

**Annex 5 - Euroframe-EFN Autumn 2007 Report**

**Social Europe: responsibility of the EU or the Member States<sup>1</sup>**

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One way to assess the most appropriate level for social policy in Europe is to use the subsidiarity principle. Since the Treaty of Maastricht in 1992, the EU Member States have applied the subsidiarity principle in arranging the division of competencies between individual Member States and the EU. This principle means that the EU should only be given central powers if there are solid grounds for assuming that this will produce better results for the Member States than a decentralised policy. Since countries differ from each other in their history, culture, preferences and circumstances, competencies are often situated at the lowest possible level. Moreover, decentralised governments are closer to their citizens and therefore better able to gather information about people's preferences, enabling policy to respond more effectively to local preferences and circumstances.

However, subsidiarity is not the same thing as decentralisation. There may be solid arguments for centralised European coordination, for example in relation to scale effects or external effects. Scale effects occur when policy is more effective and more efficient if implemented jointly. External effects arise when policy in a particular Member State has consequences for other Member States and countries take no account of these cross-border 'spillovers'.

The arguments in favour of centralisation must ultimately be weighed against the disadvantages. In making this judgment, not only should centralisation or harmonisation of policy be analysed as an alternative to national policy autonomy, but also less far-reaching alternatives such as minimum standards or other basic rules within which the process of policy competition can take place. In this note we apply the subsidiarity to two elements of social policy: social security expenditure and labour market regulation.

### **Subsidiarity and social security expenditures**

How does the subsidiarity test turn out if we apply it to social security? To answer this, we need to weigh any scale effects and external effects against the importance of heterogeneity in social policy.

#### **Scale effects**

Scale effects occur when the social security system is more effective and efficient when operated at European scale than at national scale, for example because of lower implementation costs or better insurance. With regard to this latter aspect, countries could insure themselves at European level against asymmetrical macroeconomic shocks by means of a European unemployment fund, for example. A country that was hit by a negative macroeconomic event would then receive money from this fund, to which countries where unemployment does not increase would contribute. In this way the fund would stabilise shocks occurring in specific EU countries. Insuring against asymmetrical shocks also raises potential problems with its implementation, however, and creates moral hazard, i.e. the risk that governments could become less alert to the need to prevent unemployment because the unemployment benefits are paid by someone else. It is therefore not clear whether the benefits of such an insurance scheme outweigh the disadvantages.

Another scale effect could arise in the implementation of social security. We investigated whether there are any empirical indications for this by examining whether large Member States achieve more efficient redistribution than small Member

States. By inspecting the relationship between social security spending and income inequality in the countries of the European Union in 1999, we notice that the four largest countries: Germany, France, UK and Italy spend a relatively large amount on social security in order to achieve the same degree of equality than compared to the EU average. This offers no empirical support for the idea of scale effects in the implementation of social security.

### **External effects**

Might policy competition in social security lead to social dumping as a result of cross-border external effects? On average, social security spending in the EU rose from 21.5% of GDP in 1980 to 25.8% in 1998. This percentage has been falling since the second half of the 1990s, especially in the social-democratic and liberal countries, though to a large extent this is related to the decline in unemployment over this period. All in all, there are no indications of social dumping in the EU. This observation finds broad support in several studies (Bean et al., 1998). For the time being, therefore, cross-border external effects offer no convincing argument for the harmonisation of social policy.

### **Heterogeneity**

There are considerable differences between countries in terms of their welfare states. On the other hand, countries can converge over time. Particularly striking is the strong increase in social security spending in the Mediterranean welfare states. While social security spending as a percentage of GDP rose by an average of 20% in the EU over the period 1990-1998, it grew by 50% in the Mediterranean countries. This gives a first indication that spending on social policy in the EU has converged. In order to investigate convergence in a more scientific way, CPB and SCP have estimated the convergence speed. Our estimate shows that there is significant convergence in social security quotients of about 4% per annum. In other words, an arbitrary European country will have made up half the difference between its social security spending and the EU average after approximately 17 years. The spread between countries in terms of social security spending has also reduced considerably. The variation coefficient (the standard deviation divided by the average) fell from 27% in 1981 to 19% in 1998. Although there are still substantial differences in the level of social security spending, the heterogeneity has reduced over time. This lowers the costs of harmonisation, but the recent enlargements in 2004 and 2007 have increased the heterogeneity of social security spending once again.

