself activity (Rosen 1996:736). Careful analysis by Friedrich Schneider and Dominik Enste suggests that the size of the shadow economy in OECD countries has increased significantly since the early 1980s. This is especially true for the Scandinavian countries, where the shadow economy represents between 18 and 20% of official GDP (Schneider and Enste 2000).

Finally, high taxes on labor create equity problems, especially if a large part of these taxes consists of social security contributions. Based on proportional rates and often with income caps, social security contributions tend to be proportional or regressive with regard to their distributive effect.[13] Growing reliance on them has led to a redistribution of the tax burden downwards. According to OECD data, the effective marginal tax rate on families with low-labor income rose by more than seven percentage points in OECD countries between the late-1970s and the mid-1990s, while the effective tax rates for high-labor income families rose only modestly or fell in most cases (Leibfritz / Thornton / Bibbee 1997:43; OECD 1998a:161). It is difficult to gain popular acceptance for high taxes on labor, especially if financial income is taxed outside the personal income tax through final withholding taxes or the dual income tax (Sørensen 1998:23). Why should poor laborers pay more taxes than wealthy capital owners? Maintaining a certain level of perceived fairness is important (Bird / Perry / Wilson 1998:87), and most people still assess fairness in terms of tax progressivity (Steinmo 1994).

In short, high labor taxes tend to increase inequality, discourage employment growth, and spur the growth of the shadow economy. However, low participation rates and high levels of shadow activity need not lead to tax cuts. On the contrary, governments faced with an erosion of the labor tax base may be forced to raise the taxes on labor even further to maintain revenue. The continental European countries in particular are at risk of getting locked into a mutually perpetuating trap in which high labor taxes erode the labor tax base, and tax base erosion prompts the raising of taxes: "welfare states without work" (Esping-Andersen 1995). To avoid this pathology, the European Commission suggested in 1994 (Europäische Kommission 1994), and the European Council agreed the same year at its summit in Essen, that the tax burden on labor should be reduced by at least one or two percentage points of GDP. But how should the revenue loss be compensated? The European Commission advocates higher taxes on capital (European Commission 1996). However, this requires coordinated action to eliminate tax competition, which so far has not been forthcoming. An alternative option is to raise consumption taxes (Messere 1997:305). Since consumption taxes affect not only labor income but unearned income from capital and transfers as well, they may help reduce the tax burden on labor. No international cooperation would be required. Unfortunately, consumption taxes

13 All depends on whether workers perceive a direct link between their social security contributions and future benefits. If they do, the contributions would have the character of insurance premiums rather than taxes. The willingness to accept real-wage reductions in exchange for increased contribution payments will be higher, ceteris paribus, because workers feel that they get something in return. See Esping-Andersen 1995: 8. However, even in countries such as Germany, where there is an explicit link between contribution levels and benefit levels, the perception of the pension system as an insurance scheme is shaky. Not only is the link between individual contributions at the margin and individual future benefit levels often unclear. Many, especially young, workers doubt that the promise to pay out future pensions in relation to current contribution payments is credible, given prevalent demographic trends .

suffer from the same deficiencies as labor taxes: They tend to increase unemployment, encourage the growth of the shadow economy, and create equity problems.

5.2. Consumption taxes

Consumption taxes may increase unemployment in two ways. First, by reducing the consumption that workers can finance out of their earnings, they induce trade unions to increase their wage claims with similar results as in labor taxation: higher gross wages, lower labor demand, increased unemployment (OECD 1995). Second, by reducing the demand for goods and services, consumption taxes reduce the demand for the factors that go into the production of these goods and services. If the goods are labor-intensive, as in the case of non-tradable services – hairdressing, cleaning, house repair, child care, etc. –this implies a reduction of labor demand. Given a price-elastic demand for such services, the burden of adjustment will almost entirely fall on labor (Scharpf 2000:205): Workers, often unskilled, are laid off. A reduction of consumption taxes on non-traded services has therefore been suggested as a strategy to raise low-skill employment (OECD 1995:65). Sweden, for example, introduced reduced VAT tax rates for restaurant services, contracting work, and tourist services in the early 1990s.[14] It has been argued that these reductions had a positive impact on the labor market (Andersson and Mutén 1998). But they also limited the scope for consumption taxes as an alternative source of revenue.

A second problem with consumption taxes is that they stimulate the shadow economy. They drive a tax wedge between gross-consumer and net-producer prices and thereby create opportunity for mutually beneficial deals: The consumer pays cash and does not receive a regular invoice, the producer does not report the income, and the tax authorities lose consumption tax receipts. Italy is notorious for such illegal dealings (Castellucci 1998:192), but they are also commonplace in less suspicious countries such as Canada. Much of the alleged recent growth in the Canadian shadow economy is attributed to the introduction of the Goods and Services Tax in 1991. The new tax covers a wide range of services previously untouched by consumption taxes. "Within a short time, for example, it became common practice in the home renovation business for many firms to quote a lower 'no GST' price for cash transactions - and if they did not do so initially, their customers often asked them to do so" (Bird / Perry / Wilson 1998:70). Reductions in tax rates are sometimes suggested to lure illegal business back into the formal economy (OECD 1995:84).

Finally, a switch to consumption taxes may create equity problems because poor people tend to consume a higher share of their income than rich people. It is possible to attenuate regressivity by excluding daily necessities from consumption taxation (Garrett 1998c:154). But again, this reduces the revenue potential of consumption taxes and, in turn, their capacity to compensate for lower labor tax revenues. Note also that a move towards consumption taxation reduces the tax burden on labor only if those outside the labor force are not compensated for the increase in prices (OECD 1995:95). As many in this group live on transfer payments, this can be socially and politically tricky: Taxing poor pensioners and social assistance recipients in order to lessen the tax burden on labor may not strike everybody as fair. For this reason, raising taxes on consumption can be politically costly. This was experienced most dramatically by governments that attempted to introduce new consumption taxes. In Canada, for example, the governing Conservative party was virtually wiped out in the election following the

14 Technically, Sweden did not cut the tax rate as such, but reduced the VAT tax base to which the tax rate is applied – by 30 percent and 80 percent, respectively.

introduction of the Goods and Services Tax (Bird / Perry / Wilson 1998:76). The defeat of the Australian Liberals in the 1993 elections has also been attributed to their pledge to introduce the VAT (Sandford 1993:106).

5.3. Green taxes

Some governments in Scandinavia and continental Europe have recently become interested in ‘green taxes’ on energy, pollution, and natural inputs to production as an alternative source of revenue. The European Commission also advocates green taxes as a means to reduce the tax burden on labor (Europäische Kommission 1994; European Commission 1996). Yet, the tax base of green taxes is narrow. According to Eurostat, energy tax receipts from excises on mineral oils and other fuels accounted for 2.2 percent of GDP in EU member states in 1995, while environmental taxes narrowly defined - everything from duties on tap water to charges on aircraft noise - raised only 0.7 percent of GDP. Taxes on labor, by contrast, accounted for 21.4 percent of GDP (Eurostat 1997:99). In other words, reducing the effective taxation of labor by two percentage points of GDP, as suggested by the European Commission, requires energy and environmental taxes to be almost doubled. No government has attempted anything like that. Even in the most environmentally minded countries, increases of green taxes have been modest with marginal effects on employment, if any (Schlegelmilch 1999). Steeper increases face numerous difficulties.

Basically, green taxes pose problems similar to those found in consumption taxation. They may not substantially relieve labor because much of the tax burden is passed on in higher prices. In unionized labor markets, higher prices may translate into higher wage claims, higher gross wages, and, eventually, lower labor demand (OECD 1995:95). In addition, green taxes are likely to create distributive inequities because, as many studies show, energy consumption is higher among low-income households (Piekkola 1998:90). Finally, to the extent that green taxes affect the competitiveness of domestic producers, they may be vulnerable to tax competition. There is concern that the uncoordinated introduction of charges on the environment may result in the closure or relocation of production facilities and in labor shedding(OECD 1995:78-79) – a horrifying scenario which has induced many governments to go slow on green taxes and wait for international coordination (Europäische Kommission 1994:166).

Given the difficulties of shifting the tax burden to consumption or the environment, it appears plausible that, in the absence of tax competition, governments would have used additional tax receipts from corporate and financial income to reduce labor taxation. Indeed, taxing capital more heavily has often been promoted as a way of correcting a perceived bias against labor in the tax system. This was, for example, a theme of the corporate tax reforms in the UK in 1984-86, and the introduction of the Generalized Social Contribution in France in 1991, which extends social charges to non-labor income including interest, dividends, and capital gains (Blotnicki and Heckly 1998:93). It was one of the reasons why the Danish Tax Reform Committee of 1992 suggested progressive rather than proportional taxation of capital income (Sørensen 1998:23). It was discussed in Belgium in connection with a report on the financing of the social security system, and it was a core element of the tax reform plan of Germany’s former minister of finance, Oskar Lafontaine (OECD 1995:72; Lafontaine 1998). Finally, it has been used by the European Commission as an argument to push for tax harmonization. In order to increase the taxation of capital, tax competition first must be stopped (Europäische Kommission 1989; European Commission 1996).

6. Taxing dilemmas

The contest between the conventional wisdom and its critics ends in a draw: The critics have the better data, but the conventional wisdom has the better intuition. The critics are right in pointing out that there is no evidence for a race to the bottom in capital taxation or a meltdown of total tax revenues. But they are wrong in concluding that tax competition does not constrain national tax policy. Even Garrett admits that "income-based tax evasion is a significant problem in the global economy"(Garrett 1998c:155) and acknowledges "a strong tax-based constraint on the future of the welfare state" (Garrett 1998c:153). Unfortunately, he does not explain how this fits into his "much more optimistic picture of the prospects for national autonomy in the global economy" (Garrett 1998b:94). The conventional wisdom is correct in assuming that globalization constrains national tax policy. Indeed, it is hard to see how it should not. How should the elimination of barriers to cross-border movements not lead to more international tax arbitrage and evasion, and how should this not increase the difficulties of taxing mobile tax bases? The conventional wisdom is wrong, however, when it assumes that arbitrage pressures will automatically lead to a race to the bottom in taxation.

The race to the bottom has not taken place because tax competition was not the only problem that the welfare state faced during the 1980s and 1990s. There was also slow growth, high levels of precommitted budget expenditure, a mounting public debt, rising unemployment, and the threat of the shadow economy. These problems, which were not directly related to globalization, exerted countervailing pressures on tax policy that eclipsed the effects of tax competition. The welfare state is not trapped in a race to the bottom, but boxed in between external pressures to reduce the tax burden on capital, on the one hand, and internal pressures to maintain revenue levels and relieve the tax burden on labor, on the other.[15] There is no policy that can offer an easy way out. Governments can try to reduce their exposure to competition by cutting taxes on capital and by relying more on taxes on labor and consumption. But this may depress employment levels, encourage the growth of the shadow economy, and create equity problems. Alternatively, they can try to stimulate employment by reducing the tax burden on labor and consumption. But this implies higher taxes on capital and thus threatens to accelerate tax flight to other countries. Governments can take temporary refuge from this dilemma by running a larger deficit. Yet this merely postpones the problem. The taxes that are not raised today will lead to higher interest payments tomorrow. Less pain now causes more pain later. Whatever solution is chosen, it may backfire. If taxes on labor and consumption are raised too much, the welfare state may end up in what Gösta Esping-Andersen described as the welfare-state-without-work trap. If taxes on mobile capital are too high, they may drive investors and investment abroad. If budget deficits are too high, the ensuing interest payments will drive up spending requirements and make it ever more difficult to balance the budget.

15 Obviously, it would be nice if the magnitude of these pressures could be assessed quantitatively. However, this is difficult to do because they cannot be observed independently – if they can be observed at all. Policy makers factor the problems of tax competition into their decisions on public expenditure levels, so that the null-hypothesis level – the level of expenditures in the absence of tax competition – is impossible to discern. The same is true vice versa. Tax levels are not independent of spending requirements. Therefore, we cannot tell how much taxation would have been driven down by tax competition if spending levels had adjusted easily. At least the actual levels of taxation and expenditures are measurable. This is not the case when it comes to international capital tax evasion and avoidance or the size of the shadow economy. These quantities are, for systematic reasons, not knowable. Given these methodological difficulties, the ambition of this paper is rather modest. It simply wants to raise plausible arguments against the prevalent view that tax competition has not seriously affect tax policy just because nothing has changed in tax aggregates.

