Social protection in Europe: do we need more coordination?

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SOCIAL PROTECTION IN EUROPE: DO WE NEED MORE COORDINATION?

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Summary

This article deals with the question whether we need to speed up social convergence in the enlarged EU by setting common standards for social benefit levels. We conclude that the case for such a harmonization is not strong. Analysing several indicators, we show that there are no clear signs of a social race to the bottom yet. And we do not expect this to happen as a consequence of the enlargement either. Once economic convergence will materialise, the new member states should also be able to converge to higher protection levels.

However, we do acknowledge the importance of the social dimension of the integration process and argue that the currently used method of open coordination in the social domain should be strengthened, in order to face the common challenge to reform the social system. Not more, but more effective coordination is needed.

Samenvatting

In dit artikel staat de vraag centraal of in het licht van de EU-uitbreiding een sterkere coördinatie van het socialezekerheidsbeleid gewenst is, bijvoorbeeld door het vaststellen van minimumnormen voor sociale uitkeringen. We concluderen dat er geen sterke argumenten zijn voor een dergelijke harmonisatie. Aan de hand van verschillende indicatoren laten we zien dat er tot dusverre geen duidelijke tekenen van sociale dumping zijn. En we verwachten ook niet dat de uitbreiding een dergelijk effect zal hebben. Als de nieuwe lidstaten een economische inhaalslag kunnen maken zullen ze ook in staat zijn hun beschermingsniveau's te verbeteren.

Wij onderschrijven echter wel het belang van de sociale dimensie in het integratieproces en bepleiten een versterking van de open coördinatiemethode, met het oog op de gemeenschappelijke uitdaging om het sociale stelsel te hervormen. Niet meer, maar meer effectieve coördinatie is vereist.

INTRODUCTION

The various national systems of social protection are deeply rooted in the member states of the European Union (EU). The principles and organisation of social security are national responsibilities. Yet, the social dimension has been accorded its own place in the European integration process. Social convergence within the EU has since long been an important goal. A new and important step was taken with the adoption of the strategic Lisbon Agenda in the year 2000, which explicitly coupled the economic objective of becoming the most competitive and dynamic economy with the social objective of greater social cohesion. This is a major challenge, even more so in the enlarged EU, and requires modernisation of the European welfare states. When the Constitution is accepted, social protection and social cohesion will also become constitutional goals of the EU.

The open method of coordination is applied to social policy. This means that the member states define and evaluate common objectives. These objectives refer to employment, social inclusion and pension reform. This method is based on benchmarking and peer pressure, but does not offer the possibility of sanctions. The EU does not prescibe how to achieve these objectives. This remains in the realm of national sovereignty, under the principle of subsidiarity. That principle means that decisionmaking takes place at the lowest level of government, appropriate for the particular issue in question. But what level of government is appropriate for social policy? Or, in other words, do we need more coordination of social protection policies? This is the central question of this article. We address this question especially in the context of the enlargement. Should the enlarged EU try to speed up convergence by setting common standards? This question will be dealt with both from a theoretical and from an empirical point of view.

Theoretically, there can be a ground for coordination or even harmonisation if there are failures of decentralisation, such as international spillovers or externalities and economies of scale. These failures should outweigh the benefits of decentralisation, such as diversity in preferences and accountability. As far as social policy is concerned, the main argument in favour of more coordination is the existence of externalities. Labour and capital mobility in a fully integrated economic space may lead to forms of competition, which could result in lower protection levels; the well known 'race to the bottom argument'. Because of the dangers of 'social dumping' and 'benefit tourism' it has often been proposed to introduce European minimum social standards, such as minimum benefit levels (Hutsebaut 2003).

However, others argue that there are no clear signs that a race to the bottom actually takes place. Also, the costs of premature harmonization can be very high (Sinn and Ochel 2003). After briefly discussing the history of Social Europe in section 2, we will deal in section 3 with the theoretical discussion on the coordination of social policy. In section 4 we present empirical evidence on the race to the bottom argument. It appears that during the last decades, social protection levels have in fact converged to a common higher level. In section 5 we discuss the impact of the enlargement on social policies. Do lower protection levels give the new member states a competitive advantage? And are the social systems in the old member states threatened by this? Finally, in section 6 we draw some conclusions. We argue that the open method of coordination provides a good balance between subsidiarity on the one hand and the – supposed – need for a stronger European social policy on the other hand. However, to be effective, this method and its implementation should be strengthened.

SOCIAL EUROPE

From Rome to Lisbon

Already the founding fathers of the EEC acknowledged the importance of the social dimension of the European integration process. However, they expected social progress to result from economic integration. Partly as a result thereof, the European Treaty of 1957 only offers a legal basis for harmonization of social policies in relation to the free movement of labour. Regulations concerning the social protection of migrant workers have been accepted as early as 1957. The most important regulation in this field, 1408/71 (recently replaced by regulation 883/2004), on the coordination of social security systems relating to migrant workers, was passed after the free movement of workers was fully realized at the end of the 1960s. As Leibfried and Pierson (1996) note, this regulation has, together with the accompanying case law of the Court, restricted the sovereignty of member states in social policy[1]. Yet, the emphasis is clearly on coordination instead of harmonization of social policy. Reconsideration (4) of regulation 883/2004 now explicitly states the necessity to respect the special characteristics of national social security legislation and to draw up only a system of coordination.

