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# Beyond Cooperation and Competition: What Kind of Federalism for EU Social Policy?

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**Abstract**

The EU has become a loose kind of social federation, a fact that has not been adequately taken into account due to the peculiarities of the Maastricht strategy for monetary integration. Yet, a new approach to the economic theory of federalism is required if one wants to analyze 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 seriously by member countries' governments. The minimum requirements framework for social policy that the EU Commission has adopted must be taken as a point of departure, even though it is a less than satisfactory approach from this point of view. Laboratory standardization, in contrast, would not set specific minimum requirements but meta-standards that protect systems functions and safeguard against systems failures.

## 1. Introduction

The EU Commission faces a major dilemma: In the multi-tier governance structure of the European Union (EU), the upper tier should assume those responsibilities for which lower tiers can hardly substitute. But its current political mandate and fiscal means to do so are extremely limited. Nowhere is this more obvious than in social policy matters now that monetary unification of eleven, soon twelve member states has been finalized. The way out of this dilemma, given the course set by the Maastricht strategy to monetary integration, points to some form of "laboratory federalism" (cf. Oates 1999, 1131-1134). Such a federal setting would be fundamentally different both from the competitive federalism of the U.S. and the cooperative federalism of Germany. These two archetypes of federalism, though different in other respects, are functionally equivalent in that the national government furthers upward convergence of states and regions. The central level of both governments can do this thanks to the stick of considerable regulatory powers as well as the carrot of fiscal means to effectively bribe the lower tiers of government into cooperation. In this paper, I will argue that for the time being this role of the central level is neither feasible nor proper for the EU.

This argument will be developed in four steps: In the next section, I will have a look at the Maastricht strategy for monetary integration in order to understand why we got the federal set-up we have as well as what course this has presumably set for any further developments. Then I will discuss why the economic and monetary union of Europe (EMU) calls for some kind of social federation. Thirdly, I will outline the public finance approach to federalism and make the case for a new approach to tackle the issues raised by an EU social federation.[1] Finally, I will indicate what laboratory federalism would mean for the present EU approach to social policy, first by pointing out the difference *laboratory standardization* would make to the so called minimum requirements framework and, secondly, by way of illustrating it with the example of workfare reforms.

Before I start, I would like to add a note of caution to the reader who is familiar with more recent contributions to the political economy of fiscal federalism: I am not primarily concerned with the two strands of that literature, namely either the Tiebout (1956)-tradition on the agency problems between national electorates and the different tiers of government in the EU, or the Musgrave (1959)-tradition on coordination and incomplete contracting problems among different (EU, national and regional) levels. 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.

[1] For the purpose of this paper, I use EMU and EU interchangeably. A precise definition of what I mean by a "social federation" is given at the beginning of section 3.

EU) level? And how can that federal role be gradually given substance if there is no prior consensus on what it should be? A closer look at the Maastricht strategy and the coordinates it fixed for further social policy evolution in Europe can explain why these basic questions have to be answered prior to an analysis of the more traditional issues and also why we have to watch out for a less conventional kind of federalism.

## 2. The Maastricht Strategy For Monetary Integration: Where Do We Stand?

The Maastricht strategy for monetary integration foresaw the implementation of rules that establish monetary policy as a disciplining device for the macropolicy regime of prospective member states. If a government wants to join EMU, several macroeconomic indicators – the inflation rate, long-term interest rate, the budget deficit and public debt – have to comply with the notorious Maastricht criteria ex ante and with stipulations of the Stability and Growth Pact ex post. The basic notion of path-dependency tells us that any evolving federal structure will emanate from the policy regime that this strategy has moulded. Given the path on which this has put the EU, I suppose it is unlikely to arrive at a division of labor between the different tiers of government that would conform the established theory of fiscal federalism. The present EU approach in social policy matters, the framework of minimum requirements, is politically adapted to that Post-Maastricht regime but it is deficient from an economic point of view.

### 2.1 A Burdensome Heritage

How did we get on the path? The Maastricht provisions did not fall from heaven but were designed by the governments of member states, in countries like France, Germany, and Italy even endorsed by the mainstream opposition parties. Yet, part of the national electorates, if not the majority, perceived the Maastricht strategy as an elitist project. This perception is not without cause. The Maastricht Treaty and its offspring, the excessive deficit procedure of the Stability and Growth Pact, did and does play an instrumental role for national reform agendas. As such, European monetary integration is an integral part of domestic reform politics and rhetoric, the politics of ostensible external constraint (what I would call "Politik des Sachzwangs" in German). Yet the constraints were essentially self-imposed. The strategy was an impressive exercise in governments' tying their hands.[2]

[2]Thus, the Maastricht strategy is a variant of the two-level game that governments play in international policy coordination, namely one in the supranational or intergovernmental arena and another one in their domestic policy arena. As originally forwarded by Putnam/Henning (1989), the domestic game constrains governments to enter and keep international commitments. In contrast, the Maastricht Treaty seems to have served them to gain room for maneuver in dealing with domestic interests. The economic doctrine supporting this will be dicsussed in the text as an "instrumentalization of the Lucas Critique."

