The theory and policy of an EU social federation: Towards laboratory federalism.

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Abstract: The EU has become a loose kind of social federation. Yet the political support for a distinct social policy agenda of the EU remains doubtful. This paper re-examines the cases both for concerted efforts in social policy and for the EU level to play an indispensable role. A theory and policy of "laboratory federalism"is suggested that takes into account that the EU has yet to build consensus as regards its role in social policy matters. The corresponding method of social policy coordination, laboratory standardization, is contrasted to the Open Method of Coordination adopted at the Nice Summit.

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1 Introduction

The evolution of a distinct social policy agenda of the EU is characterized by apparently contradictory traits: On the one hand, the EU represented by the Commission and the Court of Justice gets ever more involved in shaping social policy, an involvement that goes beyond measures to complete the internal market (Falkner 2000). On the other hand, the current political mandate and fiscal means to pursue such an agenda are extremely limited. The Open Method of Social Policy Coordination (OMSPC) is a striking example of this. Adopted at the EU summit in December 2000, the OMSPC is a clear indicator that a loose kind of social federation is already in place, yet the Commission's role is formally rather limited and not one of specifically representing EU-wide concerns.

This lack of a political mandate for the building of an EU social federation that nonetheless is progressing raises some fundamental issues of political economy. The Commission's strategy is risking a political backlash from voters and some Member States' governments, the EU being accused of interventionism and political activism in a policy area that is none of its business. A lack of political support may be due to the Commission doing too little to define and justify a specific role for itself, thus raising legitimate fears of an ever more intrusive bureaucracy. Or, more fundamentally, it may be due to the widely held view that an EU social federation is futile, if not positively harmful.

This is why I suggest to re-examine the cases, first, for an EU social federation, and, secondly, for the EU level, represented by the Commission, to play an indispensable role in social policy matters. We will find, however, that the theory and policy of federalism warranted cannot simply take recourse to the textbook. It must take into account that in the EU a federal consensus about the appropriate level of governance in social policy matters has yet to emerge while the Commission is taking on certain tasks at the same time. This kind of "federal consensus building-on-the-job" points to the idea of *laboratory federalism.*

The approach I suggest is basically of economic origin. This is not because the political dimension of EU social policy seems to me of lesser importance. On the contrary. Both the EU and EMU were created as vehicles that apply economic means, creation of an internal market and a monetary union respectively, to a political end. Therefore, the project of European political integration derives its popular support from a widely shared public perception that it contributes to the economic well-being of the respective country.

The argument will be developed in four steps: In the next section, I discuss why the internal market and the monetary union of Europe might call for some kind of social federation. Then I argue that the traditional public finance approach to federalism is not yet applicable to the EU which is why a complementary approach is required, more precisely one based on the modern insurance view of redistribution that is extended to issues of stabilization. The fourth section is concerned with laboratory federalism by drawing on the recent literature on technical standardization, a literature that deals with strikingly similar market phenomena as the modern insurance view of social policy. It will be pointed out, in particular, what difference the corresponding method of social policy coordination, i.e. *laboratory standardization*, would make to the OMSPC in monitoring domestic reforms.

2 The cases for an EU social federation

The term EU social *federation* will be used here in contrast to social *union*, not in contrast to *confederation*. A (con)federation stands for a multi-tier governance structure where the different tiers or levels have explicitly assigned, exclusive or overlapping, jurisdictions and their own fiscal means to fulfill the respective functions. In that sense, the EU is a federation, because the EU (then EC) got its own revenue base in 1970, the so called "system of own means" (Wagner 1999, 34-35), and it has an overriding jurisdiction to guarantee the four economic freedoms concerning the flow of goods, services, capital, and of EU-citizens in the internal market. In particular, the freedoms related to services and citizens bestow competencies in social policy matters upon the EU Commission and the European Court of Justice that seem to justify applying the term "social federation" to the EU.[1] In contrast, a social union would imply a fiscally centralized, legally unitary system in which the regions or municipalities only serve to implement the social policies of the centre.

The case for a social federation of the EU is basically threefold: First, there is a macroeconomic argument since closer market integration and currency unification for the majority of EU countries leads to a new pattern of aggregate income risks that can only be insured at the central level. Secondly, market integration and enlargement intensify fiscal competition and thus call for some kind of horizontal and vertical policy coordination. And, lastly, EU integration was always driven by the perception of governments that it may help them to find answers to common reform pressures which supports the idea to set up a federation as a laboratory for 'best practices'.

2.1 New pattern of income risks

The most immediate economic rationale for the EU to become a social federation stems form the macroeconomic consequences of the internal market and the monetary union. Together they replace old and create new income risks that can only be pooled at the uppermost level. While a monetary union lessens the risk of exchange-rate instability as a source of country specific shocks, the new risks are basically threefold: (1) an ever more closely synchronized EU business cycle due to market integration, (2) a common price dynamic, i.e. inflationary or deflationary pressures, and (3) a one-size-has-to-fit-all interest rate policy which may affect different regions differently. This is why the central, that is the EU, level has to assume a role in stabilization (Goodhart/Smith 1993). This statement is usually understood to call for closer coordination of EU member states' fiscal policies. But social policy also provides partial insurance against each of the three novel income risks just mentioned.

[1] Falkner (2000) identifies trends in EU social policy that go beyond measures to complete the internal market while Leibfried/Pierson (2000) show how integration, in particular a free market for services, impacts on domestic social welfare provision and reforms.