In the 1970s EU directives were introduced on equal treatment between men and women and on safety and health regulations. The social protection systems, however, remained, with the

exception of the issues involving the social protection of migrant workers, in the realm of national sovereignty. This has not changed since then. The Amsterdam Treaty of 1997 and the inclusion of the Social Protocol into the basic Treaty were a step forward in the social domain in general, but provide no basis for involvement of the EU with social protection levels in the member states.

Still, member states have accepted a certain degree of commitment in terms of social protection. This commitment is embodied in two recommendations accepted by the European Council in 1992. The first recommendation, of June 1992, dealt with common criteria concerning sufficient resources and social assistance in social protection systems (92/441/EEC). The second recommendation, of July 1992, explicitly addressed the "convergence of social protection objectives and policies" (92/442/EEC). The motivation was that convergence seeks to guarantee the continuation and stimulate the development of social protection within the context of the completion of the internal market. And also that member states face common problems, such as ageing of the population, unemployment, changing family structures and poverty; common objectives must act as pointers to the way social protection systems are modified to take account of these problems. The recommendation further stipulates broadly defined goals, but "without prejudice to the powers of the member states to establish the principles and organisation of their systems". Finally, the monitoring is recommended of the progress achieved in relation to the convergence of social protection aims and policies across the Union.

The desirability of convergence of member states' policies has been reconfirmed in several reports of the European Commission, such as the White Paper on European Social Policy of 1994 and reports on Social Protection in Europe. The 1998 Employment Guidelines, as a result of the Jobs Summit in Luxembourg at the end of 1997, can partly be seen as an implementation of the convergence strategy. A main line of action in these guidelines is to improve the employability of those out of work. This reflects a change in orientation of systems of social protection: a shift towards a more active policy designed to get people into employment rather than merely transferring income to those who are out of work. Though crucial in modernising social protection, this change in orientation does not have implications for benefit levels, coverage and eligibility criteria, *i.e.* for the scope and generosity of national systems.

A new and important step was taken at the European Council in Lisbon 2000. For the EU the strategic goal was set for the decade ending in 2010: to become the most competitive and dynamic knowledge-based economy with sustainable economic growth and greater social

cohesion. The economic and social agendas were thus explicitly coupled. To achieve these aims, the social model needs to be modernised. To ensure long-term sustainability of the social security systems in the light of the ageing process, participation rates should be increased.

The method of open coordination

The Treaty of Nice took the social agenda forward. It was agreed to advance social policy on the basis of the method of open coordination (OMC). The OMC was first employed with respect to employment policies in the EU, but as far as social policy is concerned, the foundations were already laid in the recommendation of July 1992. The method recognizes that social policy remains the responsibility of member states, under the principle of subsidiarity. It implies that member states define and evaluate common objectives and learn from each other how to best reach these objectives. Best practices are disseminated and benchmarking is used. Coordination is based on evaluation and peer pressure, but does not offer the option of sanctions. In Nice it was decided that member states should implement action plans for combatting poverty and social exclusion and to define common objectives on social indicators. The indicators encompass financial poverty, income inequality, long-term unemployment, regional variation in employment rates, life expectancy and poor health. Some consider these common indicators and the national action plans for social inclusion as significant progress towards integration along the social dimension (Atkinson 2002). Others question this form of coordination. De Mooij and Tang (2003) argue that the lack of binding agreements may also render coordination of social policy ineffective, in which case fears for social dumping may again lead to calls for harmonization.

Three forms of coordination of social policy in the EU

The developments summarized above have resulted in three forms of policy-coordination in the social field:

- Coordination of social protection systems with respect to migrant workers, retired workers, their family members and students (regulation 1408/71 and its case law).
- Minimum harmonization with regard to certain aspects of working conditions. Although article 137 Treaty of the European Communities (TEC), which provides the legal basis for minimum harmonization, also covers social security and social protection of workers, secondary legislation relating to minimum harmonization of social protection does not exists. On this aspect of article 137, decision-making is by unanimity.

- Open coordination with respect to social inclusion, modernization of pension systems and, as proposed by the Commission, also on health care systems.

PROS AND CONS OF COORDINATION

In this section we will discuss the economic literature on the impact of economic integration on social protection levels. Do externalities provide ground for centralisation of social protection policies?

Effects of economic integration

Theoretically, economic integration can be both beneficial and harmful to social protection systems. According to a well-known argument economic development undermines traditional solidarities in family and local structures (Chassard and Quintin, 1993). And increased labour mobility also creates a need for employment-related insurances and for broader networks of solidarity. At the same time, higher levels of income also offer the possibility to develop a system of social security with adequate protection levels. At least the funding of such a system will become easier. So, according to this line of reasoning, economic development strengthens the need for an extended system of social protection as well as the opportunity to fund it. And, to the extent that European integration promotes economic development by reducing uncertainty, lowering risk premiums and improving investment opportunities, it may therefore contribute to the expansion of such systems. Intensified contacts between countries may promote convergence of policies as well.

