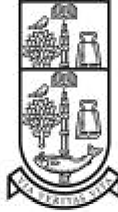

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STEVENSON LECTURES in CITIZENSHIP:

1. "Making Welfare Work: the Politics of Reform", by **Frank Field**
2. "EU Enlargement and the Future of the Welfare State", by **Hans-Werner Sinn**
3. "Globalization and the Future of Social Protection", by **Vito Tanzi**.

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MAKING WELFARE WORK: THE POLITICS OF REFORM

A Stevenson Lecture in Citizenship

By the Rt Hon Frank Field MP

University of Glasgow

Tuesday 18th April 2000, 18.30

Summary

Welfare reform, if it is to be successful in the longer-term, needs to be based on a carefully thought out political strategy. The new political arithmetic, where the poor are an electoral minority, and many working class voters have rising aspirations, requires welfare reform to appeal to the interests of the majority. While welfare reform similarly must work with rather than against the grain of human nature, self-interest has to be harnessed in a way which builds an inclusive programme. The Government's drive towards ever greater means-tested provision looks good in year one. The penalties means-tests impose on working, saving and honesty become apparent only later with an ever-growing proportion of the population having to think about how best to work this system. Equally importantly, this drive to even greater means-tested dependency is set to blow apart some of the key characteristics which underpin a common citizenship.

Introduction

Thank you for extending to me the privilege of giving a Stevenson lecture on citizenship. There is much that could be said about the founder of this lecture series, his role in your university, city and country. I limit myself to one matter. At a time when the population is aging, a man who becomes your Chancellor at the age of 83, and holds that position for a decade, gives a fairly clear steer on how welfare might develop, particularly on where, if at all, Governments should pitch the official retirement age!

I begin by outlining what I intend to say. Winston Churchill, as a junior member of the Liberal Government, turned his mind in 1908 to the question of how best to mitigate the evil influences of unemployment on families. He referred to this issue as that "untrodden field of politics".[1] So too with the idea of citizenship in the English political tradition. The word citizenship is rarely given any clear meaning in political ideas of political activity. It is nevertheless of considerable political significance.

The underlying theme I wish to develop is that welfare reform needs not only to be thought out carefully, but it has also to be backed by a coherent and inclusive political strategy if it is to be successful. Indeed, I shall argue that the importance of this political strategy is such that it must help shape how the principles may be translated into working reforms. The expectation (certainly my expectation) was that thinking the unthinkable would form the basis of the welfare reform strategy Labour would advance in office. To illustrate the politics of welfare reform I shall endeavour to introduce you to how stakeholder pensions could have been enacted. By turning its back on this approach the Government has been forced to concede a growing dominance to means-tested welfare. The consequence this has for citizenship in the twenty-first century is the last theme on which I wish to touch.

[1] Winston S Churchill, "The Untrodden Field of Politics", **The Nation**, 7 March 1908.

Not by the poor alone

A new political arithmetic of our age was the starting point underpinning the politics of thinking the unthinkable. Expressed crudely, there have already been three periods with their own distinct political arithmetic in modern politics. There was, first, that which operated before the advent of the universal franchise, which is itself a fairly recent phenomenon in Britain, although we sometimes convince ourselves otherwise.[2]

During this first stage political leaders, such as Peel and Gladstone, were adamant that parties should not produce programmes until they were "called in" as it was known. The phrase, presumably, derived from the monarch summonsing or calling to the Palace, a political leader and inviting them to form an administration. The rhetoric was nothing if not proud. Politicians were there to exercise judgement and not to be swayed by the preserves of voters. Given this was still an age when landed magnates could and did determine not only the choice of some candidates, but which of those candidates were successful, the "no policy" declaration until a leader was "called in" did not fully describe the subtlety of the political process. Here, then, was a political arithmetic where interests were represented in Parliament but in a manner totally foreign to our current democratic comprehension.[3]

[2] Some working class men gained the vote in 1867 and others in 1884., But the main bulk of unskilled working men did not gain the franchise until 1918 when the size of the electorate increased threefold: up from 7.5 million to over 21 million voters. Women did worse. Although they won the vote for elections for poor law guardians, women did not gain a parliamentary vote until 1918 and even then only did so on their thirtieth birthday. Age equality for voting was only established in the lifetime of my parents – in 1928 – and single voting only in my lifetime – in 1948.

[3] See Martin Pugh, **The making of modern British politics**, Blackwell, 1993, for an excellent introduction on how contemporary participants saw politics operating around the time of the Second Reform Act.

It is not hard to imagine the shock when someone who had *made* their fortune, rather than inherited it, and done so from *trade*, rather than from land, challenged this thinking and heralded the "age or ransom". In this short, tough, explosive phrase, Joseph Chamberlain delivered an unyielding message. If the rich wanted to keep most of their loot they would have to buy off poorer voters with social reform. Here, then, was the political arithmetic's second era. Politicians of all parties sought an election victory on the basis of offering gains for the working class paid for with money taken from other voters.

The age of the have nots comprising a majority of the electorate spilled over into quite recent times. To be a majority group does not, of course, mean that the majority voted as a single entity. The party of the left had to appear a credible government for that to happen. Yet, looking again recently at the Socialist commentary's **Must Labour Lose?**[4] report, I was struck by just how large a proportion of voters in the 1960s still thought of themselves a working class and belonging to a party which championed the under-dog.

The politics of ransom provided a political cover for the poor. We are still talking of a time when there was a large overlap between being working class and being poor. There were marked differences, of course, between those at the top and at the bottom end of the working class income spectrum. But there was enough common ground still to make an electoral appear relevant to poor and non-poor working class alike.

Protecting and promoting the interest of the poor today takes us into political arithmetic's third age. A sizeable part of the working class and lower middle class now have incomes which given them for the first time real choices. They rarely look to those below them. They associate themselves increasingly with the aspirations common amongst those higher up the social hierarchy. Gaining reforms paid for by someone else's money is one matter. Being expected to pay for your own reforms puts the issue into a different focus. Moreover, paying

for the reforms over which you have little say is guaranteed to generate friction. This third age is therefore one where consumer interests replace the dominance of producer interests.

A ration book fare from central government has less and less appeal for these new discerning consumers. Choices can and are made. Look, for example, at how the holiday trade has been transformed. It was not that long ago when the so-called enlightened middle classes scoffed at the idea of working class people holidaying abroad. Similarly, the left, in particular, has been loath to enfranchise public sector consumers. Yet within the severe restraints imposed upon them many voters are trying to insist on choice in what is offered by what remains of the public sector.

In the third age of political arithmetic the traditional approach to social reform no longer commands enough support. Rousing calls of fraternal greetings, of common endeavours and the like, are important for the political platform, although, even here, the audience has for the most part quietly tip-toed away. Altruism alone is not strong enough or durable enough to sustain a radical programme. An appeal to self-interest of the majority has to be clearly pitched, and it is only within this appeal that the interests of the poor can now be advanced.

Self-interest and the common good

The role of self-interest raises a second strand of the politics of thinking the unthinkable. Self interest is basic and intrinsic to human nature. How otherwise would mankind ever survive? But while self-interest is distinct from selfishness, and selfishness is a different stimulus from greed, self-interest does not automatically preclude, or even necessarily

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[4] Mark Abram, Richard Rose and Rita Hinden, **Must Labour Lose?**, Penguin, 1960.

preclude altruistic intent. In the post-Freudian age we perhaps ought to know better than to asset a purity of motive for any single action or thought. I would guess that altruism is very often underpinned by self-interest. (It certainly is in the USA where it is tax deductible!) That is not in any way to devalue altruistic intent. It certainly does not lessen its effect. It is merely to draw attention to a force strengthening its durability.

