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EU ENLARGEMENT AND THE FUTURE OF THE WELFARE STATE

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Abstract

The eastern expansion of the EU resembles German unification in its momentousness. Whereas the latter led to a 26% increase in the population of the Federal Republic, the former will increase the population of the EU by 28% if all ten entry aspirants are accepted. A special problem will be posed by migration. In view of the existing wage differences between eastern and western European countries, a massive westward migration can be expected after EU expansion. A temporary east-to-west migration up to the time that the eastern countries have created an efficient capital stock makes economic sense if it is driven by wage differences and meets with a flexible labour market. Migration does not make economic sense, however, if, and to the extent to which, it is induced by the current social assistance systems. Moreover, welfare-motivated migration would create competition among western European states to frighten off potential migrants, which would lead to an erosion of the traditional social welfare state. If the EU plan incorporated a limitation of the free movement of labour, the beneficial migration would also be stopped. A better solution would be to limit access to the western social systems, at least for a transitional period in order to filter out migration induced by differing social standards. An EU-wide application of the home-country principle in the granting of social benefits would achieve this goal.

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Introduction

With the introduction of the euro and the eastern expansion of the EU, the European Single Market is nearing its completion. Within the foreseeable future, 25 European countries will be joined in a unified economic region in which the four basic freedoms guaranteed by the Treaty of Rome will be largely fulfilled. People, capital, goods and services will be able to cross European borders unimpeded, and when Cyprus and Turkey are EU members, these freedoms will be extended into Asia Minor. Economic freedom is the foundation for the utilisation of trading advantages and specialisation benefits that result from a prospering European economy, but it will also cause problems that need to be recognised and solved at an early stage.

Eastern expansion is not insignificant. It will increase the EU population from 375 million to 480 million or by 28%; this does not include Turkey with its 70 million people. It would be disastrous to stumble into EU eastern expansion as unprepared as Germany went through its own eastern expansion, which was accompanied by considerable economic problems as the population increased by 26%.

One of the problems of eastern EU expansion is the fiscal burden that will result when the existing assistance programmes are extended to the new EU citizens. In a prominent position are the agricultural subsidies that comprise 45% of the EU budget. In Poland ten times as many people of working age are in agriculture than in Germany, and a linear extrapolation of current EU subsides results in expenditures of an additional 0.8% of the western European GDP for the agricultural sector when all eastern European accession candidates are accepted. This is a problem, albeit a minor one. Of greater importance is the adjustment pressure that will be placed on the national political decisions of the western EU countries from the mobility of people and businesses.

Europe stands at the threshold of a new phase of its development, characterised by a fierce competition of systems between the institutions of the old national states. In a Europe of 25, the national states will no longer be able to act in the isolated fashion as once was the case. The opening of borders forces them, on the one hand, to compete for the investment and location decisions of potent firms with lower taxes and a good infrastructure. On the other hand, every state will be wary that a generous social system may induce migration streams of the needy that may turn it into a "poorhouse" of Europe. Competition among countries has its strengths, but its impact on the institutions of the social welfare state is not promising. The migration of people and businesses threatens to trigger off deterrence measures that could lead to an erosion of the social welfare state.

The Extent of Mobility

Guest workers and poverty refugees from eastern and south eastern Europe are already flocking into western Europe, enticed by the extremely high wage differences or forced to migrate because of catastrophic conditions in their home countries. In the large EU member states such as Germany and France, the foreign population is more than 6%, and all estimates point to further increases in the coming years.

A particularly high mobility is expected from people in the ten eastern European countries that are negotiating for EU membership, since their standard of living will not approximate that in the west for some time to come. Wages in eastern Europe are one tenth to one fifth of that in western Germany or one fourth to one half of German welfare payments, at least according to present exchange rates. In Munich the average hourly wage in the engineering industry is DM 28.50 in comparison to DM 4.80 in west Poland and DM 2.70 in east Poland. In real terms the discrepancy is not quite so large due to the lower prices of non-traded goods, but it is still considerable. Given the size of the discrepancy, it seem likely that eastern EU expansion will lead to substantial westward migration.