On the other hand, it can be argued that economic integration may be harmful to national social security schemes. First, economic integration and a well-functioning internal market may stimulate migration. Migration as a result of relative price signals is economically efficient. A different situation arises however, when migration flows are provoked by differences in levels of social protection. In that case an adverse selection problem occurs: individuals who expect to be net beneficiaries will be attracted to countries with generous social programs, while net contributors are deterred by the high tax burden in these countries. Consequently, the social protection systems there are confronted with increasing outlays as well as a narrowing financial base which will ultimately result in lower protection levels (Sandmo 2001). This is a standard argument for centralising redistribution policies in an economic union, although it can be shown that centralisation is not an inevitable consequence

(Wildasin, 1991) and measures can be taken to limit and perhaps even eliminate the problem in practice.

Another problem may occur when lower levels of social protection translate into lower labour costs. In that case economic integration and higher transparency can damage the competitive position of countries with relatively generous protection systems *vis-à-vis* other countries. The former may react by lowering protection levels and, thus, set into motion a 'race to the bottom'. In the end social protection may indeed converge, but only at a very low level of protection. This is usually called the 'social dumping' or 'wage dumping' argument (Sinn 2003: 89). A more neutral term is 'policy competition'.

Both views on the effect of economic integration on social protection are echoed in article 136 TEC, which states the objectives of European social policies. According to this article, the objectives of improvement and convergence of living and working conditions and proper social protection will not only ensue from the functioning of the common market, which will favour the harmonization of social systems, but also from minimum requirements for gradual implementation (as stated in Article 137(2) TEC). Of course, the adaptation of EU minimum requirements is subject to the subsidiarity principle. This means that the Community only can take action when, by reason of scale or the effects of the proposed action, the objectives cannot be sufficiently achieved by the Member states. 'The effects of the proposed action' refer to potential external effects, which in this case could either arise because of social security migration or competition effects.

A closer look at the policy competition argument

The possible effects of social security tourism on social protection systems are hardly disputed in the literature. The main point here is whether this poses major problems in practice for member states. We will deal with this question in section 5. The social-dumping or competition argument is more disputed, both theoretically and empirically. We discern three themes in the literature:

- Tax incidence: does social expenditure increase total wage costs or does it mainly affect the composition of total wage costs?
- Competitiveness: does the welfare state poses a threat to competitiveness?
- Spontaneous convergence: are low standards, as argued by Sinn (2003), a necessary concomitant of a long adjustment process and will countries with lower social standards ultimately catch-up with countries with higher standards? Sinn argues that a premature

harmonization would delay the catch-up process, resulting in large migration from new members states to old member states. According to him, these migration streams would, in turn, put pressure on social expenditure in old member states.

In the remainder of this section we will briefly discuss the first two points. The third theme – spontaneous convergence – will be more extensively dealt with in the next section.

Tax incidence

Although employers usually pay part of social security contributions, it is not self-evident that these contributions automatically contribute to higher nominal wage costs. The degree to which social expenditure contributions will result in higher wage costs will generally depend on three factors (see OECD 1990; Alogoskoufis et al, 1995; Alesina and Perotti 1997):

- The elasticities of the labour demand and labour supply curves. If the labour supply curve is highly inelastic – labour supply hardly reacts to changes in wages – and labour demand elasticity is within a normal range – than contributions will mainly affect the composition of wage costs and not result in higher wage costs. In this case employers will be able to ultimately shift their contributions to employees by offering lower wages.

- The degree to which employees see contributions as insurance premiums instead of a tax on wages. This will determine the incentive to change employment behavior as reaction to higher contributions and the degree of tax shifting.

- The behavior of trade unions. In the presence of trade unions, social contributions will be borne in part by employers and will therefore increase labour costs even if the individual labour supply is perfectly inelastic. However, centralized, encompassing trade unions will internalize the resulting adverse consequences of higher wage costs on employment and consequently moderate wage claims.

Because of differences in short-run and long-run elasticities, differences in trade-union behavior, and possible differences in the appreciation by employees of social protection, it is hardly surprising that the empirical studies do not give an univocal answer to the question whether higher contributions result in higher labor costs. The OECD Jobs Study (OECD 1995: 247) concludes on the basis of several studies that increases in taxation are often – but not universally – found to affect real wage costs. However, differential responses for different taxes should be interpreted with caution. Nickell (2003) concludes in his recent survey of the matter that there is probably some adverse long-run tax effect on labour costs. Note, however,

that even if this effect would be substantial (which is not obvious), this does not necessarily mean that increased policy competition will put a downward pressure on social expenditure. It *does* imply that increased policy competition may force employees to pay a bigger part of social expenditure and shift less to employers. Seen in this perspective, policy competition will mainly have distributional consequences.

Competitiveness

Recently a number of studies have asked whether welfare states can survive globalization. They investigate the relation between the degree of openess of economies, competitiveness, and the level of social expenditure (Rodrik 1998; Agell 1999, Krueger 2000, De Grauwe and Pollan 2003). Perhaps surprisingly, these studies typically find a *positive* relation between the degree of openness and the level of social expenditures. It thus appears that countries which are more prone to external competitive pressures have on average higher expenditure ratios. There are a number of possible explanations for a positive relationship between openness and social expenditure ratios:

- Open economies are usually small economies with centralized, encompassing unions which internalize possible adverse effects of social expenditure on labor costs and competitiveness.

