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Social and labor market policies in a growing EU

Giuseppe Bertola*

Summary

■ In the enlarging but sluggish European Union economy, social and labor market policies are blamed for poor employment and growth performance; perceived to be threatened by economic integration; and almost completely assigned to subsidiary national action. This paper outlines interactions between international economic integration and policies meant to address the distributional implications of imperfect financial markets. Theoretical considerations, empirical evidence, and examination of the European institutional framework indicate that the benefits of economic integration may indeed be offset, from politically important viewpoints, by the side effects of unreformed or uncoordinated labor market and social policies. ■

JEL classification: H1, E24, F15.
Key words: Economic integration, welfare, growth.

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The 1990's were a crucial decade for Europe. Its early years saw German reunification, Central and Eastern European countries' transition towards a market economy, and the inception of the Single Market Program. At the end of the decade, the euro was introduced as the single currency of a large portion of Europe. Since 2001, however, cyclically depressed macroeconomic conditions put stress on the Eurozone's monetary and fiscal policy arrangements. The enlargement to a 25-member European Union (EU) in 2005 was immediately followed by the French and Dutch electorates' rejection of the *Treaty Establishing a Constitution for Europe* ("EU Constitution" in what follows) and by the withdrawal of the draft Directive meant to extend the Single Market to services. These developments make it difficult to envision further progress of Europe's Economic and Monetary Union (EMU) process and may threaten the sustainability of its unprecedented, but still incomplete, achievements.

As pointed out by Sapir et al. (2004), economic prosperity is an essential precondition for all policy objectives. Much of the resentment that led to rejections of the EU Constitution was indeed rooted in the sluggish economic situation of France, the Netherlands, and other European countries. Efficient Single Market interactions were expected to boost growth, but poor economic performance may, in fact, result from the interaction of economic integration with ill-configured complementary policies. In particular, a lack of appropriate reforms in the social and labor market area may well be what prevents the adjustments that would allow European economies to take advantage of economic integration.

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Policy-making competence in that area is assigned to the member countries, but it is theoretically unclear that appropriate reforms may be expected from national policy actions. Just because economic integration interacts with social aspects, a case can be made for explicit attention to social issues at the supranational level. Such a case was prominently made in the 1980's by Commission President Jacques Delors, who promoted market competition as keenly as collective protection of workers' welfare, which in his view was key to the legitimacy of European integration. Social policy coordination across increasingly heterogeneous EU countries proved difficult but, twenty years later, the tension remains high between social policy and almost complete economic integration. Among the top five reasons given by French citizens who gave a "no" vote to the EU Constitution, Eurobarometer (European Commission, 2005a) lists *"loss of jobs"* (31 percent), *"too much unemployment"* (26 percent), *"economically too liberal"* (19 percent) and *"not enough social Europe"* (16 percent). Joblessness and other economic problems were also cited by Dutch voters as a reason for rejecting the Treaty, while in France, remarkably, *"first step toward a social Europe"* was cited as a reason by 7 percent of those who voted "yes." Similarly, the Services Directive was successfully opposed, especially by the French and German governments, on the basis of the fear that freedom to supply cheap, unregulated labor in the regulated markets of Continental European countries would endanger their social welfare models.

This paper examines the sources and consequences of the tension between Europe's social policy reform processes and economic integration processes, tracing their theoretical basis to the more or less desirable effects of labor market and social policies, reviewing practical aspects of EU countries' heterogeneity and distinctiveness, and outlining the unsatisfactory current configuration of the EU policy framework as regards the relevant issues. Dissatisfaction with Europe's economic integration reflects both poor economic performance and a perceived inability on the part of governments to continue to provide the extensive social protection nets introduced in earlier decades. The relationship between economic performance, international integration, and social policy sustainability is complex. Many crisis factors are country-specific (see Lindbeck, 2005, and references therein), and structural changes depend on technological and global trade developments that span well beyond the borders of the EU. But the uneasy interaction of cross-border economic deregulation and na-

tional social policies is very apparent and politically relevant in the EU context: as integration results from explicit policy decisions, lack of attention to social policies can easily cause resentment against (at least apparently) avoidable economic integration. While policy discussions cling to the hope that national governments might be induced to reform their labor markets as the EU continues its market-oriented liberalization experiment (Sapir, 2005), European citizens increasingly tend to cling to their own national unreformed policies, and to blame economic integration itself for their economic woes.

Section 1 reviews the facts that motivate European concerns, focusing on the growth and inequality performance of old and new EU member countries in comparison to the US and other global competitors. Section 2 illustrates theoretical mechanisms by means of a simple formal model, focused on the tradeoffs facing market and non-market mechanisms of income production and distribution in centralized and decentralized policy-making frameworks: policies that were beneficial when adopted need to be adapted to changing circumstances, but if structural change reflects stronger international interactions, neither unreformed policies nor reforms chosen in an uncoordinated fashion will maximize the policymakers' objective functions. Section 3 reviews social and labor market policies in the EU and in the wider sample of OECD countries. The very wide heterogeneity of policies and outcomes across EU countries makes it very difficult to envision harmonization. But the dynamics over time of each country's policies and outcomes are consistent with European citizens' fear of weakening social protection, and suggest that policy harmonization may indeed be needed for the sustainability of economic integration.

Section 4 summarizes the embryonic state of EU legislation and action in the relevant field, discussing articles of the EU Constitution and well-intentioned but toothless "open coordination" methods. The concluding Section 5 draws together insights from the theoretical, empirical, and institutional analysis in the previous sections to outline the narrow path facing EU economic and policy integration policies. Both at the national and the EU level, social and labor market policies are prisoners of history, stuck between the twin dangers of increasingly obsolescent traditions and uncoordinated, partial reforms. A process of "positive integration" through explicit collective agreement is certainly even more difficult in that area than in monetary and fiscal policy areas, but will arguably need to be engineered in order to overcome resistance to further integration.

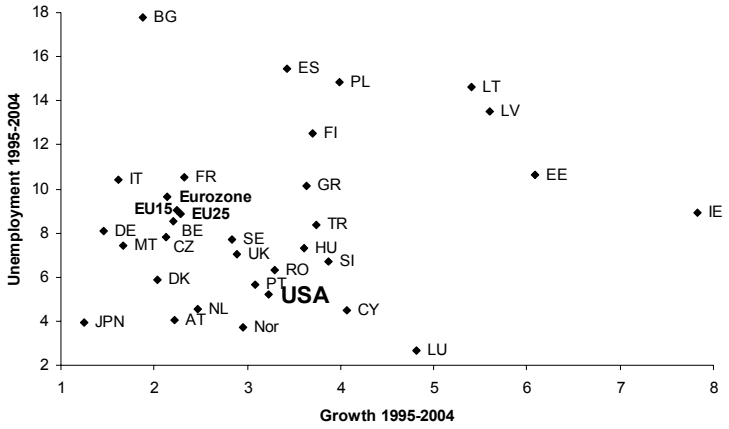
1. Growth, unemployment, equality and enlargement

The EU has surpassed the US in population and is approaching it in terms of total output and number of states, but lags behind the US not only in terms of the per capita income level, which has been about 30 percent lower in real terms for the last 20 years, but also in terms of unemployment and growth. In the 1990's and the first few years of the new millennium, EU countries do appear to be significantly worse off than the US. Figure 1 plots average growth and unemployment during 1995-2004, for all EU and OECD member countries (see the Appendix table for a list of country identifiers in the figures). Old and new EU member countries are identified by upper case abbreviations. Their performance is very heterogeneous, but only tiny Luxembourg and Cyprus did better than the US in terms of both growth and unemployment. Ireland and many transition countries grew faster than the US, but their unemployment rates were on average higher. In France, Germany and Italy, unemployment was twice as high and growth half as fast as in the US: the poor performance of these large countries accounts for most of the difference between the performances of the US and the Eurozone, or the EU15 (slightly improved by the United Kingdom's almost American performance), or the EU25: the new members perform slightly better than older members in terms of growth or unemployment, but their small size leaves EU-average statistics essentially unchanged (on average during 1995-2004, unemployment was 9.05 percent and growth 2.25 percent in the EU15; EU25 members had 8.86 percent unemployment and it grew at 2.28 percent).

The comparison with the US recent performance is worrisome for the EU. But in the post-War period, and until the 1970's, unemployment was lower in Europe than in the United States. Until the 1990's, EU labor markets consistently experienced faster real-wage growth and smaller increases in wage inequality than their American counterparts; and unemployment increased above the US rate in the early 1980's, but it was not an important source of social tensions as long as primary earners enjoyed stable employment at high wages. Growth also used to be fast in Europe. Between 1950 and 1973, GDP grew at an almost 5 percent annual rate (almost 4 percent per capita) in the EU-15 countries: even in the recent evidence of Figure 1, European countries do fare better than Japan in terms of recent growth (if not unemployment), and their slower growth performance partly reflects a

slower population growth (during the 1990's, the EU15 population grew at 0.4 percent per year, that of the US by 1.2 percent: the 0.8 percent difference accounts for about half of the 3.6-2.1=1.5 percent growth differential between the US and the EU).