The first wave of accession, which will include five countries is now expected to come by 2004 at the latest. Estonia, Poland, the Czech Republic, Slovenia and Hungary with a total of 63 million people will then be members of the EU. Latvia, Lithuania, Slovakia, Rumania and Bulgaria with another 42 million people are determined to follow soon. Even under the most optimistic assumptions of the growth rates of the EU candidates, it will not be possible by the scheduled time of entry to raise average wages to 20% of western German wages or to one half of German social welfare assistance.

In a recent econometric approach published by the UK Department of Education and Employment it was predicted that about 2% to 3 % of the eastern European population will migrate to western Europe if migration remains restricted. However, for the case of free migration the econometric evidence points at much higher figures. No less than 6 % of all Poles, 16% of all Bulgarians and 27% of all Rumanians can be expected to leave their countries. On average, nearly 11 % of east Europeans will leave their countries when they can, and this is a total of 11 million people if all 10 applicants are admitted.

These figures are confirmed in a poll carried out by the International Organization for Migration (IOM). The poll reveals that about on fifth of Slovenians, Poles, Hungarians and Czechs, and even one third of Rumanians would wish to emigrate for a couple of years if they could.

A look at the migration from Turkey is also instructive. Today, 4% of the Turkish population lives in Germany. If only 4% of the new eastern European EU citizens came to Germany, this would be more than four million people. When eastern Europeans will enjoy the freedom of settlement in Germany, this is probably at the lower end of plausible estimations.

It is sometimes argued that the previous experience with Spain and Portugal suggests that there will not be much migration from the east, when the freedom of settlement is granted. However, for a number of reasons this is a misinterpretation of the Iberian experience. First of all, there was a six year transition period after joining the EU during which migration was largely forbidden. Second, the wage gap was much smaller than it now is between eastern and western Europe. In the years before membership started Iberian wages were about 47 % of the west German wages; by contrast, the average wage in the five eastern applicant countries is currently only 13% of the west German wage. (The respective figures for all 10 applicant countries are certainly much smaller, but reliable information is not available.) Third, and most importantly, much of the migration potential may already have been exhausted before Spain and Portugal became members. In the sixties, both countries had dictatorships but did not forbid their citizens to travel abroad. Thus many people fled from their countries seeking protection in EU countries. Between 1960 and 1974, the accumulated Iberian net emigration was 5,5%. When Spain and Portugal applied for EU membership in 1977 and became members in 1986 most of the potential migrants had already left, and many of them actually took the opportunity to return. This scenario is very different from the situation in eastern Europe. When the eastern population lived under communist dictatorship a tight Iron Curtain effectively prevented emigration, and when the Iron Curtain was lifted, the west decided to no longer accept easterners as political refugees. As of today, therefore, the migration pressure has not yet been released. Indeed a mass migration can be expected when the right to settle freely is granted to the people in the east.

Westward migration will have strong implications for the western European social welfare systems, since the decision of which western country to migrate to will primarily be determined by economic incentives. To be sure, a large income differential is necessary to induce people to leave their home countries, but once this decision has been made, the choice of the destination country will be influenced by even small differences in living standards. Thus, a nearly perfect *differential* mobility among the western European countries can be expected, and the pressure on present social systems will be enormous.

Deterrence Measures

The benefits of the social welfare state will become a problem in this situation, because they attract migrants who are net recipients of public resources. The western European countries will endeavour to examine their social benefits so as not to emit unnecessary migration incentives. Since poverty refugees' choice of country will depend on where the most extensive social benefits can be expected, there will indeed be a competition for the most effective deterrents, where each country tries to be less attractive than its neighbours. In the competition for the lowest possible social standards, the European social welfare state will be exposed to strong erosive forces which threaten its very substance.