### **Judgment**

Scale effects and cross-border external effects appear to be irrelevant at present for social security spending. They therefore offer hardly any justification for harmonisation of social policy. External effects could become more important if increasing labour mobility in the EU leads to intensified policy competition between national governments. A large influx of immigrants, for example from the Accession Countries, could also put pressure on social provisions, particularly if generous provisions were to act as a magnet to new immigrants

### **Subsidiarity and labour market regulation**

The subsidiarity test can also be applied to labour market regulation. The EU has already agreed a number of (minimum) standards here, relating among other things to working hours, holidays, health and safety at work, and various other worker rights.

These harmonised rules have been developed in response to fears of social dumping. However, it is unclear how relevant the threat of social dumping would have been if the rules within the European Union had not been harmonised. There are no clear indications of such external effects in this area. But how important are scale effects and heterogeneity?

### **Scale effects**

The creation of an internal European market could be interpreted as a scale effect. This not only applies for goods, services and capital, but also for labour, because the creation of an internal European labour market through the removal of institutional barriers to labour mobility can increase prosperity in Europe. It implies that people are able to respond better to wage differentials and can more easily go to work in the country where they are able to achieve the highest return on their knowledge and skills. This fosters competition on the labour market, improves the efficiency of the allocation of labour in Europe and increases productivity. In addition, migration can reduce regional inequality in unemployment and boost the flexibility of the labour market by enabling the labour volume in a particular region to adapt more quickly to changing circumstances.

At present, however, labour mobility within Europe is low, caused on one hand by language and cultural differences between countries. On the other hand, there are institutional obstacles to labour mobility. These barriers are both financial - pensions, for example - and information-related. For example, an employee with Dutch nationality who goes to work in another EU Member State falls under the regulations of the host country. The complexity and diversity of those regulations tend to prevent people from looking for work outside their own national borders.

How could Europe achieve the goal of an internal European labour market by promoting labour mobility? An analogy can be made here with the goods market. The internal market has removed technical trade barriers through harmonisation and mutual recognition. Harmonisation of labour market regulations and social policy appears to be a step too far in the light of the heterogeneity of the EU. However, in parallel with the internal market for goods, it would be possible to introduce a system of mutual recognition on the labour market. Padoa Schioppa (2002) has developed this idea further, suggesting that social provisions should no longer be based on the host country principle, but on the home country principle. Migrants could then go to work anywhere in the Union under the conditions and with the social provisions that apply in their home country. This could help promote labour mobility. On the other hand, the home country principle would lead to unequal treatment of indigenous and foreign workers, making this a very controversial proposal.

### **Heterogeneity**

Harmonisation of regulations ignores the fact that countries differ from each other. The harmonised social regulations will be expensive for the majority of new Member States and will not match their level of economic development: the preferences for social standards are simply different for rich and poor countries. Differences in regulations need not in fact be harmful; they can help the economic development of new Member States because they will be able to attract more capital and strengthen their competitiveness with lower social standards. Western European consumers will ultimately also benefit from this through increased trade and specialisation.

Convergence could then subsequently lead to adaptation of social policy to the EU norms. If on the other hand high social standards are imposed on the new Member States immediately, this could make it more difficult for them to achieve the growth necessary to catch up with the West. The enlargement of the EU thus exposes the disadvantage of harmonisation of social policy. Differences between countries create a need for a cautious approach in transferring powers to the EU.