(1) The first risk which stems from a synchronization of business cycles is the classic realm of automatic or built-in stabilizers, i.e. built into the fiscal system. Such stabilizers are, on the public revenue side, items like social insurance contributions that rise with the rise in aggregate income and, on the expenditure side, items such as unemployment benefits that move countercyclically. These automatic changes serve to dampen aggregate demand in a boom and to support it in a recession.[2]

(2) As regards the second risk, a common price dynamic: Ever since modern social welfare was invented in the New Deal to fight the depression, cash assistance was meant to stabilize the macroeconomy, especially against a downward spiral of falling wages and prices. Cash assistance helps to sustain a floor for nominal wage levels in that it provides an alternative to wage income below a certain level. Therefore cash assistance is an anti-deflationary device along with downward rigid nominal wages and countercyclical net government expenditure. This macroeconomic function of social policy is particularly important to complement monetary policy since a central bank is much less effective in preventing deflation than inflation.[3]

(3) Regions or member states are differently affected by a common interest rate policy of the ECB which sets the course for monetary conditions in all EU countries. Also, if regions or countries experience asymmetric, i.e. region-specific shocks such as a fall in demand for an important regional product, there is no differential monetary policy available to ease adjustment.[4] Social policy cannot truly substitute for differential interest rate policies in member states because its primary impact is on goods and labor markets not on asset markets, and the time horizon is different from that of monetary policy. But the financing of as well as the expenditure on social welfare can dampen or reenforce such deviant regional developments.

These are the macroeconomic cases to be made for EU social policy now that EMU and the internal market have arrived.

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2 Cf. Cohen/Follette (2000) for a recent estimate of automatic stabilization in the U.S. and Kletzer/von Hagen (2000, 4-7) for a comparative overview of automatic stabilization in federal states.

3 Providing cheap refinancing and printing money does not necessarily stimulate commodity demand since households and firms rationally increase their money holdings and wait if they expect prices and wages to fall further. Nor does easy money necessarily induce banks and firms to finance investment if they expect to default for the very reason of weak demand and prices at the beginning of the production process being higher than at the time of sale. After all, real wage costs may even rise for firms whose prices fall faster than nominal wages. In contrast, income maintenance via social benefits effectively stems these deflationary pressures because it stabilizes demand and confines price competition for jobs.

4 For evidence with respect to the U.S., see Carlino/DeFina (1997). They find that the most important factor for a differential impact of the Fed's interest rate policy is a differential demand for long-term credit, e.g. between regions with a high share of manufacturing as compared to regions where service industries dominate.

2.2 Intensified fiscal competition

In a federation such as the EU, fiscal competition between national social welfare regimes intensifies due to enhanced actual mobility or -- more likely -- due to welfare magnetism. The latter concept stands for perceived and feared mobility of potential welfare beneficiaries which may be quite unrelated to actual changes in their mobility (Peterson/Rom 1990, 72-81). Exit and voice, especially the voice of taxpayers, may then generate pressures to cut back on social insurance and taxation to finance it (Atkinson 1996, 294). The bottomline of this argument is that the EU forms a social federation by default, namely its heterogeneity in welfare regimes and income levels leading to an imminent rush to the bottom of welfare provision. Eastern enlargement which will make the economic and monetary union of Europe even more heterogeneous can only lead to more pressures in this regard (Chassard 2001, 308-309).

What is the problem with fiscal competition? From a theoretical point of view, mobility and tax revolt or exit and voice, amount to rational choice of the social welfare system *after* the veil of ignorance has been lifted. Marginally employed households who migrate choose better insurance after they learned that they might depend on it, while better-off households who vote or migrate in favor of leaner welfare provision want to leave an insurance scheme after they learned that they do not need it. The same holds if it is governments that try to attract households with high taxable incomes and to deter the marginally employed ones as permanent residents. The very basis of insurance therefore breaks down, notably not only of social but of private insurance as well.[5]

But there is also a benign interpretation of fiscal competition, namely institutional rivalry leading to more efficient government. This notion of healthy institutional competition goes back to the Tiebout (1956) model which endorses competition for the very reason that it would create a quasi-market for local public goods. According to this line of reasoning, governments should opt for reforms that create a more immediate cost-benefit nexus of social services. After all, high-income taxpayers also value the higher level of public services made possible by higher taxes. Such reforms would surely be welcome. Unfortunately, the potential for such popular reforms seems to be more limited in the realm of redistribution via unemployment insurance and social assistance than in public infrastructure or education. First of all, it is hardly obvious to voters how much social assistance contributes to the containment of crime and destitution, let alone to the containment of deflationary pressure or cyclical volatility. It is non-events that a fairly working social welfare system produces. Moreover, redistribution implies that those who contribute most to the financing are not the greatest beneficiaries. But since social insurance is of a compulsory nature, this is easily rated as unfair. And yet, it has to be compulsory in order to overcome the problem of adverse selection responsible for the failure of some private insurance markets (cf. section 3.2 below).

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5 That is, there is an analogon to market failure, namely systems failure, if social insurance and welfare is economically interpreted as a way to deal with the failure or incompleteness of insurance markets. This is the point of departure of the approach I put forward in section 3.2.

2.3 Common reform pressures

The European integration project got fresh impetus in the 1980s when mainly conservative governments decided that the internal market program was needed to overcome the notorious Eurosclerosis. The goal was to enforce supply-side structural reforms of market and policy regimes considered responsible for high and persistent unemployment (Moravcsik 1999, 293). The same was true for monetary unification: Leading proponents of EMU argued in favor of a common currency because they expected the change of the exchange rate regime to discipline labor market parties and to get reforms accepted which would make labour markets more flexible.[6] The same holds now under a majority of social democratic governments. Like their predecessors, they are preoccupied with the question: how can (reforms of) social insurance make the economy (more) efficient, how can social protection become (again) a productive factor?