The new political arithmetic demands that if policies are to have a chance of being carried at the election they must have a majority appeal. But it is possible to make such a pitch, and make the approach comprehensive in order to include the poor. Of course a majority appeal does not automatically ensure comprehensibility. But these two goals are not inevitably opposed.

To illustrate the other assumptions which underpinned the political strategy of thinking the unthinkable I wish to concentrate on pensions reform. It would be possible to recast stakeholder pensions from its present mould shaped by the personal pension regime and to build it as a guarantee offering a pension valued at a set level of average earnings. Such a scheme would see the achievement of a number of aspects of thinking the unthinkable.

It would establish a link between self-interest and the welfare of the poorest. A pension guarantee set as a percentage of average earnings cannot be bought in the private market other than by the seriously rich, and they, not surprisingly, are unlikely to be interested in a stakeholder guarantee. Such a guarantee can only be offered to ordinary voters if it is underwritten by the community as a whole.

Universal but not state

This form of stakeholder pension illustrates how universal coverage can be gained in an era of non-government provision. Indeed, looking beyond government may by the *only* means

by which a new universalism can be established in respect of pensions which is, after all, by far and away the largest item of expenditure in the traditional welfare budget.

The proposal I put forward in government was for new recruits to the labour market to be required to contribute to a funded pension as well as their national insurance pension. The aim of both contributions would be to accumulate funds sufficient to offer a stakeholder pension set at a high enough proportion of average earnings to ensure that all pensioners were lifted free of means-tested entitlement.

The funded side of the scheme would not be divided up into little personal pots of wealth, as is the norm for personal pensions, but kept as part of a number of larger investment funds. Contributors would be able to opt for one of the funds, and move between them. The selling of stakeholder would be allowed only through membership owned bodies.

Compulsion is crucial to the success of this proposal. All those in employment above a very low income threshold would have to be in a stakeholder pension scheme. But, because of the attractiveness of the idea – it cannot be bought elsewhere – self-interest could allow some form of graduated contributions – ie, self-interest could support the altruistic objective of raising the funds within the scheme to include the poor.

Sending the right message

This is not the place for the full details of this proposal, but one important advantage of such an approach is that it would send out all the right messages on work and saving. This is in stark contrast to the messages emanating from the Government's means-tested Minimum Income Guarantee. This means-tested approach results in possibly 40 per cent of the working population being unable to save enough to provide an income greater than that which comes from the Minimum Income Guarantee. Saving has become worse than a useless activity. It is positively dangerous to the financial health of a very significant

proportion of the population. And this is not simply a debating point. The Government's short term Minimum Income Guarantee reform undermines the sense of saving for the long-term. Already there is evidence showing retired lower paid workers with small occupational pensions finding themselves worse off than neighbours who refused membership, and also those who had the money but who refused to save, preferring to spend today and let taxpayers look after them tomorrow. What message does this send to the next generation of potential savers?

A universal stakeholder pension can guarantee that all those on low incomes will keep all the savings they have made in addition to their contributions towards a stakeholder scheme. None will be clawed back through any means-test. It also sends out the right message to those who cannot work at any one time. Providing people in this category fulfil the conditions as a carer or, as unemployed people, are actively seeking work, their contributions will be paid each year to the stakeholder pension plan. This group of the population would therefore know that when they are able to work again they would be building upon an accumulating pension entitlement, and not be faced with the prospect of perhaps being too old to join a pension scheme.

Transparent redistribution

This single pension reform illustrates three other aspects of the political strategy aimed at fundamental welfare reform. First, the age when taxpayers are prepared to finance significant unconditional redistribution is passing. This is not to say that redistribution is impossible. It is, however, a plea to stand conventional wisdom on its head. Rather than the redistribution being hidden from the electorate as the only way of achieving this end, it needs to be made transparent. If this redistribution is to be sustained over the longer term it also needs to be lined to encouraging behaviour that taxpayers believe enhances the public good.

The pension scheme I have described sets out to meet these objectives. The extent of redistribution is there for everyone to see. Indeed, it might be said that the scheme errs on the side of rubbing the noses of contributors into this very fact. This transparency is, I believe, crucial. The standing of politicians is low. Political activity is mocked, if not despised. To try and hoodwink voters on this, or any other major issue, might work for a while, but it courts a nasty backlash when voters rumble, as they surely will, what the hidden agenda is.

Best form of contract

Next, the scheme also builds on the belief that, while no arrangement can be expected to last into the very long-term, history points to some contracts having a longer life expectancy than others. In welfare there are two ways of financing a pensions programme, apart from the short-term expedient of borrowing from abroad. Both make claims on any year's national income. The first attempts to bind taxpayers into transferring income. The second is to build up holdings of capital, and for this capital ownership to be used as a means of lodging a claim on any year's national income. And both approaches are necessary, I believe, in any sensible welfare settlement. But, on the question of extending welfare provision, for that is what pension reform is fundamentally about, I believe the balance of argument is in favour of greater funded provision. History teaches that, in this country at least, claims on national income by way of dividend payments are met more easily than taxpayers finding themselves committed by previous generations to a high level of taxation.[5]

But funding is not the panacea that it is often thought to be. Indeed, the one which holds the better track record for delivering payments, via wealth holdings, could be overturned if a future generation feels that the wealth holders have an unfair claim on national income. The overturning may come by political means, ie, through the ballot box. Or the challenge could

[5] This was the line argued in the welfare reform Green Paper, entitled significantly, **New ambitions for our country – a new contract welfare**, HMSO, 1998.

be economic, whereby workers push up inflation to cut the real income levels of wealth holders.

A third political judgement centres on what the best arrangements might be for spreading risks common to practically the whole community. Here the debate is usually crudely polarised, with collective provision being pitched against market arrangements. But collective provision here does not mean state provision, and collective provision can be such as to draw upon a market spirit in its administration.

Collective non-state provision

From the perspective of the years just prior to the outbreak of the First World War most observers would have predicted that Britain's welfare would continue to develop along the highly decentralised lines of membership owned organisations.[6] This is not the place to discuss why, 50 years later, this country had one of the most highly centralised and government run welfare states in the free world. What is important is to register that the "coming of the welfare state", as so many text books bill these events, was neither inevitable in this form, nor did it mark the utopian end game as far as welfare was concerned.

Collective provision is still the best way to advance in covering common risks. With risks spread over the greatest number of people, average costs are low. As cherry picking is not allowed, taxpayers are not left to underwrite the costs of those with the greatest risks who the market refuses to cover. But collective provision is not necessarily synonymous with a state run system. Here was another key political judgement. Welfare expenditure needs to increase – we are, for example, living decades longer and pensions therefore need to be

[6] Jose Harris, "Political Thought and the Welfare State 1870-1940", **Past and Present**, May 1992.

drawn over a much longer time span. Yet individuals generally are resistant to increased taxation, and increased state provision, as a means of delivering this expanded welfare package.

The increasing cost of welfare might be borne collectively, and therefore offer cover to the poor, if new membership based organisations were established to control and handle the assets, and to distribute the benefits. In other words, by putting government, as we currently know it, at arms length. By achieving this goal – and so allowing comprehensibility – another equally important goal is achieved. Welfare reform dovetails with the more traditional constitutional reform debate. But in place of devolving power to geographical regions, this programme of reform is about extending the power of individuals within new membership-owned organisations. Increasing individual control over welfare assets is, I believe, the *quid pro quo* of an agreement to save more for a better pension income in the future.

A major task is completed. I have outlined the politics which underpin the welfare strategy I hope the Government in the not too distant future will implement. But there is one part of the story which waits to be recalled. The Government's rhetoric about welfare is markedly different from the line pursued in opposition. Are we in a new era? Or is the old welfare wine merely being put into new bottles? And does the course of reform which is now being pursued strengthen or destroy one of the major supports for a common citizenship?

New labour or old policies?