- Open economies are generally rich. Richer countries can afford to spend more on social programs. Moreover, social expenditure may be considered as a 'luxury good' with an income elasticity greater than one. This will cause social expenditure to rise proportionally faster than income (see next section).

- Because open economies are more prone to the ups and downs of the world market, the demand for social protection will be bigger in these economies.

- Adequate social protection may foster risk taking, which may stimulate productivity and competitiveness.

This is not the place to discuss which explanation is best. Moreover, they are not mutually exclusive. The point we want to make is that both the literature on tax incidence and the relation between openness and social expenditure ratios raises serious doubts about the premises of the policy-competition argument.

SOCIAL CONVERGENCE?

The evidence surveyed above raises doubts about the validity of the policy-competition argument. Further evidence can be gained by looking more directly at the developments over time of social expenditure and replacement rates. Is there spontaneous convergence? If so, is it towards a high or low level? What are possible explanations?

Tests on convergence

Have social protection systems converged under the influence of economic integration? Cornelisse and Goudswaard (2002) have analysed whether social protection systems actually have converged or diverged during the past decades. To that end, they used data on gross replacement rates of unemployment benefits and data on the share of GDP spent on social benefits. The social security expenditure ratio gives an indication of the financial effort to provide social protection, while replacement rates are a measure of the level of benefits and thus of the generosity of the welfare programs. A test on convergence was carried out using the standard deviation and the coefficient of variation as yardsticks. They apply the term relative convergence (divergence) when observing a drop (rise) in the value of the coefficient of variation and the term absolute convergence (divergence) when using the standard deviation as criterion[2]. For the EU countries Cornelisse and Goudswaard find both a relative and an absolute convergence of replacement rates during the last decades. The coefficient of variation dropped by one third since 1980. Social expenditure ratios showed a rather strong relative convergence (the cooefficient of variation fell by some 30 percent since 1980), especially in EU countries (the present member states), but also in non-EU OECD countries. However, the EU countries did not show absolute convergence (the standard deviation hardly changed during the period of observation). In other words, the relative convergence they observe is the result of the rise in the average value of the expenditure ratio.

Table 1, which is based on the most recent Eurostat data, also indicates a strong convergence of social protection expenditure, both relatively and absolutely. Between 1980 and 2001 the standard deviation of social expenditure declined by 60%, while the coefficient of variantion showed a decrease by 59%. Especially the Mediterranean countries, with rather low levels of protection in 1980, catched up rapidly in terms of social expenditure. This largely explains the rather strong social convergence.

Table 1 Expenditure on social protection* as % of GDP (EU-15)

	1980	*1990*	*2001*
Austria	22.4	26.7	28.4
Belgium	28.0	26.4	27.5
Denmark	28.7	28.7	29.5
Finland	18.6	25.1	25.8
France	25.4	27.9	30.0
Germany	28.8	25.4	29.8
Greece	9.7	22.9	27.2
Ireland	20.6	18.4	14.6
Italy	19.4	24.7	25.6
Luxembourg	26.5	22.1	21.2
Netherlands	30.1	32.5	27.6
Portugal	12.9	15.2	23.9
Spain	18.2	19.9	20.1
Sweden	32.0	33.1	31.3
United Kingdom	21.5	23.0	27.2
Average	22.9	24.8	26.0
Standarddeviation	3.75	2.00	1.55
Coefficient of variation	0.25	0.13	0.10

*Including benefits for the following functions: sickness, health care, invalidity, disability, old age, survivors, maternity, family, vocational guidance, unemployement, housing, miscellaneous.
Source: Social Protection in Europe, Eurostat.

Dekker et al (2004) estimate β-convergence of social expenditure. This is done by regressing the growth of social expenditure on the initial level of expenditure. They find a β-convergence of 4% per year during the period 1980-1998. This means that the difference of a country with respect to the EU-average declines by 4% per year.

But what about the indicators used? These have several limitations. It is well known that statistics on social expenditures and benefits are difficult to compare across countries. Countries use different definitions of social security and social protection. Perhaps the most important problems are related to differences in the public/private mix in the provision of social protection and differences in tax systems.

Adjusted indicators

The OECD has developed indicators that aim to measure what governments really devote to social spending, *net public social expenditure*, and what part of an economy's domestic production recipients of social benefits draw on, *net total social expenditure* (Adema 2001).

Benefits may be provided by either public institutions or market institutions. In the latter case, market provision may be regulated by government in such a way as to make it equivalent to public provision. These different forms of social protection are not included consistently in national statistics. A specific statistical problem is related to the tax treatment of social benefits. In some countries benefits are taxable as a rule, in others not. Also, benefits can take the form of tax relief, for example a tax deduction for children.

Table 2 presents figures on the net social expenditure as percentage of GDP for 1997, for the EU-countries for which these data are available.