As such, the EU is an integral part of domestic reform politics and rhetoric. Reform agendas as regards social welfare and labor markets are pushed by pointing to the budgetary constraints of the Maastricht criteria or the perfection of capital mobility in the internal market. In this respect, EU integration is a variant of the two-level game governments play in international policy coordination, namely one in the supranational or intergovernmental arena and another one in their domestic policy arena. While the domestic arena is usually seen as a constraint for the extent of international cooperation[7], the EU turns this logic upside down. International commitments seem to have served governments to gain room for manoeuvre in dealing with domestic interests. The EU has thus become a social federation because Member State governments are keen to get additional leverage for their domestic reform agendas. The political economy of this reform strategy entails some dangers for the EU Commission because it could easily become the scapegoat for reform failures (Pierson 1998, 156; Chassard 2001, 318).

But an open situation like this, namely the policy area to be federalized being in a state of flux, can also be an opportunity and the very rationale for a federal set-up of social policy. It is an old idea of political economy, going back to the 19th century and recently recalled by Oates (1999, 1131-1134), that a federation can be used as a laboratory for reforms. Learning experiences can be interpreted as public goods for the dissemination of which individual agents, i.e. sovereign governments, have too little incentives. Semi-sovereign governments in a federation, on the other hand, may be quite willing to engage in an exchange of learning experiences because there exist fora and common organisations in which they meet regularly anyway as well as joint constraints and interests vis-à-vis the centre.

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6 Cf. publications by the European Commission (Emerson et al. 1992, 149f.; Buti/Sapir 1998, chap.13).

7 As notoriously applied by Putnam/Henning (1989), the domestic game constrains governments to enter and keep international commitments.

3 The cases for an indispensable role of the EU level

After having reviewed the cases for a distinct social policy of the EU, the following questions arise: Which level of governance, the EU, on the one hand, national and local governments on the other, should assume which operative or financial responsibilities? In particular, what role should the Commission or perhaps a specifically created body representing the central level play? I will first recall the traditional public finance approach to fiscal federalism which should make us aware of the challenges EU social policy faces. This is to show that the traditional approach is not applicable to the political economy of the EU. It would leave us with the conclusion that what is economically sound is politically not feasible. Yet this frustrating message of traditional analysis rests on assumptions that eliminate the most relevant issues raised by an EU social federation. Thus, I suggest a new approach that complements the theory of fiscal federalism. While this approach is primarily concerned with the economics of social policy, the notion of fiscal competition links this theory of social insurance to issues of federalism. This link also extends to the stability concerns that provide the basic economic rationale for an EU social federation in the traditional approach.

3.1 The functional approach to public finance

The theory of fiscal federalism is about decentralized, multi-tier governance structures in economically relevant policymaking (Oates 1999, 1120). Why is there, according to this theory, an a priori case for an indispensable role of the EU level in a decentralized system of redistribution? In the multi-tier governance structure of the EU, the upper tier as represented by the Commission should assume those responsibilities for which lower tiers can hardly substitute.

The traditional theory of fiscal federalism as established by the classic works of Tiebout (1956), Musgrave (1959), and Oates (1972) is based upon the functional approach to public finance.[8] Its point of departure are the three economic functions or branches of public policy: redistribution, stabilization, allocation. Social policy is relevant to all three branches of public policy: Its primary goal is redistribution, from the better off to the worse off and from the luckier ones to the less fortunate. A large part of social policy, namely social insurance, is about the efficient allocation of resources in the economy since it induces the production of insurance services that fill a vacuum left by complete or partial failure of private insurance markets. Finally, stabilization, as outlined in the last section, has been another important function of social policy ever since charity became modern welfare.

- Insofar as it is redistribution, the financing of social policy should be assigned to the central level in order to prevent or constrain tax and welfare competition, the race to the bottom of ever lower taxes and lower spending on this particular public good. The operation of redistributive programs, since it is categorically equivalent to a supply of public goods, can be left to lower levels of government. This assignment follows efficiency considerations.

[8] For excellent overviews of the recent literature cf. Oates (1999) as well as the contributions to a symposium on fiscal federalism, in particular Inman/Rubinfeld (1997) and Qian/Weingast (1997).

- Insofar as social policy is providing a public good such as insurance, the allocation should be decentrally organized so that households can choose the one among different locations that taxes them according to their prefered level of public goods. This is basically an efficiency criterion.
- Finally, insofar as it is (automatic or built-in) stabilization, social policy should be assigned to the central level because only there the risks of regional income formation can be pooled and thus insured. The argument here is one of effectiveness in achieving the very goal of stabilization via social policy.

Thus, traditional public finance approaches to fiscal federalism suggest that we should centralize all financing of social welfare in the EU because this would be the most effective assignment of the redistributive and the stabilizing function. Provision of social welfare services should mainly be the task of local governments at the ground level. This role of the center in financing programs is likely to bestow not only the fiscal power but also considerable regulatory power on the center (Conlan 1998, ch.10).