Caught between high spending requirements and the risk of eroding the tax base of both capital and labor, many European states suffered from a sense of permanent fiscal failure during much of the 1990s. Something always seemed too high: the debt, the deficit, the taxes on capital, the taxes on labor. Yet it was impossible to reduce any of these factors without at the same time increasing one of the other factors. Tax reforms seemed urgent, but given high spending levels, there was little room for reform. Problems were shifted from one end of the tax system to another, but hardly solved (Ganghoff 2001). Many reforms were inconsistent and unstable over time. France, for example, reduced the tax burden on corporations during the late 1980s to stimulate investment, only to introduce a surcharge on corporate income when budget consolidation became pressing during preparation for the monetary union. Sweden reduced the progressivity of its income taxes during the 1991 tax reform, only to reintroduce progressivity during the mid-1990s (Steinmo 2000). Germany reduced the corporate tax burden in 2000, only to start making desperate attempts in 2002 to increase it again.

In the midst of the current recession it seems that the fiscal crisis of the welfare state is here to stay. As long as this does not change, the concern for tax competition will remain.

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Philippe Pochet °

Monetary Union and Welfare State Reform: Perceptions, Strategies, Evidence

Monetary union is the final stage of a dynamic process which began in the early 1980s, when several European governments were convinced of the supremacy of a model combining low inflation, a strong and stable currency and a balanced budget. Economic and monetary union or EMU could be considered as the culmination of this process. Indeed, the decision of governments in the Netherlands, Austria, Denmark, Belgium, and France to adopt a new monetary regime encompassing the goals of low inflation, a stable currency and budgetary restraint was taken (formally or de facto) at the beginning of the 1980s. At European level, most commentators consider that EMU also constitutes an extension of the process initiated with the completion of the internal market and the liberalisation of capital movements.

The single currency has brought about multiple supplementary changes. On the one hand, the governments and social actors within EMU no longer have any loopholes for escape; they must be efficient inside this framework without hope of exit (mainly because of the costs of leaving the euro-zone). More than ever before, governments must respond to and anticipate small deviations in key indicators (inflation, global costs, wage costs, and so on), while the social partners need to take into account the macroeconomic environment in their bargaining processes.

In other words, the European level may very well have become, for many EMU-related issues, the main battlefield, resulting in either an increase or a decrease in the room for manoeuvre for national social reforms. Indeed, the single currency may (and, to central bankers, should) also reinforce reforms of the labour market and social protection. As Trichet (2001), governor of the Banque de France, puts it, "*EMU certainly stimulates structural reform in the labour market. With increased capital mobility and a better functioning single market, firms will become more and more sensitive to overall labour cost differentials and business regulation in choosing a particular location in the Euro-zone. They will therefore exert a considerable pressure for appropriate reforms*". Since the very beginning of EMU, some key players have been well aware of its potential consequences.

In this article, we will try to shed light on several questions. Are the constraints imposed by EMU really new for all the countries involved? What kinds of consequences could the single currency have in the social sphere at the national level and in which areas might these effects be more important? Do we have indications of effects of the new monetary regime on national social security systems?

The first section briefly presents some of the methodological points. First, how can we establish a causal link between EMU and social protection? Secondly, how can we integrate changes in social security in a broader perspective, the national social model (encompassing collective bargaining, working conditions and social security)? We argue that any assessment of the impact of EMU on the welfare state should also take into account developments in the collective bargaining system. Nevertheless, we do not examine this indirect effect in depth. Thirdly, what date do we use as the starting point of the analysis? We argue that there is an important difference between the period of selection (for EMU membership) and the current period.

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Section 2 focuses on the consequences for the welfare state following the division into two sub-periods (first, between Maastricht and the selection of candidates for EMU; secondly, the years since the introduction of the euro on 1 January 1999). The kinds of pressure observed during the selection years differ from those observed since selection was completed; naturally, their impact will be different.

1. The changing macroeconomic environment of EMU and its potential impact on the welfare state

Most studies on the potential impact of EMU in the social sphere have trouble defining the precise mechanisms whereby national social models could be affected. The existence of a public debate often serves as proof. Thus the failure of the Juppé pensions plan in France and that of the Berlusconi government in Italy in the mid-1990s would seem to indicate that Maastricht had a powerful adverse effect on social protection.

In the analysis of interactions between Europeanisation and the welfare state, Monetary Union constitutes an ideal case study. Indeed, the different stages and conditions for its completion were set out in the Maastricht Treaty. What is more, we have a situation where some EU member countries have joined and others have not, which should make it possible to ascertain whether any relevant changes occur in the countries remaining outside the euro-zone.

Monetary Union enables us to focus on two questions: i) the timing of changes or when changes take place at national level, and ii) differentiation between measurable changes – for example, in the share of GDP devoted to social security and the relative perceptions these changes have brought. In Dyson's (2002: 24) terms, it is necessary to "clarify the relationship between EMU as a material phenomenon, associated with changes in markets and in policy mechanisms, and EMU as a discursive construction or narrative".

The key issue, then, is to identify the essential variables involved and to examine how an "objective change" in one of them (for example, the centralisation of monetary policy),[1] may, or may not, alter the others. The three variables most frequently quoted in this context are mobility, national or European budgetary policy, and labour market flexibility (pay and working conditions). Other papers in this volume deal with this issue and we shall not return to it here. We merely point out that low mobility is an empirical fact, whereas budgetary constraints – due to the Stability and Growth Pact and the low level of the European budget (1.2 % of EU GDP) – are the result of political decisions.

Because of these political choices, labour market flexibility remains the main instrument of adjustment in the case of adverse economic shocks. As wage increases or higher contributions to social security could trigger a loss of competitiveness or an inflationary spiral, the control of wage formation is becoming a crucial issue (Pochet 1999). Indeed, many fear that in order to avoid a rise in unemployment, member states will be able to respond to (asymmetric) economic shocks or to competitive pressure only by adapting (that is, lowering) wages and prices. Since, in a monetary union, the latter become far more transparent, taxes, labour and social protection could become national instruments of competitiveness and macroeconomic stabilisation, ending in a "race to the bottom" and social dumping. At any rate, this is the logical chain of events posited by those who link EMU and adverse effects on social policy (in a broad sense).

1 By "objective change" we mean a change the nature of which is agreed upon by all, without the need for discussion, as is the case, for example, with the end of the option to devalue.

The main arguments advanced to describe the impact of EMU on national social models differ considerably depending on the period and the domain under consideration (Pochet et al. 1998). Table 1 distinguishes between two periods. The first period (1992–7) ran from the Maastricht treaty to the selection of participants for the third stage of EMU. The second period (1998 to the present) is characterised by adaptation to the new reality of a single monetary policy led by the ECB and by attempts to strengthen the political dimension and economic coordination at the European level. Ultimately, this period should lead to the creation of a new (and more stable) framework at national and European levels. We can also single out three domains: wage bargaining, working conditions and social security.

Table 1: Main arguments describing the impact of EMU on wage bargaining, working conditions and social security

Period	**1992 – 1997:** **Selection**	**1998 to present:** **Transition and Stabilisation**
Wage bargaining Impact due to:	• Inflation • competitiveness	• inflation • competitiveness • asymmetrical shocks • signalling process • global demand
Working conditions Impact due to:	• asymmetrical shocks	• asymmetrical shocks • capital market
Social security Impact due to:	• fiscal deficit	• fiscal deficit • Stability and Growth Pact • pension funding • global labour costs

However, as pointed out by Dyson (2002: 22), "*[s]ince Maastricht in 1991, EMU has expanded in scope and its boundary with other policy sectors has become more permeable. Hence we are dealing with a variable – EMU – that has changed.*"

Returning to the lessons of Table 1, one can easily see that the arguments are rather different from the perspectives of the three social domains. For the first period, EMU's impact on social security is mainly associated with the reduction of fiscal deficits. Asymmetrical shocks are invoked in favour of deregulating working conditions, and moderation of wage claims is linked, for most authors, with the risk of inflation and a lack of competitiveness. If these were the standard arguments during the (EMU) selection period, new elements are progressively emerging in analyses of the current period. Thus, fears of asymmetrical shocks are complemented by fears of a crisis of global demand as a consequence of cumulative wage moderation in the framework of competitive social pacts. Furthermore, some commentators believe that the growing integration of capital markets will lead, as a consequence of EMU, to the wide diffusion of the Anglo-Saxon "shareholder" model (replacing the present "stakeholder" model), a development that is bound to have strong (that is, negative) consequences for working conditions.[2] As far as social security is concerned the funding of state pensions and the budgetary restraints imposed by the Stability and Growth Pact occupy the focus of attention, alongside global wage costs.

The impact of EMU on collective bargaining is important.[3] At the beginning of the 1990s, most European governments attempted to negotiate macro-agreements with the social partners so as to enable adaptation by consent, rather than risking the disruption and unrest which might arise from imposed adaptation. The social partners and government negotiated new macro-agreements in Belgium, Italy, Spain and Ireland in 1992–3, and in Portugal, Finland, Germany and Ireland, and once again in Belgium, Italy and Spain in 1995–6. Although these pacts failed in Belgium and Germany, this was not the case in the other countries mentioned, where substantial agreements covering a wide range of issues were signed. These go beyond labour market matters as such, related to a host of factors linked to competitiveness and attractiveness of location. In a period of high unemployment, everyone attempts to find a solution to the employment crisis. Beyond the national differences, what the pacts have in common – whatever else they deal with – is wage restraint, precisely because this is what is needed to cope with the immediate and pressing problem of inflationary tendencies (Italy, Spain or Portugal), competitiveness (Belgium) or asymmetrical shocks (Ireland, Finland).[4] By contrast, in our own research regarding the flexibility of working conditions related to EMU (Pochet et al. 1998), we found that any direct link to monetary union is fairly weak.

What these examples illustrate is that "*reforming labour market regulation and recasting welfare states may require in most European countries a search for a new type of 'corporatism' rather than its abandonment and, rather than an Anglo-Saxon deregulated labour market, a readjustment of the 'continental' model to accommodate market pressures with the preservation of social protection and social consensus*" (Rhodes 1997: 1; see also Hemerijck et al. 2000).

The centralisation or decentralisation of the collective bargaining system is also related to issues of social security. The social wage (social benefits) is part of the total income of the worker and the government can influence the behaviour and incentives of the unions by altering the size and composition of this wage. This was clearly the case in Spain at the beginning of the 1990s. After the breakdown of centralised bargaining in the mid-1980s the Spanish government tried to renew the dialogue with the trade unions in the early 1990s by increasing social expenditure. The expenditure on social security, which was 20% of GDP in 1989, reached 22.5% in 1992. The respective figures for the EU (12 countries) as a whole were 25.1% and 27.1% of GDP (Astudillo Ruiz 1998). Some in the government hoped that, in return for increasing social security expenditure, trade unions would be ready to return to the centralised income policy and wage moderation which were characteristic of the previous social pact period (Pérez and Pochet 1999).

2. EMU and social protection

In this section we shall examine the global effects of EMU one by one, illustrating this issue by means of two causal chains, the first entailing positive repercussions and the second negative ones. Thereafter we shall turn our attention to the possible impact during the 1992–7 selection phase and, finally, under the euro-zone.

2 For a contrary view see Rhodes and van Apeldoorn 1998.

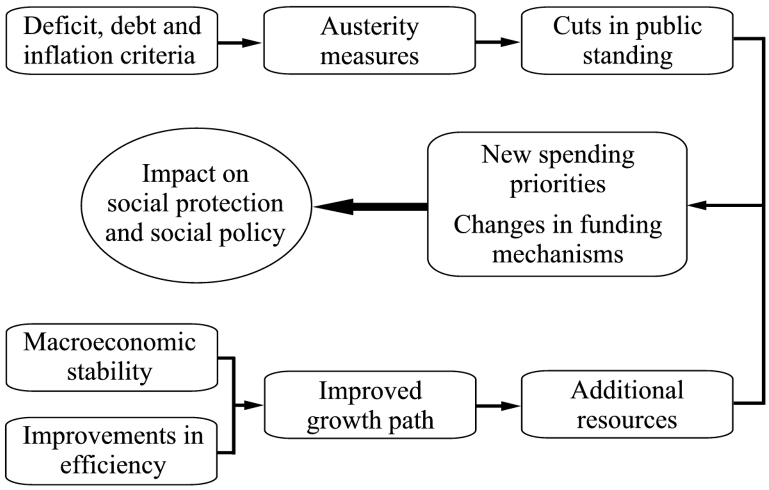
3 We will not go into detail here on the potential impact of EMU on collective bargaining and working conditions. We shall confine ourselves to recalling a number of factors emerging from our recent studies.

4 For more details see Pochet 1999 and Fajertag and Pochet 2000.

2.1. Two causal chains

Summarising the different positions on the possible impact of EMU on social protection in general economic terms, Begg and Nectoux (1995) described them, for any member state, as a double chain reaction with conflicting effects (see Figure 1).