Let us go back to the labour Opposition's central attack on the Tory's welfare budget. While there was a sense of shock when the leadership realised that by far and away the largest part of the Government's budget – a cool third – went on welfare, the rate at which this budget was growing, and the negative impact of means-tested welfare on behaviour also became a matter of major political concern.

Indeed, the attack on means-testing was linked to the growth in the budget. By far and away the fastest growing part of the welfare programme was the means-tested element. That proportion of the budget stood at 35 per cent in 1997, up from 13 per cent in 1979. The number of people living in households with a least one member dependent on means-testing had doubled during this time, from one in six to one in three.

The Labour Opposition Front Bench rounded on a government forcing an ever-growing army of pensioners on to means-tested income support. Family Credit – a subsidy to low wage earners – was condemned in similar fashion. It sustained the evil of low wages, it benefited scrooge employers and, by subsidising their wage bill, it not only created unfair competition but distorted the market by its downward push on low wage rates.

The government claims it has halved the growth in the overall welfare budget.[7] Two reasons principally account for this trend. The buoyant economy has played a positive role. In many areas of the country, but alas not all, the increase in the number of jobs has ensured that there is work for people anxious to move off welfare. A series of Tory welfare cuts – hotly opposed by the Labour Opposition – are now in place and having a downward push on the size of the welfare bill. People's entitlements to some benefits have been cut or abolished.

The Government's welcome welfare to work strategy is also a factor in the equation. But its importance in reducing unnecessary welfare expenditure is not comparable to these other two factors. Indeed, its costs, so far, outweigh its benefits in terms of reduced welfare expenditure. The programme's impact will however be felt in the longer-term. Welfare to

[7] The claim is even more impressive than this. The current spending plans to 2001/02 project an average increase of 0.2% each year (excluding tax credit) or 1.1% (including tax credits). This lower rate of growth is largely attributable to a real terms fall in benefit expenditure in each of 1997/98 and 1998/99. Growth in each of the three subsequent years, ie, after 2002, is expected to be well above that in each of the last three years of the Conservative Government.

work signals a change from what might best be called a passive welfare system, with an operation largely concerned with paying out benefits, to a proactive one which weights the crucial task of paying benefit with an equal concern with helping people into work when that is a realistic possibility. The change in public culture these series of welfare to work measures will bring about should not be under-rated. But they are not, as yet, a major influence in the fall in the rate of growth of welfare expenditure.

Behind the bravado claims of welfare success – the "cuts" in what the budget was forecast to be, falling numbers of young unemployed, the numbers generally moving from benefit to work – lurks the acceptance of an every-growing role for means-tested welfare. Sooner or later this development will derail the welfare reform strategy on which the Government has now embarked.

Means tested welfare

The strategy's presentation is nothing if not ambitious. Just as redistribution has fallen out of the political vocabulary, to be replaced by the concept of fairness. The terms Minimum Income Guarantee and tax credits are used as dazzling headlights. But these headlights are mounted on to the front of a means-tested bandwagon. And no amount of inventiveness over names will prevent the huge downside any means-tested strategy drags in its wake. The attack on work, savings and honesty is inevitable, and the more ambitious the strategy the greater the destruction on these fronts which will be wrought.

The Government's pension strategy already illustrates how short-term means-tested expedience can undermine noble long-term objectives. So as to provide more generous pensions in the future the Government's longer-term strategy is to reverse the current 60-40 rate of publicly financed pensions to private pension provision. A second overall objective is to reduce the number of pensioners on means-tests. If everything goes as planned, the Government's long-term reform will see the proportion of pensioners so dependent on

means-tests falling from one in three to one in four of the pensions population 50 years hence. And this modest, but not unimportant reduction, assumes the extent of means-tested help to current pensioners will have no adverse long-term effect on savings.

To make this assumption, however, is to stretch realism beyond the bounds of possibility. Buying the new stakeholder pension will be voluntary. Rebates will encourage target workers to joining, but there will be no compulsion. And, as I have already noted, at the same time the means-tested Minimum Income Guarantee is currently offering a growing proportion of the population a pension which is more valuable than anything they could acquire by saving. An army of pensioners who did save now would find themselves worse off than if they had simply squandered every penny the had ever had. The dignified but quiet anger expressed by pensioners writing from around the country who feel mocked by a government which rewards those who did not save – I accept there were some who could not have saved – and rely on future taxpayers to look after them, will not only be registered in a lower turnout at the next election if no action is taken, but within the extended families of these pensioners a most profound questioning is taking place. If work the system is well rewarded why not join the crowd?

Extending means tests

In his budget statement, in little more than an aside, the Chancellor hinted that pensioners would in future be covered by a pensioner credit system. Quite what this involves is as yet unclear. What is clear is how extensive is the spread of the tax credit system to those of working age. The flagship in this whole enterprise is the Working Families Tax Credit which subsidises low wages and pays a handsome contribution towards child care. So generous are the proposals that a family with three children may have an income of £40,000 a year and still be claiming the Working Families Tax Credit.

But there is a down side to this means-tested approach of making work pay. From net income of £91 and above, families face a withdrawal rate of 55p on the Working Families Tax Credit for each £1 rise in earnings. When income tax or National Insurance are added in the tax credit marginal withdrawal rate peaks at 70 per cent, or up to 95 per cent with housing benefit and council tax benefit withdrawal. This is at a time when the 40 per cent marginal tax rate is thought to be the highest that should be levied on top income earners.

Means-tests, it has to be admitted, do encourage entrepreneurial skills. But they are skills associated with working the system and they feed the black market or hidden economy. Means-tests encourage and reward dishonesty. Family Credit, the WFTC's predecessor, invited collusion between employers and employees. Wages were paid at a minimum. Family credit payments came in at a maximum and large sums of cash were drawn on the firm's bank account each week. Employees picked up part of their wages in cash, employers reduced their wage bill at the expense of taxpayers.

The National Minimum Wage builds a floor below which wages cannot legally be paid. This is an important reform, but between an hourly rate of £3.60 and £5.00, no wage increase can financially improve the worker's take-home pay. As with Family Credit, the Working Families Tax Credit will push low wage rates down towards the national minimum.

We are not talking of a means-tested welfare system affecting a small, declining proportion of the population. The current means-tested strategy will cover 40 per cent of the population, up from a third under the Tories. Once the pensioner credit system is introduced this proportion will surge above the 50 per cent mark.

The lure of the tax credit is powerful. But it is essentially a short-sighted strategy. It offers significant increases in take home pay. But workers so rewarded find themselves trapped

on a welfare treadmill. Next year marginal tax rates of up to 95 per cent will slash any pay increase.

We were told not long ago that you cannot buck the market. Indeed, but the political system bucked the person who told us this truth. Similarly, a welfare reform programme cannot buck human nature. One key aspect of thinking the unthinkable was that welfare had to work with, rather than against, the grain of human nature. Like the bricks made without straw, first appearances tell us nothing about durability. But just as those bricks did not last, disintegration under the lash of wind and rain, so too a Minimum Income Guarantee, or a tax credit system, cannot survive in the longer-run, no matter how creative the name of the means-tested benefit.

Ricocheting onto citizenship

Tax credits are presented as a simple and efficient means of making work pay. They certainly achieve this goal in their first year of operation, but, as I have already suggested the longer-term impact on a worker's net pay is less straight forward. But tax credits are not simply about modernising the tax and benefit system. They also have the potential to glow apart a major part of the current political agreement on citizenship.

The authority the Government claims for its lurch into tax credits is an apparently innocent sounding sentence in the manifesto. It reads: "We will keep under continuous review all aspects of the tax and benefit systems" adding, ironically, as matters have turned out "to ensure that they are supportive of families and children".[8] The adequacy of such an oblique authority for a revolution in taxes and benefits may be left unchallenged with the Government has a majority of 180 behind it. But this administration has embarked on a high

[8] **New labour: because Britain deserves better**, 1997 Manifesto, 25.

risk strategy. It is undermining a widely accepted agreement on how people should be treated in some very basic respects, and how to pay for a major part of the Government's programme, without discussion let alone testing the consequences of such a momentous change. Whether the Government realises how profound a change it is attempting to the basis of citizenship in this country is in some doubt.