The competition for effective deterrents does not presuppose that migrants are attracted by social benefits alone. This connection is ruled out because recipients of social benefits need to have present or prior employment, according to present EU law. The marginal migrant makes a contribution to the GDP of the host country which is equal to his or her gross wage income, and the infra marginal migrant makes an even larger one. Thus his wage is no burden for the citizens of the host country, and therefore no political deterrent measures are induced. The problem arises, however, in the form of state income redistribution for the benefit of workers with lower wages. Low-income workers pay little or no taxes, but they are entitled to supplementary welfare payments for themselves and their families, their children enjoy free schooling, they have access to public housing programmes, they gain from the redistributive elements in the health insurance system and, last but not least, they profit from the infrastructure the state provides free-of-charge. These benefits imply that the marginal low income immigrant receives more than he or she produces and that the existing population has a strong incentive to reduce the benefits. Systems competition in the presence of free migration will take the form of lowering the net transfers of resources to low-income workers, and this means at least a partial dismantling of the social welfare state.

It is true that the challenge to the social welfare state from the migration process is not harmful in every respect. The state's influence on the lives of its citizens is too extensive and the false incentives it creates are too many. The traditional social welfare state creates a strong incentive to avoid the labour market. Typically, social benefits are received as long as one does not work, and they are lost when, and to the extent to which, labour income arises. This type of welfare needs to be thoroughly reformed, and if such reform is touched off by migration-induced financial problems, this can only be welcomed in principle.

The problem is, however, that even a well-constructed social system that rewards self-initiative rather than idleness will be eroded by the systems competition. A well-constructed welfare system helps people help themselves, it provides workfare instead of welfare, because workfare makes wages flexible downward and creates additional jobs. Germany’s traditional welfare system implies a minimum wage which is about 70% of the median wage. By way of contrast, the U.S. earned income tax credit in itself implies no minimum wage, and the legal minimum wage is only about 30% of the median wage. The earned income tax credit shows how from every dollar that the government is prepared to spend for welfare measures a maximum of social-policy objectives can be achieved. This is a prime example of a social system that encourages self-initiative, apart from the fact that its level is far too low by European standards. Unfortunately, however, even a well-constructed social welfare state is not protected from the erosive forces of systems competition. The essence of a social system is the redistribution from rich to poor, including the working poor, and it is this redistribution that will erode, for the reasons given above, regardless of whether it is well or poorly constructed.

From a theoretical perspective, a more fundamental reason for the erosive force of systems competition can be seen in a policy externality that is created by a national redistribution policy. A country that makes gifts to the poor and forces the rich to finance these gifts induces the rich to go abroad and the poor to come from abroad. In this way the country reduces in other countries the real wage of the factors of production offered by the rich and increases the real wage of the factors offered by the poor. Thus the wages for skilled labour and the rate of return on capital will fall abroad and the price for expensive real estate will rise. Conversely, wages for simple work abroad will rise and the price for basic real estate will fall. Moreover, the outflow of net payers and the immigration of net recipients of government benefits will produce government budget surpluses in other countries that can be used for social purposes. The degree of target fulfilment of foreign social policy will be increased without foreign governments' own efforts. At the same time, the degree of target fulfilment of domestic social policy will be weakened since the departure of the rich and the entrance of the poor will increase the gap between the gross wage rates of the factors of production offered by these groups. From all this it follows that a portion of the equalising effects of domestic social policy will be distributed abroad by factor migration and will be lost domestically. This policy externality reduces the domestic incentive to maintain the welfare state.

In the theoretically extreme case of a small country and perfect mobility of the affected population groups, the effects of national social policy would fall completely on other countries. The domestic net-of-tax income distribution would then be determined exclusively by conditions abroad regardless of the national redistribution efforts, and it would be meaningless to pursue a national social policy.

A Comment on Social Standards

Some commentators have feared that the competition between countries touched off by migration will also erode the social standards in connection with the workplace. The 1989 European Social Charter refers to these standards and includes workplace safety, working conditions as well as in-company training and education. The fear of an erosion of working standards is unsubstantiated, however, as can easily be demonstrated, since measures for workplace safety and comfort have little in common with state redistribution measures. They are a wage-equivalent compensation in kind that has a value for employees but that also, just as cash wages, makes the factor labour more expensive. In terms of this compensation in kind, an optimistic view of systems competition is justified since countries will endeavour to create an optimal mixture of monetary payment and compensation in kind in order to attract as many mobile workers as possible and thus maximise the income of immobile factors that co-operate with these workers and profit from them.