Given the fiscal and political constraints on EU jurisdiction in social policy matters, this prescription is not likely to be followed in the foreseeable future, however. The approach leaves us with the message that for the time being we in the EU live in a second-best world. The message of textbook economics is not easily dismissed because it makes us aware of imminent threats to the resdistributive and the stabilizing functions that decentralized operation of social policy entails. However, the functional approach to public finance is based on three assumptions that eliminate most of the relevant issues of EU social policy:

1. First of all, it assumes a hypothetical situation of constitutional choice in which a federation is set up from scratch. Yet, the EU has to deal with established social welfare states at the national level. Over time, different social welfare regimes have evolved which are deeply rooted in the socio-economic fabric of the respective countries.[9] As such, they have to be respected as institutionalisations of different views about social solidarity and individual responsibility.
2. Moreover, the functional approach has to assume a basic consensus that the respective policy area, here social policy or parts thereof, should be federalized, to be assigned to the government level that can implement it most effectively. But the role of the central level in social policy is far from uncontested in the EU. For a long time, the Commission was confined to regulate matters relevant to market integration, in particular mobility of EU citizens.[10] Some governments see a "social deficit" in this limited jurisdiction of the EU Commission while others see it as leaving too much scope for intervention.

[9] Cf. Scharpf/Schmidt (2000) for a rich documentation of what this entails for ongoing welfare reforms in twelve OECD countries.

[10] This is, of course, analogous to the U.S. case where nation-wide regulations usually have to be justified by the "inter-state commerce clause" of the constitution. Cf. Falkner (2000) for gradual changes in this regard.

3. Finally, in the traditional approach there is no uncertainty or dissent about the substance, instruments and goals of the policy area to be federalized, again social policy or parts thereof. In contrast, virtually all EU member states would like to reform their labor market regimes and their social insurance systems. But a consensus on how these reforms should look like is unlikely to emerge in the foreseeable future.

For a meaningful policy-oriented analysis of EU social policy, none of the three traditionally made assumptions can be taken as given, assumptions that are also shared by the more recent literature on the political economy of fiscal federalism, the "second generation economic theory of federalism".[11] For an EU social federation, I consider problems that this literature assumes to be already solved more relevant: Should the policy area under consideration, i.e. social policy in the EU, be federalized at all? If so, what is the indispensable role for the central (i.e. EU) level? And how can that federal role be gradually given substance if there is no consensus yet on what it should be? A new approach is required to answer these basic questions prior to an analysis of the more traditional issues.

More specifically, the new approach must replace the setting of quasi-constitutional choice by one that assumes path-dependency, i.e.different levels and stages of economic development which typically correspond with the comprehensiveness or maturity of social insurance. The implicit political economy of a federalist consensus has to be replaced by a political economy in which the central level is complementary to domestic policy agendas because it has a rather weak political legitimacy of its own. And, finally, instead of excluding learning and uncertainty about the very policy area to be federalized a new approach has to provide room for both features.

3.2 The social insurance view of redistribution and stabilization

Laboratory federalism, the new approach I have in mind, ought to be based on the social insurance view of redistribution[12] since that view entails both the case for strong safety nets and for diverse safety nets. Although this view does not have federalism as its point of departure, it assigns an indispensable role to the central level.

The social insurance view of redistribution takes off from the Rawlsian argument that redistribution is a kind of social insurance that risk-averse *homo oeconomicus* would choose behind the veil of ignorance (Rawls 1999, ch.3). Only then can all – including those who turn out to be the lucky and the better off ex post - be expected to consent to compulsory social

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[11] Cf. Qian/Weingast (1997, 84). Two strands can be discerned, namely the Tiebout (1956)-tradition on the agency problems between national electorates and the different tiers of government in the EU, and the Musgrave (1959)-tradition on coordination and incomplete contracting problems among different (EU, national and regional) government levels. Both aspects are of obvious relevance to an EU social federation.

[12] Wildasin (1995, 528n) uses that expression. Its leading proponents make up a rather heterogenous group of economists (e.g. Anthony Atkinson, Nicholas Barr, James Buchanan, John Harsanyi, Hans-Werner Sinn and Hal Varian).

insurance arrangements that entail redistribution, for instance progressive taxation or actuarially unfair contributions of high-income households.

Social insurance is seen as **a public good** that makes up for some failures of private insurance markets. The approach takes recourse to the microeconomic theory of rational choice under uncertainty and asymmetric information. Under these conditions, markets suffer from complete or partial failure. If information about the true risk of those who seek insurance is private, i.e. asymmetrically distributed between the seller and the buyer of an insurance contract, market failure results from adverse selection (asymmetric information ex ante) and moral hazard (asymmetric information about ex post changes in behavior). Typically, this leads to a market outcome in which low-risk individuals, the "good risks", are rationed. They become underinsured because private insurance companies will not offer them full insurance contracts at actuarially fair premia as they cannot discriminate between good and bad risks. Mandatory social insurance is then a cost-efficient way to provide full insurance to all, good and bad risks, although good risks may become overinsured that way (Zweifel/Eisen 2000, 385-389). This is basically due to the fact that its compulsory nature prevents adverse selection.

This view answers the efficiency question that preoccupies reform-minded governments these days. The social welfare state may enhance the efficiency of economies because it allows individuals to bear more risk: "Under the protection of the welfare state, more can be dared." (Sinn 1995, 507) The enabling features of social insurance show up in that individuals become more mobile, acquire more specialized skills, found companies in tiny market niches, or spend more time in educating themselves instead of pursuing gainful employment. More generally, social insurance and redistribution do not necessarily entail a trade-off between efficiency and equity (Sandmo 1995, 473). Market forces tend to select projects which exhibit a positive correlation between risk and return. Therefore social insurance that is effiency-enhancing would show up in an increase in the expected aggregate income without increasing volatility, or vice-versa, in a reduction of volatility at a given mean income.