Just how profound a change is being undertaken is brought into focus if we look at the 1945 settlement which the tax credit system seeks to replace. Not for the first time Jose Harris plots the subtle movement of debate over the decades which led to the advent of this contract-based citizenship. An insurance based agreement was established, and remained "extraordinarily tenacious" because it "fitted in with the current principles of fiscal reality, and with current evaluations of virtue, citizenship, gender, personal freedom and the nature of the state".[9]

Destroying the 1945 settlement

Tax credits strike at each of these foundation props of the 1945 settlement. Let me comment on each aspect, taking first the view about fiscal reality, of people's willingness to pay for a major part of the Governments programme. The Chancellor has yet to state that he views insurance contributions as anything but a tax. In the television broadcast following his first budget he referred ominously to the National Insurance tax.

What is the sense of regularly referring to a "National Insurance Tax" when voters stubbornly refuse to see it as such and insist on it being an insurance contribution? The Tories ruthlessly mined this particular electoral seam. Major increases were also made to National

[9] See Chapter 6, "'Contract' and 'Citizenship'", in A Selsdon and D Marquand, **The ideas that shaped post-war Britain**, Fontana, 1996, 137.

Insurance contributions and yet, because cuts were made to the rate of Income Tax, the Conservatives fought successive elections as a low tax party, and were believed.

The Chancellor's strategy becomes even more surprising when other attitudes of taxpayers are brought into view. We live in an age when voters will vote against the party seen to be in favour of increasing direct taxes. Steadfastness on this issue in the privacy of the ballot box belies whatever is whispered to pollsters.

In contrast to a marked hostility to raising direct taxation, a hostility which is spreading to indirect taxes, the voters offer Chancellors a hand of friendship on the question of insurance contributions. Such contributions are emphatically not seen as taxes. What sense can be made of the current Chancellor's campaign to equate insurance contributions with a taxation? Can such regular "slips" be put down to carelessness? Or does the Chancellor have a longer term game plan which he is loath at present to disclose? Is the aim to abolish the National Insurance system?

Foundation stones of citizenship

Next, what impact will tax credits have on the gender basis of citizenship? Both Eleanor Rathbone and William Beveridge, along with their campaigners, supported a work-based National Insurance system because they saw work in the home as equally valid, and an activity to be rewarded through the insurance system. Our age is still working through a new gender contract, with perhaps much distance still to go. But the threat that tax credits pose to independent taxation, to take one item from the gender contract, is only slowly being recognised. Yet each political concession to re-establishing principles of independent taxation with a tax credit system makes what was allegedly a simple administration of tax credit into one with considerable complications. And one which is more intrusive. Employers have never had to know as much about the private living arrangements of as

many of their workforce as they now must know as the administrators responsible for tax credit payments.

How well does today's National Insurance system fit with other underpinning views on citizenship – of virtue, freedom and the nature of the state – all of which Jose Harris sees as crucial to the 1945 settlement? Of course the system needs to be modernised. Above all it has to become a scheme where the contributor genuinely feels ownership. But the underlying values of the scheme are, if anything, more relevant now than half a century ago.

The belief that people should look after themselves, if at all possible, remains as strong as ever. Work, savings, and honesty, it is believed should be rewarded and not penalised. Tax credits, the Minimum Income Guarantee, and their like, attack each of these three aspects of the good society. They also attack what is commonly regarded as an important aspect of freedom. A citizen's immediate well-being is enhanced by means-tested help. But an effective counter-poverty strategy is not simply about increasing the poor's immediate income, important as this is. For the long terms success it is crucial that the means by which the income of the poor is increased simultaneously widens their freedom. Means tests, because benefits are reduced or withdrawn as income rises and because savings can disqualify a person from help, place a heavy penalty on telling the truth on either of these two accounts. Means tests in the short run increase the poor's income, but only at the great cost of narrowing their freedom.

Conclusion

Let me briefly summarise the points which I have been trying to make. There is a technical side to welfare reform. How are the details of policies worked out? But, of equal importance are the politics of welfare reform. Welfare reform will not be successful if it ignores a number of crucial points on the political compass.

Welfare reform which is beneficial to the poor can only be successfully pursued in the longer run within a framework in which the self-interest of the majority is served.

Universal provision must still be a goal for basic welfare. But in this new political age extending the principle of universalism will only be realisable within a system of joint public private provision. The phrase private provision should not be simply equated with private company provision. Private provision, ie, non government provisions, can still be a collective provision with welfare provided through membership-owned bodies.

Human nature cannot be written out of the equation. No matter how beguiling a welfare reform programme is, if it works against the grain of human nature, it will fail. This will be the fate of the tax credit and Minimum Income Guarantee reforms. The Government will soon learn that human nature is not for turning. Worse still, this misadventure blows apart some important sentiments which underpin a common citizenship.

Version II

EU Enlargement and the Future of the Welfare State

by

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Abstract

The eastern enlargement 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. Given the existing wage differences between eastern and western European countries, a massive westward migration can be expected after enlargement. A temporary east-to-west migration until the eastern countries create an efficient capital stock makes economic sense if this is driven by wage differences and meets with a flexible labour market. Migration does not make economic sense, however, if, and to the extent that, 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, and this would lead to an erosion of the traditional social welfare state. If the EU plan incorporated limitation on the free movement of labour, beneficial migration would also cease. 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 enlargement 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 enlargement is not insignificant. It will increase the EU population from 375 million to 480 million or by 28% and this does not include Turkey with its 70 million people. It would be disastrous to stumble into EU eastern enlargement as unprepared as Germany was for its own eastern enlargement. Then the population increased by 26% and this led to considerable economic problems.

One of the problems of eastern EU enlargement is the fiscal burden that will result when the existing assistance programmes are extended to the new EU citizens. The agricultural subsidies that comprise 45% of the EU budget are prominent among these. In Poland there are ten times as many people of working age 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 in 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 they once could. Opening the borders forces them, on the one hand, to compete with lower taxes and a good infrastructure for the investment and location decisions of private firms. On the other hand, every state will be on its guard because 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.

Often it is argued that the competition between countries is similar to that of firms in the market, that Adam Smith's Invisible Hand is operative here, too. I doubt that, particularly when it comes to the competition among welfare states, and I shall try to explain my doubts in this lecture.

The Extent of Mobility

Guest workers and poverty refugees from eastern and south-eastern Europe are already flocking into western Europe, either 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.

Particularly high mobility is expected for 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 those 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 compared 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 enlargement 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, Romania 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 to raise average wages to 20% of western German wages or to one half of German social welfare assistance by the scheduled time of entry.

According to recent estimates by Zimmermann and Bauer[10] in the case of a longer restriction of the freedom of settlement, a total emigration of 2.7% of the population of the new member states can be expected. However, for the case of EU membership with free migration, the study arrives at a much higher figure (Table 10, p. 51). No less than 6% of all Poles, 16% of all Bulgarians and 27% of all Romanians can be expected to leave their countries. On average, 10.6% of east Europeans will leave their countries if 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

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[10] Thomas Bauer and Klaus F Zimmermann, Assessment of Possible Migration Pressure and its Labour Market Impact Following EU Enlargement to Central and East Europe, Study for the UK Department for Education and Employment, IZA, Bonn 1999. In Table 10, which presents the results of the econometric estimates, the authors only publish country-specific emigration numbers. The aggregate numbers quoted in this article are the direct result of weighting with individual population shares. The authors relativize their results and reach the conclusion that a migration of between 2-3% of the home population is to be expected. They do not mention whether this number refers to the case of free or restricted migration. Since the first column in Table 10 has a value of 2.7% for the case of at times free migration and at times restricted migration in the form of quotas, it can be assumed that the summary only refers to this case.