Table 2 Net social expenditure (% GDP), 1997 (ranked according net social expenditure)

	Gross public social expenditure	Gross total social expenditure	Net total social Expenditure
Sweden	31.8	34.8	27.3
Germany	26.4	28.6	26.1
Belgium	27.2	29.5	25.4
Denmark	30.7	32.0	23.5
Italy	26.4	27.8	22.7
Finland	28.7	30.0	22.1
Austria	25.4	27.0	22.0
United Kingdom	21.2	24.9	21.8
Netherlands	24.2	29.1	21.5
Ireland	17.6	19.2	16.5
Average	*26.0*	*28.2*	*22.8*
Coefficient of variation	*0.15*	*0.14*	*0.13*
Standard deviation	*4.02*	*3.98*	*2.88*

source: Adema (2001); Goudswaard and Caminada (2003)

The data clearly indicate that these adjustments have an equalising effect on levels of social effort across countries. Both the standard deviation and the coefficient of variation show a decline.

Table 3 presents a comparison of the countries for which information is available on net replacement rates of unemployment benefits.[3] Only the first period of unemployment is considered (social assistance included).

Table 3 Gross and net replacement rates unemployment benefits (in %), 1999

	Index gross replacement rates	Index net Replacement Rates
Austria	41.7	69.5
Belgium	45.7	72.4
Czech Republic	22.0	66.8
Denmark	66.0	80.8
Finland	54.0	81.0
France	59.0	75.3
Germany	37.0	67.5
Greece	41.3	47.1
Hungary	50.0	62.3
Ireland	35.0	51.4
Italy	60.0	45.5
Luxembourg	80.0	84.5
Netherlands	70.7	84.8
Poland	29.0	51.5
Portugal	65.0	83.0
Slovak Republic	40.0	77.8
Spain	63.0	74.8
Sweden	74.0	81.5
United Kingdom	17.3	53.6
Average EU 15	*54.1*	*72.1*
Coefficient of variation	*0.32*	*0.17*
Standard deviation	*17.2*	*12.3*

Source: OECD, Benefits and Wages, OECD Indicators, 2002; Goudswaard and Caminada (2003)

Net adjusted replacement rates appear to be much higher than gross rates. Again, we calculated the standard deviation and the coefficient of variation. The coefficient of variation drops by 47 percent, while the standard deviation drops by 27 percent.

To conclude, this analysis indicates that accounting for private social benefits and for the impact of the tax system indeed has an equalising effect on levels of social effort across member states. Unfortunately, there are no time-series of the adjusted figures of social protection. But the fact that differences in (adjusted) protection levels have become that small suggests that convergence of social protection may even have been stronger than measured by earlier studies.

How to explain convergence?

In his recent book on the development of social spending and economic growth, Lindert summarizes five leading forces which help to explain the rise of social expenditure as well as cross-country differences in that rise (Lindert 2004: 188): democratization, the aging of

populations, globalization, the rise of income per capita, and international differences in the social affinities felt by middle-income voters. To explain the convergence of social expenditure ratios in EU- member states, the first four factors seem to be relevant. With respect to the first factor one can point at the transition to democracy that Spain, Portugal and Greece underwent from the mid seventies onwards. Governments not only needed to stabilize the countries politically but also respond to new and pressing social needs that were brought about by the coincidence of political transitions to democracy and economic crisis (Castles 1995; Guillén and Alvarez 2000). Together with the aging of the population and the rise of income per capita this probably explains most of the rise of social expenditure ratios in these countries, and consequently the convergence of social expenditure ratios within the EU-15 (see table 1 above).

Scharpf (1999: 177) observes a strong correlation between gdp per capita and social expenditure ratios in the EU. He notes that the member states are remarkably alike in their revealed preference for social spending. By and large, the richer member states have proportionally larger public social expenditure than less rich countries. It seems that past patterns of overall social spending can largely be explained by changes in the ability to pay. As Scharpf observes, this is by no means a trivial explanation, since it does not hold for the total set of industrialised OECD-countries.

We have done a simple regression analysis with an update of Scharpf's data for 2000, and included new member states. Figure 1 shows the result.

Excluding the two outliers Ireland and Luxemburg from the sample, the strong correlation between gdp per capita and social expenditure ratios noted by Scharpf is confirmed ($R^2 = 0,65$)[4]. The extreme position of Ireland is mainly explained by its relatively young population. Ireland is the only country in the sample where pension payments do not constitute the biggest part of social spending. The next section will focus on the position of the new member states.