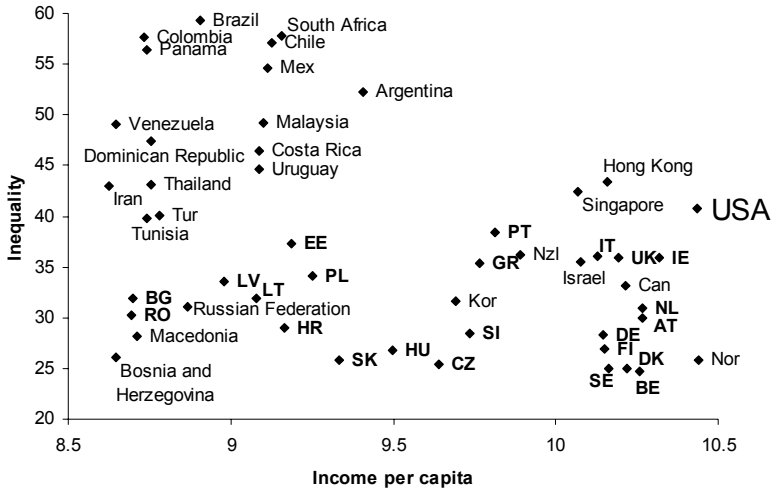
Figure 1. Average growth and unemployment



Notes: See the Appendix for country abbreviations.
Definitions and sources: real GDP growth rate, average 1995-2004, Eurostat; unemployment rate, average 1995-2004, Eurostat.

Inequality indicators also paint a more favorable picture of the EU economy. Figure 2 plots Gini coefficients, a measure of inequality, against per capita income in the sample of countries with per capita incomes comparable to those of current and potential EU members. In that global context, European countries stand out as a cluster of uniformly low within-country inequality and very heterogeneous per-capita incomes. Old and new member countries have remarkably similar levels of inequality (Eurostat reports the average Gini coefficient of the EU15 at 29.33, and that of the 10 new member countries at 29). The US stands out as the country with the highest real income, but also a very high level of inequality: higher than that of all current and potential EU members (and as high as that of Turkey), and only substantially lower than the inequality levels of countries with much lower real incomes.

Figure 2. Inequality and income per capita



Notes: Only observations with income per capita above 5000 PPP$ in 2000. See the Appendix for country abbreviations.
Definitions and sources: Gini coefficients, average of available data in 1995-2003, World Bank WDI database; logarithm of GDP per capita in PPP, 2000, World Bank WDI.

The descriptive regressions of Table 1 revisit the evidence displayed in Figures 1 and 2, and explore the role of country size—which may matter for growth and unemployment, e.g. because economic integration is a factor of different importance for countries of different size, as well as for inequality if larger countries are intrinsically more heterogeneous. The first six columns run regressions on the sample of Figure 1, which includes other European and North American comparison countries along with the 25 current members. They give no evidence that EU membership is associated with higher unemployment in the 1995-2004 period, but uncover a positive interaction effect of size and EU15 membership. Neither EU membership, nor recent accession are associated with slow growth and high unemployment. Rather, it is the combination of large size and EU15 membership, an interaction effect obviously driven by the positions of France, Germany, and Italy in Figure 1.

Table 1. Unemployment, growth, and inequality in the enlarging EU

Dependent variable:	Unemployment				Growth			Inequality	
EU15 dummy	-0.86	-1.46	-2.73	-0.51	-0.88	-0.25	-8.06	0.22	-0.02
	(0.59)	(0.85)	(1.41)	(0.93)	(1.40)	(0.36)	(2.57)	(0.06)	(0.01)
EU25 dummy		1.66	1.02		1.03	1.34		-10.7	-10.7
		(0.69)	(0.42)		(1.16)	(1.54)		(3.03)	(2.99)
Population	-1.16	-0.64	-1.47	-0.70	-0.38	0.02	4.65	2.91	2.84
	(0.88)	(0.42)	(0.90)	(1.41)	(0.67)	(0.04)	(1.75)	(1.16)	(1.08)
EU15 interaction			5.65			-2.76			1.11
			(1.32)			(1.81)			(0.11)
Observations	30	30	30	30	30	30	50	50	50

Notes: Unemployment and real GDP growth, average 1995-2004: Eurostat (27 current and potential EU members, and United States, Japan, Canada). Average of available Gini coefficients during 1995-03 and population in 2000 (measured in units of 100m): World Bank, World Development Indicators (all countries with inequality information and PPP GDP per capita over $5000 in 2000). All regressions include a constant. Absolute value of t statistics in parentheses.

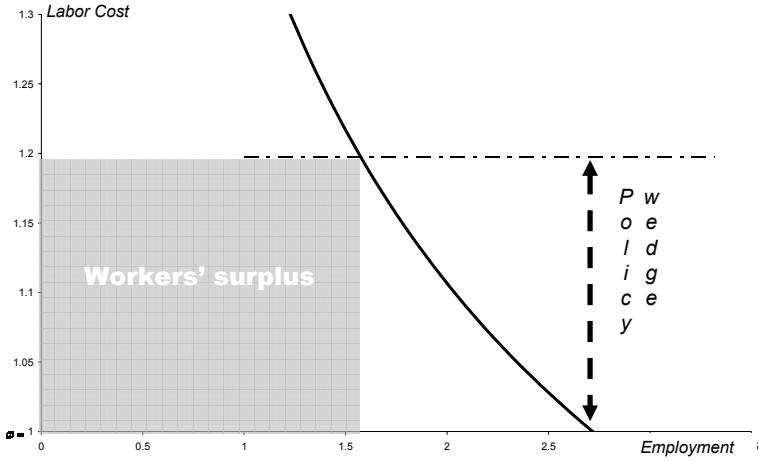
The last three columns of Table 1 focus on inequality in the wider Figure 2 group of countries whose levels of economic development are comparable to those of European countries. The descriptive regressions indicate that country size is mildly associated with higher Gini coefficients, confirm that EU countries (with no distinction between new and older members) feature markedly lower levels of inequality, and indicate that the larger among the EU15 member countries tend to fare worst.

Across countries, however, enlargement does affect inequality. Overall income inequality across all citizens of the EU15 in the 1990's is lower than that across citizens of the US but, as a result of the accession by 10 new countries, inequality in the EU25 has become comparable to its US counterpart (Morrisson and Murtin, 2004). While the similarly low levels of inequality among each country's citizens indicate that all EU member countries share a culture of equality, the extent to which overall EU income inequality reflects differences across national income levels poses important challenges to policy integration in Europe. And the new growth opportunities afforded by economic integration across increasingly different countries may be difficult to exploit in light of the tension, discussed in the next section, between social protection and market forces.

2. Labor markets in an imperfect integrating world

Economic integration may have important implications for the pros and cons of interference with labor market outcomes, such as that implied by attempts to prevent poverty and reduce inequality by means of unemployment insurance, labor taxes and social transfers, employment protection, and officially sanctioned collective bargaining frameworks. To illustrate the relevant channels of interaction, consider the depiction in Figure 3 of labor-demand-determined employment. If wages are such as to equate labor supply and demand at the margin, decreasing marginal productivity of employment lets inframarginal returns accrue to employers, but workers are indifferent to employment if their alternative income is constant and, as in the simple formal model sketched in Appendix A.1 and illustrated in the Figure, they receive none of the social surplus represented by the area below the downward-sloping marginal schedule.

Figure 3. Employment, wages, and policy interference



Note: Illustration of Appendix A.1, parameters: $\eta = 0.33$, $\beta = 0.5$, $\omega = 1$.

Individuals who earn no surplus as workers can benefit from a producer's surplus as owners of other factors of production. If all producer's surplus is weighed equally, the simple computations in Appendix A.1 confirm that the welfare of a "representative" individual is maximized by competitive equalization at the margin of the costs and benefits of employment. But taxes and regulations, in all countries, do alter *laissez faire* labor income outcomes in ways that would be difficult to explain if all individuals' welfare depended on maximization of productive efficiency. In reality, financial markets are imperfect and, for many individuals, labor income is vastly more important than capital income. As shown in Figure 3, higher wages and lower employment reduce overall producer's surplus while also (up to a point) increasing workers' surplus. Appendix A.1 shows that higher wages, and lower employment, are chosen if the objective function attaches more weight to labor income than to other income.

This outcome may be implemented by legally enforced wage minima, which imply unemployment (involuntary from the perspective of individual workers, who are prevented from bidding down the wage of employment relationships). From this perspective, the weight parameter from which the markup arises may be given a bargaining-power interpretation, as in Belot and van Ours (2004). As in that paper, however, a variety of policies besides union empowerment bear

on the relevant outcomes, and payroll and other taxes are an important source of wedges between labor costs and workers' marginal willingness to work, and therefore of lower employment. The higher wages of individuals who are employed may be partly distributed to those who are ex-post unemployed, as is perhaps most obvious when the two groups of workers are members of the same family or the same persons at different points of their lifecycle; similarly, the revenue of payroll taxes is redistributed to workers in the form of pensions or unemployment subsidies, or public-sector employment opportunities at favorable wage/effort ratios (Algan et al., 2002).

All such policies serve similar purposes: while an explicit wage floor prohibits workers from bidding down other workers' wages, alternative income-support sources eliminate the need to bid for employment (and achieve "decommodification" of the labor market). In the simple model outlined in Appendix A.1, the extent of interference with labor market outcomes depends on two parameters: the relative weight of profits in the objective function, denoted β in Appendix A.1; and the elasticity of the inverse labor demand function, denoted η: low values of η imply that small changes in labor costs have a large impact on employment. The wedge between labor demand and supply becomes larger as β decreases below unity: if labor income is more important in the policy's objective function, it is more attractive to increase it by raising wages and accepting lower employment. But the latter effect is more pronounced if employment is more sensitive to labor costs: hence, the wedge becomes smaller as labor demand becomes more elastic (more nearly horizontal in Figure 3), and η approaches zero.