In this, it had its precedents in the internal market program and became part of an attempt on the part of mainly conservative governments to overcome the notorious Eurosclerosis, i.e. to enforce supply-side structural reforms of market and policy regimes considered responsible for high and persistent unemployment Moravcsik (1999, 293).[3] In the meantime, Third Way social democrats have subscribed to that strategy of constraint and contrived reform.

It is an extremely important consideration that this implies a two-way causation of change, namely EMU changing the framework of domestic politics but domestic politics also influencing the way EMU was set up and supposed to work (Martin/Ross n.d.). National policy regimes are bound and meant to change by stipulation of the Maastricht criteria. The disciplining character of the Maastricht criteria seems to me implied by the very fact that they were not used as strict preconditions for entry but as opportunistically applied stipulations to reward intentions, not results. To me, the consideration that they were meant to affect national regimes is fundamental for the role of the EU level in any foreseeable social federation.

This is not to say that all measures implemented under the heading "Maastricht made us do this" are necessarily counterproductive. For instance, it made sense for the Italian government to abolish wage indexation in order to get rid of built-in inflation or to try a social security reform, even if it were for fiscal reasons alone. Stressing the instrumentality of monetary integration for domestic politics does not necessarily invalidate the reform agendas. Rather, it shows how we got on that track and where it might lead to. But it says that the EU could easily become a scapegoat for failing as well as successful reforms (Pierson 1998, 156). This is a lasting burden with which EU social policy will have to cope.

So was the Maastricht strategy all about economic logic distorted and instrumentalized by domestic politics? Far from it. The economic doctrine informing the Maastricht strategy provided at least a rationale for the politics and is therefore to blame as well. That doctrine is a strange and largely unreflected amalgam of old and new economic theory (Schelkle 2000). The old elements were provided by Robert Mundell's theory of optimum currency areas (OCA, cf. Mundell 1961). According to that theory, certain criteria such as labor mobility or inflation convergence ought to be met in advance of the ominous OCA being formed. The new parts came from the literature on dynamic consistency or credibility of economic policy. It basically says that the private sector rationally expects policies, adjusts its price- and wage-setting to it and thus can only sometimes be fooled by government. A government known by private actors to have interventionist leanings

[3]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 which would then generate positive employment effects. Cf. publications by the European Commission (Emerson et al. 1992, 149f.; Buti/Sapir 1998, chap.13), or, in Germany, a vocal economics professor turned president of a regional central bank (Sievert 1993) and a publication by the Institut der deutschen Wirtschaft which is affiliated with the employers' association (Fröhlich et al. 1997, 82f.).

will simply not succeed.[4] Therefore it can do no better than credibly tying its own interventionist hands, for instance entering a monetary union and abstaining from sovereign monetary policy (Giavazzi/Pagano 1988).

Recent literature on the credibility of economic policy is based on the famous Lucas (1976) Critique of the then prevailing approach to economic policy. The Lucas Critique holds that the structure of an economy is endogenous to the economic policies applied to it. That is, actual behavior and expectations that govern market supply and demand will change if there is a change in policy as regards, for instance, employment programs or the monetary stance of the central bank. Economic actors rationally expect these changes, given their information set. The problem with the "new" theory of optimum currency areas (Tavlas 1993), i.e. the Mundell (1961) approach that has absorbed the Lucas Critique, is that this Critique makes the evaluation of OCA criteria *ex ante* a futile exercise. The theory of economic policy post-Lucas (1976) has to evaluate how policies may alter the behavior of households, firms, or unions, and how this affects the *ex ante* intended results.

The Maastricht strategy is an inconsistent undertaking, in practice if not in theory. Its OCA criteria imposed *ex ante* convergence of macroeconomic indicators, in line with the Mundell tradition, but were adopted to engender further change. The latter amounts to what I would call the *instrumentalization of the Lucas Critique*: if policies change behavior, take policy measures to induce (specific) changes of behavior. Such an instrumental use is based on a dubious leap of faith, however, namely that behavioral changes in practice are as predictable as the Rational Expectations Hypothesis (REH) suggests. Yet the REH only means that expectations are consistent with the underlying theoretical model. In practice, policymakers would need to know what models of the economy people (trade unionists, employers, consumers etc.) have in mind when they form expectations about inflation or growth and, if these models differ, which expectations will prevail. Only then can they ascertain what kind of changes their policy measures induce. Recent research on national responses to globalization and integration pressures suggest that such a leap of faith is unwarranted (cf. Swank 2000). There seems to be a "complex dynamics of choice" (McNamara 2000, 2), governments responding differently mainly because of the differences in their domestic environments.