If a state increases its monetary transfers to poorer people, it diverts the migration streams into its own country and lowers, as has been explained, the gross incomes of those it wishes to help. If, however, the same state increases safety standards marginally, it will not create any migration effects provided that wages are determined competitively and that the standards have been chosen optimally. Since, in the national policy optimum, the marginal cost of workplace safety equals its marginal benefit, an increase in standards will only lead to an equivalent lowering of monetary wages, and the migration incentives will remain unchanged.

Of course, the full equivalence no longer applies when wages are not flexible or when workplace standards have not initially been optimally chosen. But this by no means presents a policy externality that would create similar doubts on the effectiveness of systems competition as are applicable in the case of redistribution measures of the social welfare state. This is a point that is overlooked by many critics as well as proponents of systems competition. It is only the redistribution measures that stand to be eroded.

Haider, Harmonisation or Home-country Principle

The looming erosion of redistributive policies calls for counter measures if one is in favour of redistribution in itself, for instance if one sees the redistributing state as insurance against career and living risks that are not privately insurable. A particularly simple but just as problematic protective measure lies in postponing the freedom of settlement and in erecting a legal wall in place of the physical wall that was torn down ten years ago. Votes can be gained by proposing such a system, as Haider's success in Austria has shown, but it implies throwing out the baby with the bath water.

Preventing free migration, namely, also means not enjoying the welfare gains that such migration, in principle, can be expected to bring about. A migration free of artificial incentives would only lead to so many guest workers from eastern countries to the west that the marginal migration cost equals the wage difference between east and west, and this precisely is the welfare-maximising rule for the allocation of the existing European work force, provided that the wages equal the marginal productivity of labour in the countries involved. If a Polish worker is induced to give up his Polish job for one in Germany, then Poland's GDP will fall, but that of Germany will rise. As long as the increase of the German GDP exceeds the reduction of the Polish one, the overall European GDP will increase, and as long as the increase in GDP is larger than the Polish worker's migration cost, a welfare gain arises. Migration in principle is a good thing, especially since the initial wage difference leads us to expect an export of capital to Poland, an increase in wages there, and a later return of the guest workers. In the transitional phase up to the convergence of the eastern European economies to those in the west, a temporary westward migration of a portion of the working population is a welcome development. The problem is not that such migration takes place, but that the western European social welfare states create an excessive migration incentive.

To remove the excessive migration incentive, thought could be given to a harmonisation of social systems. There would indeed be no artificial incentives to westward migration if the same social standards prevailed everywhere. Harmonisation at the level of the eastern countries, i.e. at one tenth to one fifth of the current western level, would be tantamount to the state calling for a revolution in western Europe, and harmonisation at the western level could not be financed, neither by the east nor the west. Extrapolating from the experience of German unification, the burden will amount to 5-7% of the western European GDP, which surely no one in the west would accept, let alone the west Germans, who already transfer 4.5% of their GDP to east Germany every year.

Only two alternatives remain. The first is to select immigrants by their income, wealth or skill level to make sure that no net recipients of public resources are allowed to enter. Although this approach is chosen by some immigration countries, it does not seem appropriate to the European Union. It is a crude dirigiste approach which suffers from the mistakes government bureaucrats will make. It may select the wrong people and it excludes people with low earnings capacities altogether even though there is no reason why, in principle, they should not be allowed to migrate as well.

The second alternative is the EU-wide application of the home-country principle wherever this appears to be possible. Instead of restricting the freedom of settlement, relying on the judgements of bureaucrats or harmonising social standards, access to the benefits of the western social systems can be limited. Either the claims for social benefits should be directed towards the home country, or benefits in the country of residence are only to be paid to the amount they would be paid in the home country. For many redistribution elements in the state budget it cannot be prevented that the migrants also benefit. But in a new EU treaty at least social welfare, housing grants, the rights to be considered for municipal housing and similar benefits could be converted to the home-country principle. Perhaps it would even be conceivable to introduce a special type of income tax for immigrants which embodies less redistributive elements than the usual one. Currently one of the basic EU rules is that people are entitled to social transfers from their country of residence, where they both live and work or where they have worked. If, however, entitlements could only be claimed from the home country under its conditions, there would be no more artificial migration incentives, and the hope would be justified that the free migration decisions people make would approach an optimum level. This would also be an effective check on the erosive forces of systems competition.