This representation of the motivation and effect of labor market policies is highly stylized, but can help interpret real-life labor taxes, which are large and heterogeneous across countries. For the average production worker, the wedge between labor costs and take-home pay averages 36.9 percent in the OECD in 2000, ranging from 15 percent in Mexico to 56.2 percent in Belgium, and from 30.8 percent in the US to 42.4 percent in the EU15. If the elasticity parameter η is equal to about 1/3, so that the labor demand schedule implies that wages are around 2/3 of aggregate production, a 20 percent wedge between labor costs and workers' opportunity costs is justified by assigning half the weight given to workers' surplus to profits (and implies about 60 percent lower employment along the demand curve, if workers'

outside options are constant: upward-sloping labor supply realistically reduces that percentage in the slightly more complex model of Bertola, Blau and Kahn, 2002). Tax revenues finance public goods as well as transfers, and employment and wages can be altered by other policy instruments and institutions. But the variation of tax rates across countries may in reality, as in the simple model, reflect differences in the elasticity of the relevant wage-employment tradeoff schedules and the extent to which labor income is privileged by country-specific politico-economic interactions. Only perfect capital and financial markets could support equal weights for labor and non-labor income and maximization of the welfare of a "representative" individual, and only lump-sum redistribution at a hypothetical pre-market stage could cleanly disentangle distributional and efficiency concerns. In countries where well-defined groups of workers do not have access to the financial markets where claims to employers' profits are traded, they and their representatives may well favor outcomes that reduce overall income more than they increase labor income.

Labor and social policies may thus be responsible for low employment (and slow growth, in a dynamic setting) at the same time as they pursue appealing goals (Agell, 2002). Transferring resources towards poor individuals relieves social pressure, as "excluded" individuals who cannot earn a decent living in the market tend to engage in disruptive or even criminal activities, and collective policies also address the fact that markets are not well equipped to handle lifetime risk: much welfare is at stake in the labor markets and, to the extent that information problems prevent markets from delivering suitable insurance against labor income risk, there is a legitimate role for government intervention in the form of regulation and/or compulsory coverage by social security schemes. Poverty and labor market misfortune, however, can result from low effort as well as exogenous bad luck. To the extent that governments cannot distinguish between the two, and face the same information problems that prevent insurance markets from perfectly smoothing workers' consumption, policies meant to relieve poverty and offer insurance also imply smaller incentives to work and produce. In pre-industrial societies, family- and village-level interactions could take care of smoothing out idiosyncratic shocks within narrow, subsistence-oriented economic systems. In the large-scale economic systems of modern societies, either organized financial markets or state-organized redistribution schemes are called upon to smooth out consumption fluctuations across individuals:

markets and redistribution play roles of different importance in different economies, and both fail to perfectly insure individuals against bad luck, for neither could do so without eliminating incentives for individual effort in seeking more highly productive work opportunities.

2.1. Protection and integration

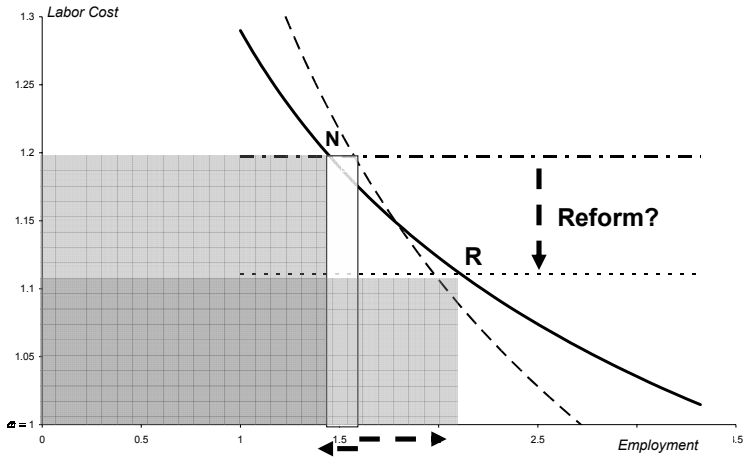
The relative importance of the negative side effects of social policies in general depends on structural features of the underlying system of economic and social interactions. The framework of Appendix A.1 offers a stylized representation of the possible welfare shortcomings of competition in the labor market in a second-best economy where other markets fail and/or form the point of view of agents different from the "representative" one. From that perspective, parameter β_i represents a given society's inclination, need, or ability to interfere with laissez faire labor market outcomes: it may, for example, depend on the extent of "class" segmentation in income sources, or on the depth of financial markets, or on the relative efficiency of public and private administration of contingent payments.

Policy implementation and policy outcomes, however, do not only depend on the objectives of policymakers and the structure of labor market interactions (summarized by β and η in Appendix A.1). They also depend on the scope of policy decision processes. Just like imperfect factor and good markets can fail to appropriately balance the objectives of different economic agents with conflicting objectives, so interactions between collective decision-makers can result in undesirable policy configurations if their objectives and instruments are interrelated, and improper "systems competition" can engender policy failures (Sinn, 2003). Economic integration is relevant to both aspects. Allowing market interactions to compare and choose among alternative modes and locations of production, it improves efficiency and employment and production opportunities, but also increases the elasticity of employment to labor costs and introduces strategic interactions across the policy choices of different countries.

In the stylized framework discussed above, these effects can be represented in terms of larger own-wage and cross-wage employment elasticities (see Appendix A.2). Consider first the implications of the higher responsiveness of employment to labor costs implied by the easier substitutability of each country's labor with other factors of

production or with foreign labor. As discussed in Andersen et al. (2000) and Bertola and Boeri (2002), and as implied by the micro-founded model in Andersen (2003), integration and stronger product market competition imply more negative employment side effects of any interference with laissez faire labor markets. In Figure 4, the flatter labor demand schedule is drawn for parameters that (in the absence of interference) yield higher welfare and employment than the steeper one of Figure 3 (also drawn as the dashed curve in Figure 4). Higher reactivity of employment to labor costs makes it less attractive to bid up the wage. Hence, even if the aspects captured by $\beta_i < 1$ remain relevant (for example, because financial markets remain underdeveloped), policy objectives are better pursued by a smaller markup: the relevant reforms, as indicated in the figure, would be conducive to higher employment, at point R. But if labor relations and tax-subsidy schemes are not reformed appropriately, then more elastic labor demand can associate integration and unchanged labor costs with lower employment, as in Bertola and Boeri (2002) and Blanchard and Philippon (2004).

Figure 4. Effects of more elastic labor demand, with and without reform



Note: Parameters: $\eta = 0.33$ (dashed line), 0.2 (solid line); $\beta = 0.5$, $\omega = 1$.

In Figure 4, integration and an unchanged markup bring the economy to point N, where employment and worker welfare are both lower; reform instead reduces wages and increases employment, at

point R. The former outcome may be more likely in larger countries which, by virtue of their relatively lower exposure to external influence and their higher internal heterogeneity, can more easily fail to perceive the need for reform and be less able to react appropriately. As drawn, however, the figure implies that also at point R, the workers' surplus is lower than before integration and reform. By construction, integration is beneficial at the aggregate level but, in the parametric example shown, more than all its benefits accrue to owners of production factors different from labor. And Appendix A.2 uses the stylized framework to show that, in a second-best setting where policies address issues that are (perceived to be) worthwhile, economic integration can decrease welfare not only if policies fail to adapt to new circumstances, but also if reforms take place independently and in an uncoordinated fashion across interdependent labor markets. While the wage is set in each country on the basis of flatter labor demand, overall welfare maximization would need to take into account that each labor demand curve's position depends on the wage set in the other market. Uncoordinated deregulation on the basis of the more elastic schedule facing each country, as in Figure 4, would fail to maximize a welfare objective that, in the aggregate, should still be based on the steeper schedule that disregards cross-country substitution possibilities.

The simple formal framework of the Appendix can support some suggestive back-of-the envelope calculations. The efficiency gains engendered by economic integration are important but, of course, not enormous: a 20 percent rise in the simple model's labor demand shift parameter implies, at unchanged wages, higher employment, welfare, and production by realistically positive small percentages (the Single Market Program was estimated in the 1988 Cecchini Report to increase European GDP by some 2-6 percent, and in 1996, the effects of the first four years were estimated to be some 1.1-1.5 percent higher GDP; the completion of a single market in services would, according to current estimates, increase GDP by 0.6 percent and employment by 0.3 percent in the medium run: see European Commission, 2005b). Let the elasticity effects of integration be represented by a decline of η from 0.33 to 0.2 and, to put the relevant effects in stark relief, suppose an increase of the cross-elasticity of demand exactly offsets this effect across two symmetric countries. Then, the expressions derived in Appendix A.2 imply that the markup factor falls from 20 percent to about 11 percent if labor income is weighed twice as

much as other income in the policy objective function, and that the objective function falls by some 15 percent, as much of the larger surplus deriving from higher employment accrues to the relatively less important non-labor component of aggregate income.

Even in this very simple framework, it would be more realistic to consider the implications of interactions with non-EU countries, which certainly do not leave unchanged the EU-level aggregate labor demand elasticity, and the implications of effects on the politically relevant objective function of privatizations and improvements in household financial markets. The stylized model and simplistic example leading to substantial welfare losses from integration, however, do offer a representation of problems that loom large in the eyes of those citizens and politicians who, in each Member Country, express resentment against economic insecurities engendered by international economic integration. The removal of barriers to economic integration would certainly improve aggregate welfare if all markets functioned perfectly. But if collective policies are needed to address market failures, and country-specific policymaking processes fail to take into account effects that bear on other countries' welfare, then integration can engender coordination failures. By the same logic that underlies the prohibition of state aid in the EU policy framework, social policy should be coordinated if, at least in each country's eyes, it pursues worthy goals.