Figure 1: Framework for assessing the social impact of EMU



Source: Begg and Nectoux 1995: 290.

The first factor of influence arises as a consequence of conforming to the requirements imposed by the Maastricht Treaty and the Stability and Growth Pact. Many member states will have to continue to practise budgetary consolidation, entailing raising taxes or cutting public expenditure, or, more likely, both. According to this scenario, governments can be expected to seek ways of cutting or eliminating expenditure programmes and to encourage private provision as an alternative. An increase in tax competition could strengthen the current trend of shifting taxation on capital to taxation on labour, leading to a deterioration of the employment situation (Cardani 1998).

Additionally, in view of the need to curb inflation and maintain the value of the euro, the ECB is likely to keep monetary policy relatively tight, which could also depress economic activity and thus put added pressure on social budgets. The final result of this first chain reaction would be substantial pressure on social protection and its financing.

According to a second scenario, EMU will create a more stable macroeconomic environment while permitting efficiency gains, thus providing growth incentives and economic development, with incomes increasing and the employment situation improving. In this chain tax revenues may increase and EMU end up benefiting social protection and its financing. The second chain shows many similarities with the logic which envisaged only a minimalist role for social policy in the 1957 Treaty of Rome: its founding fathers placed their faith in the "*automatic improvement of social conditions, relying on the assumed knock-on effect that economic integration would produce*" (Pakaslahti 1998: 60).

Which of the two chains will materialise in the long term depends on a number of considerations, but the 1991–3 recession may have given rise to an exaggerated pessimism about the feasibility of convergence targets. Indeed, some argue that the deterioration of current deficits was the result more of cyclical than of structural problems (Thygesen 1998; Begg and Nectoux 1995). The same can be said of the 1998–2000 situation in which growing economies, decreasing unemployment and budget surpluses seem to fit better with the second scenario.

National diversities in terms of initial economic position must also be taken into account when assessing the final outcome. The impact of EMU has without doubt been bigger in Italy – with a total debt of around 120% and a deficit just below 3% in 1998 – than in, say, Luxembourg. However, the positive prospects of EMU as regards the reduction of general interest rates, for example, has been much more important for the southern countries, which until recently were subjected by the financial markets to a marked risk premium. This implies that for some countries the benefits will outweigh the costs, whereas for others the outcome is more uncertain and the final decision about whether or not to go ahead with EMU was based on political rather than economic grounds.

We have argued that the analysis of Monetary Union would require proper consideration of how things stood in a given member state at the point of change of monetary regime. In this way, analysis of the impact on wage negotiations would be different. There is a strong correlation between moment of change of monetary regime and fall in the share of wages in GDP (between 7 and 10 percentage points). This argument does not apply to social protection reforms. In fact, social protection measured by expenditure as a proportion of GDP provides no correlation with the change of monetary regime at national level.

In the following sections we distinguish between two subperiods: i) from Maastricht to the selection of EMU members and ii) the euro-zone. We shall also distinguish between the changes in policies pursued, on the one hand, and in the sphere of ideas, on the other.

2.2. Preparation for EMU

During the period of selection of EMU participants in terms of the Maastricht criteria, the principal argument was that, by curbing expenditure, the 3% government debt criterion and thereafter the Stability and Growth Pact would have a major impact on welfare state funding. To verify this hypothesis two aspects will be briefly examined: first, social protection expenditure in terms of GDP for the period 1990–8 – one effect of EMU should be a fall in the share of social expenditure in GDP; secondly, the analysis of budgetary reforms during this period, based on an OECD study, since such reforms would, for example, lead to a fall in social expenditure in overall government spending. In order to underline a possible causal link, we should point out that social protection has been the domain in which the most significant cuts have been made compared to other expenditure.

The indicator most commonly used – and criticised as such – to study developments in social security systems is comparative social protection expenditure over time.[5] For the EU as a whole, the proportion of GDP spent on social security had reached nearly 29% in 1993. By 1998, the last year for which data are available, the European average had fallen to 27.7%. However, this proportion is still higher than the 25.4% observed in 1990 (CEC 2002).

If we take the latest data (CEC 2002) which cover 1998, only in three countries – Portugal, Greece, and Germany – did spending continue to rise after 1993 (in comparison to GDP).

5 Government expenditure as a percentage of GDP is a useful measure of cross-national differences at a given point in time, but the GDP denominator makes it difficult to interpret change over time (two things could be changing: the amount of money spent and the size of GDP). More importantly, at any given level of entitlement provisions, an increase in the number of claimants automatically generates increased social spending by the government. Increased spending might be associated with a reduction of entitlements.

It should also be noted that there is still a 2:1 disparity between the highest and the lowest spending member states (spending as a proportion of GDP); the gap in *per capita* spending is even larger.[6] And yet "*the differences in spending on social protection have diminished by 30% since 1980 . . . This is mainly due to improvements in the systems in the southern member states . . . one could therefore speak of a certain spontaneous social convergence, but in the positive sense"* (Goudswaard 1998: 84). If true on a long term analysis, only Portugal clearly continued its catch-up during the period 1990–8. More investigations should be made into the apparently different paths of the four cohesion countries (Ireland, Spain, Portugal and Greece).

Table 2: Social protection expenditure (% of GDP)

	E15	B	DK	D	EL	E	F	IRL	I	L	NL	A	P	FIN	S	UK
90	25.4	26.4	28.7	25.4	23.2	20.5	27.6	18.7	24.2	19.1	32.4	26.7	15.8	25.1	33.1	22.9
93	28.9	29.5	31.9	28.4	22.3	24.7	30.9	20.5	26.2	24.5	33.5	28.9	21.3	34.6	38.6	29.1
98	27.7	27.5	30.0	29.3	24.5	21.6	30.5	16.1	25.2	24.1	28.5	28.4	23.4	27.2	33.3	26.8

Source: CEC 2001.

Revealing data concerning the different measures preferred by governments (for example, increasing revenues – by raising direct taxes – and reducing investment spending and public consumption) to avoid cutting social spending can be found in a study on the experience of fiscal consolidation in OECD countries between 1974 and 1995 (OCDE 1996). According to this study "*governments have often hesitated to react as quickly and as vigorously as they should have"* because political resistance to specific adjustment measures has been strengthened by worries concerning the short-term negative macroeconomic consequences of budgetary stringency (p. 37). According to the authors, who investigated 15 cases of structural fiscal consolidation involving 11 countries (nine of them EU member states),[7] transfer spending (social transfers) fell in only seven cases, and generally by very modest amounts. Even in these periods of budgetary crisis and intense fiscal consolidation, only three of the 15 cases reduced their transfer spending by more than 1% of GDP. By contrast, six achieved an equally large cut in public consumption, and seven in investment spending.

In any case, it remains to be seen what aspect of welfare state developments will be attributable, directly or indirectly, to EMU. As Pierson (1998) remarks: "*Yet it is essential to realize that the broad constraint on the government debt/GDP ratio, and the implications of rising interest payments, would exist in a world without EMU*".

During the current phase there is little evidence that EMU has led to or has been the principal cause of welfare change. Let us now turn to the effects of EMU on welfare perceived by the actors themselves and the use or non-use by some of them of EMU-related arguments in the debate about welfare state reform. In this case, the difficulty stems from the reliability of the materials used to evaluate this more subjective aspect. For our purposes, we have at our disposal a Europe-wide research study conducted by Pakaslahti (1997) on the basis of the collection and analysis of 35 national newspapers in the 15 member states over several months of 1996, which was the key year for producing the 1997 budgets, which were to serve as a reference for the qualification (or otherwise) of the first EMU group.

6 In 1995 the difference between the highest (Luxembourg) and the lowest (Greece) member state as regards social protection spending per person, expressed in terms of purchasing power, was 3.4 to 1 (Eurostat 1998).

7 At least a 3% reduction in the public deficit realised without interruption over several consecutive (two or more) years.

In a nutshell, Pakaslahti delineates four groups of countries. The first comprises France, Germany, Belgium, Austria and Italy.[8] The first three of these "*used the 1997 budgets designed to meet the convergence criteria to implement key changes in social protection and to open up a process of reducing social expenditure*". These governments adopted a schizophrenic attitude by, on the one hand, affirming that, with or without Maastricht, these reforms would have been unavoidable, and on the other, using EMU to justify some of the most difficult measures. In Austria even before 1995 the economic need for budget consolidation was widely accepted in principle and several attempts had already been made in the early 1990s. In 1995 and 1996 two "austerity packages" (including severe cutbacks in social spending) were introduced. According to Tálos and Badelt (1999) it is highly unlikely that without the external pressure of EMU these political decisions would have been taken in Austria.

The *second* group of countries consists of Portugal, Spain and Greece. They made entry into the single currency or phase three of Economic and Monetary Union (EMU3) "*in 1999 a national priority, and were prepared to carry out far-reaching measures to secure this aim*". However, their governments emphasised a prudent approach to social expenditure and tried to ensure EMU entry "*by all other means*" (Pakaslahti 1997: 52). The Greek case, for example, shows a government trying to avoid discussion of social security reforms until entry into the EMU zone (see Featherstone *et al.* 2001), while the public deficit fell from over 12% in 1993 to less than 1% in 1999 (Ioakimidis 2001). Careful scrutiny of the development of social protection expenditure reveals that this group can be divided into two: Greece and Portugal (and especially the latter) embarked on a process of convergence, whereas social spending in Spain has stagnated.

The *third* group consists of the Nordic countries – Denmark, Sweden and Finland – and the Netherlands. Although these countries have different approaches to EMU3, they were close to fulfilling the convergence criteria. These states "*have already undergone or started a thorough process to change social protection due to economic restraints or recession*", but they all want to maintain the basic elements of their national social model. "*The transformations of social protection in these countries have no direct link with the EU course of EMU*" (Pakaslahti 1997).[9]

For the three last countries, Luxembourg, Ireland and the UK, that either fulfilled or were close to fulfilling the convergence criteria: "*In these countries there has also not been much high profile discussion concerning social protection in terms of securing EMU entry*" (Kuhnle 2000, 53).

This research reflects the state of the public debate and not necessarily the "reality". Indeed, it might suit those concerned to highlight for various reasons a factor such as EMU or, on the other hand, to pass over it in silence while carrying through policies deemed appropriate. But even if the borders between the four groups of countries may not always be clear, and even if this approach merely reveals the coinciding of a debate (about EMU and social protection) with the elaboration of a budget, this classification illustrates that, as far as the press is concerned, it is not clear that EMU has been in itself and for all EU countries a threat to social protection. Member states have responded in different ways to the challenges imposed by EMU.

These findings are only partially confirmed by the results of an inquiry by Pieters (1996) on the perception of the effect of EMU on social protection by different actors, who found that a clear majority of all EU respondents (researchers, political and administrative decision-makers, social partners, interest groups, and so on) were convinced that attempts to meet the convergence crite-

8 Note that Pakaslahti put Italy in the second group. According to our information this is erroneous.

9 In a review of changes in these countries during the 1990s, Kuhnle (2000) points to a "less generous welfare state" as a common denominator. This is particularly interesting in that it covers four different scenarios: Norway is outside EMU, Finland wanted to join, Denmark is outside but changed its monetary regime at the beginning of the 1980s, and Sweden is also outside but has not changed its monetary regime.

ria have resulted in national social policy changes, and that these efforts will in the end lead to either a stabilisation of national social security expenditure growth or to its reduction. However, numerous respondents from Germany, the UK and Denmark argued that, although their national policy has changed, it has not been as a consequence or in the framework of EMU. Respondents from almost all the other member states linked the convergence criteria (mostly the "3% norm") to a stabilisation/reduction of national social security benefits, although most of them suggested that these would have had to be cut anyway and that EMU served merely as a pretext.

These partial data show that in addition to the diversity of initial situations in terms of global debt and the need to reduce the public deficit, different political strategies were implemented. The overall perception has often been influenced by the 1995 strikes in France and pension reforms in Italy. Nevertheless, other configurations exist, if less publicised. The Finnish case is worth underscoring in this regard. They created a stabilisation fund to reduce the cost of labour in case of an asymmetric shock by offsetting losses through an automatic transfer from the fund to social protection funds.[10] The Finnish case is also useful because the solution chosen (stabilisation fund) appears more important in terms of its political effects (consensus that EMU should not lead to fears of a dismantling of the social protection system) than its real macroeconomic effects (the modest scope of the fund prevents it from exerting a real stabilisation function).