What does all this imply for the prospects of an EU social federation? To me, there are basically four insights in this account of the political foundations and the economic doctrine of European economic and monetary integration.

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[4]Strangely enough, though, the same median household votes such a government into power. Presumably, the electorate has no alternative since politicians are all alike, that is interventionist and expansionist. However, a low turnout, widespread refusal to vote, would seem to be the more plausible (rational?) outcome of such a situation.

1. First of all, it implies that the present federal set-up, providing for no role of the EU Commission in stabilization and very little in redistribution, cannot be regarded as just a question of time, due to a yet incomplete project. The Maastricht strategy for monetary union was about politicians' signalling their tying of hands to gain room for maneuvre, i.e. for pushing domestic reform agendas, above all in social policy matters. Thus, it seems to be more correct to say that this federal set-up is complete for the time being and that it has been deliberately designed that way. The EU Commission has to start from here.
2. Secondly, herein lies a problem and not a solution. The policy framework and the optimum currency area approach on which it was based did not signal any need for future policy coordination. What is more, these rules are and were meant to discipline and to exclude prospective members, not to facilitate their policy coordination (De Grauwe 1997, 155). The problem has to be dealt with. An approach will be needed that works within the present non-system, but is open to gradually develop a framework of social policy coordination.[5]
3. Thirdly, the EU Commission may not want to push too hard for a jurisdiction in social policy, despite all the good reasons listed in the next section. If the Maastricht strategy is about shifting blame for domestically contentious reform pressures, it is not in the interest of the EU administration to get full responsibilities. EU social policy could be used not only as a pretext for domestic policy constraints but also for domestic shortcomings. This could inflict further harm on what is fragile public support for European integration anyway. Thus, it is imperative for the EU Commission to engage in the politics of blame avoidance (Weaver 1986; cf. Pierson 1994, 21) by seeking a less exposed role than that of a central social policy coordinator and financier.
4. Finally, an EU social federation will only be conceived as a useful complement of monetary union and the internal market, if it is conducive to the reform moves of the member states. Domestic reform pressures exist independently of the internal market and monetary union.[6] But, as I read the Maastricht provisions, this does not hold vice versa: The peculiar institutionalization of EMU, in particular, has been due to these reform agendas. And now that it has happened, the Commission must have a vital interest to make itself noticed in these reform processes. As I will argue below, this is particularly important to avoid counterproductive measures that in the long run could jeopardize macroeconomic stability in the EU.

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[5]Cf. Begg (2000) for an outline of how such cooperation within the EU might be started.

[6]Among the notorious problems that call for reform are the aging of society, the inadequacy of the male breadwinner-lifetime employment-model of social insurance, and manifest problems of social exclusion, in particular longterm unemployment and marginalization of immigrant communities.

## 2.2 The Present EU Approach to Social Policy

The Maastricht Treaty explicitly mentions the principle of "subsidiarity," which is the European term for the Decentralization Theorem in public finance (Oates 1972, 54): competencies and responsibilities for public policy should be assigned to the lowest level of government that can implement measures effectively. It is a principle for assigning both jurisdictions and operational competencies. The European Treaty (Article 3b), however, has applied the subsidiarity principle only to the latter, i.e. as a rule to designate operational competencies (Hilz 1999, 31). This lapse implied that the EU level got more limited jurisdictions, especially in (the coordination of) fiscal and social policy, than what would have been the most effective assignment as will be elaborated below.

The official approach to EU social policy relies basically on "a framework of minimum standards." This framework was first established in the Social Charter signed in 1989 by then twelve member states except the U.K. (which signed it shortly after the Blair administration took office) and was followed up in a White Paper in 1994. The Amsterdam Treaty has promoted it from the status of a Protocol to a genuine part of the EU legal framework in 1997.

These minimum standards concern working time (e.g., eleven hours of rest every day and an average maximum working week of 48 hours), workers' rights (e.g., equal treatment of men and women, fair remuneration and social protection according to the arrangements applying in the individual member states) and provisions to safeguard the internal market (e.g., work permit in any member state, recognition of qualifications and portability of social entitlements). Only the latter provisions have been an area of social policy activity in the years of the then European Community (EC). At the time, these activities aimed at coordinating social protection systems for migrant workers who exercised their freedom of movement guaranteed by the EC Treaty.

The various standards require unanimous decision by the Council of Ministers, must be passed by the European Parliament and have then to be routed through the national legislatures in order to make them domestic law. Contrary to what is often suggested by critics of centralist tendencies in the EU, the approach so far has not been one of harmonization of standards. It is rather to induce the convergence of goals and policies over a period of time by fixing common objectives because that would supposedly permit the coexistence of different national systems. In that sense, the approach certainly meets the first stipulation, namely it does not call into question the rationale of the Maastricht strategy for domestic politics, i.e. to provide leverage for domestic reform agendas.