Migration (IOM).[11] The poll reveals that about one fifth of Slovenians, Poles, Hungarians and Czechs, and even one third of Romanians would choose to emigrate for several years if they could.

For the case of a politically non-restricted emigration, the Ifo Institute[12] came to somewhat more modest estimates of about 6% to 7%, of which about 4% to 5%, or 4 to 5 million people, would have Germany as their goal. In contrast to the numbers of Zimmermann and Bauer, these results are estimated on the basis of an approach that adjusts for eastern Europeans already living in the EU, and they also refer to an longer period of estimation which extends from 1974 to 1997 instead of 1985 to 1997.

A look at the migration from Turkey is also instructive. Today, about 5% of the Turkish population lives in western Europe. If, like the Turks, only 5% of the new eastern European EU citizens came to western Europe, this would be more than five million people. Because eastern Europeans will enjoy the freedom to settle in Germany, this is probably at the lower end of plausible estimations for the case of unrestricted migration over a 15 year period.

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, this is a misinterpretation of the Iberian experience for a number of reasons. First of all, there was a six-year transition period after joining the EU during which migration was largely forbidden. Second, the wage gap then was much smaller than it is now 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

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[11] International Organization for Migration, Migration Potential in Central and Eastern Europe, UN Sales No. E.98.III.S.18, New York 1998.

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 and sought 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 e. 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 provide unnecessary migration

[12] See Hans-Werner Sinn, Gebhard Flaig, Martin Werding, Sonja Munz, Nicola Düll, Herbert Hofmann, EU-Erweiterung und Arbeitskräftemigration: Wege zu einer schrittweisen Annährung der

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, and each country will try 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 not a 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 or pays in taxes.

On the basis of the socio-economic panel, the Ifo Institute calculated the amount of net resource transfers from the state to the immigrants. Included were all social insurance contributions and taxes as well as all services received including the social benefits financed by taxes and payroll deductions and the proportional costs of the public infrastructure that the immigrants use. The results are that during the first ten years in Germany, immigrants

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Arbeitsmärkte, Ifo study commissioned by the German Ministry for Labour and Social Order, 2001.

register a net per-capita resource gain of DM 4,600 a year. This is no small amount; for a five-member family it adds up to DM 230,000 in ten years.[13]

The state, seeing the budget constraints caused by immigration, will reduce its social benefits fearing that these may act as a magnet in attracting immigrants. Its motto will be fairness but less generosity than its neighbouring states. Since all governments will act the same way, the benefits of the welfare state will be gradually reduced. The process of change in political values will take somewhat longer since the political climate, and with it the ideals of the socially oriented parties, will only change slowly. Perceptions and ideologies that have formed over the decades will be subject to creeping erosion, hardly noticeable at the outset but which will receive an additional push with every new generation of politicians and which will ultimately be expressed in a different understanding of the state, more like that in the United States than the one now common in Europe.

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 that, 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 own 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.

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[13] See Sinn et al., op. cit.

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 own initiative, although 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 the real wage of the factors of production offered by the rich in other countries and

increases there 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 of government benefits and the immigration of net recipients will produce government budget surpluses in other countries that can be used for social purposes. The degree of target fulfilment for foreign social policy will be increased without foreign governments' own efforts. At the same time, the degree of target fulfilment for domestic social policy will be weakened since the departure of the rich and the entry 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 some 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, as has been explained, it lowers 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 similar to those applicable in the case of redistribution measures of the social welfare state. This is a point that is overlooked not only by many critics but also proponents of systems competition. It is only the redistribution measures that can 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 the redistributing state is seen as insurance against career and life risks that are not privately insurable. A particularly simple, but just as problematic, protective measure is postponing the freedom of settlement and 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 involves throwing out the baby with the bath water.

Preventing free migration thus 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 the number of guest from eastern countries that would make the marginal migration cost equal to the wage difference between east and west, and this is 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 and Germany's will rise. As long as the increase in 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 is in principle 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 some 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 harmonisation of the 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 either by the east or 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 levels 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 interventionist approach, relies on the wisdom of bureaucratic decisions, and discriminates against weaker immigrants from the new EU countries.

A much more sensitive, market-oriented, and just approach is the application of the home-country principle wherever this is possible. Instead of restricting the freedom of settlement, bureaucratically selecting workers, 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 should only be paid to the amount they would be paid in the home country. Benefit to the migrants as well cannot be prevented for many redistribution element s. But, in a new EU treaty, social welfare, housing grants, the rights to be considered for municipal housing and similar benefits could be converted to the home-country principle so as to avoid a net fiscal incentive for the migrants. Calculations by the Ifo Institute indicate that this would be sufficient to generate a balanced fiscal stance for the migrants. Currently, one of the basic EU rules is that people are entitled to social transfers from their country of residence, where they either both live and work or have worked. Only tourists and visitors are treated according to the home country principle. If entitlements could only be claimed from the home country under its conditions, there would be no more artificial migration incentives, and the hope that the free migration decisions people make would approach an optimum level would be justified. 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. 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.

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.

Today we have two Mezzogiornos: one is in southern Italy, the other in east Germany. Harmonising social standards after EU enlargement will mean that we have another ten Mezzogiornos in Europe.

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 that the eastern European countries wish to participate in by their membership would be jeopardised. Here, the home- country principle is indeed the better alternative. It avoids the limits to freedoms that some are already proposing and it preserves the west's commitment to integration.

The home country principle for tax-financed social benefits is based on economic principles that are incompatible with the juridical concepts that have shaped current EU law. The immediate inclusion of migrating workers and at the same time the exclusion of people who have migrated for other reasons has been the guiding principle of EU law. This is a political problem that must be overcome.

The problem is not really prohibitive, since EU eastward enlargement is in itself not possible on the basis of the current legal situation. Much change is needed, and the conversion from the residential to the home-country principle is only a small reform measure. To be sure, EU expansion can only be discussed on a *de lege ferenda* basis, i.e. in terms of legal reforms, and not *de lege lata,* in terms of what can be done without changing the laws. Since the enlargement of the EU and the underlying conditions must be agreed unanimously, every EU country can demand adjustments in the prevailing laws.

It is true that it would be desirable for political reasons that the home-country principle be introduced in such a way that only a minimum of legal changes are required. Attention must be given in particular to the already negotiated association treaties between the EU and the eastern European accession countries. These agreements call for integrating the migrating workers from the first day of their work in the contribution-financed social systems, i.e. in

particular in the statutory health insurance system, the pension system, and the unemployment insurance scheme. Moreover, they are obligated to pay taxes, and they of course cannot be excluded from using the public infrastructure. The agreements do not stipulate how the tax-financed social benefits should be handled. An exclusion of the migrants from supplemental social benefits, from housing allowances and the already scarce municipal housing would not be in contradiction to the association agreements but would help to balance the net fiscal losses and would prevent a harmful competition among welfare states to reduce benefits.

Possible legal reservations can be countered by limiting the exclusion from certain social benefits to a certain period of time. Since the integration of the immigrant improves over time, his market income approaches the domestic average, thus eliminating the net fiscal losses for the state. A waiting period of 5 to 10 years up to full integration of the immigrant in the social welfare system of the host country should suffice to avoid the net fiscal losses.

For this proposal, the Ifo Institute has coined the phrase "selectively delayed integration" of immigrants in the social welfare system. Integration is not prevented but only delayed, and it is not delayed in general but only selectively, namely for the tax-financed social benefits that are not covered in the association agreements. Selectively delayed integration is an alternative to the quota system for integration favoured by politicians which calls for a selection of individuals and which deprives many eastern Europeans of the freedoms contained in the Treaty of Rome. In weighing up the various legal rights that are up for discussion, priority should be given to the rights contained in the Treaty of Rome and they should be protected from too strict an interpretation of the inclusion principle.

