Contra: Europe Does Not Need a Social Union

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Europe does not need a social union. Why? Because a social union would replicate the problems east Germany faced after unification. Germany introduced a monetary union, a political union and a social union, and the social union turned out to be a disaster. It pushed wages way above the market clearing level, because the welfare state paid high replacement incomes such as unemployment benefits, social assistance and early retirement pensions, and people were unwilling to work for wages below, or equal to, those replacement incomes. Mass unemployment resulted.

The welfare state is not a problem if it remains moderate, i.e. if the wage floor that it implies is not binding. That this condition is met can be assumed for rapidly growing economies whose wages rise faster than the welfare state can react. However, shrinking economies with declining wages have their problems, because the entitlement wage levels reflected by the welfare benefits stem from better times. Similarly, poor economies whose replacement incomes are co-determined by the rich ones cannot prosper.

This would be Europe's problem if a social union were implemented. The political consensus on the harmonised level of replacement incomes would, in all likelihood, be too high for the poorer countries in the South and the East, because the richer countries of the North would not be willing to reduce their social standards. There are Spanish, Portuguese and Greek areas where wages are only a quarter of west German wages, and in the new Eastern European member countries, wages average hardly more than a sixth. A rapid de-industrialisation or at least a halt to further industrialisation in these areas would result from social harmonisation measures and their implied wage equalisation. Today, west German social assistance paid to a family with two children is 1500 euro, which is more than three times the 450 euro that the typical Polish industrial worker earns. There would not be two, but twenty Mezzogiorni in Europe if European welfare levels were harmonised at the west German level.

Migration would exacerbate the situation. There would be mass emigration of unemployed from the low-productivity to the high-productivity regions where the probability of finding a job is higher, but this migration would not bring about the usual welfare gains which result from migration driven by competitive wages. To prevent mass migration, the richer countries would be forced to pay huge fiscal transfers to the poorer countries similar to those that flow from west to east Germany.

The defenders of a social union argue that open borders and free migration make it difficult, if not impossible, to preserve the welfare state, because independently acting welfare states will erode under systems competition. Welfare states will try to treat rich capital owners better than their competitors do in order to increase their tax bases via capital imports, and they will treat the poor less generously than their competitors do in order to avoid becoming targets of welfare migration. Thereby they will be caught in a downward spiral that leads to a gradual reduction of taxes and social benefits even though all would prefer maintaining their benefit levels if there were no migration.

This argument is correct in principle. The huge divergence in productivity and income levels across Europe is far too high, however, to conclude that a social union with harmonised benefits is the right way to prevent the erosion of welfare systems. The price in terms of mass unemployment in the less-productive regions of Europe would be excessive.

There is a better way to preserve European welfare states in an integrated Europe. It consists of two elements that were proposed in the first report of the European Economic Advisory group at CESifo[1] The first element is the payment of wage subsidies instead of wage replacement incomes. That would make the welfare state a partner rather than a competitor of the private sector. It would make wages flexible and prevent unemployment. The second is the selectively delayed integration of migrants. In Germany, the annual net fiscal benefit enjoyed by the average migrant who had been in the country for less than ten years was 2.600 euro in 1997. The selectively delayed integration would exempt migrants during some transition period from some of the tax financed benefits of the welfare state and make the net fiscal benefit zero. As a consequence, free migration would be efficient and the European welfare states could be maintained without harmonisation.

[1] "Welfare to Work", Report on the European Economy 2002, CESifo 2002.