The perception is that EMU's influence is widespread, but the available financial data are not adequate to support this. Pakaslahti's analysis shows that only a few governments have deliberately and openly linked EMU and welfare reform issues. In this regard, the Greek case is very interesting. At the beginning EMU was used as a scapegoat but from 1996 "the government's handling of the EMU factor shifted from a scapegoat strategy to a positive, full-fledged endorsement of the European and EMU vision, as a national objective imposed not only by necessity but by its desirability and growing feasibility, too" (Pagoulatos 2001: 200). Although during this transitional phase the situation was more complex than just a mechanical deployment of EMU to roll back the welfare state, the fact remains that the very nature of monetary union has propagated a liberal vision and has acted "as a rhetorical device to discipline the expectations of others about what is politically, economically, and socially feasible" (Dyson 2002: 24). The full effects of this were to be felt during the debate on the future of state pensions.

2.3. Social protection during the third stage

Once accepted, EMU members have to respect not only the 3% deficit but also the requirements of the Stability and Growth Pact, which states that in normal times the budget should be balanced or even in surplus. Furthermore, it is no longer only a matter of how each country fares individually but also of the stability of the euro-zone as such. That is why, for example, the question of long-term state pension funding (pay-as-you-go) has become a topic of common interest.

The question of reducing budget deficits took a different form during this new phase. In the period 1998–2000 it was no longer a matter of how to reduce deficits but of how to utilise the room to manoeuvre created by surpluses or better than expected budgetary results.[11] In a second phase the situation became polarised. Most of the countries managed to balance their public finances or even achieved substantial surpluses, whilst the three largest countries in GDP terms – Germany, France and Italy – were pushing the 3% limit. Recently, Germany went beyond that mark, as Portugal had done before it. Given this situation, the Stability and Growth Pact proved to be ineffectual (Fitoussi 2002). This shows the extent to which an analysis of the impact of EMU must

10 For more details, see Boldt 1999 and Pochet 1999)

11 I explored these new tensions in detail in an earlier paper (Pochet 2000).

also take account of the development of monetary union itself. A further impetus has come from the additions to the mechanisms provided by the Maastricht Treaty: the European employment strategy and then the open method of coordination in the field of social protection (De la Porte and Pochet 2002; Jenson and Pochet 2002).

Compared to the previous period, two topics are being addressed by most member states, namely fiscal reform to reduce labour costs (taxation and social security) and long-term reform and funding of pensions. At European level, the question of the quality of budgetary spending is being discussed (to put it briefly, expenditure which can foster growth along the lines of endogenous growth theory is considered as good, such as education, R&D, infrastructure, and so on).[12]

Two lines of argument can be identified. The first focuses on the potential negative effect of the social security burden on employment. As the communication from the Commission on Community Policies in Support of Employment indicates (CEC 1999a), "*[o]ngoing work seeks to analyse the new and evolving context in which social protection systems will operate – defined by EMU, the European employment strategy and future enlargement – with a view to strengthening the cooperation with, and between, member states on social protection issues, especially including efforts to make protection systems more employment friendly*". According to the Commission, the reduction of social charges should target low-skilled workers. The best results would be obtained by compensating for this reduction with a cut in spending rather than a tax increase. As concerns fiscal reform, the European Central Bank and the Ecofin Council have an ambiguous attitude and do not really favour reforms not accompanied by cutbacks in expenditure. This seems difficult to achieve at the national level, as indicated by the stability – or even increase – in taxes on labour (as a percentage of GDP) between 1994 and 1998 (CEC 1999b).[13]

The second concentrates on the funding of public pension systems.[14] For example, the European Central Bank states that "*[i]n addition, government budgets and, in particular, unfunded public pension and healthcare schemes will be confronted with the serious financial consequences of ageing populations over the medium term in almost all Euro-area countries. For these reasons, budget plans should not only be tailored so as to safeguard public finances against the financial consequences of potential future recessions, but should also build up reserves from which to reduce implicit future liabilities accumulated within the government sector*" (ECB 1999). The subject of pensions is viewed by the European Central Bank and the Ecofin Council (supported by the Employment Policy Committee) as being crucial for the stability of public finances and for long-term compliance with the rules of the Stability and Growth Pact.[15] If the effects on member states' policy reforms is still unclear (De la Porte and Pochet 2002), at least some cognitive harmonisation is under way (Palier et al. 2000). In the field of pensions, monetary union has provided finance ministers with a legitimate reason to speak out about this politically very sensitive issue on the grounds of stability of public finances. In this respect, EMU has altered the structure of opportunities among the various actors. Dudek and Omtzigt (2001) identify different means

12 In this context we must stress that the current European approach is contradictory. Governments cannot at the same time reduce public deficits (as prescribed by the Stability Pact), keep the overall level of taxes stable (or decrease it in some cases) as requested by various European Councils, invest in factors for long-term growth (education, research, infrastructure, and so on), and maintain the same level of expenditure on social security. Until now this contradiction has largely been resolved by reducing expenditure on infrastructure, education and research. As the share of this expenditure has fallen to a very low level, social security could soon be in the firing line for future cuts.

13 Three national cases, Spain, France, Sweden are analysed in De la Porte and Pochet 2002, showing the interaction between the national level and European prescriptions in this field.

14 The most comprehensive argumentation can be found in a document issued by DG XV. The role of DG XV as a lobby on the question of "the pension bomb" is put forward by Chassard (1999).

15 For a detailed overview of the arguments see Math 2001; for an analysis of the process, Math and Pochet 2001.

whereby the European Union has an influence on the available options for pension reform. Three of these are particularly worthy of attention.

First, the discussion forums it creates have disseminated ideas and led to the emergence of policy networks or "epistemic communities". EU influence is therefore making itself felt in the field of ideas: their circulation and their legitimation. Various Community-level documents will energise these policy networks. Secondly, economic integration and monetary union make each partner more attentive to the policies pursued by its neighbours. In this context, it is likewise more legitimate to ask them to account for their actions. Thirdly, the European Union constitutes a resource for those who, at national level, are in step with the European line of reasoning, at least in those countries where European integration is regarded as positive and valuable. As pointed out by a recent Commission study, *"besides economic arguments, coordination can also play a useful role from a political-economy viewpoint by helping to implement unpopular but necessary policy actions at national level*" (CEC 2002: 4) – especially since the configuration of groups mobilised at European level is different from that in the member states.

The results of an analysis of the current phase of monetary union and its consequences for the welfare state differ from those of the accession period in that they signal a fundamental change. On the one hand, the pressure from financial markets has radically declined (Mosley 2000), but on the other, pressure is now exerted by a whole host of actors involved in a number of institutions (ECB, Ecofin Council, Economic Policy Committee, and so on). These actors are often regarded as an "epistemic community" or a "policy network" (Haas 1992; Pochet and Vanhercke 1999). It could be argued that while external pressure – the financial markets – has diminished, the effects have been internalised in the sense that a group of powerful actors has picked up the same arguments. As pointed out by Erik Jones (cited by Rhodes 2002), EMU can be viewed as an "alternative form of embedded liberalism".

However, this approach suffers from three limitations. First, it overestimates the coherence of the interest group revolving around the central bank. Discussions about the Stability Pact and its future demonstrate a clash between different approaches and visions. Diversity is being underestimated, as it were. Secondly, the groups promoting these ideas are ideologically associated with the central bankers or finance ministries, which do not appear to be considered as legitimate actors in the social field in general and the social security domain in particular. Finally, greater pressure than before to reform welfare states allows for the emergence of other discourses and institutions, for example the Employment Strategy or the Social Protection Committee.

3. Conclusion

This paper has pointed out disparities between countries and the fact that, up to now, EMU seems to have played only a marginal role in the development of social welfare systems. These systems in fact present contradictory tendencies across countries and between domains of social security, which suggests the operation of specific dynamics. This should serve as a warning against excessive generalisation. None the less, extrapolation from the past experiences of individual countries is an uncertain business: for example, the time variable is an essential element in any assessment. We have also highlighted a number of cyclical factors, such as the fact that European Monetary Union has taken place at a time when unemployment is very high, especially in the larger countries (France, Germany, Italy). On the other hand, lower interest rates are having a positive effect on public and – in particular – consumer debt ratios. In this respect, EMU could increase room to manoeuvre and facilitate changes in the welfare state.

Developments in the area of social welfare are for the most part incremental and slow to materialise, while monetary union must also be seen over the long term. It is as well to be cautious, however: the fact that a clear link between EMU and welfare state recalibration cannot yet be established does not necessarily imply that such influence does not exist. For the time being, the necessary analyses are missing and it may well be that the effects of some measures already taken will become visible only in the long term, are being offset by a temporary economic upturn, or cannot be captured in terms of social security spending levels. Moreover, as our analysis illustrates, the 'EMU effect' may be more a matter of changing ideas and of options apparently left open than of policy-making or expenditure levels.

That being the case, various member states have used monetary union as a pretext for reform of their social welfare systems. This is not a generalised phenomenon, however, and more detailed analysis shows the complexity of the process. Our investigation underlines the (feeble) legitimacy of the players putting forward these arguments in relation to welfare reforms. To put it bluntly, does a call from a central banker to reduce social welfare carry more weight than the desire of a minister of labour for a more accommodating monetary policy? On the contrary, one could also argue that the creation of a unified monetary zone has in addition broadened the range of national social policy options. Indeed, financial markets can no longer sanction a national policy deemed inadequate (assuming that this was the case in the past) by increasing long-term interest rates or speculating on the national currency. Similarly, the European Central Bank has to take into account the entire zone and not just one particular country.

Clearly, EMU has not yet achieved institutional maturity. On this development will depend the interaction between EMU and welfare state. It is nevertheless true that there is no known example of a monetary union without, in the long run, centralised systems of interpersonal and interregional solidarity.

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Deepening Social Europe in an Enlarged Union

1. Introduction

Social policy concerns have moved progressively towards the top of the European agenda since the mid-1990s. The completion of the internal market and the creation of monetary union in a period of high unemployment have provided strong incentives for social policy initiatives. Shared concerns about employment, sustainable pensions, poverty, and social exclusion have sparked off initiatives by the Commission, discussions in the European Council, and decisions by the European Court of Justice (ECJ). The separate chapter devoted to employment in the Treaty of Amsterdam (June 1997) marks a watershed in the Europeanisation of social policy. This 'constitutional choice' is an important political acknowledgement of the interdependence of economic and social policy in a pan-European Union (Van der Meer and Van Riel 2002).

The EU's current social and employment policy consists of four components. On the level of *constitutional principles*, first, Article 2 EC explicitly mentions the promotion of high rates of employment and social protection, equality of men and women, high standards of living for EU inhabitants, and social cohesion and solidarity between member states as tasks of the Union. Secondly, *binding community legislation* (regulations and directives) is now in place in many areas of social policy. The Treaty of Rome's market-compatibility requirement (largely related to the free movement of workers) lies at the heart of an elaborate set of supranational rules and jurisprudence ensuring the transferability across member states of nationally defined entitlements and promoting the interpenetration of national social security systems. Equal-treatment and gender-opportunities directives – and ECJ case law deriving from them – have consolidated a binding set of rights for men and women across national borders. Thirdly, a number of *institutional innovations* exist to promote member states cooperation on the politically sensitive aspects of social security and employment policy. The bipartite social dialogue that is now included in the EC Treaty (Article 138 EC), allows the social partners to conclude agreements at the community level which may be transformed into (framework) directives. In addition to these relatively 'hard' forms of coordination, many 'softer' forms of cooperation and coordination have recently emerged, including the so-called open method of coordination (OMC) and the looser macroeconomic dialogue known as the Cologne process (1999). Finally, there exists a relatively autonomous *policy network*, *above and beyond the nation state*, of policy institutions and committees which are capable of concluding alliances with non-national actors, thereby influencing European policy (Ferrera, Hemerijck, Rhodes 2000; De la Porte and Pochet 2001).

Will this historically developed system be able to cope with the new social policy challenges of an EU of 25 member states, after the entry of so many new members with significantly less sturdy social protection systems? This chapter will examine this issue and explore additional and alternative strategies for strengthening the EU's problem-solving capacities.

Using the popular notion of the 'European social model', we begin with an historical *tour d'horizon*, tracing the development of this policy area. This shows that EU social policy is largely determined by policy developments at the national level. Section 3 describes the turn taken by European social policy since the Amsterdam Treaty and the movement of the European

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Employment Policy (EES) towards more flexible forms of governance. Section 4 traces the manner in which the substantive and institutional challenges of social policy are likely to interact in an enlarged EU. The closing section offers our conclusions and recommendations concerning institutional strategies for strengthening European social policy in a pan-European Union. We believe that flexible and differentiated forms of governance, although in need of some fine-tuning, are essential additions to the EU's existing institutional framework.