Figure 1 Social expenditure ratios and gdp per capita (2000).
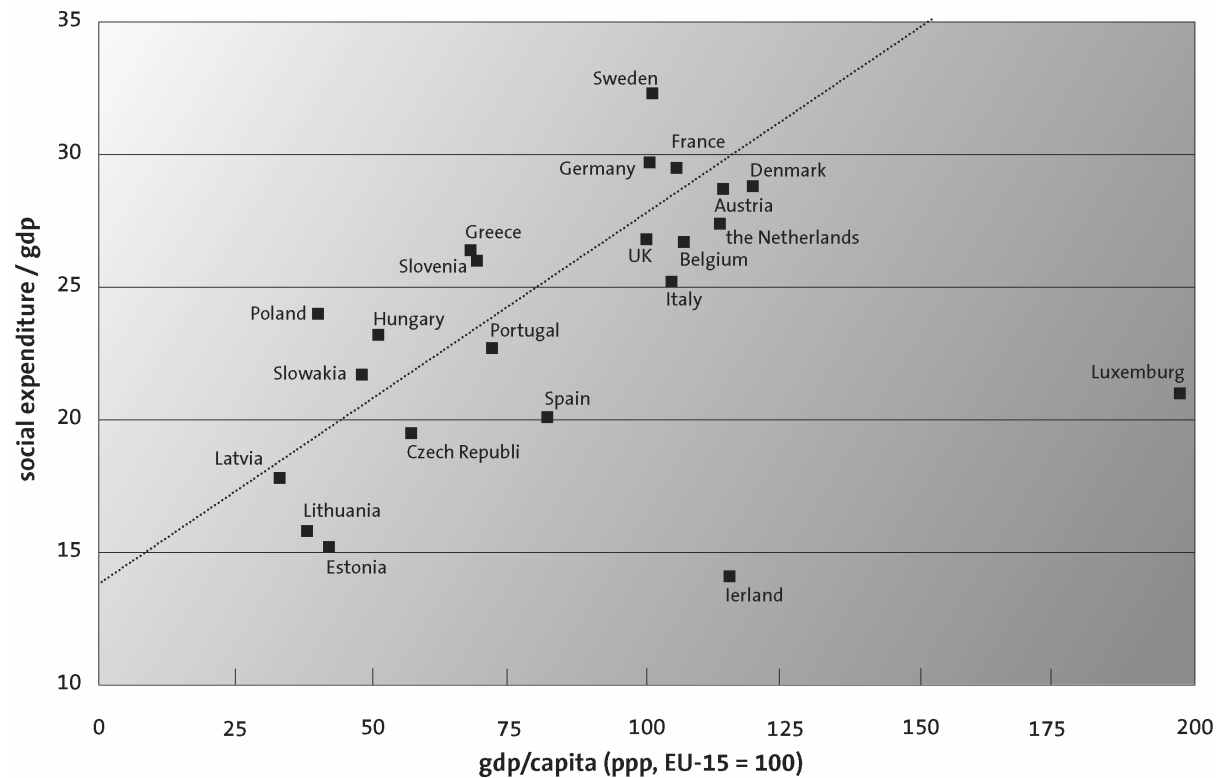
Sources: Social expenditure ratios EU-15: Eurostat, *European Social Statistics, Social Protection, Expenditure and receipts data 1991-2003*, Luxemburg 2003, p.14 (compare table 1); New member states: Gesellschaft für Versicheringswissenschaft und -gestaltung, *Study on the Social Protection Systems in the 13 Applicant Countries,* november 2002 , p. 22; gdp/capita: EU-15: Europese Commissie, *The EU Economy 2002*, op.cit., pp. 286-287; New member states: Eurostat, *Towards an Enlarged European Union, Key indicators on Member states and Candidate Countries.*

NEW MEMBER STATES

In most of the new member states social expenditure ratios are lower than in most of the old member states. Does this gives new member states a competitive advantage? And will this set into motion a 'race to the bottom' (e.g. Vaughan-Whitehead 2003). Moreover, are social protection systems in old member states threatened by migration from new member states? Or will social expenditure ratios in new member states catch-up with the levels in old member states?

Social expenditure ratios

The average social expenditure ratio in the new member states is seven percentage points below the average for old member states. However, as figure 1 shows, there is considerable variation within the new member states. The Polish expenditure ratio is almost 9 percentage points higher than the Estonian ratio. In fact, Polish, Hungarian and Slovenian expenditure ratios are near the EU-15-average, and for example well above the Irish ratio. This is quite remarkable given the much lower GDP per capita in these countries. As figure 1 shows, there is a rather strong relation between GDP per capita and social expenditure ratio in the enlarged EU. The fit of the trend line even improves when new member states are included in the sample. Seen in this perspective, social expenditure ratios in new member states are in line with their income levels and in some countries like Poland even well above their income level. (see Lindert 2004: 216-217).

Note also that table 3 in section 4 shows that adjusted net replacement rates of unemployment benefits in the new member states do not differ very much from those in the EU-15 countries.

Pension reform in new member states: a case of 'social dumping'?

The main reason why social expenditures in Poland, Hungary and Slovenia are relatively high has to do with their pension systems. For example, pension expenditure in Poland is over 14% of gdp. Compared to the age structure of the population, these countries have relatively high numbers of pensioners. The easy access to pension benefits arose in three ways (see Barr 2001: 252). First, the general retirement age under communism was low. Second, for some privileged groups like miners the retirement age was very low. Third, during the transition period in the 1990s, generous early retirement has been frequently used as an exit route from the labour force. As a result, employment ratios in general and for older workers in particular, are well below the figures for old member states (see table 4).