In order to exploit the better production and employment opportunities afforded by integration without disregarding the issues represented in the model by the larger weight of labor incomes in the policy's objective function, it would be necessary to formulate appropriately harmonized policies. This is difficult, of course, and especially difficult if the countries—unlike those considered in Appendix A.2, but very much like EU members— are asymmetric in terms of their policy objectives or economic structure. A harmonized policy would call for different policy wedges in markets with differently elastic labor demand schedules, and for cross-country transfers if productivity levels differ. Countries where workers' interests are important may well have incentives to boost their own employment possibilities by increasing other countries' labor costs (Spilimbergo, 1999): a mechanism that is certainly at work across regions of large European countries where uniform wage levels and welfare benefits price workers of less-developed regions out of employment. Empirical information about the relevant parameters is very scarce, all the more so consider-

ing that reality is much more complex than the simple reduced-form model discussed here, and distributional conflicts can easily be as sharp across countries as across workers and other economic agents. To the extent that laissez faire is (perceived to be) suboptimal, however, integration of market relationships without coordination of policy choices can theoretically decrease welfare through second-best interactions, a mechanism that certainly looms large in at least some citizens' current opposition to further economic integration in Europe.

3. Policies and outcomes in the EU and the OECD

The modeling perspective in the previous section represents the concerns and tensions engendered by economic integration in societies where social policies are important in a simple way. It can also offer an organizing framework for the assessment in this section, on the basis of institutional facts and somewhat patchy empirical evidence of the state and evolution of social and labor policies in the EU and comparable non-EU OECD countries.

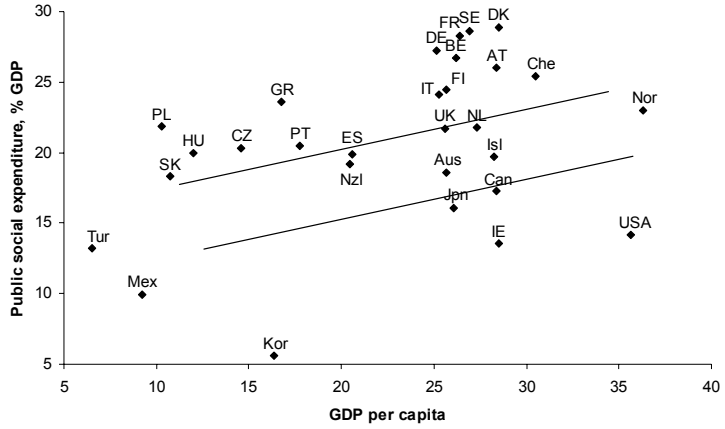
The figures and simple regressions below, besides standard income and labor market indicators, exploit two sources of empirical information as to the configuration and effects of social policies. Eurostat collects and publishes social expenditure data, on the basis of the ESSPROS classification, for current and prospective members and for the 1995-2001 period; for some countries and some years in that period, Eurostat also provides indicators (elaborated from the European Community Household Survey) of the effects of social transfers on income distribution and poverty. The OECD's Social Expenditure Database offers a wider variety of countries and a longer time span (1980-2001 for many countries, shorter for new member countries); it is compiled on the basis of a somewhat different classification, and while offering interesting comparisons with non-EU industrialized countries, it offers more limited coverage of European Union countries (only Poland, the Czech Republic, and Slovakia are OECD members among the 10 accession countries).

3.1. Diversity

Figure 5 plots total public social expenditure in percent of GDP, a rough indicator of social concerns in each country's policy objectives, against GDP per capita. Three unsurprising but still remarkable fea-

tures stand out in the picture. First, there is a tendency—both within the EU and across the wider set of OECD countries—for richer countries to spend more on social policies. Second, EU member countries (labeled in capital letters) tend to spend more, and the US much less, than would be predicted by their income: simple regression lines, plotted in the figure, yield a point estimate of about 8 percentage points for the EU25 membership dummy coefficient (see Table 5 below for a set of related regressions, which confirm that EU25 rather than EU15 membership is the empirically significant driver of European diversity within the set of OECD countries). Third, EU member countries are remarkably homogeneous in terms of their social spending relationship to income (with Ireland as a significant outlier), but very heterogeneous in terms of income levels: the range of EU25 income levels spans almost all the OECD range.

Figure 5. Public social expenditure and per capita income



Notes: The lines are predicted values from a regression with EU25 dummy. See the Appendix for country abbreviations.
Definitions and sources: Public Social Expenditure in 2000 (1999 for Turkey) as percent of GDP, OECD; GDP PPP per capita in 2000, OECD.

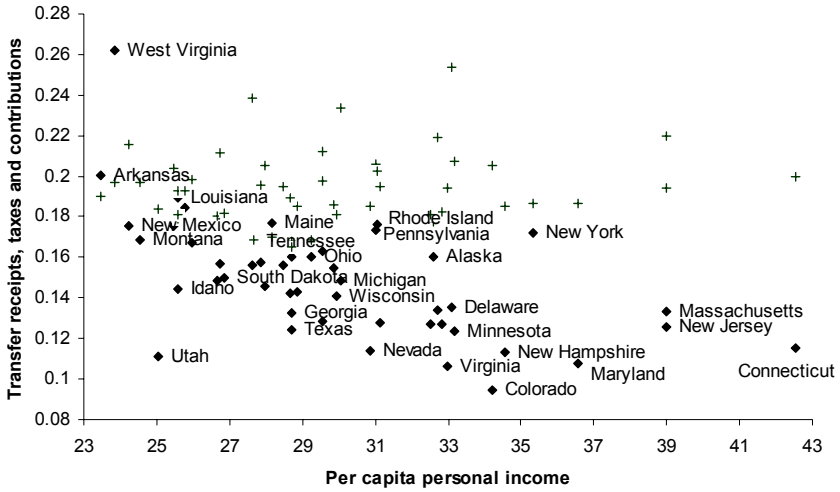
The fact that richer countries feature more than proportionally higher social expenditure is not surprising. Helping (poor) workers decreases employment, but production also depends on many other country-specific features, and richer countries can more easily afford the luxury of caring for their poor. Inequality also depends on coun-

try-specific features, but the fact that social expenditure is higher in Europe than in comparably developed countries indicates that, in Figure 2 and Table 1, at least part of their lower inequality results from collective policies. This common concern with income equalization does not cross country borders, but does cross the borders of US states: while within the EU and across the world, social expenditure is increasing in income (and the US is a negative outlier in that overall relationship), Figure 6 shows that social transfers constitute a higher proportion of income in poorer US states (and, of course, in poorer segments of European nations, such as Southern Italy or Spain, or Eastern Germany). Lower overall expenditure in the US is accompanied by strong cross-state redistribution: social insurance contributions are a remarkably constant fraction of income across US states which show a considerable variation in their respective richness, since as an integrated country where local decision makers would find it hard if at all possible to care for the poor, the US runs or co-finances the bulk of its social policy at the federal level—although important aspects of it, such as unemployment insurance, are state-specific (see Grant and Koeniger, 2005).

Very little such redistribution takes place within the EU. In Figure 5, EU membership appears much more closely related to social expenditure than to income levels, and in this respect EU member countries' concern for welfare policies appears rather homogeneous. There is, however, substantial heterogeneity in the policy toolkits used to pursue those goals: EU member countries do not only devote different amounts of resources to social objectives (reflecting their heterogeneous income levels), but also use different instruments (determined by historical heritages) to pursue those objectives. As discussed in more detail by Esping-Andersen (1990) and Bertola et al. (2001), four different Welfare State "models" can be identified in the EU15 set of countries. Nordic countries (Sweden, Finland, Denmark) and the Netherlands have a tradition of full employment and universal welfare provision with generous unemployment insurance benefits and a very important role for active labor market policies (including job creation in the public sector), while Continental countries (Austria, Belgium, France, and Germany) have a Bismarkian tradition of centralized wage determination, stringent employment protection legislation, and contribution-financed occupational pensions, health services, and unemployment benefits. In these groups of countries, there is only a residual role for social assistance safety nets, which instead

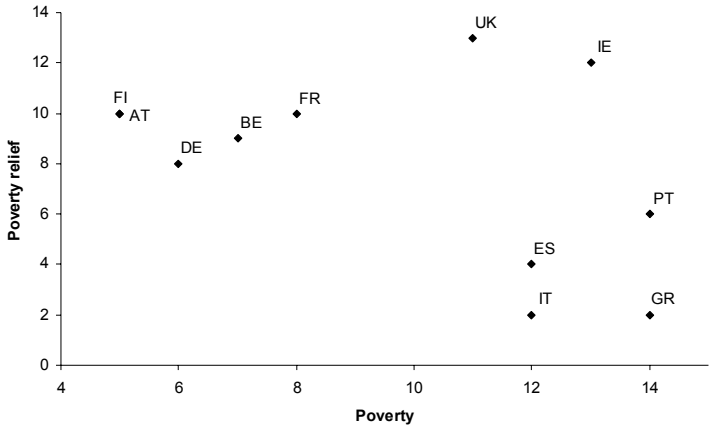
play a Beveridgian poverty-prevention role in the Anglo-Saxon model of the UK and Ireland, whose unregulated labor markets feature relatively low unemployment insurance benefits, little employment protection, and decentralized wage-setting. Southern European countries (Greece, Italy, Portugal, and Spain) have more recent and less precisely defined welfare states, where extended family arrangements still tend to play a nontrivial role.

Figure 6. Social transfers and contributions across states of the US



Notes: Diamonds plot transfers received, crosses plot taxes paid for all US states (some state labels are omitted to reduce clutter).
Definitions and source: income per capita, unadjusted current dollars; federal, state, and local transfers to persons, fraction of personal income; federal, state, local taxes plus social insurance contributions, fraction of personal income; data for 2002, Bureau of Economic Analysis.