The home country-principle in welfare benefits has been in use among the Swiss cantons for some time and has proven to be effective. The German government would also like to implement a portion of the home-country principle in its suggestion that migrants should be treated as independent contractors to preclude automatic entitlements to the German social welfare system. How the home-country principle should be implemented in detail must be the task of thorough political and economic analysis. It is certain, however, that this principle in the EU-25 will be a prerequisite for creating the desired freedom of job selection in the first place. Without this principle there will be such serious negative effects, both with regard to people's migration decisions and the stability of the western social systems, that fears will be raised as to the process of European integration itself. Haider’s success should be a warning.

It is true that the home-country principle is not compatible with current EU law, but so is EU enlargement as such. Eastern enlargement puts everything under scrutiny, and nothing is taboo. The legal system underlying the current EU needs to be overhauled in many respects. The adoption of the home-country principle is a minor step relative to other reforms the EU must undergo. Of course, EU enlargement can only meaningfully be discussed *de lege ferenda*, i.e. in terms of legal reforms, and not *de lege lata,* in terms of what can be done without changing the laws.

Many may consider the application of the home-country principle as a historic step backwards that violates the principle of the inclusiveness of the social welfare net. It is also to be expected that the EU membership candidates will oppose the home-country principle, fearing that their guest-worker families in EU countries will be at a disadvantage. It must be recognised, however, that the other available policy alternatives are by no means more attractive for the new EU countries. The restriction of the freedom of settlement or the selection of easterners who are allowed to migrate would mean even more exclusion than the home-country principle, and the harmonisation of the social systems to the western level would lead to an increase in the minimum wages of the new EU countries, which would induce mass unemployment. Even if the western countries were willing to pay the costs of mass unemployment in eastern Europe for several years, such a transfer of the German solution to Europe would not be in the interests of the new EU countries since their economies would then never prosper.

The eastern countries will probably strive for a rapid integration without any “ifs” and “buts” in the framework of current EU law. This cannot be accepted by the west, however, because of the destructive implications for its own social systems. The membership candidates must be told where the negotiable limits are and it must be made clear to them that immediate integration on the basis of the residence-country principle would have such socially explosive potential in the west that ultimately the social and political stability would be jeopardised that the eastern European countries wish to participate in by their membership. Here, the home- country principle is indeed the better alternative. It avoids the limits of freedoms that some are already proposing and it preserves the west's commitment to integration.

Quite possibly the home-country principle will not need to be permanent. It is basically intended as protection from excessive migration during the adjustment phase of the new EU countries to the western standard of living. Once this adjustment has taken place, which can be expected after a generation, thought can be given to returning to the inclusiveness of the residence-country principle. This will depend on whether general mobility has not by that time increased for other reasons. If mobility in Europe has reached American proportions, under the residence-country principle there would be such competitive pressure on the social welfare state, even without mass migration from the east, that only the American level of social welfare would remain.

Final Remarks

Europeans expressed great misgivings about the euro although it was clear that the euro would have no immediate consequences for actual commercial transactions. In contrast, eastern EU expansion, which is currently attracting little public attention, is a very great problem which approaches German unification in terms of its significance and difficulty. German unification was carried out by political fiat without consideration of economic factors, and it is clear today how expensive it was. Even after ten years every third mark spent in eastern Germany comes from the west, and the national debt continues to grow to finance unification. It almost seems as if similar mistakes are about to be repeated at the European level. Hardly anyone in Brussels is looking at the question of what reforms of European social law are necessary in order to master the challenges that will come. All attention is focused on the progress the eastern European countries are making to adjust to western laws, as if the western European countries and the EU are ideally prepared for expansion. The carefreeness with which people refuse to analyse the economic issues fatally resembles what was observed during German unification. “Full steam ahead” is again the motto, and once again the accusation will be made that also the economists did not give advance warning of the problems.