The risk-efficient level of redistribution is likely to vary with the stages of economic development, namely rising with the maturity of an economy.[13] This is because the efficient level of individual risk-taking varies with preferences for risk and the constraints to insure them. As regards preferences, there is the stylized fact of a positive income elasticity of demand for social insurance, i.e. household expenditure for insurance rising with income and wealth (Zweifel/Eisen 2000, 20-23). This suggests that the risk-efficient level rises with income as well. Simultaneoulsy, the constraints of financing universal insurance also become less binding with rising income and wealth of an economy. Given the positive correlation of risk and return, a normative interpretation of these considerations would be that more individual risk-taking is required if an economy wants to maintain high and rising income levels. This can be seen as an

[13] This statement has to be taken ceteris paribus, i.e. given all other institutional and behavioral factors that determine the attitude towards risk. The hypothetical scenario is one of comparing the same economy with more or less social insurance of income risks, not one of comparing different polities.

a priori case for diversity of social insurance arrangements in a federation of member states as heterogeneous as the EU.

The analysis has immediate implications for the role of the central level in an EU social federation. The economic rationale for redistribution, namely that redistribution insofar it is social insurance makes up for market failure, provides a link. This diagnosis implies a rather **skeptical view of systems competition** between locations. As already mentioned above, both migration of households and fiscal competition between governments tend to undermine the basic insurance principle, namely that insurance has to be contracted behind the 'veil of ignorance', i.e. before the actual risks are revealed. Moreover, in the case of social insurance, systems competition decreases the efficiency of an economy because it undermines a remedy of market failure as Sinn (1998, 6) aptly points out: "Since market failure is at the very basis of the duties of the state, it makes little sense to reintroduce markets through the back door of systems competition." In the EU, given its diversity in development and income levels, competition that leads to convergence is likely to leave all member states less risk-efficient. This calls for some kind of federal intervention to preserve variety. Specific forms of public standardization could be a means to that end as will be discussed below.

What is more, systems competition may not only lead to less efficiency but also to less stability. Even though this approach does not directly speak to the **concerns of macroeconomic stabilization**, it can be complemented in this regard.[14] After all, the traditional economic case for a social federation in Europe largely rests on the stability issues raised by a common currency. A link between the efficiency argument for social insurance and the stabilization arguments can be established by reflecting upon the stochastic distribution of aggregate income. It is the possibility set of single income distributions. In an analysis of (efficient) risk allocation, this possibility set is taken as given. The existence of social insurance then allows risk-averse individuals to choose out of this given set more of those income distributions that promise a higher expected return at the price of greater dispersion. However, while the set, i.e. the distribution of aggregate income, is given for the individual, individual behavior may jeopardize the very fact of it being given. The individual competition for jobs amounts to a negative externality which shows up as an imminent threat to nominal stability. Aggregate income could become more volatile without a corresponding increase in median income if automatic stabilizers cannot be made effective for the EU as a whole. Deflation may even lead to a decline in the expected income for the median household. Unemployment insurance and cash assistance provide nominal anchors for the price level and are thus barriers against that deterioration of the income distribution. If social insurance does not internalize these externalities of individual mobility, integration could result in the possibility set of single income distributions to worsen.

Generally, while the risk-efficiency of a social insurance arrangement refers to the optimum of a given income distribution, social policy is part of the macroeconomic conditions that make for a particular income distribution to be given -- for how optimal the individual can get. More

[14] The social insurance view is applied microeconomic theory. Atkinson (1999) is a notable exception but he is not concerned with linking his macroeconomic analysis with the microeconomic social insurance view.

generally still, the primary redistributive function of social policy cannot be dissociated from its stabilizing function (Atkinson 1999, 20).

The social insurance view of redistribution backs the traditional rationales for strong and diverse safety nets in a heterogenous currency area. In contrast to functional public finance, it does not tell us the appropriate level for social policy in an established federal set-up. But it tells us what the overriding concern of the central tier of government should be, namely to contain systems competition between lower tiers of government in social policy matters. This is deemed necessary to preserve risk-efficient levels of redistribution. In a socio-economic space as heterogeneous as the EU, the criterion of risk-efficiency calls for safeguarding variety since convergence in any direction is likely to provide too much and too little insurance. Finally, this view is even more powerful if stability concerns are taken into account. Its theoretical stance, namely that social insurance has to be seen as a solution to the shortcomings of (market and systems) competition under conditions of uncertainty and asymmetric information, endorses social insurance not only on efficiency grounds but also for the sake of greater macroeconomic stability.

4 Laboratory federalism in EU social policy

Laboratory federalism in social policy starts from the premise that differences between the members of a federation provide opportunities for learning. In a "setting of imperfect information with learning by doing" (Oates 1999, 1132), a federal set-up can be used for spatially limited reform experiments. This is both to internalize the positive and the negative externalities from reforms. Learning experiences is itself a positive externality which those who acquired it have, from a social point of view, too little incentive to exchange them if that involves some effort or costs. Reforms partly or wholly driven by fiscal competition may also generate negative externalities, as outlined above, for instance entail potentially destabilizing spill-overs for others if they weaken the counter-cyclical properties of the social policy budget. To ensure "stability in diversity" is in the self-interest of each member state but since spill-overs are by definition externalities, no national government will have enough incentives to take this fully into account. This is why it is also in their self-interest to have the EU provide that public good, namely to monitor reform processes with the objective that Member States internalize such externalities.