2. Development of social policy in Europe

2.1. National anchoring of the European social model

Although European welfare states vary widely, they share at least three characteristics that justify the term 'European social model' (Hemerijck 2002). First, they are based on a normative commitment to social justice and solidarity. Minimum guaranteed resources are widely accepted by European publics and deeply entrenched in policy programmes and institutions. At the cognitive level, secondly, it is recognised that social justice can contribute to economic efficiency and competition. As a productive factor, social policy can minimise uncertainty, increase the ability and willingness to take risks, and mitigate market downturns. A well-developed system of social welfare and protection allows citizens to fulfil socially useful and prosperity enhancing functions that are economically risky for individuals. Thirdly, the European social model is characterised by institutionalised discussion between government and social partners, based on mutual respect and trust. General discussion is supported by a relatively high degree of organisation of employers and employees. In comparison with North America, European labour relations are quite stable and the majority of workers are covered by collective agreements (Ebbinghaus and Visser 2000). In addition, social partnerships encourage a problem-solving style of policy-making, thereby channelling and tempering social conflicts and enhancing political stability and social cohesion (Streeck 1992; 1997).

We can therefore truly speak of a 'European social model'. Too often, however, this model is referred to as if it described a uniform phenomenon; in fact, it encompasses a great diversity of social systems, policy traditions, political preferences, and organisational and financial structures in the current EU, explained by the intensely 'national' developmental history of social policy. In comparative research, typologies are often preferred. Following Esping-Andersen (1990) and Ferrera et al. (2000), three or four distinct types of welfare state are distinguished. The continental European Christian-Democratic or Bismarckian welfare state is based on the principle of social insurance, in which generous payments are related to previously earned wages and family circumstances. The Anglo-Saxon liberal welfare states of the Republic of Ireland and the United Kingdom are characterised by relatively low, individualised social payments dependent on income and a significant private insurance contribution. The Scandinavian social-democratic welfare states provide universal and relatively generous individual payments and social services, with a limited role for privatised insurance and social services. Social provisions in Denmark, Finland, and Sweden are financed mostly by taxes. Finally, the Southern European model institutionally resembles the continental welfare states, but provides more chequered and unequal coverage in terms of public services and social insurance, with disproportionately high expenditure on retirement. Holes in the social safety net are patched by family members in countries such as Italy, Greece, Portugal, and Spain (Esping-Andersen 1990; Ferrera 1996; Zeitlin 2002).

The divergent development of national welfare states and European social policy in the second half of the twentieth century can generally be divided into four periods (see Table 1): (i) economic modernisation and expansion of the national welfare state (1950–73); (ii) social conflict and national crisis management (1974–83); (iii) economic internationalisation and market integration (1984–94); and (iv) respect for policy diversity under shared European social policy concerns (1995–2002). Each enlargement of the EU has increased the institutional diversity of EU social policy.

Table 1 Development of European social policy

Period	National level	European level	European social legislation	Governance method and forces of Europeanisation	Enlargement related diversity
1950–1973	Economic modernisation; expansion of the welfare state; activating Keynesian policy; moderate social partners	EEG Council of Europe	– Free movement of labour – Equal pay for men and women – Common social security of migrant workers – European Social Fund – European Social Charter	Harmonisation: driven by intra-European labour mobility and market driven social policy convergence Political ambitions for universal social rights	The Six: continental welfare states and Southern European model (Italy)
1974–1983	Stagflation; polarisation; social conflict; national crisis management		– Protection of workers' rights – Equal treatment of men and women – Protection of health and safety at work	Harmonisation with relatively little success (euro sclerosis)	Denmark, UK, and Ireland (1973) and Greece (1981): Scandinavian, Anglo-Saxon and Southern European model
1984–1994	Neo-liberal moment; deregulation; economic internationalisation; market integration	Single European Act Social Protocol Maastricht Treaty TEU	– Health and safety at work – Social Protocol – Decision of the European Court to protect the national diversity of welfare states	Minimum standards decided by a qualified majority (QMV); British *opt out*; driven by the deepening of market integration QMV extended; driven by globalisation, deregulation of markets, budgetary and debt constraints imposed by EMU	Spain and Portugal (1986): Southern European model
1995–2002	Social-democratic moment; social pacts; diverse policy driven by different interests	Amsterdam Summit Nice Summit	– European Employment Strategy, laid out in the Treaty of Amsterdam – Social Dialogue – Basic rights maintained – OMC legitimised in Lisbon	Social dialogue (fundamental guidelines concerning employment opportunities, social inclusion, retirement). Open method of co-ordination; driven by structural unemployment, ageing populations, constraints imposed by EMU (Growth and Stability Pact)	Sweden, Finland, and Austria (1995): Scandinavian and continental welfare states

2.2. Economic modernisation and the expansion of national welfare states

During the time of *economic modernisation and expansion of the national welfare state* (1950–73), the foundations were laid for new ground rules of national unity, economic order, collective action, and social citizenship for a large number of Western European countries. The post-war democratic governments in Western Europe strove for economic growth, full employment (especially for men), and a higher level of social security, health care, and education through the implementation of an active and interventionist socio-economic policy. Moderate forces within the trade unions and business organisations supported the welfare state and the Keynesian mixed economic order, which offered the prospect of a positive spiral of full employment, high wages, rising demand, increased productivity, and, finally, a higher standard of living (including social protection) for everyone (Scharpf 1991; Hall 2001).

The ambitious social policy laid out in the Treaty of Rome was the product of post-war optimism and the 'historical compromise' between the moderate representatives of labour and capital. The preamble of the EC Treaty established economic and social advance and the continual improvement of lives and labour environments as essential goals of the EC (Barnard 2000: 6). Still, national policy-makers, with the exception of the French, believed that European social authorities should be limited to establishing only the basic conditions of free movement of labour and harmonisation of social security rights. The fact that, despite this, the treaty referred to 'closer collaboration between member states' in the areas of education, employment, labour conditions, labour relations, and social security can be explained by the Franco-German compromise that occurred at the last minute during the Treaty negotiations when the French proposal for increased harmonisation of social legislation and regulation encountered resistance from Germany, Italy, and the Benelux countries (Hantrais 2000: 2–3). However, the road towards harmonisation was not cut off by this setback. On the contrary, considering that the first member states, with the exception of Italy, belonged to the group of 'continental' welfare states, a process of 'spontaneous' convergence as a pendant of economic advance was not considered unthinkable. In this period, it was expected that national welfare states would tend towards uniform, qualitatively high standards of social protection in the long run. At a later stage, positive spillover effects of this partial convergence could still lead to further harmonisation. The belief was that, whatever happened, it would be a 'race to the top' rather than a 'race to the bottom'.

In the course of the 1960s European businessmen began to want to develop a level playing field in the social domain within a free internal market. This wish was an important driving force behind the Commission's agendas concerning health and safety in the workplace. With reference to the authority of the Community, as far as working conditions were concerned the Treaty of Rome did little more than require the member states to promote these aims (Article 117 EC). The Commission was given the task of coordinating the member states' activities in the social sphere, including working conditions (Articles 51 and 118 EG). Gender equality in wages and workers' freedom of movement was laid down in the Treaty (Articles 119 and 48–50 EC respectively – Leibfried and Pierson 2000: 274; Barnard 2000: 1–3). The crucial item of legislation from this period was Regulation 1408/71. In the Treaty of Rome, it had already been determined in Article 42 that, after the completion of the customs union, the free movement of employees had to be realised. Regulation 1408/71 established the social security rights of migrant workers. Through this regulation, national governments lost a degree of control over 'their' working citizens, so that ever since we can speak of 'semi-sovereign welfare states' (Leibfried and Pierson 2000).

2.3. Social conflict and national crisis management

After 1974, European social integration progressed more slowly. The member states of the European Community were afflicted by the worst economic crisis since the 1930s. They entered a new phase of *social conflict and national crisis management* (1974–83), partly because of the continuing high wage demands of the strong national unions. Waves of international recessions led to divergent national responses, in which each member state of the EC pursued its own crisis management policy. The naïve expectations of spontaneous social convergence within the EU, supported by intensified policy coordination, dissipated rapidly.

Regardless of the striking renationalisation of social and economic policy, the Commission creatively used its limited power to promote the social dimension of the labour sphere. Based on the general fundamentals of harmonisation contained in Article 100a EC (now Article 94 EC) several guidelines were agreed upon which pertain to conditions in the workplace. When the governments of the Six decided to put the Werner plan (1970) for monetary union on the agenda against a background of economic decline and industrial conflict in a number of member states, a window of opportunity presented itself. Starting that year, the Commission launched a series of Social Action Programmes, which served as a launch pad for a boom in their legislative initiatives.

Eventually the aim of harmonisation encountered the strong opposition of three allied member states which had joined in 1973: the United Kingdom, the Republic of Ireland, and Denmark. Because their welfare traditions and institutions differed fundamentally from the dominant continental model, Danish and British policy-makers in particular rapidly became outspoken opponents of every form of European legislation that could be seen as detrimental to national autonomy in social policy (Hantrais 2000: 24). The creativity of the Commission and the Court in the development of the social *acquis* was continuously challenged because of this resistance to further deepening of the union in the 1970s and 1980s.

2.4. Economic internationalisation and the deepening of market integration

Despite economic recovery in the second half of the 1980s, unemployment remained high in most European countries. Many abandoned the neo-corporatist experiments that initially had seemed so effective. One exception to this is the Netherlands, where the Accord of Wassenaar of 1982 ushered in a new period of 'responsive corporatism' (Visser and Hemerijck 1997). Most continental welfare states combated unemployment in part by lowering the effective retirement age and tolerating an increase in the number of people on temporary and permanent sick leave (Ebbinghaus 2000).

In the political arena, it is significant that at this time European electorates turned their backs on social democracy to join the supply-side-focused neo-liberal solutions of deregulation and privatisation. The position of trade unions was weakened by processes of deindustrialisation, rapid technological advance, and expansion of the service sector. Keynesian economic policy made way for a more stringent macroeconomic variant, focusing on fiscal stability and hard cash. The ability to influence employment hereby shifted from macroeconomic policy to the adjoining domains of wage, social security, and labour market policy. In the sphere of labour relations, a reorientation took place towards market-conforming wage moderation.

At the EU level, this dynamic period of *economic internationalisation and the deepening of market integration* (1983–95) found its rejoinder in the launch of the '1992 programme', intended to complete market integration. This was stressed as a project of internal economic development and external economic assertiveness with regard to the flourishing Japanese and American economies and not as a programme of internal social intervention. The Single European Act of

1986 developed a twofold method: on the one hand, establishing European guidelines, and on the other, harmonising national legislation.

With the entry of Greece (1981) and of Portugal and Spain (1986), the Southern European welfare state made its debut in the political arena of the European Union, although (southern) Italy already represented this category to some extent. Divergence was facilitated partially because the member states were able to implement guidelines in very different ways and because the EC could exert little control over whether directives were upheld. In the more developed economies of north-western Europe, this led not only to fear of possible objections to decisions regarding new initiatives, but also to a fear of social dumping. The perception was that unequal levels of social protection and the very different traditions among the member states could make social rights detrimental to competitiveness. Countries with higher standards of social protection would be at a great financial disadvantage compared to those with lower standards. Generous welfare states unable to respond adequately to the extremes of policy and tax competition would have to pay a high price in terms of economic stagnation and unemployment.

The expectation of social dumping was never fulfilled. In the first place, social costs turned out to be only one of many factors considered by enterprises making investment decisions, in addition to productivity, education and training, innovative potential, infrastructure, business climate, and labour relations stability. Secondly, the proclivity of Southern European member states to engage in a 'race to the bottom' was mitigated by EU cohesion policy as a kind of quid pro quo. The relatively easy expansion of the cohesion policy, compared with the small steps made in the areas of labour market regulation, labour relations, and social security, can be partly explained by the fact that the cohesion fund, although costly for those making net payments, did not threaten the policy autonomy of the generous welfare states.

Near the end of the 1980s, it became increasingly clear that accommodating so many policy traditions, systems of finance and enforcement, and decision-making styles was no longer feasible on a European basis. This stimulated the development of more innovative, flexible institutional solutions in the 1990s. Ultimately, it was not the competition between the policies of the Southern European and the continental and Scandinavian welfare states, but the political confrontation between the European Commission and the United Kingdom (with other 'unwilling' countries in its wake) that forced the issue of the necessity of institutional flexibility in the EU.