The minimum standards approach to ensure Social Europe and the internal market seems politically sensible since it is cautious in its attempt to guarantee a relatively high level of social protection. And yet, I do see shortcomings in this approach.

- As I will argue below, the very rationale of the minimum standards framework is also its fundamental weakness: containment of diversity. Even though designed to protect the richer, more mature social welfare states, there is nothing in it to prevent convergence to a medium level which could easily be inefficient for all.
- Moreover, the minimum standards framework was never meant to deal with new income risks that come along with currency unification. It does not address the issue of a macroeconomically stabilizing function of social policy.
- Finally, it does little to take national governments' reform agendas as an opportunity to assert the stability concerns of the EU as a whole and to explore the possibilities for social policy coordination at the same time.

Therefore a review of the present approach seems to be overdue.

## 3 The case for an EU social federation: What is at stake?

The term "EU social federation" will be used here in contrast to a "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 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.[7]

In contrast, a social union would imply a fiscally centralized, legally unitary system in which the regions or municipalities only serve to implement social policies.

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 a social federation of the EU, i.e. a decentralized regime of redistribution in which the EU level has to play an indispensible role? The macroeconomist's immediate answer is: because the internal market and monetary union will bring forth 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 asymmetric shocks,[8] the new risks are basically threefold: (1) an ever more

[7] Cf. Leibfried/Pierson (2000) on the present and future impact of a free market for services on semi-public provision of social security and health care services in some EU countries, an impact that is likely to increase with partial privatization of these social insurance systems

[8] Cf. Goodhart/Smith (1993, 440) for a survey of recent contributions which all come to the conclusion "that fiscal stabilization measures are highly desirable in a unified economy and that these are best done

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 that may affect different regions differently. This is why the central, that is the EU, level has to assume a role in stabilization. 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.

5. 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.[9]
6. As regards the second risk, a common price dynamic: Ever since modern social welfare was invented in the New Deal, 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.[10]
7. 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.[11]

at the central, federal level [...]." Note that to me the elimination of bilateral exchange rates is a benefit of EMU that in and of itself relieves other adjustment mechanisms. In contrast, traditional OCA theory portrays this as a cost of monetary union which calls for other adjustment mechanisms to substitute for the exchange rate (e.g. Kletzer/von Hagen 2000, 1-2). In Schelkle (2000), I argue that this line of argument is incompatible with modern exchange rate theory.

[9]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.

[10]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.

[11]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

8. 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. The social insurance view of redistribution and stabilization I will elaborate later on will add to these cases. But its usefulness will become more obvious if we first ask the classical question of fiscal federalism: which level of governance should play what role? What is the proper division of operative and financial responsibilities between the EU, on the one hand, national and local governments on the other?

## 4 The economic rationale of an EU social federation: what role for the commission?

In this section, I will first recall the traditional public finance approach to fiscal federalism, which should make us aware of the challenges EU social policy faces. In light of what has been said about the Maastricht strategy, it is obvious that the traditional approach is not applicable to the political economy of the EU. This leaves 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, a new approach is required that complements the theory of fiscal federalism.

### 4.1 The Functional Approach to Public Finance

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.[12] Its point of departure are the three economic functions or branches of public policy – redistribution, stabilization, allocation. In the present context, this means to take the different economic functions of social policy and find the proper level of government to fulfill them.

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 the 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.

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credit, e.g. between regions with a high share of manufacturing as compared to regions where service industries dominate.

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

- 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.
- 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 offers their preferred 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.

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 (e.g. Conlan 1998, ch.10; Münch 1999). Given the background of the Maastricht strategy and its 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. This is economic theory that sounds a bit like Christian doctrine: the world lives in sin and must await redemption. In other words, if the public finance approach to fiscal federalism is all we have, policymaking as well as policy-oriented research in the EU would have to proceed on an ad hoc basis. We can do little but try to maintain (or try to understand how to maintain) existing social policy regimes at the national level.

While the message of textbook economics is not easily dismissed, it is also not quite the end of the story. Textbook economics is important to make us aware of imminent threats to the redistributive 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, not only those raised by an EU social federation but, incidentally, also those of U.S. welfare reform:[13]

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[13] Cf. Oates (1999, 1131). These assumptions are also shared by more recent contributions, the "second generation economic theory of federalism" (Qian/Weingast 1997, 84) in the Tiebout (1956)-tradition and the political economy of intergovernmental relations (Inman/Rubinfeld 1997) in the Musgrave (1959)-tradition.