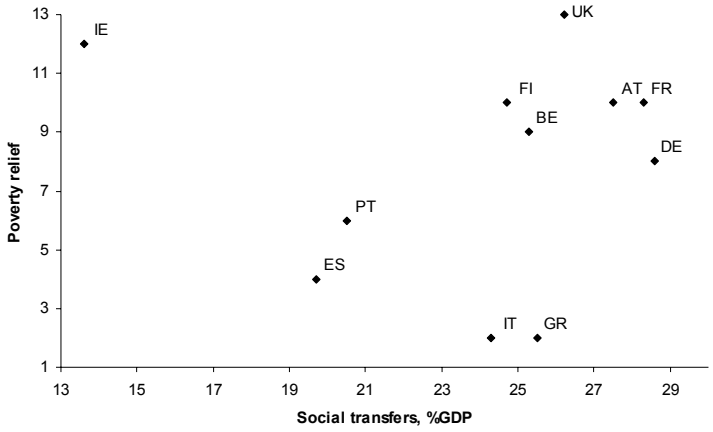
Figure 7. Poverty and poverty relief



Notes: See the Appendix for country abbreviations.
Definition and source: poverty is the percentage of the population with an income lower than 50 percent of the country's median income; poverty relief is the difference between poverty measured after vs before social transfers other than pensions; data for 2000, Eurostat.

Eurostat statistics on the size and impact of social expenditure make it possible to illustrate some aspects of this heterogeneity. In Figure 7, countries for which data on pre-and-post-social transfer poverty rates are available cluster nicely according to the "models" introduced above. Pre-transfer poverty is similarly high in Anglo-Saxon and Mediterranean countries, but is less reduced by social transfers in the latter (where much social expenditure takes the form of old-age pensions). And Figure 8 shows that higher social policy expenditure does have effects on poverty rates, but rather heterogeneous ones: Ireland is a positive outlier, and Italy and Greece are negative outliers, in a noisy upward relationship between social expenditure and poverty relief.

Figure 8. Social protection benefits and poverty relief



Notes: See the Appendix for country abbreviations.
Definition and source: Social protection benefits, percent of GDP, 2000, Eurostat; poverty relief, as in Figure 7.

3.2. Outcomes and dynamics

The "side effects" of social and labor market policy, on which much has been written (Bertola, Blau and Kahn 2002; Nickell et al., 2005, and their references), are not readily apparent in cross-sectional data. In the top panel of Figure 9, for example, the countries where social transfers are more generous are also those that have higher employment rates. But it would be naïve to conclude from that simple relationship that poverty relief has no negative effects, or that all EU countries would benefit from adopting the social welfare model of countries that empirically feature both effective poverty relief and high employment, because each country's policies and their effects depend on country-specific characteristics. It is, of course, difficult to precisely relate the effects of the various policies in the stylized model and in the real world to measured employment and unemployment. The clustering of Mediterranean countries in the bottom-left corner is an important clue to the relevance of female participation and the strength of family welfare relationships. The position of the Scandinavian countries in the figure may reflect the fact that solidarity concerns depend on within-country social homogeneity (Alesina and Glaeser, 2004), and that the effects on work incentives of redistribu-

tion and poverty-reducing policies may be less negative in countries where uniform ethnic and social backgrounds make their administration easier by reducing information problems. However, the positive and negative effects of each country's policy framework cannot be assessed on the basis of the simple statistics plotted in a two dimensional figure. The costs and benefits of some of the (public) employment and active policies in the Nordic model, for example, may well be akin to those of non-employment in other countries (see Algan et al., 2002, for a cross-country analysis of the labor-market motivation and effects of public employment). Inequality also differs across countries: Checchi and García Peñalosa (2005) study the impact on inequality of other labor market institutions such as union density, unemployment benefits, and tax wedges, and find it to be significant.

While neither a thorough review of the findings of the literature nor detailed statistical analysis are possible here, it is worth briefly exploring whether a tradeoff between employment and equality is instead apparent when focusing on within-country dynamic developments. In the bottom panel of Figure 9, the deviations from country-specific means of poverty relief and employment indicators do tend to align along a downward relationship for the same countries that, in the top panel, displayed an upward cross-sectional relationship between those indicators. This and other evidence is consistent with a movement along (different, and possibly shifting) tradeoffs of the type discussed in Section 3. The regressions reported in Table 2 confirm that while the cross-sectional relationship between the poverty impact of social transfers and employment rates is positive, controlling for country dummies identifies a sharply negative relationship in within-country variation during the (admittedly short) period when data are available. Some of the employment rate dynamics are cyclical, as indicated by the significantly positive coefficient of output gap indicators. But even after controlling for that indicator, poverty relief dynamics are negatively associated with employment rate developments, and (in the last three columns of Table 2) appear to feature the kind of mean-reverting dynamics that may justify "race-to-the-bottom" concerns on the part of European citizens.

Figure 9a. Poverty relief and employment

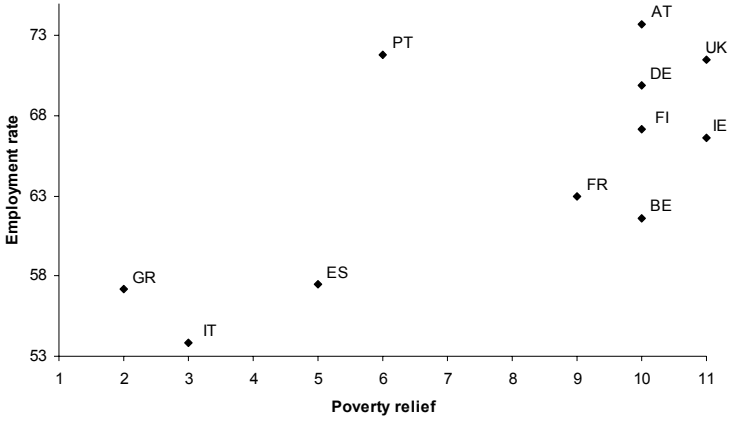
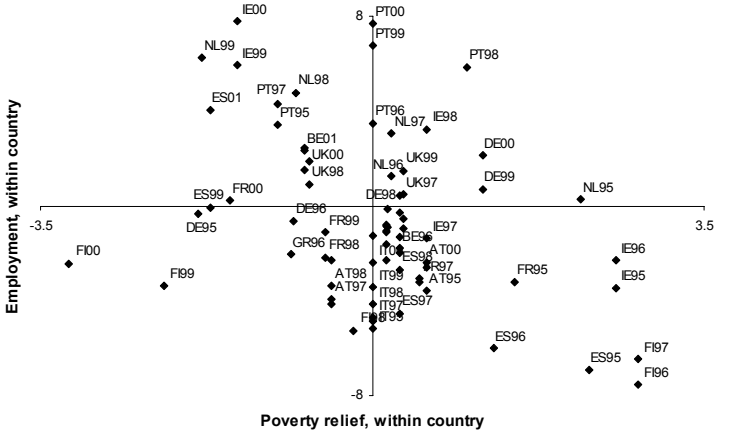


Figure 9b. Poverty relief and employment



Notes: Top panel: data for 2000; bottom panel: deviations from country means. See the Appendix for country abbreviations. In the bottom panel, two digits identify the observation year and some points are not labeled to reduce clutter.
Definition and sources: employment rate of working age population, OECD; poverty relief, as in Figure 7.

Table 2. Poverty relief and employment in EU countries

Dependent variable:	Employment rate			Poverty relief		
Poverty relief	0.65	-1.27	-0.45			
	(3.29)	(7.18)	(3.35)			
Year			0.48			
			(4.84)			
Lagged dependent variable				0.73	0.91	0.55
				(7.45)	(32.31)	(4.82)
Output gap			0.56		-0.03	-0.22
			(4.03)		(0.60)	(2.79)
Country dummies		Yes	Yes	Yes		Yes
Constant	Yes				Yes	
Observations	77	77	77	65	65	65
R-squared	0.13	0.94	0.98	0.96	0.95	0.97

Notes: Sample: 1995-2001, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal, United Kingdom. Poverty relief is measured as the difference between the percentages before and after social transfers (other than pensions) of citizens with an income lower than half the median income in the country.
Source: poverty rates before and after social transfers other than pensions: Eurostat (based on ECHP survey statistics); employment rate of the working age population, output gap: OECD. Absolute value of t statistics in parentheses.

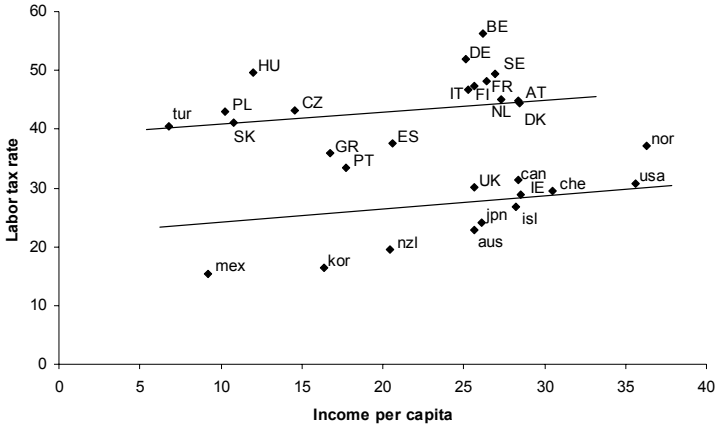
Table 3. Taxes, social subsidies, and employment outcomes

Dependent variable	Employment rate of working age population						
Labor tax rate	-0.68	-0.30	-0.35	-0.68	-0.12	-0.14	-0.38
	(3.49)	(2.80)	(2.96)	(3.41)	(1.60)	(1.45)	(1.57)
Labor tax rate & EU25					-0.45	-0.44	-0.12
					(2.73)	(2.10)	(0.39)
Social expenditure	1.12	-0.46	-0.58	1.14	-0.45	-0.26	1.27
	(4.73)	(3.28)	(3.79)	(4.64)	(3.23)	(1.32)	(3.98)
Social expenditure & EU25					0.10	-0.39	-0.17
					(0.47)	(1.41)	(0.33)
Country dummies		yes	yes		yes	yes	
Year dummies		yes		yes	yes		yes
Constant	Yes						
Observations	275	275	275	275	275	275	275
R-squared	0.34	0.97	0.96	0.36	0.98	0.97	0.43

Notes: Sample: OECD countries, 1991-2002. Taxes as a percentage of labor cost and total public social expenditure as a percentage of GDP.
Source: OECD. Absolute value of t statistics in parentheses.