This proposal is a variation of the home-country principle[14] and the “delayed integration” for

[14] Hans-Werner Sinn, Tax Harmonization and Tax Competition in Europe, *European Economic Review* 34, 1990, papers & proceedings, pp. 489-504.

all social benefits that the Scientific Council of the German Federal Ministry of Finance called for in a recent study.[15] The proposal has arisen from efforts to create conditions for competition among social welfare countries to restrict the erosive forces of free migration with as few changes as possible to current EU law.

Final Remarks

Europeans have 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 enlargement, 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 how expensive it was is clear today. 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 the reforms of European social law that will be necessary to master the challenges that will come. All attention is being 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 enlargement. 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 after the fact the accusation will again be made that economists failed to give advance warning of the problems.

[15] Wissenschaftlicher Beirat beim BMFi, Freizügigkeit und soziale Sicherung in Europe, Study, 2001 Berlin.

Globalization and the Future of Social Protection

*Vito Tanzi**

ABSTRACT

Social protection in industrial countries has been provided through regulations, tax expenditures, and public spending. This paper argues that globalization will affect the governments' ability to continue providing social protection at the level of recent decades. Specifically, tax competition among jurisdictions, ballooning electronic commerce, and increased mobility of the factors of production will likely cause significant falls in tax revenue in future years while increasing competition will reduce the scope for some forms of regulations. The paper concludes that countries need to look for new ways to provide social protection.

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Keywords: globalization, welfare state, tax expenditure, regulations, taxes, public spending, social expenditure.

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THE GROWTH OF SOCIAL PROTECTION

The period of globalization that ended with the First World War occurred in a world without formal governments systems of social protection. For the 1870-1913 period, the ratio of public spending in GDP was very low, by today's standards. For a group of 18 countries, including many of those now referred to as welfare states, the share of public spending into GDP was, on average, about 11-13 percent over this 43 year period. See Tanzi and Schuknecht (1997). At that time public expenditure as a share of GDP for the group of countries averaged: for education about 0.6 percent; for health 0.3 percent of GDP; for pensions about 0.4 percent; and public expenditure for unemployment compensation and for other transfer programs was insignificant.[16]

After that period, public spending started to grow mainly as a consequence of changing social attitudes. Especially, after the Second World War many countries, and especially the European countries, developed formal, government financed, systems of social protection that aimed at protecting citizens against risks associated with old age, illnesses, various forms of incapacity, unemployment, and poverty due to particular situations such as becoming widows, orphans, or being part of large families. The growth in public spending occurred in periods when countries were still relatively closed. By the time globalization was in full swing, the systems of social protection had reached maturity.[17]

Governments have tried to provide social assistance and protection to various groups through the use of three instruments, namely, (a) public spending, (b) the tax system, and (c) the regulatory framework. To some extent each instrument has been preferred in particular countries and at specific times. In some countries taxation has been the instrument of choice. In others, it has been regulations. In many countries it has been public spending. However, in most countries these three instruments have been all jointly used but in varying proportions. Thus, some countries have ended up with large public spending, others with high and much distorted tax systems, while still others have ended up with overregulated economies. Some have combined all these characteristics.

Figure 1 provides a simple, schematic view of the structure of the arguments presented in this paper. Social protection is seen to be influenced by the three instruments mentioned above and these instruments are in turn shown to be influenced by globalization. Thus, it will be argued that globalization affects social protection mainly through the impact that it has on these instruments. Of course, to the extent that globalization also changes social attitudes towards social protection, it may have a direct impact not channeled through the instruments. In the rest of this paper we discuss the actual and future impact of globalization on these instruments.

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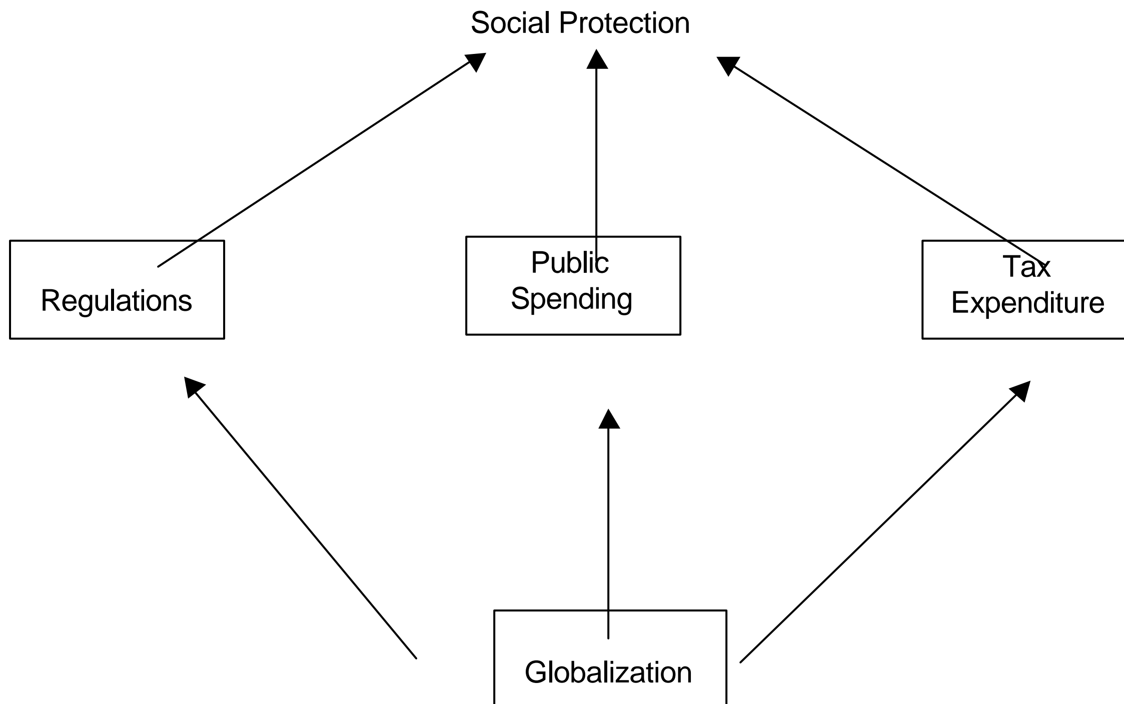
[16] Information on the growth of public spending since 1870 in 18 advanced countries is available in Tanzi and Schuknecht (2000).

[17] For a good description of a mature social protection systems, see Ministry of Social Affairs and Health (Helsinki, 1999).

Figure 1

Impact of Globalization on the Instruments of Social Protection



SOCIAL SPENDING

While public spending started rising during and after World War I, its growth remained modest until the 1950s.[18] Between 1960 and 1980 a large increase in public spending took place in all industrial countries but especially in the European countries. For 18 advanced countries combined for which information is available, average, unweighted public spending grew from about 28 percent of GDP in 1960 to about 43 percent of GDP in 1980. For the European countries in the group the increase was somewhat larger. If attention is focused on public spending for subsidies and transfers in the European countries in the group, its share of GDP rose from 10.8 percent of GDP in 1960 to 24.0 percent of GDP in 1980. See Table 1. A large part of the increase in public spending was accounted for by increases in subsidies and transfers which were the basic ingredients of the welfare state.