9. First of all, it assumes a hypothetical situation of constitutional choice in which a federation is set up from scratch. Yet, the EU does obviously not start from scratch but 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.
10. Moreover, the functional approach has to assume a basic consensus that the respective policy area, here social policy or parts thereof, should be federalized, that is 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. While the Maastricht and the Amsterdam Treaty have confined it to matters relevant to market integration, in particular mobility of EU citizens,[14] some governments see a "social deficit" in this limited jurisdiction of the EU Commission.
11. 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. As outlined before, the internal market program as well as monetary union were instrumental for these domestic reform agendas. But a consensus on where these reforms should lead to is unlikely to emerge in the foreseeable future.

Thus, none of these three traditionally made assumptions can be taken as given if we want to do a meaningful policy-oriented analysis of EU social policy. It would have to replace the setting of quasi-constitutional choice by one that assumes path-dependency. 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. And, finally, instead of excluding learning and uncertainty about the very policy area to be federalized a new approach has to provide room for them. That is why I suggest to take another tack and endorse the "social insurance view of redistribution."[15] It has social policy, not federalism, as its point of departure but is of immediate relevance to social policy in a federation. Thus, what is politically feasible in the EU may economically not be so bad after all.

### 4.2 The Social Insurance View of Redistribution and Stabilization

Laboratory federalism, the new approach I have in mind, can be based on the social insurance view of redistribution. This view allows not only the case for strong safety nets in the EU but also

[14]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.
[15]Wildasin (1995, 528n) uses that expression. Its leading proponents make up a rather heterogenous group of economists (Anthony Atkinson, James Buchanan, John Harsanyi, Hans-Werner Sinn and Hal Varian).

entails a case for diverse safety nets. Moreover, it assigns an indispensable role to the central level, and is amenable to integrating the stability concerns of the traditional approach.

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. Risk aversion is a non-trivial, though necessary assumption because only then can the few who turn out to be lucky be expected to consent to compulsory social insurance arrangements that entail redistribution, for instance progressive taxation or actuarially unfair contributions of high-income households.[16]

Social insurance is used in a very broad sense here, it encompasses not only traditional social welfare but also progressive taxation, public education and bankruptcy legislation.

And social insurance is a public good that makes up for the failures of private insurance markets, at least as far as these failures are due to adverse selection. It shows this with 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.[17]

Against the background of my interpretation of the Maastricht strategy, it is thus important to note that this view answers the *efficiency question* that preoccupies reform-minded governments these days: how can (reforms of) social insurance make the economy (more) efficient? 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 them-

[16]Risk aversion seems to be an undueIy specific assumption about preferences. After all, individuals like to gamble, take part in lotteries where the expected return is lower than the price paid for participation, etc. Yet, one may argue that for the very reason that such opportunities exist individuals are able to satisfy their want for risk ("thrill") in leisure time. They could exhibit risk-aversion at the same time, namely in undertakings that concern their own or their family's income security.

[17]In all OECD countries, social insurance is much more important than private insurance to provide assistance against adverse individual risks. In the early 1990s, social insurance is about four times as large as private insurance measured in terms of revenues (Zweifel/Eisen 2000, 381).

selves instead of pursuing gainful employment. A lot of observable behavior is then not easily discerned from behavior characterized by moral hazard. For instance, is it efficiency-enhancing risk-taking or moral hazard if a rising numbers of students indulge in long and rather exotic studies? Yet there is an efficiency criterion: A social welfare system which pools the risks of such behavior would nevertheless be "risk efficient" as long as the rise in aggregate income thus generated is larger than its cost in terms of social insurance. In this case, high or rising skill premia for labor in mature economies may indicate that even long and exotic studies may enhance the capacity to create wealth. Social insurance and redistribution would thus enhance the efficiency of an economy. To put it more generally, there is not necessarily a trade-off between efficiency and equity (Sandmo 1995, 473).

The exämples given also imply that the risk-efficient level of redistribution is likely to vary with the stages of economic development, namely rising with the maturity of an economy. 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. Market forces tend to select projects which exhibit a positive correlation between risk and return. Therefore effiency-enhancing social insurance shows up in an increase in the expected aggregate income without increasing volatility, or vice-versa, less volatility at a given mean income. The risk-efficient level of individual risk-taking varies with preferences for risk and the constraints to insure them. As regards preferences: 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), suggests that the risk-efficient level rises with income as well. And the constraints of financing universal insurance also become less binding with rising income and wealth of an economy. 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 ***a priori case for diversity of social insurance arrangements in a federation*** of member states as heterogeneous as the EU. Note that this argument implies convergence in any direction hampers the risk-efficiency of such a federation.