In the wider and longer OECD sample of countries, measures of the poverty-prevention effects on social policy are not available, but social policy concerns can be measured in terms of the relevant policy instruments. In the real world, as in a tax-and-subsidy interpretation of the simple model of Section 3, labor taxes and non-employment subsidies are chosen so as to improve the welfare of workers as a group. In Figure 10, like in Figure 5, countries that are EU members as of 2005 are marked by upper-case labels. They tend to feature higher labor tax rates than OECD countries with similar income levels: the regression lines indicate that EU membership accounts for almost 20 percentage points of the average production worker's tax wedge; their fit would obviously be improved if Turkey was included in the EU sample and the UK and Ireland joined the—mostly English speaking—subsample of non-EU members.

Figure 10. Labor taxation and GDP per capita

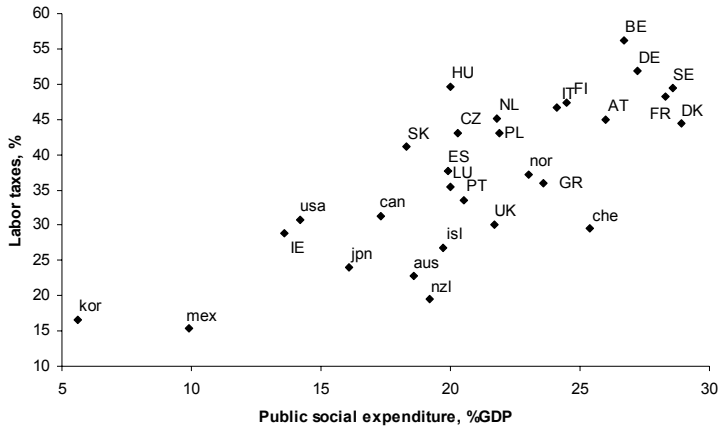


Notes: See the Appendix for country abbreviations. Lines are predicted values of regression with EU25 dummy.
Definitions and source: Taxes on the average production worker as percent of labor cost, 2000, OECD; GDP per capita in PPP, 2000, OECD.

Figure 11 shows that, in cross-section, the tax and transfer components of social policy are broadly positively related across the OECD, and the EU member countries—while substantially heterogeneous, again especially as regards the British and Irish position—cluster together in the high-tax, generous-transfer quadrant of the pic-

ture. The descriptive regressions of Table 3 indicate that social expenditure (but not labor taxes) is in cross-section positively related to employment rates. Controlling for country dummies, however, again makes it possible to detect a statistically significant within-country negative relationship between the strength of social policy intervention and employment rate developments—a relationship that, at least as regards tax rates, appears stronger within the set of EU countries (as indicated by the coefficients of interactions with the EU membership dummy) than across the whole of the OECD.

Figure 11. Social expenditure and labor taxes



Notes: See the Appendix for country abbreviations.
Definitions and source: Taxes on the average production worker as percent of labor cost, 2000, OECD; Public Social Expenditure in 2000 as percent of GDP, OECD.

A similarly suggestive indication of the relevance of policy interactions along the theoretical tradeoffs illustrated in Section 3 is given by the regressions reported in Table 4, which use indicators of administrative extension of contractual wage minima and unemployment expenditure, along with labor tax rates, as explanatory variables for unemployment rates. More effective collective bargaining and more generous unemployment expenditure (controlling for year dummies) are unsurprisingly associated with higher unemployment rates along country-specific recent experiences, albeit with no significant role for EU-membership interactions. And Table 5 uses descriptive regressions to summarize the configuration and dynamics of labor tax and

social spending across new and older EU members, in comparison to other OECD countries. Cross-sectional relationships confirm that, as was apparent in Figures 5 and 11, EU membership (with no significant distinction between old and new members) and income levels explain about 50 percent of the cross-country variation in taxes and policies; and simple autoregressions, controlling for cyclical factors by output gap indicators, confirm the stability of country-specific policies that was apparent in Figure 11, and detect little sign of faster convergence within the EU.

Table 4. Collective bargaining, taxes, unemployment subsidies, and unemployment outcomes

Dependent variable	**Unemployment rate**						
Collective contract coverage	0.04	0.01	-0.02	0.01	0.08	-0.01	0.10
	(2.34)	(0.51)	(0.38)	(0.60)	(2.63)	(0.62)	(3.41)
Collective contract coverage & EU25		0.02	-0.01			0.01	-0.05
		(1.19)	(0.06)			(0.16)	(0.65)
Tax on the average production worker, percent labor cost				0.03	0.27	-0.03	0.24
				(0.44)	(4.20)	(0.45)	(3.53)
Tax on the avg. prod. worker & EU25						0.10	0.05
						(1.13)	(0.45)
Unemployment public expenditure, percent of GDP				1.21	2.53	3.59	3.24
				(1.39)	(6.96)	(6.51)	(5.80)
Unemp. public expenditure & EU25						-2.78	-0.89
						(2.38)	(1.87)
Country dummies			Yes		Yes		Yes
Year dummies			Yes		Yes		Yes
Constant	Yes	Yes		Yes		Yes	
Observations	360	360	360	194	194	194	194
R-squared	0.10	0.13	0.79	0.25	0.95	0.31	0.95

Notes: Sample: OECD countries, 1986-2002 or 1991-2001 depending on data availability.
Source: OECD. Absolute value of t statistics in parentheses.

Table 5. Levels and dynamics of taxes and social expenditure in the EU and the OECD

	(1)	(2)	(3)	(4)	(5)	(6)
Dependent variable:	**Public social expenditure,percent of GDP**			**Tax on the aver. production worker, percent of labor cost**		
EU25 dummy	5.74			19.07		
	(1.80)			(3.71)		
EU15 dummy	0.90	-0.09	0.40	-3.77	-2.17	-0.88
	(0.29)	(0.20)	(0.61)	(0.72)	(2.21)	(0.85)
GDP per capita, PPP	0.18		-0.00	0.13		0.02
	(1.49)		(0.05)	(0.69)		(0.66)
Lagged dependent variable		0.95	0.96		0.97	0.98
		(74.67)	(37.19)		(64.00)	(27.76)
Lagged dep.var. & EU15		0.00	-0.02		0.05	0.02
		(0.05)	(0.78)		(2.01)	(0.61)
Output gap			-0.06			-0.18
			(1.49)			(2.80)
Constant	Yes	Yes	Yes	Yes	Yes	Yes
Observations	29	202	147	30	231	148
R-squared	0.50	0.99	0.98	0.53	0.98	0.99

Notes: Columns (1) and (4): Cross-section, 2000. Other columns: unbalanced panel regressions, 1991-2002 (shorter if missing observations).
Source: OECD, sample based on data availability. Absolute value of t statistics in parentheses.

4. European Union policy

Among its goals, the 1960 Treaty of Rome mentioned improved working conditions, "so as to make possible their harmonization," especially "with regard to equal pay for equal work for men and women and paid holiday schemes" (Bean et al., 1998, discuss this and other vibrant and largely unenforced social concerns in European treaties in detail). More generally, the European integration process that started in the aftermath of World War II with the primary objective of preventing further wars in Europe, and which was primarily pursued by economic policy instruments, has always shown an awareness that the development and integration of market relationships may encounter decisive opposition in the absence of "social" accompanying measures. This concern is theoretically justified by the arguments sketched in Section 2 and by member countries' clear and persistent inclination, documented in Section 3, to pursue social policy

goals. The evidence of Section 3, however, also indicates that EU member countries remain heterogeneous in many relevant respects.

This section illustrates how EU-level policy action, while dismantling barriers to mobility of goods and factors of production and taking unprecedented steps in the Eurozone towards a thoroughly unified macroeconomic policy environment, has so far been ineffective in social policy fields nearer people's lives. Social and labor market policies are almost completely subsidiary, as most EU legislation in this area is subject to unanimity requirements, and the attractive Lisbon Strategy "growth and jobs" buzzwords are not pursued by anything more than statements of principle. The EU Constitution stipulates decision processes and majority rules (Article I-25) that would be more appropriate for a EU of 25 counties than those decided in Nice. Other than that, however, it largely coincides with the content of previous Treaties. As regards social and labor market policies, it inherits their ambivalence, and the often awkward wording of the articles in the Constitution paints a faithful picture of the high principles and toothless implementation lining the path of European social-policy processes.

The objectives listed in Art.I-3 are, first and foremost, "to promote peace" and offer a borderless "internal market where competition is free and undistorted." Social aspects are the objectives of a longer paragraph citing a "highly competitive social market economy," "social progress," and promising that the Union "shall combat social exclusion and discrimination, and shall promote social justice and protection". All this, however, need not lead to any practical action. Art.I-5 states the Union's obligation to "respect the equality of Member States before the constitution as well as their national identities," Art.I.8 formulates the "United in diversity" motto, and Article I-11 states the subsidiarity principle: in areas which do not fall under its exclusive competence, the Community shall take action "… only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States, …" Social policy is listed in Art.I-14 as an area of shared competence, but only "for the aspects defined in Part III." And while Title IV ("Solidarity") of Part II's Charter of Fundamental Rights of the Union forcefully states highly "social" principles (such as the right for workers to "negotiate and conclude collective agreements", to have "protection against unjustified dismissal", and to receive "social security benefits and social services … in the case of loss of employment"), the discussion of "In-

ternal policies and action" in Title III of Part III paints a diminutive picture of the Union's responsibilities in the social and employment areas. Chapters I and II deal with Internal Market and Economic and Monetary Policy matters, respectively, and while restating well-established principles, they deny the member states the ability to implement policies at the national level in those areas. Chapter III's treatment of Policies in Other Areas also states important principles, but mostly in order to deny policymaking to the Union.