During the negotiations for the Treaty of Maastricht, attempts to include the objectives of this Charter as Article 117 in the text of the Treaty failed because of the British veto (Cullen and Campbell 1998: 264). The final result of the negotiations was a separate binding Protocol for each of the eleven member states concerning social policy (in short, 'Social Protocol') relating to work environments and a unanimous vote concerning the development of working conditions and social security (Brinkmann 1998: 239; Hantrais 2000: 27). With this compromise over the closer coordination of eleven countries, acceptable to all twelve member states, it was possible for the group of eleven to impose guidelines concerning labour conditions, consultation of employees, and equal opportunities for men and women by a qualified majority. With this, most market-correcting interventions remained dependent on unanimity within the Council. In a sense, the British opt-out marked the first step towards greater differentiation in European social policy development. A second institutional innovation that sprang from the Social Protocol pertains to the formalisation of the European social dialogue between the social partners at the community level.

In this, the *Union of Industries of the European Communities* (UNICE), the *European Centre of Public Enterprises* (CEEP), and the *European Trade Union Confederation* (ETUC) participate as representatives of the social partners. The Social Protocol allows the European social partners to sign collective agreements. Through decisions of the Council, these agreements are capable of attaining the status of fundamental guidelines, with minimum standards that permit much freedom of policy at the national and sectoral levels (Brinkmann 1998: 241–2). According to Article 4 of the Protocol, it is also possible to assign the social partners, at their own request, the task of implementing specific guidelines. This new status of the social partners is an example of 'horizontal flexibility'. The results of the social dialogue have not entirely lived up to expectations. Besides the guidelines on parental leave, only a few collective agreements have been made so far.

3. Towards more flexible forms of European governance in the social sphere

In the mid 1990s a phase commenced that can best be characterised in terms of *respect for policy diversity with shared European social concerns* (1994–2002). To many (social democratic) observers, the British opt-out, the limited results of the European social dialogue, and the anchoring of the subsidiarity principle in the Maastricht Treaty showed 'uneven growth' between the EU's economic and social policies: market-correcting 'positive integration' could not keep up with market-expanding 'negative integration'. Many critics, furthermore, assumed that the scope for autonomous national welfare policies would increasingly be limited by the loss of national exchange rate and interest rate policies and the budgetary restrictions resulting from participation in Economic and Monetary Union (EMU). Some also pointed to potential spillovers from monetary integration for national wages and employment policies (Scharpf 1999). EMU would dictate more market-conforming and flexible wage and employment policies (cf. Hemerijck and Colijn 2000: 197; WRR 2000).

EMU provided a significant incentive for the conclusion of social pacts in Ireland, Italy, Finland, Austria, Portugal, and Spain. From the outset, it amplified pressures to reform national welfare states, even for those member states not initially participating but secondarily tied to a hard currency policy (United Kingdom, Sweden, and Denmark). Through participation in EMU, national governments were confronted with the need to reduce debt and budget deficits; at the same time, they faced the medium-term burden of rapidly aging populations. The large-scale endorsement of early retirement and other forms of paid inactivity was therefore seen as increasingly destabilising. This is why access to social security was made more selective, social rights increasingly took on a conditional character, and social payments were reduced. Finally, the financial and institutional composition of national welfare states was reformed (Hemerijck and Schludi 2000).

Despite pressure for policy convergence and the fact that they were facing similar challenges, such as economic internationalisation, the rise of a service economy, and population ageing, policy reactions for the reform of the welfare state still diverge across the four European welfare-state types (Scharpf and Schmidt 2000; Hemerijck and Schludi 2000 – see Table 2).

Continental welfare states have found it very difficult to create employment opportunities in the last twenty years in the public or private service sectors (the Netherlands is a positive exception). High gross labour costs combined with the relatively low participation of (married) women and the elderly in the labour force hinder job growth in the private sector and encourage early retirement in a number of different forms. Employment in the public sector is inhibited by the heavy burden placed by the large group of the inactive on welfare state financing. The level and duration of payments are tied to a person's working history and family circumstances. They are also largely financed through premiums and payments from employers and employees. This results in a downward spiral of low productivity, wages, and labour inactivity (Esping-Andersen 1996; Scharpf 1997).

Table 2 Job market statistics (2000), EU-15 (by cluster)

	Employment in %	Unemployment in %	Unemployment in % (2001)	Long-term unemployment in %	Employment of women in %	Youth unemployment in %	Employment of elderly in %
Belgium	60.5	7.0	6.5	3.8	51.5	6.5	25.0
Germany	64.8	7.9	7.8	4.4	51.7	4.6	37.4
France	62.0	9.5	8.5	3.7	55.1	7.1	29.3
Luxembourg	61.7	2.4	2.0	0.7	48.6	2.5	27.2
Netherlands	72.9	3.0	2.6	0.8	63.6	4.0	37.9
Austria	68.2	3.7	3.4	1.0	59.5	2.9	29.2
Ireland	65.2	4.2	3.8	1.6	54.1	3.3	45.1
UK	71.5	5.5	5.3	1.5	64.8	8.3	50.5
Denmark	76.3	4.7	4.6	1.0	71.6	5.3	54.6
Finland	67.3	9.8	9.1	2.8	64.3	11.1	41.2
Sweden	70.8	5.9	5.2	1.7	69.3	5.5	64.3
Greece	55.7	11.1	10.5	6.1	41.2	11.3	39.0
Italy	53.7	10.5	9.8	6.3	39.6	11.8	27.3
Portugal	68.3	4.1	4.6	1.6	60.3	4.2	51.7
Spain	54.8	14.1	12.8	5.9	40.3	11.4	36.6
EU-15	*63.3*	*8.2*	*7.7*	*3.6*	*54.0*	*7.8*	*37.5*

Source: European Commission, DG Employment and Social Affairs, *The Social Situation in the European Union 2002.*

In the *Anglo-Saxon welfare states* the reforms of the last few decades have gone hand in hand with steady growth in the quantity of poorly paid jobs and an enormous increase in income inequality, labour market segmentation, and relative poverty. Selective access to social insurance has resulted in an upsurge of private social insurance (especially pensions). Because of the low level of payments to the unemployed, the sick, and the elderly, fiscal maintenance problems are limited, despite the relatively low tax rates, and labour participation rates are relatively high. The United Kingdom in particular, however, lacks adequate childcare for women who (often involuntarily) accept low-paying part-time jobs. The incomes of poorly paid employees and their families are supplemented through wage subsidies (Clasen 2001). In relatively traditional, Roman Catholic Ireland, this sort of social problem is less acute.

The *Scandinavian model* is confronted by growing fiscal problems due to high capital mobility, budget limitations resulting from monetary union, and political opposition to high tax rates. At the same time – and in contrast to Scandinavian ambitions towards egalitarianism – employment in the private, low-wage service sector is growing. Stubborn pursuit of equality of incomes in combination with strict budget discipline leads to more unemployment. A unique feature of the Scandinavian welfare state is the role of the government as an employer in the labour intensive service sector for families with young children, the handicapped, and the elderly: the service-intensive Scandinavian welfare state creates employment opportunities not only for well educated professionals, but also for the less educated.

Finally, in *Southern Europe* the continental ‘inactivity trap’ is intensified by strict labour market regulation, as a consequence of which there is a growing gap between job market ‘insiders’ and ‘outsiders’, resulting in the social exclusion of the young and women (especially young women with children – Ferrera 2000). Women have few opportunities to combine a career with home care. This explains the low birth rate in Southern Europe and the high financial burden of retirement pensions. More than elsewhere in Europe, the Southern welfare state is still based on the traditional 'breadwinner model', with the black market serving as an important additional source of income for family networks.

The similar challenges (such as service sector growth, falling demand for unskilled labour, and population aging) facing existing welfare state models are thus producing quite different policy problems (see Table 2), and so no ideal remedies are available: only welfare regime-specific endeavours, based on national policy, will be adequate. This underscores the continuing importance of national political and socio-economic institutions, in spite of – or perhaps because of – the EU's increasingly prominent role in macroeconomic and social policy.

In the 1990s, social-democratic parties were able to regain power in a large number of member states. At the time of the European Council in Amsterdam, June 1997, no fewer than 13 out of 15 member states had social-democratic or socialist governments, giving the Europeanisation of social policy a vital impulse. Originally, however, social-democratic leaders faced an exceedingly troublesome dilemma: while they recognised the need for a flexible approach to social problems (particularly the stubborn unemployment, which exceeded 10 per cent in 1993), they also knew that, at both the national and the European level, policy room for manoeuvre had become limited. Recognising the diversity of national welfare states at the European level, they escaped this dilemma through new ways of coordinating national reform trajectories based on broadly formulated common social goals.

At the Amsterdam Summit, a renewed European social policy agenda emerged, based on the principle of respect for the integrity and divergence of national systems. The European Council unanimously supported the creation of a separate chapter on employment in the Treaty (Articles 125–130 EG [formerly Article 109n–109s]). In addition, the United Kingdom, under 'New Labour', signed the Social Protocol (Articles 136–143 EG [formerly Articles 117–120]), which made it an integral part of the EC Treaty. The adapted social chapter introduced co-decision-making authority for the European Parliament, decision-making by a qualified majority in the Council, explicit reference to fundamental social rights, and a new provision for the development of social inclusion programmes.

The introduction of a separate employment chapter in the Treaty of Amsterdam was not so much a 'functional' as a 'political' spillover of EMU (Van der Meer and Van Riel 2002). It was forcefully championed by the European Commission and most centre-left governments. Through their combined efforts to tackle unemployment, they wanted to show that Europe was about more than just 'a market and money', and that its social dimension is also important to the average European citizen. In a political sense, this employment policy can therefore be seen as a 'correction' of Maastricht. In both substantive and institutional respects, the EES has served as an example of governance in other areas of European social policy.

In Amsterdam, the European Council also accepted a separate resolution concerning 'growth and employment' and decided to hold an extra summit, in Luxembourg, in November 1997 to launch the EES. In the EES, EU member states commit themselves to improving their employment policies by formulating shared objectives (guidelines) linked to the multilateral supervisory procedure known as the 'open method of coordination' (OMC). Common guidelines laid down on the Commission's initiative must be translated into national policies comprising concrete policy goals, preferably with quantitative indicators. These guidelines are drawn up on analogy with the *Broad Economic Policy Guidelines* (BEPG), the common guidelines used for coordinating economic policy across the EU. In the BEPG, coordination is relatively 'hard': member states can formally hold one another to account when rules are transgressed – if budget deficits occur, the

Council can, ultimately, inflict fines. By comparison, the 'open method of coordination' under the EES is markedly 'soft'.

The Treaty determined that the Community should support the national employment policies of member states by promoting coordination between them, whilst fully recognising their national policy autonomy. Thus, the EES was accepted on condition that no national authority would be transferred to Brussels, there would be no extra cost, and EMU rules would be fully respected (Van der Meer and Van Riel 2002). The EES consists of four priority pillars: employability, entrepreneurship, adaptability, and equal opportunities. Every member state agreed to develop an annual National Action Plan (NAP) for employment to translate the common guidelines into clear-cut national policy measures, supplemented by – often multi-annual – policy goals. There is also an annual multilateral inspection procedure, in which member states evaluate each other's NAPs (*peer review* – see Article 128 EG). The social partners on the national and European levels are involved in developing plans to improve employment on their respective levels. The Commission plays a facilitating role by defining indicators, exchanging information, and producing comparative analyses. The (Social) Council can make recommendations to member states based on qualified majority voting and at the proposal of the Commission, but it cannot impose sanctions. The Council can also adjust EES pillars and guidelines on the basis of the insight and suggestions of the Commission. These guidelines can be very specific: at the Lisbon Summit, agreement was reached on an overall employment level of 70 per cent (60 per cent for women) by 2010. In Stockholm, the EES was further strengthened by the setting of interim objectives and the introduction of a target employment rate of 50 per cent among older employees (55–64 years of age) in 2010.

Box 1: The Employment Strategy as the cradle of the 'open method of coordination'

- The UK negotiates an opt-out in relation to the Social Protocol in the Maastricht Treaty (1991).
- Social dialogue anchored in the Social Protocol (1991).
- Since the white paper 'Growth, Competitiveness and Employment' (1993), EU social policy has become increasingly dynamic. In Essen (1994), the European leaders lined up behind a medium-term strategy to combat unemployment.
- The Amsterdam Treaty (1997) was drawn up with a separate employment chapter.
- In Luxembourg (1997), the European Employment Strategy was agreed under the four pillars of employability, entrepreneurship, adaptability, and equal opportunity.
- In Cologne (1999), this was supplemented by the so-called macroeconomic dialogue (the Cologne process) between the social partners, the Commission, the Ecofin Council, the Social Council, and the European Central Bank.
- In Lisbon (2000), concrete employment objectives were agreed upon and the method of coordination was explicitly recognised and extended to the fight against poverty and social exclusion and the modernisation of social security.
- In Nice (2000), these common goals based on Court decisions were integrated into the Treaty, as was the Social Protection Commission (Article 144).
- In Laken (2001), OMC was introduced for pension reform.