This 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***. In a federation such as the EU, systems competition between national social welfare regimes intensifies due to enhanced actual mobility or – more likely – due to welfare magnetism, i.e. an increase not in actual mobility, but in perceived and feared mobility of potential welfare beneficiaries (Peterson/Rom 1990, 72-81). Exit and voice, especially the voice of taxpayers, may then generate pressures to cut back on social insur-

ance and taxation to finance it (Atkinson 1996, 294). I will argue later on that the notorious rush-to-the bottom, downward convergence, is not the only possibility but that convergence in one or another direction are the systems failures that may result. The role of the central level then is to prevent premature convergence in either direction.[18]

In contrast, the Tiebout (1956) model implicitly endorsed competition irrespective of the outcome of convergence or variety, for the very reason that it would create a quasi-market for local public goods.[19] 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 regardless of EMU. Unfortunately, the potential for such popular reforms seems to be more limited in the realm of redistribution via unemployment insurance and welfare than in say public infrastructure or education. For one thing, 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. By contrast, failure and abuse of social insurance are easy to identify just because they occur. 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 very problem of adverse selection responsible for the failure of some private insurance markets.

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 governments want to attract high-income households and deter the marginally employed ones as

[18]Rieger (2000) argues against the notion that EU governments are susceptible to systems competition as a consequence of the internal market. According to his insightful and original essay, the institutionalization of the EU is meant to endow national governments with more room for maneuvre, both with respect to their electorates and to pressures from mobile capital (cf. my interpretation of the Maastricht strategy). And yet, his Weberian account of political economy maintains rather strong assumptions as regards the role and capacities of national governments. By setting up institutions like the EU, they are the guardians of social welfare democracies *against* the electorate. The EU allows them to circumvent democratic mechanisms in favor of market liberalization which in turn both curbs and nurtures the social welfare state. However, this suggests that market liberalisation and thus systems competition do exist and affect social welfare, admittedly in more complex ways than is usually assumed. Moreover, this argument has to assume degrees of steering capacity and of interest convergence between EU governments that I find implausible.

[19]Cf. Pauly (1973) for the view that income redistribution may be seen as such a local public good, namely if interdependent preferences have a spatial dimension and if mobility is low. Ladd/Doolittle (1982) discuss the pertinent arguments and reaffirm the traditional case for redistribution being more efficiently provided by the central level.

permanent residents. The very basis of insurance therefore breaks down, notably not only of social but also of private insurance.

The competition of fiscal systems in general, social welfare systems in particular, is likely to have adverse effects and the analogy with competition of private economic actors is unwarranted as Sinn (1998, 6) aptly points out: ". . . competition of states will not work even in the absence of cross border externalities and European public goods, since the states by their very nature are supposed to carry out exactly those tasks where private markets fail. 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." That is, systems competition decreases the efficiency of an economy because it undermines a remedy of market failure. 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 I will argue in the next section.

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.[20] After all, the economic case for a social federation in Europe largely rests on the stability issues raised by a common currency (cf. section 3). 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, the 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. Deflation entails redistribution from labor and firms to owners of (nominally fixed) assets such as saving deposits which are revalued with falling prices. Unemployment insurance and cash assistance provide nominal anchors for the price level[21] and are thus barriers against that deterioration

[20]The social insurance view is applied microeconomic theory. Its proponents use it primarily to dissolve the trade-off between redistribution and allocation in favor of a mutually reinforcing combination of equity *cum* efficiency. Atkinson (1999) is a notable exception but he is not concerned with linking his macroeconomic analysis with the microeconomic social insurance view.

[21]They support downward rigidity of nominal wages which anchors the price level if firms practice mark-up pricing.

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 given income distribution – for how optimal you can get, to state it plainly. The primary redistributive function of social policy cannot be dissociated from its stabilizing function (Atkinson 1999, 20).

Stability considerations would also reenforce and specify the skepticism regarding the beneficial effects of systems competition brought about by mobility. Wildasin (1995, 528), a leading proponent of the social insurance view, after all has a point when he qualifies that skepticism:

"... while greater factor mobility may add constraints to the ability of governments to redistribute income, it can also itself provide a form of market insurance against income risk. Access to 'external' factor markets limits the extent of factor price variation through spatial arbitrage and may, to some degree, obviate the need for public sector insurance of such risks." This statement is based on a purely microeconomic point of view in which – by assumption – mobility does not jeopardize nominal stability in a currency area. So Wildasin must assume that national social welfare regimes remain intact, in particular that they continue to provide for a relevant cash income alternative to low wage earnings. Only if existing barriers against deflationary tendencies are sustained, may the economy reap the beneficial effect of flexibility in the reallocation of labor. But mobility, real (exit) and virtual (voice), is also a transmission mechanism for systems competition which may result in destabilization of the EMU macroeconomy and a worsening of the distribution of aggregate income.[22]

To sum up: The social insurance view of redistribution backs the macroeconomic rationale 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)

[22]This is why I consider the position of Sinn (1998, 10-13) to be inconsistent. On the one hand, he argues in favor of strong measures to hinder mobility as the resulting systems competition is likely to make the social welfare state shrink dramatically. On the other hand, he proposes to abolish all kinds of cash assistance and replace it by workfare transfers. If he thus denies any stabilizing function of social insurance against unemployment, Wildasin's argument quoted in the text applies.