Among "Policies in Other Areas," it is interesting to consider the provisions on "regard to the requirements of animal welfare" in Article III-121. Its wording is typical of provisions in the Social and Employment policy area and deserves to be reproduced in full: "In formulating and implementing the Union's agriculture, fisheries, transport, internal market, research and technological development and space policies, the Union and the Member States shall, since animals are sentient beings, pay full regard to the requirements of animal welfare, while respecting the legislative or administrative provisions and customs of Member States relating in particular to religious rites, cultural traditions and regional heritage." This Constitutional provision originates from a Protocol on the Protection and Welfare of Animals annexed to the Treaty at British insistence when the 1997 Amsterdam Treaty incorporated the Social Chapter that the UK had refused to sign in its earlier shape as the 1989 Community Charter of the Fundamental Social Rights of Workers, and now appears in Part II of the EU Constitution. Like many of the articles in the Constitution's Title III-Part III-Chapter III, Article III-121 includes a debatable but inconsequential assertion of principle ("animals are sentient beings") and a firm statement, originating in earlier obscure political compromises, that there are many reasons for member states to formulate their own laws on such matters.

The stipulations regarding Employment (in Section 1) and Social Policy (in Section 2) have much the same flavor. On employment policies, only "exchanges of information and best practices" are envisioned, coordinated and monitored by the Commission, following in the steps of the Luxembourg and Lisbon "processes."

On social policies, Article III-210 identifies areas where shared EU legislation competence might "establish minimum requirements for gradual implementation," and stipulates an intricate ranking of decision ease among them:

- in the fields of "(a) improvement in particular of the working environment to protect workers' health and safety; (b) working conditions; … (e) the information and consultation of workers; …. (h) the integration of persons excluded from the labour market, without prejudice to Article III-283; (i) equality between women and men with regard to labour market opportunities and treatment at work," the normal qualified-majority codecision process would apply to any legislative action, while:
- unanimity would still be required for legislation regarding "(c) social security and social protection of workers," as wells as for "(d) protection of workers where their employment contract is terminated; … (f) representation and collective defence of the interests of workers and employers, including codetermination, subject to paragraph 6; (g) conditions of employment for third-country nationals legally residing in Union territory;" should the Constitution be ratified, however, in the latter three fields, a unanimous decision could relax the unanimity requirement.
- In the remaining two fields listed, "(j) the combating of social exclusion; (k) the modernisation of social protection systems without prejudice to point (c)," the only action foreseen is "European laws or framework laws [that] may establish measures designed to encourage cooperation between Member States," along the same lines as those foreseen for Employment policies, "excluding any harmonisation of the laws and regulations of the Member States."
- "pay, the right of association, the right to strike or the right to impose lockouts," while mentioned in the context of the Fundamental Rights list, are explicitly excluded from the scope of Art.III-121.

Without considering the historical roots of EU policy processes and the extent of cross-country heterogeneity in the relevant respect, it would be hard to see why the various aspects of social policy are treated so differently in this Article: after all, as discussed in Section 3 above, all are meant to pursue very similar goals of balancing of economic efficiency and equity in imperfect market settings, and all face tradeoffs that are theoretically influenced by economic integration. To some extent, the fields singled out for EU action may be those where national institutions are more similar. To a larger extent, however, this intricate set of provisions—like the provisions on animal welfare quoted above—is rooted in historical Treaty negotiations, focused on "level playing field" competitiveness concerns. The 1957 Treaty of

Rome already singled out for harmonisation equal pay for equal work for men and women (since the French already required it under national law and feared foreign competition in industries employing a large fraction of female workers; the principle still rates a full Article, III-214) and paid holiday schemes, which like other working conditions provisions are by now established as an important area of the acquis communautaire. Other policy areas were included in subsequent Treaties as a result of somewhat random give-and-take negotiations. Legislative action is most stringently limited in areas where the member countries' policy framework is most heterogeneous. But areas where Community legislation is allowed need not be the most important ones from the theoretical perspective sketched in the previous section, and this may justify perceptions, on the part of European citizens, of an excessively market-oriented EU integration process. At the same time, action is intense in the areas were political compromises make it possible, and this may justify symmetric perceptions of excessive regulation and preoccupation with relatively inconsequential "social" objectives, as for example in the case of the controversial Working Time Directive and the recently scrapped draft *Physical Agents (Optical Radiation) Directive* meant to protect workers—as allowed sub (a)—from sunshine.

The member countries obviously feel that all of their citizens' concerns should be safeguarded in the integrated EU's policy framework, but also feel that those concerns are so different from those of other countries' citizens as to make it unadvisable to delegate the relevant safeguards to supranational policy processes. The final provisions of III.210, in fact, state that "The European laws and framework laws adopted pursuant to this Article: (a) shall not affect the right of Member States to define the fundamental principles of their social security systems and must not significantly affect the financial equilibrium of such systems; (b) shall not prevent any Member State from maintaining or introducing more stringent protective measures compatible with the Constitution." Concern about the welfare of animals is certainly stronger in Britain than in Continental Europe, and the converse is true as regards the inclination towards social policy government action. A rather dysfunctional policy framework makes it exceedingly difficult to mediate all such concerns in the light of the relevant tradeoffs, aiming at fostering welfare through appropriate reforms and changes rather than at preserving each country's status quo.

Lacking legislative powers, EU policy interactions have resorted to rather ineffective "open coordination" processes. The revised Lisbon guidelines (European Commission, 2005b) are appropriately aware of their own implementation shortfall, due to lack of policy instruments, and to some extent acknowledge the need to take into account the relevance of country-specific circumstances, rather than trying to fit to all a specific policy framework (such as the Nordic model of the Amsterdam process). European policy guidelines, however, still steer clear of recommending positive, coordinated social action. While it is easy to understand why, it is also increasingly clear that the absence of a social dimension leads most European citizens to reject European integration. As in the case of the rejections of the Constitutional Treaty in the French and Dutch referenda, European integration is perceived negatively as a source of meaningless interference with country-specific arrangements.

In this complex framework, an important source of policy tensions is the interaction of fundamental rights, enforced by the European Court of Justice (ECJ), with national competencies in the social protection area. Some controversy has surrounded provisions for access to social services. Indirect effects, of the type discussed above, are potentially much more powerful than direct reliance by immigrants on the host country's social welfare system. The latter is much more visible, however, and has been extensively studied in the US context, where labor mobility limits the ability of states and other local constituencies to provide welfare services, which are therefore co-financed at the federal level. As discussed above, labor market and social policy spillovers are potentially important (through product-market competition) even in the absence of labor mobility. In the European context, however, important tensions may arise from the interaction of the right to personal mobility (Article I-10) and the entitlement to "social security benefits and social advantages" (Article II-94). The recent Directive 2004/38/EC (updating 90/364 and other previous directives) grants the right of residence for longer than 3 months to workers also when they become temporarily unable to work because of illness or accident, or involuntarily unemployed and duly register as job seekers (provided that they have worked for at least a year; if employment lasted less than a year, the right to residence is not open-ended but must be extended for at least 6 months), or to non-working individuals who "have sufficient resources for themselves and their family members not to become a burden on the

social assistance system of the host Member State during their period of residence and have comprehensive sickness insurance cover in the host Member State." The latter provision may, in principle, allow benefit-seeking migration, and ECJ decisions based on the notion of fundamental European citizenship rights in an environment of locally provided services. It is hard to see what else could be legislated, if mobility is to be targeted as a fundamental feature of the EU, however, and the tension should be addressed by appropriate supranational policy measures.

5. Conclusion: The case for a social Europe

Cross-country evidence indicates that concern for the poor is a luxury and will become increasingly less affordable for the rich countries of Europe if inefficient economies fail to provide the necessary resources. As argued by Sapir et al. (2004), European economic policy should therefore aim at growth and prosperity, as means to all social goals. This paper has discussed the possible role of social and labor policies in preventing European integration from fostering growth. In a more competitive economy, labor becomes easier to substitute, and any given interference with *laissez faire* labor market outcomes implies larger employment losses. Hence, reforms are needed in order to foster employment and growth. But their design should take into account that labor and social policies do serve useful purposes in the eyes of the many European citizens, and that in an integrated economy, the distributional implications of uncoordinated country-level deregulation may be even less palatable than the welfare losses implied by obsolete labor market institutions.

So far, EU policy processes have envisioned social-policy convergence and co-ordination as the automatic result of economic integration and national reforms by countries sharing a common social model, facing common challenges, and sharing information through "soft" coordination processes. Empirically, this hopeful scheme has failed to either spur reform or appease suspicions of downward pressure on cherished labor market arrangements. Reforms are hesitant and politically unpopular as European citizens are more inclined to attribute their economic woes to economic integration (especially its more visible aspects, such as the single currency and immigration) than to national welfare systems. The tension between economic integration and the lack of social policies at the EU level is unlikely to be

resolved by labor market deregulation as long as household financial markets remain undeveloped and social exclusion remains politically unpalatable. Deregulation of labor and social policies is an extremely unlikely outcome in any European country, and resistance to integration (as in the case of the Services Directive) is understandably strong as long as the EU's lack of a US-style federal safety net engenders a race-to-the-bottom fear.