4.1 Public standardization and social insurance

Laboratory federalism can build on a tried EU method of social policy coordination, namely the minimum requirements framework, in that it is a specific approach to standardization. Theoretically, insurance and standardization belong to the same set of economic phenomena, dealt with in information economics. Markets will not provide the efficient amount of either good because private supply and demand for each is hampered by imperfect (asymmetric) information, on the part of insurers or on the part of users, respectively. Social insurance and public standardization have characteristics of a public good, i.e. they exhibit a positive externality that is non-rivalrous in its use. The externality to be internalized in the case of insurance is diversifiable individual risk while it is consumer benefits from network relationships in the case of standards.[15] And just as social insurance deals with market failures due to adverse selection, public standardization is a response to market failures that may provide for too much or too little variety. These market failures relate to under- or oversupply of technical standards by private actors.

From an economic point of view, there are analogous systems failures of social standardization resulting from competition between social welfare states. In his excellent primer on technical standardization, David (1995, 25) mentions specifically three market failures: (1) free riding: "private interests will free-ride by not investing sufficiently in the process of developing non-proprietary standards for interoperability"; (2) monopolistic competition: "strategic interests of dominant vendors of network components will incline them to resist choosing compatible designs"; and (3) herding: "the dynamics of bandwagon formation suggest the possibility that market momentum can develop that will result in the premature extinction of a diversity of choice". At this preliminary stage of research, it seems helpful to exploit the analogy between market failures for commodities with network externalities and systems failures of social policy in a federation:

(1) Free riding: Welfare magnetism, i.e. pre-emptive lowering of social benefits, is a particular expression of free riding by governments. It allows each government to attain the fiscal goal of a balanced budget or even the distributive goal of an egalitarian income distribution (at a high level) but only at the expense of more generous governments. This systems failure entails too little variety, namely downward convergence.

(2) Monopolistic competition: Deliberate brain drain or non-portability of entitlements for resident high-income households is one way of governments to exert their authority ("monopoly power") at the expense of other locations, either the sending country or the prospective receiving country.[16] This systems failure of making social insurance a club good for the better off makes for too much variety or could account for a rush-to-the-top.

(3) Herding: The reform agendas of present EU governments, as different as their social welfare regimes are, tend to be similar in that they all contain proposals for partial privatization in social security or health care and the introduction of welfare-to-work elements in social

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[15] Network relationships are always present when the usefulness of a good or device for an individual inherently depends on others using it. Notorious examples are fax machines or a currency. Even insurance may be interpreted as a good with network externalities because, as a rule, the more individuals join an insurance scheme, the more useful the scheme will become for each one. This holds if more individuals mean more diverse, imperfectly correlated risks that can thus be pooled.

[16] A variant of *deliberate brain drain* is the recent Green Card initiative of the Schroeder administration in Germany. It has been implemented absent a general immigration law which would allow for self-selection that is only constrained by country quotas. The employer- or demand-led immigration system of the U.S. is another way to bias immigration towards brain drain. *Non-portability of entitlements* is a problem if social benefits are job-related, only partly subsidized by the government. This will become a more pressing issue with the privatization of health care and old age insurance.

assistance. This bandwagon effects make for rush-to-convergence and may lead to too little variety .

This exercise shows not only how intimately standardization and insurance problems can be related but also that systems competition entails more threats to strong and diverse safety nets than just the notorious race to the bottom, i.e. downward convergence.[17] Upward convergence or monopolistic competition to attract high skill/high income households can result because, according to the social insurance view, there is locational competition for high skill/high income members of the workforce. This is problematic even though it entails plenty of variety. The reasoning goes back the basic Rawlsian argument that a risk-averse rational actor would choose high-quality, if costly public services. The underlying preferences show up as a positive income elasticity of demand for social insurance. These preferences would not necessarily encompass (means-tested) poverty relief, however. It is thus conceivable that downward convergence in cash assistance results from the first systems failure (welfare magnetism) while the second systems failure (club good) is also present, namely upward convergence in non-portable social security and public health insurance. Moreoever, this systems competition for high income households may entail lock-in effects, that is low-welfare traps, for countries deprived of high skill/high income residents. In short, all these effects underscore the detrimental effects of systems competition.

To pursue this analogy even further, one might look at whether laboratory federalism may provide for solutions to systems failure just as the standardization literature has worked out solutions to market failures. The trend in technical standardization has been to set meta-standards rather than specific minimum or maximum requirements (European Commission 2001). They "describe a flexible architecture encompassing alternative specifications and designs that would fulfil an agreed set of systems functions". (David 1995, 29-30) The evolution towards meta-standardization is driven by two developments. For one, it has become politically imperative to ensure user participation in *emerging* technologies -- which comes close to a contradiction in terms. And, secondly, it is economically warranted because of rapid technological change which could be inhibited by specifically defined standards. Both arguments apply to EU social policy with only slight modification: the Commission has to ensure *political support for an emerging social federation* by furthering exchange about structural change and the best ways to deal with it. And it must take into account that reforms are going on in member states which the EU's intervention must not and most certainly cannot prevent.