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.

## 5 Laboratory federalism in EU social policy: Where do we go from here?

So far, I have argued that the social insurance view of redistribution and stabilization calls for the EU Commission to contain systems competition in order to preserve "stability in diversity." The Maastricht strategy for monetary integration has to be taken as a point of departure, both in that it has provided for a peculiar institutionalization of the EU macropolicy regime and in that it assigns an instrumental role to the EU level for domestic reforms. The minimum requirements framework for social policy that the EU Commission has adopted is a less than satisfactory element of that inherited setting. In the kind of federalism I have in mind, the role of the EU level would be to promote horizontal and vertical learning processes and to make sure that stability concerns are taken seriously in these reforms.

The new approach should be able to deal with those questions that are implicitly neglected in the theory of fiscal federalism, yet are the most pressing for the EU:

- Why is it in the self-interest of the member states to give the EU, more generally the central tier of governance, a role in social policy?
- What useful role could the EU Commission (or an intergovernmental body on its behalf)[23] play until a consensus will have gradually developed?

Laboratory federalism in social policy, theoretically grounded in the social insurance view, starts from the premise that 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. The EU has an indispensable role to play in this, namely to further horizontal and vertical learning experiences from reform experiments and from different approaches to social insurance. Moreover, the role of the EU Commission is to make sure that member states internalize potentially destabilizing externalities of their policies, for instance domestic reforms that may 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.

What difference would laboratory federalism make to the present approach of the EU Commission? After all, the EU already finances research on social policy and the Commission is active in giving very specific advice as regards domestic reforms.[24] But the conceptual background of this

[23]This parenthesis points to the fact that one may ask an even more profound question: Given that there is no consensus yet, how should the interests of the EU be represented? By a "supranational entrepreneur" like the Commission or rather by an intergovernmental body for cooperation in social policy reforms, for instance a Council of Social and Labor Affairs? My expertise does not suffice to discuss that question adequately and the theoretical approach I suggest is open to both forms of representation. Cf. Moravcsik (1999), who discusses the pertinent issues from an intergovernmentalist perspective, for instance whether governments or the Commission are more likely to take the initiative and shape the institutional design. Falkner (1998), on the other hand, suggests a supranational " corporatist policy community".

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

advice seems to be an indiscriminate application of the economic a priori case for unfettered competition and market integration. As I have outlined at some length above, this is unwarranted even from a purely economic point of view. The Commission has to act as a representative of EU interests in social policy proper. Mindful of macroeconomic stability, the EU should demand that national governments internalize the externalities that their reforms may entail for others and the EU as a whole. Scharpf (1999, 198) has suggested a criterion to assess the externality problem by asking – analogous to the Kantian categorical imperative – 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." So far, it is not obvious to me that the Commission has paid attention to macroeconomic consequences of reforms beyond the immediate budgetary implications of social policy.

### 5.1 Public Standardization and Social Insurance

Still, laboratory federalism can build on 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. 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 network relationships in the case of standards.[25] 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.[26]

From an economic point of view, there are analogous ***systems failures*** of social standardization resulting from competition between social welfare states. The analogy is not self-evident, of course, since it requires us to see governments in a federal system like economic units. In this view, they compete for permanent residency of high-skill/high-income households and try to divert marginally employed households seeking permanent residency. While such analogies between public bodies and private actors are often simplistic, it seems to me that at this preliminary stage of research the ***analogy between market failures for commodities with network externalities and systems failures of social policy in a federation*** is revealing:

[25]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.

[26]In his excellent primer on technical standardization, David (1995, 25) mentions specifically three market failures: (1) "private interests will free-ride by not investing sufficiently in the process of developing non-proprietary standards for interoperability"; (2) "strategic interests of dominant vendors of network components will incline them to resist choosing compatible designs"; and (3) "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".

12. 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 less stingy governments. This systems failure entails too little variety, namely downward convergence.
13. 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.[27] This systems failure of making social insurance a club good for the better off makes for too much variety and could account for a rush-to-the-top.
14. 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 workfare elements in social assistance. This bandwagon effects make for rush-to-convergence and may lead to too little variety .