How can Europe step out from the current deadlock where poor economic performance leads voters and politicians to try to protect national welfare systems from heartless market interactions, and market incompleteness, in turn, justifies attachment to welfare policies (e.g. because workers cannot access alternative financial instruments)? Since social policies strive to solve collective problems at the collective level, the much-needed modernization of the welfare systems of many European countries should take place in the context of explicit supranational policymaking targeted at social and labor market policies. As in all other policy areas, agreement is difficult across heterogeneous countries, and centralization has both advantages and disadvantages. But the EU can hardly continue to strive for one market and one money as long as it features a considerable number of labor markets, and economic integration will stall if it is perceived to conflict with social policy objectives. The development of broader social policy instruments has proceeded apace with the enlargement of economic interaction beyond the boundaries of villages and parishes. As economic relationships overcome national borders, purely national decision-making powers are theoretically inconsistent with unfettered market interaction and effective policies in the labor-market and social protection area (Bertola, 2004), for much the same reasons as those that have motivated the attribution to EU-level policy making of industrial policies, enforcement of Single Market rules, and monetary policy. Uncoordinated macroeconomic policies, fixed exchange rates, and free trade with capital mobility coexisted uneasily before the Economic and Monetary Union (Padoa-Schioppa, 1994), and uncoordinated state aid would inefficiently try to distort market incentives. Similarly, when labor market policy instruments pursue their goals in an integrated economic environment, their effects and implementation depend on elasticities that, as illustrated by the simple arguments of Section 3, reflect the wider scope of economic interactions and may not be fully taken into account by decision makers.

The results of the French and Dutch referenda and the uncertain fate of the Services Directive indicate that integration of social policies in a coherent EU policy framework is needed if economic integration is to continue. Two complementary directions of progress can be identified. First, resistance to social policy reforms and labor market deregulation may be reduced by the development of inexpensive access by households to transparent financial markets as in the US and other Anglo-Saxon countries. Reform not only of labor markets, but also of financial markets is needed in Continental and Southern Europe. EU-level policies can facilitate suitable reforms, by dismantling barriers to cross-border competition and distancing regulators from industry interests. Appropriately regulated competition in household financial services would improve efficiency and, unlike more intense competition in the goods and personal services markets, would tend to fulfill the same goals of public insurance schemes instead of undermining them without offering alternative means of protecting consumption from idiosyncratic shocks.

Second, more of the policymaking and financial resources of the supranational EU institutions could be explicitly targeted to social and labor policies. A restructuring fund for retraining displaced workers (Sapir et al., 2004), or co-financing of basic safety net subsidies combined with monitoring of the actuarial fairness of other social programs (Bertola et al., 2001), would arguably target more urgent goals than the Common Agricultural Policy which currently absorbs about half of the EU budget. The very heterogeneous level of development of EU25 member countries would certainly make such schemes controversial in a political setting that still privileges national fiscal prerogatives, but the relevant tensions need not be much more intense than those present in the context of the current EU budget: disbursing 10 purchasing-power-corrected dollars to all EU15 citizens earning less than 20PPP$ per day would cost about 1.3 percent of EU15 GDP, and cofinancing half of that budget would generate smaller imbalances across EU15 countries than those currently observed (Bertola, 2005).

Engineering appropriate harmonization and integration of markets and policies is a complex task. It is all the more difficult in the absence of continent-wide political interactions and a common political language such as exist in the United States and might conceivably develop in Europe if personal mobility approached US-style ease and intensity. Personal mobility, however, in turn requires a federal layer

of social policies, developed in the US only in the 20th century (while the 18th century Constitution, like the operative portions of the European Treaties, focused on "the regulation of commerce"). Politics, policies, and market structure will hopefully converge to a framework suitable for efficient continent-wide economics also in the European Union, which will in the meantime need to cope with tensions between resistance to economic integration and the development of suitably harmonized social and labor market policies.

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Appendix

A.1. Employment and wages in a model of policy interference

Consider a constant elasticity inverse labor demand schedule $W_i = \left(L_i / A_i\right)^{-\eta}$, where W denotes the wage rate, L denotes employment, A is a productivity level index, and subscript i refers to a country. Let all units of labor have a constant opportunity cost ω_i, so that labor supply is horizontal. In competitive equilibrium, $W_i = \omega_i$: producer surplus is maximal at $\frac{1}{1-\eta} A_i \left(\omega_i\right)^{\frac{\eta-1}{\eta}} - \omega_i L_i = \frac{\eta}{1-\eta} A_i \left(\omega_i\right)^{\frac{\eta-1}{\eta}}$, but none of it accrues to workers, whose surplus $\left(W_i - \omega_i\right) L_i = 0$.

Consider the implications of institutions and policies that increase labor costs W_i above ω_i. Employment $L_i = A_i \left(W_i\right)^{-\frac{1}{\eta}}$ is decreasing in W_i, but worker's surplus $\left(W_i - \omega_i\right) L_i = \left(W_i - \omega_i\right) A_i \left(W_i\right)^{-\frac{1}{\eta}}$ is positive if $W_i > \omega_i$, and an inverse-U shaped function of W_i. Output is $\frac{1}{1-\eta} A_i^{\eta} \left(L_i\right)^{1-\eta} = \frac{1}{1-\eta} A_i \left(W_i\right)^{\frac{\eta-1}{\eta}}$, and profits are given by $\frac{1}{1-\eta} A_i \left(W_i\right)^{\frac{\eta-1}{\eta}} - W_i L_i = \frac{\eta}{1-\eta} A_i \left(W_i\right)^{\frac{\eta-1}{\eta}}$.

Suppose that the policies that determine W_i aim at maximizing workers' surplus plus β_i times profits. Maximization of

$$A_i \left(\left(W_i\right)^{\frac{\eta-1}{\eta}} - \omega_i \left(W_i\right)^{-\frac{1}{\eta}} \right) + \beta_i \frac{\eta}{1-\eta} A_i \left(W_i\right)^{\frac{\eta-1}{\eta}} =$$

$$A_i \left[\left(1 + \beta \frac{\eta}{1-\eta} \right) \left(W_i\right)^{\frac{\eta-1}{\eta}} - \omega_i \left(W_i\right)^{-\frac{1}{\eta}} \right]$$

with respect to W_i yields $W_i = \left(1 - (1-\beta_i)\eta\right)^{-1} \omega_i$: if $\beta_i < 1$, i.e. profits have a lower weight than workers' surplus in the objective function, then the wage is marked up labor's opportunity cost.

A.2. Economic integration and welfare in a model of second-best policy

To represent the consequences of economic integration of two countries whose labor markets are represented by the model of Appendix A.1, let the elasticity and level of their labor demand schedules change as follows:

- Employment becomes a more elastic function of labor costs after integration. Hence, the elasticity of the inverse labor demand considered in Appendix A.1 is smaller*:* if a subscript 0 identifies before-integration parameters, and a subscript 1 after-integration ones, $\eta_1 < \eta_0$.
- Thus, maximization of the same objective function as in Appendix A.1 implies a smaller markup for country *i*'s given β_i. Labor costs should decline from $W_i = \left(1-(1-\beta_i)\eta_0\right)^{-1}$ to $W_i = \left(1-(1-\beta_i)\eta_1\right)^{-1}$.
- The labor demand shifter can be written as $A_i = \widetilde{A}_i\left(W_j\right)^{\nu}$:

  It is larger after integration, reflecting improved employment opportunities from specialization or economies of scale; and depends in each country on the other's labor costs: with $\nu > 0$ labor demand is *ceteris paribus* higher in country *i* if labor costs are higher in country *j*.

  Hence, the objective function

$$\widetilde{A}_i\left(W_j\right)^{\nu}\left(W_i\right)^{\frac{\eta-1}{\eta}}\left[\left(1+\beta\ \frac{\eta}{1-\eta}\right)-1/W_i\right]$$

  depends on the foreign wage, which in turn depends on the other country's labor market policies.

If the two countries are symmetric, and as η declines ν increases so as to keep constant the aggregate elasticity $-\frac{1}{\eta_i}+\nu=-\xi$, integration and uncoordinated mark-up choices yield welfare $\widetilde{A}_1\left(\frac{\omega}{1-(1-\beta)\eta_1}\right)^{1-\xi}\left[\beta\frac{\eta_1}{1-\eta_1}\right]$. Since $\left(\frac{1-(1-\beta)\eta_1}{1-(1-\beta)\eta_0}\right)<1$ if $\beta<1$, this can fall short

of pre-integration welfare $\widetilde{A}_0\left(\frac{\omega}{1-(1-\beta)\eta_0}\right)^{1-\xi}\left[\beta\frac{\eta_0}{1-\eta_0}\right]$ even when $\widetilde{A}_1\left[\frac{\eta_1}{1-\eta_1}\right] > \widetilde{A}_0\left[\frac{\eta_0}{1-\eta_0}\right]$, i.e., when integration would increase welfare (and employment and production) in the $\beta = 1$ competitive equilibrium.

Table A.1. Country identifiers for figures

AT	Austria	**Jpn**	Japan
Aus	Australia	**Kor**	Korea
BE	Belgium	**LT**	Lithuania
BG	Bulgaria	**LU**	Luxembourg
Can	Canada	**LV**	Latvia
Che	Switzerland	**Mex**	Mexico
CY	Cyprus	**MT**	Malta
CZ	Czech Republic	**NL**	Netherlands
DE	Germany	**Nor**	Norway
DK	Denmark	**Nzl**	New Zealand
EE	Estonia	**PL**	Poland
ES	Spain	**PT**	Portugal
FI	Finland	**RO**	Romania
FR	France	**SE**	Sweden
GR	Greece	**SI**	Slovenia
HR	Croatia	**SK**	Slovakia
HU	Hungary	**SK**	Slovakia
IE	Ireland	**Tur**	Turkey
Isl	Iceland	**UK**	United Kingdom
IT	Italy	**USA**	United States

Notes: EU members and candidate countries are identified by two upper case letters; OECD members that are not EU members are identified by three-letter abbreviations. Other countries, when present, are not abbreviated.