The EES can be viewed as the cradle of OMC (see Box 1). The Belgian Minister of Social Affairs and Pensions, Vandenbroucke, defined OMC as 'a mutual feedback process of planning, examination, comparison, and adjustment of the policies of [EU] member states, all this on the basis of common objectives' (Vandenbroucke 2002: viii). In practice, the method works as follows: in discussions with the Commission member states identify particular areas as problems or objects of common concern; they formulate agreements in concert and under the coordination of the Commission's policy objectives, and sanction clear, preferably measurable, indicators. The objectives are then translated into national policies, each member state in principle determining its own approach. The ultimate choice of policy thus accords with the principle of subsidiarity. Every member state is free to organise its national policy, so long as 'implementation' is compatible with previously agreed goals.

The member states' performance is monitored and judged by the Commission and periodic peer reviews (annually for the EES, biannually for social exclusion, and triannually for pension reform). National policy is adjusted by means of benchmarks, mechanisms of 'naming and shaming', and the adoption of best practice. Evaluations enable the Council to issue recommendations, if necessary. In this way, OMC goes one step further than free forms of benchmarking such as the OECD's *Jobs Study* of 1994. OMC is a form of contextualised benchmarking, which takes account of national circumstances when prescribing policy solutions (Hemerijck and Visser 2001; WRR 2002: 51). Although sanctions are not taken, the stress is clearly on mutual pressure and evaluations carried out not by the professional policy analysts of international organisations, but by politically responsible policy-makers. To achieve effective forms of comparative evaluation and naming and shaming, trustworthy and robust indicators are essential.

Based on evaluations of the longest running OMC process (the EES) we can already draw some conclusions concerning its effectiveness (cf. Best and Bossaert 2002; Zeitlin 2002). In general, employment ambitions are now loftier. Much more attention is paid to activation, and there is a strong focus on increasing labour participation and better adjustment between work and household responsibilities in young families. Especially noticeable in practice are processes of institutional re-evaluation under which better horizontal harmonisation between the previously separate areas of labour market policy and social protection, and better vertical coordination between different political and administrative layers, are supported by more flexible labour supply. The effects of this development, however, are difficult to trace back to the EES, since in many countries this policy orientation was already in place before the advent of this strategy (for the Netherlands, see Visser and Hemerijck 1997). We advance little by identifying best practice in labour market policy and social security and tax regimes. There is still little empirical evidence of the existence of a 'learning' or 'exchange network' beyond the borders of national welfare states. It seems that hitherto the EES has not been good at identifying which instruments of active labour market policy, tax reforms, and adaptations of payments have been most effective and under which circumstances. Adapting the guidelines is obviously not a clear-cut process. Unlike in the case of EMU, the member states have not committed themselves to simple and hard indicators. Finally, OMC's 'openness' can also be questioned; coordination seems to be mainly a bureaucratic process that largely escapes the attention of national politicians, interest groups, and the media. The involvement of the social partners has been cumbersome, partly because of the rigidity of procedures and the high frequency of annual statements. OMC therefore seems to stimulate a convergence of goals, performance, and policy orientations, but not of National Action Plans. It is a mixture of learning and monitoring: on the one hand, the participants are encouraged to remain open to one another, while on the other they can keep an eye on and criticise each other's performance. The incentives to take part can thus be positively as well as negatively motivated.

Since the first employment experiments began in Luxembourg, OMC has quickly spread to other social policy areas. It is now used, for example, in social exclusion (Lisbon, 2000), the modernisation of pension provisions (Gothenburg and Laken 2001), and the implementation of framework directives on lifelong education and teleworking. The European Council at Lisbon (2000) formally recognised OMC as a legitimate form of European governance. This seems to mark a new coordinating role for the EU in member states' endeavours to recalibrate their welfare states at the beginning of the twenty-first century.

4. Social policy after enlargement: implementation problems and institutional challenges

4.1. On the eve of EU enlargement

Substantial budgetary, administrative, and operational burdens will accompany the EU's upcoming expansion to Central and Eastern Europe (CEE). This is true of both the new member states and the current EU. The forthcoming new entrants face a much greater economic-development challenge than their predecessors, while the social *acquis* is more extensive than during earlier rounds of enlargement. Although the Commission's progress reports indicate that the bulk of the social *acquis* has now been transposed, some gaps remain, especially with regard to 'hard' social legislation. Furthermore, due in part to a lack of governmental administrative and financial capacity, as well as the social partners' unfamiliarity with the social *acquis*, implementation is a problem in most countries. For a long time, the EU has been offering PHARE assistance and organising international conferences for experts from current and candidate member states (de la Porte 2000). However, part of this is connected with an underlying fear of the possible negative effects of this hard *acquis* on the competitiveness of small and medium-size enterprises in Central and Eastern Europe (Draus 2000). Implementation of the *acquis* in the coming years will doubtless still fall short and in some sectors hinder catch-up growth (WRR 2001). In the worst-case scenario, this will lead to conflicts over illegal policy competition and a general lack of trust in the observance of social legislation.

In contrast to these implementation problems, the inheritance of an egalitarian communist-era political philosophy is a favourable circumstance, in that social payments in the candidate countries are already high in relation to their level of economic development (see Table 3). The tax systems in these countries are, to be sure, inferior to those of the current member states, but the composition of income from taxes and social contributions is very similar. Furthermore, the development of the European social policy regime shows that widening and deepening the social *acquis* can occur simultaneously. We see no reason why this should end with the inclusion of ten or more countries from Central and Eastern Europe.

Table 3 Purchasing power, income distribution and social expenditure in ten CEE countries

	GDP per capita as % average EU-15			Gini-index	Social expenditure (1997; % GDP) [c]		Social premiums as % of taxation
	1995[a]	1999[a]	2000[b]	1996-1998	Pensions	Health and education	2000
Bulgaria	28	22	24	0.41	6.2	7.4	11.2
Estonia	32	36	38	0.37	n.d.	12.2	9.9
Hungary	46	51	52	0.25	9.4	11.4*	12.8
Latvia	24	27	29	0.32	10.7	9.5	10.7
Lithuania	28	29	29	0.34	7.0	9.7	6.8
Poland	32	37	39	0.33	15.1	11.2	11.3
Romania	32	27	27	0.30	n.d.	5.9	10.9
Slovakia	44	49	48	n.d.	8.0	10.7	11.2
Slovenia	64	71	72	0.30	n.d.	13.3	13.7
Czech Rep.	62	59	60	0.25	8.9	11.2	14.7
MOE-10	*39*	*41*	*42*	*n.d.*	*n.d.*	*n.d.*	*11.3*
EU-15	*100*	*100*	*100*	*n.d.*	*n.d.*	*n.d.*	*14.4*

[a] Kunz (2002), p. 15.; [b] Dauderstädt (2002), p. 15; [c] Dauderstädt (2002), p. 16.; * 1996.

The social problems of the countries of Central and Eastern Europe are not essentially different from those of current member states (Clark-Dageville 2002: 123). Persistent unemployment in an unfavourable macroeconomic climate, pension systems overburdened because of an aging population, and increasing social inequality also figure prominently on national and European policy agendas elsewhere. As shall become clear, however, these problems are rather more acute in the CEE countries.

4.2. Unemployment

Most CEE countries have had to deal with severe problems of 'jobless growth', that is, high structural unemployment alongside relatively robust economic growth (see Table 4). In six of the ten countries, the unemployed make up more than 12 per cent of the labour force. Unemployment in Bulgaria, Slovakia, and Poland is approaching 20 per cent.

Table 4 'Jobless growth' in ten CEE countries

Country	Economic growth (2001) with stable prices in % ([a])	Total unemployment (2001) in % ([b])	Long-term unemployment (>12 months; 2001) in % ([c])	Unemployment among young people (<25 year; 2001) in % ([b])	Unemployment among women (2001) in % ([b])	Unemployment among the elderly (55–64; 2001) in % ([c])
Bulgaria	4.0	19.9	63.1	39.3	18.9	23.9
Estonia	5.0	12.4	46.6	24.5	13.1	48.6
Hungary	3.8	5.7	44.8	10.5	4.9	23.7
Latvia	7.7	13.1	59.1	22.9	11.5	36.4
Lithuania	5.9	16.5	56.2	30.9	13.5	39.1
Poland	1.1	18.4	50.1	41.5	20.0	30.5
Romania	5.3	6.6	48.6	17.6	6.0	50.5
Slovakia	3.3	19.4	58.3	38.9	18.5	22.5
Slovenia	3.0	5.7	63.3	15.7	6.0	23.4
Czech Rep.	3.3	8.0	52.9	16.3	9.6	36.9
EU-15	*3.3*	*7.6*	*44.0*	*15.1*	*9.9*	*38.2*

[a] Eurostat (2002c: 2).
[b] Eurostat (2002a: 6).
[c] Eurostat (2002b: 4–5).

The long duration of unemployment is also problematic. In most CEE countries more than half of the unemployed have been without a job for longer than twelve months. These are often poorly educated individuals, not easily integrated into the growing service economy. Youth unemployment is also extremely high because of a combined lack of work experience and schooling (see Table 4). Female participation in the labour force is structurally weak, mainly as a result of the cuts made in affordable childcare. The unemployment crisis has its origins in extensive economic restructuring. There is an exodus of labour from the public to the private sector and from heavy industry and agriculture to light industry and services. The situation in the agricultural regions is particularly alarming,[1] with a majority of workers employed on self-sufficient,

1 Since the beginning of the transition, unemployment has risen in the agricultural sector and the industrial regions around two and a half times as rapidly as in the city centres and regions in which the service sector is well developed. Low labour mobility (together with the consequences of poor infrastructure and housing problems through large differences in rental prices between the different regions) worsens the existing regional imbalances. As in the Southern EU member states, this regional concentration of unemployment is problematic, especially in coun-

non-competitive farms. Agricultural employment is decreasing rapidly, but in Poland, for example, it still provides about 18 per cent of all jobs. In the future, these jobs will for the most part disappear.

Table 5 Sectoral composition of labour market (10 countries of CEE and EU-15)

	Service sector in %	Industry in %	Agriculture in %
Bulgaria	54.0	32.8	13.2
Estonia	58.3	34.7	7.0
Hungary	59.8	33.8	6.5
Latvia	58.7	26.8	14.4
Lithuania	54.2	27.4	18.4
Poland	50.3	31.1	18.7
Romania	29.0	25.8	45.2
Slovenia	52.7	37.7	9.6
Slovakia	55.8	37.3	6.9
Czech Rep.	54.8	39.9	5.2
MOE-10	*52.8*	*32.7*	*14.5*
EU-15	*68.8*	*26.9*	*4.4*

Source: Kunz (2002), p. 16.

As in Western Europe, the bulk of new jobs must be created in the service sector. This requires large investments in training/education and housing. At the same time, it is clear that creating new employment opportunities via fiscal stimulus is not possible, since most countries already have excessive budget deficits. Moreover, they will have to meet EMU's convergence criteria on debts, budget deficits, and inflation. Eastern European countries are therefore likely to face fairly long periods of structural unemployment.

In order to limit unemployment growth, many CEE governments in the 1990s introduced passive labour market measures such as early retirement and disability payments, so putting even more pressure on employment. As a result, many workers have completely withdrawn from the job market or have fled into the shadow economy. In addition, many governments have begun to resort to more active labour market instruments, such as special programmes for education and training, and subsidised employment for the disadvantaged. At present, they are preparing themselves to participate in the EES. The so-called *National Action Plans for Adoption of the Acquis* require them to develop long-term strategies in preparation for the more detailed annual action plans to be developed within the framework of the EES. In an attempt to guide this process and to 'socialise' the member states' policy-makers, the Commission is drawing up so-called *Joint Assessments of Employment Policy* (JAP) in cooperation with the candidate countries. JAPs are meant to adapt labour market policies to the full requirements of EES participation. They provide some insight into the specific job market problems of individual countries and also allow for an assessment of whether the EES's original four-pillar structure can be a useful point of departure for their solution.