Table 4 – Employment ratios and unemployment rates in new member states , 2001 (percentages)

	Employment ratio				Unemployment Rate
	Total	Females	Age 55-59	Age 60-64	
Cyprus	65.5	52.5	60.5	35.1	4.5
Czech Repu.	64.9	56.8	50.2	16.9	n.b.
Estonia	60.6	57.1	58.4	29.4	12.3

Hungary	55.9	49.4	33.7	7.6	5.7
Latvia	58.2	54.3	49.3	21.8	12.9
Lithuania	60.1	58.5	56.8	26.4	16.5
Poland	55.1	49.3	37.7	20.9	18.6
Slowakia	56.3	51.1	34.5	6.1	19.7
Slovenia	62.7	58.5	29.0	15.1	5.9
EU-15	64.0	54.9	51.9	22.6	7.4

Source: Europese Commissie, *The Social Situation in the European Union,* Brussel 2003, pp. 203. No data for Malta

The new member states still have a relatively young population compared to the old member states. However, mainly as a result of rapidly falling birth rates, population aging in these countries will be strong, and consequently, age dependency ratios will convergence to those in old member states. Combined with the high system dependency ratio as a result of the low effective retirement age, this could result in an explosion of pension costs. For example, without reform, pension expenditure in Poland would rise to more than a quarter of national income in 2050 (Lindeman et al. 2000). Against this background new member states - with Poland and Hungary in the forefront - are reforming their pension systems through a combination of de-indexing first pillar pensions, raising mandatory retirement age, and introducing second pillar supplementary pension funds. Some authors (e.g. Vaughan-Whitehead 2003) consider these reforms as a form of 'social dumping'. However, as is evident from the description of the pre-reform situation, pensions reforms have been primarily enacted to ensure the sustainability of the pension systems and in stabilizing pension contributions.

Do low expenditure ratios imply lower tax-wedges?

Low employment ratios in new member states imply a narrow basis for financing social expenditure. As a consequence, tax wedges (the part of gross labour costs which consists of social security contributions and income taxes) are comparable to the average of the EU-15, despite the on average lower expenditure ratios (see table 5). This applies not only to 'high' spenders like Poland, Hungary and Slovenia, but also to 'low' spenders like the Baltic states (see for the latter OECD 2003).

Table 5 Tax wedge 1999

Poland	42.9
Hungary	52.6
Czech Republic	43.0
Slovak Republic	42.0
Slovenia	41.0
Estonia	40.0
Lithuania	39.7
Latvia	41.7
EU-15 weighted average	43.2
EU-max (Belgium)	55.6
EU-min (Ireland)	43.2

Adapted from Ederveen and Thissen (2004), p. 33. Source:Eurostat.

Tax wedge is employees' and employers' social security contributions and personal income tax less transfer payments as percentage of gross labour costs.

As table 5 shows, Hungary in particular has a very high tax wedge. Because a high tax wedge could discourage new entrants on the labour market and encourage the growth of the informal sector, a vicious circle could emerge in which a high tax wedge causes falling official employment ratios, leading to still higher tax wedges etc (compare Ederveen en Thissen 2004; European Commission 2003; United Nations 2004).

Is social expenditure too low in new member states?

We have given several reasons why one should be careful from drawing conclusion from the fact that social expenditure ratios in new member states are on average lower than in old member states:

- There are considerable differences within the group of new member states;

- Social expenditure in new member states are on average in line with their income levels, and in certain countries even well above this.

- Mainly as a result of low employment rates, related to a low retirement age, the base for financing social expenditure is narrow, resulting in relatively high tax wedges.

Consequently, we do not believe that lower social protection in new member states will put pressure on social protection in old member states. Anyway, such a scenario is unlikely given the fact that new member states are in economic terms very small compared to old member

states. We expect that social expenditure in new member states will converge to the levels in old member states as a result from demographic developments and rising income growth.

We observe that new member states mainly use lower company tax rates as instruments in locational competition. Although agglomeration rents will to a certain degree protect old member states' higher company tax rates (Baldwin and Krugman 2002), it cannot be ruled out that this will put pressure on lowering company tax rates and through this channel also puts pressure on social protection expenditure (Tanzi 2000). However, this points to the need of minimum company tax rates instead of minimum social protection levels.

It could also be argued that new member states will reduce social spending in order to fulfill the entry-criteria for the third phase of EMU. The budgetary criteria for entry in the euro-zone have been criticized in the past as being overly stringent, forcing governments to cut social expenditure. However, judging by the experience of the current members of the euro-zone, there is no evidence that budgetary consolidation in the 1990s, motivated by the will to fulfill the 'Maastricht'-criteria on debts and deficits, has resulted in substantial cuts in social expenditure. As table 1 shows, social expenditures ratios in fact increased in the 1990s, even in countries like Italy, which started with a very high government deficit. The reason for this is that most countries used mainly (temporary) tax increases and proceeds from privatizations to consolidate their budgets (see Fatás et. al. 2003, pp. 35-37). Moreover, once financial markets started to believe member states would join the euro, risk-premiums on interest rates came down very rapidly, leading to huge savings on interest expenditure on the public debt. Related to this, we do not believe that sound-public finance policies will necessarily hurt social policy expenditure. Quite the contrary, by cutting-back interest-rate expenditure, a low debt policy might contribute to the sustainability of social protection systems in the long-run.