Table 1 also shows that the rate of increase slowed down considerably in the period after 1980: the average grew by only 2.8 percent of GDP in the next 15 years compared with 13.2 percent of GDP in the previous 20 years. In non-European, advanced countries, the increase in the share of subsidies and transfers in GDP over the 1960-80 period was only half that of the European countries. Among the latter, the Netherlands, Sweden, France, and Belgium were the leaders with increases of 27 percent, 21 percent, 18.5 percent, and 17.3 percent of GDP respectively. The 1960-80 period saw the maturation if not the genesis

[18] However, by 1950 some economists and political scientists were already expressing concern about the growth of the welfare state. See, for example, de Jouvenel (1952).

of the welfare state. Country after country increased public spending in an attempt to reduce various risks. The risks of becoming illiterate, ill, old, or unemployed received particular attention and various public programs were developed or strengthened to deal with them.

Table 2 shows the contribution to the increase in public spending over the 1870-1995 period accounted for by education, public health, public pensions, and unemployment compensation for a group of industrial countries. These categories accounted for a large share of the total increase in public spending. Given the existing programs, public spending for health and pensions can be expected to continue growing because of demographic changes. Thus, if unchanged, these programs will require growing public resources.

Table 1
Government Expenditure on Subsidies and Transfers
(Percent of GDP)

	1960	1980	1995
France	11.4	24.6	29.9
Germany	13.5	16.8	19.4
Norway	12.1	27.0	27.0
Spain	1.0	12.9	25.7
United Kingdom	9.2	20.2	23.6
Austria	17.0	22.4	24.5
Belgium	12.7	30.0	28.8
Ireland	NA	26.9	24.8
Italy	14.1	26.0	29.3
Netherlands	11.5	38.5	35.9
Sweden	9.3	30.4	35.7
Switzerland	6.8	12.8	16.8
Average	10.8	24.0	26.8

Source: Adapted from table 11-4 of Tanzi and Schuknecht (2000).

Table 2
Average Public Spending for 18 Industrial Countries, 1870-1995[1]
(Percent of GDP)

Selected Categories of Spending	1870	1937	1960	1980	1995
Government Consumption	4.6	11.4	12.6	17.9	17.3 [2]
Subsidies and Transfers	1.1	4.5	9.7	21.4	23.2 [2]
Education	0.6	2.1	3.5	5.8	6.1 [3]
Health		0.3	2.4	5.8	6.4 [4]
Pensions	0.4	1.9	4.5	8.4	9.6 [5]
Unemploy-ment		1.3	0.3	0.8	1.6 [6]
Interest	2.5	3.5	1.4 [7]	3.1	4.5 [2]
Public Investment	2.0	3.8	3.2	3.5	2.9 [8]

Notes: (1) The categories are not additive. Government consumption includes defense.
(2) 1995
(3) 1993-94
(4) 1994
(5) 1993
(6) 1996
(7) 1970
(8) 1994-95

Source: Adapted from various tables in Tanzi and Schuknecht (2000)

Tax Expenditures

While public spending has been the preferred or the obvious instrument for providing social protection to the majority of the population and most economists associate the welfare state with that spending, the **structure** of the tax system has also played a significant role in promoting social protection especially in some countries. This role is additional to the one that the tax systems have played through their financing of public expenditure in ways that did not lead to inflation or to excessive increases in public debt. The tax systems have often been used to support certain socially desirable activities through the provision of "tax expenditures".[19] Tax expenditures became especially significant in Anglo Saxon countries which showed more resistance to large increases in public spending.

Tax expenditures are implicit incentives to specific activities given through the tax system. Up to a point they may substitute for, or be equivalent to, public spending in the government's pursuit of particular objectives. For example, a government that wants to promote education can (a) spend more money on it so as to lower its cost for the students or their families; (b) subsidize the students through vouchers or through other means; or (c) allow the students or, more often, their parents to take a deduction from their taxable incomes for money spent for tuition, textbooks or other school-related activities. The value of the tax expenditure to those who benefit from it depends on the level of the statutory tax rates of the income tax. Given that in the period after World War II tax rates became very high in the majority of industrial countries, the value of the tax expenditures became also very high for many taxpayers. The personal income tax became the instrument of choice for this kind of social engineering. As a consequence, in some countries, this tax became very complex as more and more social objectives were pursued through tax deductions against taxable income, that is through tax expenditures.[20]

The tax systems of many countries have been characterized by various tax expenditures provided in support of socially desirable objectives. For example, in some countries, some educational expenditures have been allowed to be deducted from taxable incomes and these expenditures have also been exempted from indirect taxes. S ome health expenditures have received similar treatment in addition to the fact that the implicit income value of health benefits provided by employers has not been taxed. Pensions have received favorable treatment either because the pensions received by the pensioners, or the earnings of pension funds, have not been taxed; or because the contributions to pension schemes by the individuals or their employers have received favorable treatment. Furthermore, individuals with particular disabilities or conditions, such as blindness or other handicaps or

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[19] The concept of tax expenditure was developed in the United States in the 1960s.

[20] In some countries other taxes such as the value-added tax, social security taxes, and property taxes have also been adapted to the particular situation of the individuals.

simply old age, have received some tax advantages such as, for example, double personal exemptions in the United States or reductions in the property tax liabilities. Large families have been often favored by particular provisions in the laws and working families with low incomes have received special deductions, such as earned income credits.

There have been some tradeoffs between the use of tax expenditures and direct social spending in the sense that a larger use of tax expenditures by a country has been accompanied by lower direct social expenditure. These tradeoffs have been particularly pronounced when activist governments have been faced with strong constraints on their ability to increase spending. This has been the case for example with Italy during the race to meet the Maastricht criteria or with the United States during the Clinton administration when there was a Republican majority in Congress.[21]

In the late 1970s and early 1980s, especially in the Anglo Saxon countries, tax expenditures came under strong criticism because of their impact on the domestic playing field and on the nominal tax rates, and because of the complexity that they brought to the tax systems. Major tax reforms were introduced in the United Kingdom, New Zealand, the United States, Australia, and a few other countries during the decade of the 1980s. These reforms aimed at reducing tax expenditures and tax incentives in general and at widening the tax bases thus permitting a reduction in the statutory tax rates. Because of the reduction of the statutory rates, the value of the remaining tax expenditures was also reduced. These reforms represented an indirect attach on the welfare state by conservative governments.[22]

Regulations

Many countries have pursued their social objectives not through public spending or tax expenditures but through regulations. In fact, one could almost speak of a **regulatory welfare state**. To understand this concept, it is necessary to recognize that, in their effects, many economic regulations can be equated to taxes, subsidies or, in some cases, to both. Through particular regulations, a government can, subsidize some individuals and tax others without having to actually collect taxes or spend money, i.e., without any impact on the budget.

A good example is rent controls which implicitly subsidize those who are occupying rented houses while they tax the owners of these houses: because of rent controls, the renters pay less rent; and the rentiers receive less rental income. Under the normal assumption that, on the average, the owners are richer than the renters, this policy represents, at least initially, a way of redistributing income. At least in theory, the government could get similar results by explicitly taxing the owners and explicitly subsidizing the renters. This, however, would increase both the tax burden and the level of public spending. Another example is minimum

[21] For the United States see Toder (2000). See Tanzi (1968) for cross-country comparisons.
[22] In the United States where the 1986 tax reform reduced many of these tax expenditures, recent years have seen some reintroduction of them.

wages that implicitly subsidize those who receive a wage that may be higher than they would have received while taxing the employers. It is easy to see how regulations can be manipulated to become instruments for promoting some forms of social protection.

These regulations are likely to reduce the efficiency of the economy. Also, their long run impact may be different from the initial impact, because incentives may be set in motion that over the years lead to different and unintended results. For example, rent controls may discourage the building of new houses or the renting of existing houses thus progressively reducing the supply of rental housing and increasing the rents paid by individuals with low incomes who do not already benefit from controlled rents. Additionally, regulations often lead to corruption.

Social protection has been promoted through the regulations of labor markets, housing markets, financial markets, the market for (or better the access to) several public services, and through other channels.