Intervention via the laboratory standardization (LS) approach is confined to newly undertaken reforms, for one, because it is a well-established result of studies in policy reform that outside intervention into preexisting policy structures are futile (Pierson 1998, 126). Moreover, the EU has more legitimacy to intervene now that an internal market and a monetary union has been

[17] Cf. Pierson (1994) for a political account of why the 'logic of retrenchment' does not necessarily lead to a dismantling of the welfare state and why decentralization of power is ambigious in its effect on retrenchment.

established so that "regional reform policies have consequences for the aggregate performance of the union." (Kletzer/ von Hagen 2000, 29).[18]

The general idea of the LS approach to social policy coordination is to make governments aware of possible spill-overs and to suggest ways to internalize them. Scharpf (1999, 198) has suggested a criterion to assess the externality problem by asking whether a particular reform is amenable to generalization: "...given the preferences of the adopting country, would measures of this kind become self-defeating if they were simultaneously adopted by all other countries?" It is straightforward to substitute 'destabilizing' for 'self-defeating'. In line with this principle, the LS approach would be concerned with the following questions whenever a Member State government is planning a major reform:

- Is the reform under consideration susceptible to certain systems failures (free riding, monopolistic competition, herding)?
- And is it compatible with certain systems functions (redistribution, public goods provision, and stabilization)?

In the following, I illustrate what these questions imply more specifically by comparing it with the OMSPC with respect to welfare-to-work reforms.

4.2 Laboratory standardization in contrast to the OMSPC

Most recently, the EU has decided to move forward and extend the Open or 'soft' method of coordination to social policy (European Council 2000, pars. 26-32). This method is seen as "a means of spreading best practice and achieving greater convergence towards the main EU goals" (Bulletin 2000). It has four elements (ibid.):

1. Common goals: "fixing guidelines for the Union combined with specific timetables for achieving the goals which they set in the short, medium and long terms;"
2. Best practice: "establishing, where appropriate, quantitative and qualitative indicators and benchmarks against the best in the world and tailored to the needs of diffeent Member States and sectors as a means of comparing best practice;"
3. National Action Plans: "translating these European guidelines into national and regional policies by setting specific targets and adopting measures, taking into account national and regional differences;"
4. Surveillance: "periodic monitoring, evaluation and peer review organised as mutual learning processes."

[18] In a most interesting paper, Kletzer/von Hagen (2000, 23-27) show that reforms which increase the elasticity of labor supply will cet.par. always increase the variability of consumption in a currency area with two regions but will also lower the costs of a fiscal insurance scheme. They get this result in a standard Neokeynesian general equilibrium model, i.e. with monopolistic competition (in intermediate goods) and nominal wage rigidity.

The main goals pursued by the open method are encompassing and sometimes very specific. They include, for instance, "to exploit fully the potential of the knowledge-based society and of new information and communication technologies and ensure that no-one is excluded, taking particular account of the needs of people with disabilities", or "to implement policies which aim to provide access for all to decent and sanitary housing." (Objectives 2001, C 82/6)

This measure does point in the right direction since it allows countries to set up national programs within common guidelines, thus encouraging initiative from below and providing for horizontal exchange of learning experiences. However, in light of the alternative, laboratory federalism, the approach as it stands seems to suffer from three drawbacks nevertheless:[19]

- The object and target of policy coordination is geared towards harmonisation. The idea is one of admittedly "differentiated policy harmonisation" (Begg/Berghman 2001). That is, the most recent EU approach is to achieve similarity of solutions over time. In contrast, LS is geared towards internalizing spill-overs, irrespective of how much diversity or gradual convergence that eintails. Given existing reform pressures, the LS approach might even have a bias towards differentiation in order to advance opportunities for learning.
- The role of the Commission (or the EU level more generally) is dispensable. It has been assigned "to support [the OMC] by means of appropriate initiatives, with particular reference to the development of indicators". The latter follows the method of identifying best practices. This emphasis on best practices is economically and politically unwarranted because it requires the Commission to head for unduly specific solutions and recommendations, e.g. with respect to reforms of pension systems.[20] This emphasis of the OMSCP does not constitute an indispensable role of the central level since Member States have incentives to find out for themselves. It is even at risk of getting none of the praise for policy outcomes but serving as a scapegoat whenever there is failure (Mosher 2000). In contrast, the LS approach is geared to ensure that the central level helps to overcome coordination failures that stem from governments' incentives to compete with each other in an area where competition is counterproductive.
- The goals and guidelines seem to be quite unrelated to the question why the EU level is involved in its formulation at all. Why, for instance, should any government be forced to subscribe to the EU paradigm of the "knowledge-based society" in its employment and social policies? At the same time, neither the guidelines nor the Commission pay much, if any attention to macroeconomic consequences of reforms that go beyond the concerns of longer-term fiscal contraints (Artis/Buti 2000, 582-586). Nor does the impact of integration on systems competition play a prominent role. But these would be the areas in which the internal market and monetary union provide the very reasons for setting common goals. The LS

[19] Cf. Begg/Berghman (2001, 339-341) for a discussion of other criticisms.

[20] Cf. Frits Bolkestein, the internal market commissioner, on funded pension systems and related tax reforms to further labor mobility and capital market integration (Financial Times October 25, 2000, 3 and 18).

approach, in ocntrast, suggests to watch out for functional equivalents to prevent systems failures and to safeguard systems functions, both micro- and macroeconomic.

It is too early to do a close comparison between the workings of the OMSPC and laboratory standardization since the Member States are required to submit National Action Plans by June 2001 only (Objectives 2001). Therefore, I confine myself to an illustration of how laboratory standardization would work with respect to particular welfare reforms that have become quite popular recently.