Social security tourism from new member states?
The other channel through which enlargement could put pressure on social security systems in old member states is migration (see section 2). More specifically, higher benefits in old member states could stimulate social security tourism, which could force old member state to lower benefits. However, we do not think this scenario to be very likely. We do not observe social security tourism within old member states, despite obvious differences between levels of benefits between southern and northern member states. A reason for this may be that EU-citizens do not have an unconditional right to social assistance, unemployment benefits, or mandatory health insurance in other member states. The right of residence for non-workers is

usually conditioned on the ability to be self-supporting and on not being a burden on the social security system in the host member state. Sinn (2003) argues that the Constitution, as drafted by the European Convention, will empower citizens with an unconditional right to social welfare in other member states. He argues that this will encourage massive migration flows from east to west, and force old member states to lower social protection. However, in our opinion this arguments rests on a misconception of the Constitution, as this explicitly denies citizens new rights (Van Riel 2003; Geelhoed 2003). Also the case law of the Court of Justice on the concept of European citizenship does not forbid member states to put certain limits to the access to their social protection systems in order to prevent social security tourism[5]. According to some authors (e.g. Bertola et al. 2001) these limits hinder the emergence of a truly European labour market as it restricts the mobility of the unemployed. Therefore harmonization of social minimum standards would be needed. However, this efficiency argument for social harmonization also fails to convince us for two reasons. Firstly, it has not been established that restriction of the right of residence of unemployed is an important reason for their low mobility. Other important factors are cultural differences and mobility costs. In addition, the unemployed are not very mobile within their own member state. Secondly, the argument fails the proportionally test. Do we really need harmonization of social minimum standards for making job search in other member states possible?

CONCLUSIONS

This article deals with the question whether we need to speed up social convergence in the enlarged EU by setting common minimum standards for benefit levels. Do we need such a harmonization of social protection systems, perhaps because of an increased danger of a social race to the bottom? We analysed the social dumping hypothesis, both theoretically and empirically and conclude that the case for harmonization is not strong. There are no clear signs of a social race to the bottom. On the contrary, several indicators show that during the past decades protection levels have converged to higher averages. This process of social convergence has been induced by the economic integration process.

The new member states have on average lower protection levels than the EU15 (although the differences are not that large), but we do not expect that this puts pressure on protection levels in the old member states. It is important for the new member states to keep their labour costs low to be able to compete on the internal market. Once economic catching-up has been materialised, these countries will be able to develop a more mature social protection system.

Premature social harmonization would be detrimental to the economic convergence process. Welfare states could also be threatened by increased migration flows. However, this threat is often exaggerated in our opinion. Citizens do not have unconditional rights to social benefits in other countries and other factors, such as cultural differences and mobility costs, also prevent massive 'social tourism'. In any case, harmonization would not be the answer to this problem either.

Although we conclude that the EU does not need harmonization of social benefit levels, we do acknowledge the importance of the social dimension of the EU in a more broad sense, both because of political reasons (the legitimacy of the integration process) and because of economic reasons. Member states are faced with the common challenge to increase the sustainability of their social protection system, which is under threat from various developments, especially from the ageing populations. The method of open coordination can help to realize these reforms. From an economic point of view, (some) economies of scale can be a ground for this coordination. Best practices and policy learning can be disseminated, while peer pressure and peer review can strengthen the commitment of member states to common (or own) objectives. However, until now the open coordination is not yet very effective. The essential problem is that the feed back to national policy making and thus the implementation is insufficient. We suggest a much stronger integration of the action programs, based on common EU-objectives and guidelines, in the national policy process. This also implies that national parliaments should pay greater attention to these programs and evaluate their implementation more systematically. A more effective coordination of social policy in the EU can contribute to the sustainability of the social protection systems of the member states and the modernisation of the European social model, which is an essential part of the Lisbon process.

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Notes

[1] Leibfried and Pierson (1996:196) summarize the key implications of Regulation 1408/71 and its case law as follows. First, a member state may no longer limit social benefits to its citizens. Second, a member state may no longer insists that its benefits only apply to its territory and thus are only consumed there. Third, a member state is no longer entirely free to prevent other social policy regimes from directly competing with the regime it has built on its own territory (e.g. in the case of posted workers). Fourth, member states do no longer have an exclusive right to administer claims to welfare benefits.

[2] A property of the standard deviation is that its value rises with the average value of the data set to which it is applied. The coefficient of variation is defined as the standard deviation devided by the average value.

[3] The calculation of net replacement rates differ in several ways compared to the calculation of gross replacement rates (see OECD 2002). Taxes and social security contributions on earnings and on benefits are taken into account. Moreover, net replacement rates do capture the effect of family-related benefits for children. Also housing benefits are included in net replacement rates.

[4] Without new member states the trend line is (y is expenditure ratio, x = gdp per capita): $y = 0,11 \cdot x + 16$ ($R^2 = 0,30$). Including new member states improves the fit: $y = 0,13 \cdot x + 14$ ($R^2 = 0,65$).

[5] See for example the conclusion of advocate-general Geelhoed in the Trojani case (C-546/02).