Since 1998 we have witnessed the transformation of labour market policies. In Bulgaria, the new legislation protecting the unemployed and promoting employment is based on the four-pillar structure of the EES. In the Czech Republic, expenditure on active labour market policies tripled in 1999. The National Action Plan for 1998/1999 included a benchmark to bring down unemployment to less than 8 per cent in three years. The Czech NAP also included measures to miti-

tries such as Poland, Bulgaria, and Slovakia. These problems will put pressure on the European structural and agricultural funds. See WRR (2001), particularly chapters 4 and 6.

gate the poverty trap. In addition, there are EU-supported small projects for innovative labour market policies on the local and regional levels. In Estonia, subsidies for new businesses and for employers who take on poorly educated workers play an important role. Poland, in contrast, has witnessed a return to passive policy measures in the wake of rising unemployment. Most active programmes concentrate chiefly on education and training, subsidised temporary work, and regional development programmes. In Slovenia, employment policy is also increasingly modelled on the EES's four-pillar structure. The EES thus has some potential to promote policy developments in the CEE countries, despite their limited financial and institutional capacities. This allows them to experiment with policy innovations that match their own labour market challenges, both among themselves and in the company of more 'experienced' EU member states.

There are certainly criticisms, however. The JAPs report minimal involvement of the social partners in Central and Eastern Europe. The institutional structures for consultation tend to be diverse, fragmented, and still in flux. In many countries, political tensions exist between new trade unions that have grown out of the anti-communist opposition and the traditional post-communist trade unions that survived the transition. Although the state has ceased to be the most important employer, there are few, if any effective (private) employers' organisations. With the exception of Poland and Slovenia, and to a lesser extent Hungary, social dialogue is also poorly developed in most countries and there is no tripartite consensus to initiate reforms (Draus 2001). Not only are trade unions usually politically weak and employers' organisations slow to develop but there is often also a paternal attitude on the part of governments and a lack of preparedness on the part of employers to collectively organise and represent themselves (Fultz and Ruck 2001: 37).

4.3. Pensions

In addition to the fight against unemployment and the creation of new jobs, pension reforms represent another important pan-European challenge. Of all income-support measures, pensions are by far the most costly (Tomes 1998: 172). Some countries in Central and Eastern Europe face a vicious circle of rising payroll contributions which hinder job creation and create incentives for workers and employers to commit social security fraud, leading to yet higher contribution rates (Barr 2001: 253). Like the present member states, they have chosen to reform the current distribution systems by raising the age of pension eligibility, re-examining indexation rules, and strengthening the link between pension contributions and payments received.

International institutions have greatly influenced these pension reforms since the 1990s. Mandatory private savings plans (the second pillar in the three-pillar system) have been introduced under the auspices of the World Bank (Brusis 1998; Müller 2001; Eatwell et al. 2000). The European Commission is also a proponent of private pension systems. Hungary, Latvia, and Poland have gone the farthest along this road. Latvia and Poland have in fact copied the Swedish model of a notionally defined contribution on the basis of which each employee builds up his or her own 'virtual' capital account (no real accumulation takes place) within the public pension system (Wagener 2002: 165; Chlon, Gora, and Rutkowski 1999). In other countries, such as the Czech Republic, the implementation of similar pension reforms has been delayed (Bräuninger 2002).

Pension reform is by definition a long-term project. Already visible, however, are the outlines of the pension systems – and their shortcomings – in the countries of Central and Eastern Europe. In common with Western countries, they are confronted with the transitional costs of introducing the second pillar in traditional distribution systems. In some countries, such as Hungary and Poland, these costs have been much higher than expected due to the initial popularity of private pensions. The contributions are also higher than in current EU member states. Finally, the social partners have little interest in the process of pension reform (Chlon and Mora 2001).

4.4. Unity and diversity in a pan-European social model

It is clear that the social agenda of the new member states partly overlaps with that of current members. Policy-makers in the CEE countries have not got around to tackling major social problems. So far, they have put all their energy into adopting the EU's social *acquis* and reducing budget deficits. The transition towards a market economy has had most impact on the social protection levels of the weakest groups. The conditional financial support of the IMF and the World Bank, the economic crises of 1997, and the precarious budget situation made it necessary to put in place a selective and ultimately modest safety net for these vulnerable groups.

The direction in which the CEE welfare states will develop after their entry into the EU cannot be foreseen. On the one hand, they present similarities in terms of policy development with the continental welfare states. Social policy is largely financed by workers' premiums and contributions. Furthermore, a multi-pillar pension system is rapidly being implemented. Labour market regulations show many similarities with the most flexible job markets in Western Europe (United Kingdom and Denmark). Trade unions and employers' organisations are in general poorly represented in the new private sectors. This institutional fragmentation hinders the development of an effective social dialogue and of tripartite consensus forming. These policy developments suggest that welfare state models are becoming increasingly mixed or 'hybridised' (Zeitlin 2002). This is facilitated by the EU's social *acquis*, which requires member states to guarantee equal treatment, to institutionalise the social dialogue, and to shadow the EES and other OMC procedures. In Western Europe, too, social and economic policy innovations across countries increasingly mirror the arrangements of successful reformers within the Union. This also suggests the emergence of new welfare state hybrids.

5. Conclusions and recommendations

Social policy has always been deeply anchored in national policy. Nevertheless, the social dimension has also been recognised as an essential focus for the European Community from the beginning. Initially, the aim lay solely in harmonising social security rights and legislation. Parallel to this, the 'hard' social *acquis* has slowly 'deepened'. During the last decade, moreover, new, 'softer' forms of governance, such as OMC and the social dialogue, have rapidly been transformed from institutional experiments on a limited scale into core elements of EU social policy. The crucial question, then, is whether eastern enlargement will exceed the capacity of this social policy regime. Enlargement shall irrevocably be accompanied by significant alterations in European policy, especially among the CEE countries. Meanwhile, European social policy is no longer a *tabula rasa*; its extensive policy regime creates lock-in effects that are increasingly structuring the policy margins for employment and social security. This in no way means that this regime is rigid and unchanging. On the contrary, we have seen that expansion of the Union in the past brought about several successful social policy initiatives and innovations.

The prerequisites of maintaining the achievements of economic integration while also safeguarding national welfare-state autonomy suggest that flexible forms of governance may well offer the most feasible solutions for enhancing social and employment policy within an enlarged EU. Forms of OMC in which a large number of parties can be involved (national and European governments, NGOs, social partners) seem to have particular advantages, although they are not without their drawbacks. Where opposition to supranational harmonisation and fears of a 'race to the bottom' are significant, 'soft' forms of coordination may well dislodge policy processes that have reached a deadlock. Sensitive policy issues can be depoliticised and dealt with in a problem-solving manner.

Recent evaluations of the first five years of the EES suggest that, in the heterogeneous context of divergent European social models, OMC has several advantages over binding legislation and mutual recognition (Best and Bossaert 2002; Hemerijck 2002; Zeitlin 2002).[2] It stimulates administrative reforms (the integration of employment policy, social security, and taxes) and more active approaches to employment policy. There has been a clear shift in attitudes toward policy on the level of the national welfare state through participation in the EES.

In addition, OMC's openness and lack of binding instruments is not seen as politically threatening. It thus encourages national policy-makers to take part in European policy development. Policy decisions are made and legitimated in the national arena, where sub-national authorities and the social partners are also involved (Goetschy 1999 and 2000). It is precisely through this recognition of national policy that OMC can also enhance the legitimacy of common European solutions.

None the less, OMC has a number of weaknesses that must be acknowledged. OMC procedures often lack transparency or are seen as technocratic evaluations that primarily concern high-level bureaucrats and EU institutions. They are often unknown and unloved, in which case there is no 'open' process of policy development. Most countries have tried to involve the social partners in formulating the NAPs. However, this has often failed because of lack of time and bureaucratic rigidities. Even national parliamentarians and policy-makers know little about what happens behind the scenes of the EES. This makes OMC a precarious process, dependent on the willingness of national policy-makers to learn from each other and voluntarily adapt their policies rather than to sabotage the process by free riding. More general and speculative, finally, is the question of how much diversity can effectively be 'absorbed' through processes of the OMC. Are peer reviews and benchmarking feasible in a Union of 25 member states? This question is particularly important, but notoriously difficult to answer.

There are several ways in which the European social policy regime can be improved upon in view of the EU's expansion. First, the CEE countries require assistance in strengthening their institutional capacities to participate in the pan-European social dialogue: this would enhance their ability to benchmark national social policy measures. Secondly, the various processes of socio-economic coordination must be streamlined. So far, there have been four such processes: the Cologne process (macroeconomic policy); the Cardiff process (structural policy); the Luxembourg process (employment, social exclusion, education and training [which was also on the agenda at Lisbon]); and the process dealing with pensions, on the agenda at Laken. These threaten to become too complex, even 'baroque', and prone to lead to an overlap of national and European policy circuits. The importance of serious rationalisation of the entire institutional framework for socio-economic coordination was indicated in a recent European Commission communication. More significant still is the decision that henceforth the European Council will convene every spring to discuss economic and social issues. When this 'European Spring Council' presents itself as the institutional core of Social Europe, the different policy processes can rally around it. A next step could be that, every two years, in the course of the Spring Council, member states could present a report on their social policy agenda (including goals and indicators). In place of the current annual monitoring cycle (such is also the case with the EES) there would be a set two- or three-year cycle.

Thirdly, defining a more precise role for national and European institutions could enhance the OMC's legitimacy. The demonstrative benefits of public exposure via parliamentary questions, for example, remain very much underutilised. The European Parliament should be consulted on

2 See also the website of the Commission, with evaluations of the first five years of the employment strategy: <http://www.europa.eu.int/comm/employment_social/news/2002/may/eval_en.html>

proposals concerning the general guidelines, while the national parliaments should concern themselves with the establishment of the NAPs. In addition, the evaluations of the Commission and perhaps the recommendations of the Council deserve more extensive attention in the national policy arena. This would improve the synergy between national policies and European policy guidelines.

Fourthly, longer-term progress can be achieved if soft forms of coordination are enhanced by harder, general forms of regulation. OMC seems to be more effective if combined with broad policy guidelines and framework directives rather than with detailed community legislation. The implementation of these guidelines can be left to individual member states, but it can also be supervised by the other participants in the OMC process and the Commission. Guidelines determined by the Council and OMC processes established by member states can thus reinforce one another. This combination can either develop further in the direction of the community method, or establish itself as a relatively flexible mode of governance.

Fifthly, the institutional structure of the coordination of future pan-European social policy can be improved by more frequent meetings of clusters of member states. These clusters can be organised on the basis of the four categories of European welfare state. Bearing in mind that the OMC respects the national integrity of welfare states, it should be ascertained whether 'further coordination' is possible in some – less sensitive – policy areas between groups of countries that share the same social policy problems. This would not be a matter of creating superior – and so also inferior – groups, but of creating subgroups of countries faced by similar, regime-specific pension or labour market problems, under the larger heading of open coordination. Differentiated benchmarking should be facilitated by the Commission and with the help of Eurostat. Such coordinated reform strategies between countries with the same structural characteristics are perhaps more likely to succeed than unilateral strategies or attempts at harmonising policies across welfare state clusters. The disadvantage of forming subgroups is indeed that the interaction of the clusters would be made more difficult during a phase characterised by increasing hybridisation of social and economic policy. Furthermore, the forming of subgroups can condemn the poorer welfare states of Central and Eastern Europe to second-class status, which would diminish the pressure to implement and maintain the social *acquis* on a national level. Irrespective of these disadvantages, however, subgroup formation may well become an essential and valued institutional addition to the current social policy framework.

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ANDREAS MAURER
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As an institutional novelty, the EU has set up Conventions with representatives from various spheres of governance and with the mandate to propose quasi-constitutional decisions for the Union. Thus, a forum is created for participative and inclusive forms of deliberation, open for parliamentary discourse and focused on consensus-building. These Conventions could become a milestone in EU political development.

Internationale Politik und Gesellschaft 1/2003

MICHAEL DAUDERSTÄDT (ED.):
EU Eastern Enlargement and Development Cooperation

The upcoming accession of eight post-communist states in central and eastern Europe to the EU will alter the relationship between them, the enlarged EU and the developing countries. This issue looks back at the development of Poland, Czech Republic and Hungary from a role of donor to recipient and back to donor since 1989, their current relations with the Third World, and their likely post-accession influence on the policy of the EU towards developing countries.

Policy Briefs on Eastern Europe (November 2002)

WORKING GROUP ON EUROPEAN INTEGRATION:
Making EU Foreign Policy More Effective

The EU is still far from exploiting its vast foreign policy potential. In order to overcome the major shortcomings of its Common Foreign and Security Policy, the EU will need to improve decision-making and implementation. Decision-making should take place by qualified majority voting. The functions of External Affairs Commissioner and High Representative should be merged in one person.

Working Group on European Integration, Working Paper No 12 (May 2002)

ALFRED PFALLER:
System Transformation and Social Protection

Liberated markets need political intervention if social protection is to be secured. Tight limits to taxation would suggest for transition countries a strategy that combines the logic of insurance with a concentration on essential public services.

Policy Briefs (February 2002)