The EU Member States have agreed that their social policy reforms aim at promoting employment and at combating social exclusion, the link between these two goals being neatly summarised thus: "Employment is the best protection against social exclusion." (European Council , 2000: par.23) Consequently, many governments have implemented 'welfare-to-work' or 'workfare' measures into social assistance. The presumption underlying these measures is that inclusion in the labour market leads to a virtuous circle of training-on-the-job, further education, recognition of one's rights as a worker and citizen, and integration into networks that have been inaccessible before. 'Workfare' means that transfer payments are subject to work requirements, i.e. handed out as in-work benefits such as negative taxes on low-wage income. Workfare benefits are means-tested by their very nature because there is no other way to restrict the access to transfers if eligibility is no longer categorically assessed, for instance being out of work or a single parent.

With respect to such reforms, the EU Commission would provide a check-list of relevant criteria for EU-compatiblity to be worked down with a government that wants to introduce major workfare elements.[21] Against the background of the social insurance view and its skepticism regarding systems competition, it is natural to ask first for *systems failures*:

1. Is workfare vulnerable to the first type of systems failure, *welfare magnetism* or the notorious rush-to-the-bottom? The answer may be yes or no. Yes, because in-work benefits are means-tested and thus create workfare or poverty traps which may induce taxpayers' resentment. No, because workfare benefits are closely targeted to the 'deserving poor' which makes this kind of poverty relief less likely to become a target of taxpayers' resentment (voice or exit). Presumably, the latter is the more likely outcome and would thus be a welcome side effect of workfare in an EU social federation.

2. How about the systems failure of making social insurance a *club good* for high skill/high income workers? From the individual household's point of view, the effect is asymmetric. A worker who migrates from a system based on social insurance to a workfare system would lose its entitlements to benefits if unemployed. So yes, there would be a portability (compatibility) problem. Conversely, a worker would gain an entitlement (cash assistance if unemployed) if he or she migrates the other way. It is then not a portability problem.

[21] A more detailled discussion of workfare can be found in Schelkle (1999, ch.D). See also Walker/Wiseman (2000) for a related exercise in that they suggest ways to induce horizontal learning experiences with respect to the politics and the public administration of workfare reforms in the U.S. and the UK.

However, the clientele most likely to qualify for workfare benefits are not high skill/high income workers. Thus, their mobility would not be hampered.

3. But indirectly this may induce a response of the receiving, contribution-based country, e.g. to introduce lengthy grace periods before someone is entitled to unemployment benefits or, more profoundly, to switch to workfare as well. In other words, workfare, while not necessarily vulnerable to become a club good directly, may indirectly prompt the other two systems failures such as *welfare magnetism* or *rush-to-convergence,* namely in non-workfare countries. If this is likely to be the case, the Commission could explore remedies, such as horizontal payments between the respective countries to compensate the social insurance system of the receiving countries, at least for a limited time.

The *systems functions* must also be amenable to be explored in such a check list, of course.

1. How does workfare perform with respect to *redistribution*? Since that system is based on means-tested benefits, it is by definition better targeted *ex ante* than more inclusive or universal social insurance. This holds true *ex ante* only, however, since there is a notorious take-up problem of means-tested benefits. The conclusion from this assessment could be that the EU Commission suggests ways to ensure a high take-up, possibly drawing on experiences in other countries.

2. How does workfare with respect to the *public good* of insuring an income risk that is hardly insured by private markets? Workfare, insofar it is targeted and insofar the take-up problem has been solved, does provide poverty relief through labor market inclusion. But it does not insure the income risk from unemployment. Consequently, the Commission may ask the reform-minded government to provide for some "employment of last resort", i.e. public sector jobs or training schemes to provide insurance against unemployment that is due to a lack of labor demand.

3. Finally, how about the *stabilizing function*? The answer depends on which kind of labor market adjustment prevails. If wage adjustment is more prevalent, then spending on workfare tends to work counter-cyclically. In a recession, more people become eligible for in-work benefits because earnings decline and thus transfers rise. But workfare does not work as an automatic stabilizer, i.e. expenditures move pro-cyclically, if quantitative adjustment prevails. In a recession, unemployed workers would leave the workfare rolls which causes lower transfer payments. This would also weaken cash assistance as a barrier against deflationary pressures. Since quantitative adjustment is typical of European labor markets, the Commission may suggest functional equivalents that ensure automatic stabilization from workfare. Again, providing public sector jobs is one possibility, counter-cyclical variation of the level of earnings subsidies another.

This has to be taken as an illustration. The upshot of the workfare example is to point out that laboratory standardization does not aim at achieving specific goals or subscribing to a paradigm that requires to create jobs in particular sectors as the OMSCP seems to do. And it gives the Commission an indispensable role because no national government is likely to take the possible consequences for the EU as much into account as is warranted from the Union's point of view.

5 Conclusions

The EU has become a loose kind of social federation for good reason. Yet, we need a new approach to the economic theory of federalism before we are able to analyse the most pressing issues of EU social policy. The social insurance view of redistribution and stabilization provides for such an approach. This view supports laboratory federalism in which it is the role of the EU Commission to contain systems competition in order to preserve 'stability in diversity'. The role of the EU level would be to promote horizontal and vertical learning processes and to make sure that stability concerns of the EU are taken into account in domestic reform efforts of member countries' governments. Laboratory standardization would not set specific minimum requirements but meta-standards that protect systems functions and safeguard against systems failures. The OMSCP points in the right direction but so far it is not obvious that the Commission is meant to act as a representative of EU interests proper. This requires above all to be both mindful of its very limited political mandate, avoiding a pressure for specific reforms, and mindful of macroeconomic stability concerns that encompass more than medium-term budgetary implications of social policy.

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