This exercise shows how intimately standardization and insurance problems can be related. In fact, the social insurance view makes us aware of a basic economic similarity between technical standardization and social policy, as unlikely as this may at first seem. Moreover, the analogy reveals that systems competition entails more threats to strong and diverse safety nets than just the notorious race to the bottom, i.e. downward convergence.[28]

Systems competition can even lead to too much variety or too much innovation, respectively (Oates 1999, 1134-1135). Upward convergence or "monopolistic competition" to attract high skill/high-income households is not necessarily at odds with the social insurance view. On the contrary, this view can explain why there is locational competition for high-skill/high-income members of the workforce and why it is problematic even though it entails plenty of variety. After all, this view rests on the basic Rawlsian argument that risk-averse *homo oeconomicus* would choose high-quality, if costly, public services. The underlying preferences show up as a positive income elasticity of demand for social insurance. As already mentioned, these preferences could explain the stilyzed fact that the share of social expenditures rises with national income, both cross-sectionally and over time. 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 pub-

[27] 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 demand-led immigration system of the U.S. is another way to bias immigration towards brain drain. *Non-portability of entitlements* is ensured, for example, by social benefits that are job-related and only partly subsidized by the government. If an employee loses such entitlements or has to accept large deductions as soon as she or he changes jobs, it makes for low labor mobility of the respective workforce. Private health care benefits in the U.S. tend to be designed that way. In Germany, contributions to private pensions are not tax-deductible while there is no tax on pension payouts. Retirees who want to move to a country with more sunshine and, incidentally, a tax on pensions, would therefore be taxed twice.

[28] Cf. Pierson (1994) more generally on 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.

lic health insurance.[29] 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 which the social insurance view implies.
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. And this would not imply to set specific minimum or maximum requirements but rather ***meta-standards*** which "describe a flexible architecture encompassing alternative specifications and designs that would fulfil an agreed set of systems functions" (David 1995, 29-30). The evolution toward this kind of public standardization that David describes 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 the EU Commission 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 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 established so that "regional reform policies have consequences for the aggregate performance of the union" (Kletzer/ von Hagen 2000, 29).[30] Specifically, the LS approach would ask a member state government planning a major reform to answer the following questions:

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

Let me illustrate what these questions imply more specifically with respect to workfare reforms.

## 5.2 Laboratory Standardization in Workfare Reforms: An Illustrative Example

Workfare means that transfer payments are subject to work requirements, i.e. handed out as in-work benefits like the Earned Income Tax Credit (EITC) in the U.S. These benefits are means-tested by their very nature. In view of persistent and high unemployment, many EU governments introduce workfare elements into their social welfare systems these days. With respect to such reforms, the EU Commission (or an intergovernmental body on behalf of the Commission) would

[29] A case in point could be the U.S. social welfare system after reform in 1996.
[30] 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.

provide a check-list of relevant criteria for EU-compatiblity to be worked down with a government that wants to introduce workfare.[31] Against the background of the social insurance view and its skepticism regarding systems competition, it is somewhat natural to ask first for *systems failures*:

15. 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.
16. 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.
17. 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.

Naturally, the *systems functions* should be explored as well.

18. 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. So the EU Commission may suggest ways to ensure a high take-up.
19. How does workfare with respect to the *public good* of insuring an income risk that is hardly insured by private markets? If the income risk alluded to in that question is unemployment, then workfare does not provide that public good. 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 obviously due to a lack of labor demand.
20. 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

[31] 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.

benefits because earnings decline and thus transfers rise. But workfare does not work as an automatic stabilizer, i.e. expenditures move procyclically, if quantitative adjustment is more important. 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. Quantitative adjustment is more likely in European labor markets. The Commission may thus suggest functional equivalents that ensure automatic stabilization of workfare. Again, providing public sector jobs is one possibility, counter-cyclical variation of the earnings subsidies involved another.

All 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 specific standards like the minimum requirements framework. Moreover, the present EU approach to social policy is meant only as a safeguard against downward convergence but does not address any of the other systems failures.[32]

In contrast, LS works via a check-list to see how reforms perform with respect to systems failures and systems functions that are of EU-wide concern. It is these systems functions and failures that are the objects of (meta-)standardization. But if a reform is found wanting in certain respects, the Commission would not be there to sanction an agenda. Its role is to suggest and engender improvements, thus to encourage experimentation at the country level. At times, this may require first to fund basic research in such improvements if solutions are not at hand or contentious as regards their likely effects. Finally, the check-list or catalogue of questions asked could be the prime vehicle to ensure horizontal and vertical learning processes. For that purpose, it has to be revised in the light of experiences made and insights into best practices gained.

## 6. Conclusions

In this paper, I have argued that the EU has become a loose kind of social federation, a fact that has not been adequately taken into account due to the peculiarities of the Maastricht strategy for monetary integration. 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 seriously by member countries' governments. The minimum requirements framework for social policy that the EU Commission has adopted must be taken as a point of departure, even though it is a less than satisfactory approach from this point of view. Laboratory standardization, in contrast, would not set specific minimum requirements but meta-standards that protect systems functions and safeguard against systems failures.

[32]Notably, it is not even a safeguard against that systems failure which would make social insurance a club good for high-income households and a barrier for their mobility. This is likely to become an important issue due to increasing privatization of social insurance in EU member states.

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