Labor markets have been distorted by regulations that make it difficult to fire workers, even when their performance is poor, that give hiring preference for particular individuals such as war veterans, handicapped, widows, orphans, unemployed, heads of families, or other individuals who are in situations which seem to justify some form of social protection. Also, at times, wage differentials have been artificially constrained in an attempt to improve the standard of living of low skilled workers.[23]

Housing markets have also been used to favor particular individuals by making it difficult for the owners to reclaim rented apartments. Banks have been forced to provide subsidized loans for activities considered of high social value, as for example, to students; or public financial institutions have been set up to achieve similar objectives. Particular individuals have received preferential treatment (i.e., lower costs) in their consumption of electricity, gas, water, public transportation, health, education, and food. Public enterprises have occasionally been forced to continue providing services at high costs to poorer areas or poorer individuals for social reasons, or to retain workers that were no longer needed. Enterprises, both private and public, have been forced to provide various social services to their workers and their families or to the communities in which they operated.[24] Price controls have been used to implicitly subsidize poorer groups.

The use of regulations to promote social protection has received almost no attention on the part of economists. Thus, there has been no analysis of what could be called a regulatory welfare state.[25] However, a general movement against many regulations started in the late

[23] For example, "In Germany the lowest wage is 70 percent of the average wage; in the United States it is 30 percent" See Hans-Werner Sinn, 1999, The IFO Viewpoint (Institut für Wirtschaftsforschung).
[24] In the planned economies, especially, public enterprises were largely responsible for many social services which should have been provided by the government.

[25] To a large extent centrally planned economies were extreme versions of regulatory welfare states.

Seventies and Eighties and, in attempts to increase the efficiency of the market, some regulations were reduced. As some of these regulations were connected with the existence and the activities of public enterprises, the movement toward privatization also played a role in their reduction.

GENERAL IMPACT OF GLOBALIZATION

The impact of globalization on the welfare state may come from various channels, some more general than others. It may come from the increasing competition that globalization brings about and thus from the need for more efficiency.[26] It may come from the increasing mobility of factors of production, especially financial capital and individuals with great ability. It may come from international pressures to level the regulatory playing field or to introduce uniform standards or codes of conduct. These channels are likely to become more important with the passing of time. Thus, effects that are barely noticeable now will become more visible later.

Globalization tends to raise the share of trade in gross domestic products and, as a consequence, to expose inefficient sectors or industries to greater foreign competition. Enterprises or workers that have operated behind the protection offered by high tariffs or by other protective policies may find themselves without such cover. This applies especially to public enterprises engaged in industrial production. For some of the countries belonging to the European Union, the help that occasional devaluation had offered in the past is no longer available. In this swim or sink environment the need to become more efficient becomes obvious. But efficiency depends, in part, on the actions of the enterprises and the workers themselves and in part on policies. A country that imposes high taxes or other constraints (say a very short work week) on its enterprises and workers puts them at a potential competitive disadvantage vis-à-vis enterprises that operate in different environments.

With globalization financial capital and highly skilled or highly talented individuals become more mobile because their options expand to other countries. High taxes or too constraining regulations create strong incentives for them to move elsewhere. The loss of highly talented individuals and the outflow of financial capital can have a negative effect on the growth rate and on the tax revenue of a country. In an open world where foreign competitors face lower taxes and fewer constraining regulations, it becomes more difficult and more costly for a country to maintain high taxes and more regulations.

Globalization brings strong pressures on the international community to level the international field in which individuals and enterprises operate. Thus, existing rules about foreign trade, the environment, cultural and health related protection, the operation of financial sectors, transparency in fiscal accounts and in accounting standards in general, will be scrutinized and, when needed, changed. The current ongoing discussion about remaking the architecture of the international financial system is, in a sense, a movement toward the leveling of the international playing field. In this environment it will become progressively more difficult for some countries to maintain the tax burdens necessary to sustain high levels of spending, or to continue to use regulations and tax expenditures to promote, through them, the current levels of social protection.

Impact through the Tax System

While globalization may affect the existing welfare states in different ways, the most direct and powerful impact will come through the tax system. There is now a growing literature on globalization and tax systems so that there is no need to repeat the arguments presented in that literature. See Tanzi (1995). For the time being there is no evidence that the tax systems of the industrial countries are collapsing. On the contrary, for many of these countries the level of taxation is at, or close to, the historical high. However, in most countries in recent years, the tax level has stopped growing and, in a few, it has even declined.

While the fiscal house is still standing and looks solid, one can visualize what could be called "fiscal termites" busily gnawing at its foundations.[27] These include:

a. **Increased travel by individuals** which allows them to shop, especially for expensive and easily transportable items, in places where sales taxes are lower. This creates incentives, especially for small countries, to reduce excises on luxury products in order to attract foreign buyers.[28] This form of tax exporting and of tax competition will progressively reduce the degrees of freedom that countries have had in imposing excise taxes on many

[26] Globalization and especially the Internet provide much more timely information on prices and other relevant variables, thus increasing competition.
[27] For a detailed discussion of this issue see Tanzi (2000).
[28] Some airports have become huge shopping centers.

high-priced products. In fact, revenue from excise taxes, especially if gasoline and tobacco products are excluded, has been falling rapidly in recent years;[29]

b. **Increased activities** on the part of some highly skilled individuals conducted **outside of their countries** which allows them to underreport or not to report at all their foreign earnings; at the same time, more and more individuals are now investing their savings abroad.

c. **A growing use of electronic commerce and electronic transactions in general** largely taking place outside of the tax system. Electronic commerce has been growing very fast and is expected to reach high volumes within a few years. A large share of the world commerce, and especially that among enterprises, could soon be channeled through the Internet. Electronic commerce is going to be a nightmare for the tax authorities. This commerce is accompanied by some important changes.

The first change is that from real transactions, requiring papers which leave more easily traceable foot prints for the tax authorities to follow, to virtual transactions which leave much less identifiable prints. If origin-based taxation should prevail, sales establishments would choose to locate themselves in places where there are low or no sales taxes. But destination-based taxation may be very difficult to implement especially in a world set to facilitate foreign trade.[30]

The second is the increasingly important change from the production and sale of **physical** to **digital** products. Many products which have been traditionally sold in shops, and in a format that gave them some physical content, will lose their physical characteristics and as a consequence the territoriality of the sales outlets will be more difficult to determine. Music, writing, photos, financial advice, engineering plans, movies, medical advice, educational services, books, and so on can now be downloaded directly over the Net. Furthermore, the downloading can be done from almost anywhere in the world. In these circumstances, the meaning of tax jurisdiction becomes vague. See Kobrin (1999). Who should pay the tax and who should collect the money? And how should this be done? The full implications of these changes are still barely understood.

d. The growing importance of **off-shores and tax havens** as conduits for financial investments that has been stimulated by the flow of digital information that allows money and knowledge to be moved easily and cheaply in real time. Estimates of these deposits are in the range of US$5 trillion. See UN (1998, p. 71). It is unlikely that many of those who earn incomes on these deposits report them to their national tax authorities.

e. The growth of new financial instruments (e. g. derivatives) and agents for channeling savings (e. g. hedge funds). Many hedge funds operate from off-shore centers and are not, or are little, regulated. Furthermore, there are huge problems of identification of individuals, of transactions, of incomes, and of jurisdictions where the individuals live or where the incomes are generated.[31]

f. The growing importance of **trade** that takes place **within multinationals**, among their different parts situated in different countries. This trade now accounts for a large and growing share of total world trade. It creates enormous problems for the national tax

[29] See OECD, *Revenue Statistics* (2000).

[30] To give a sense of the difficulties, in 1999, 475 million people, 123 million vehicles, and 21.4 million import shipments came into the United States. See Flynn (2000). Controlling these movements is almost impossible.

[31] Often it is difficult to distinguish regular incomes from capital gains and many countries do not tax capital gains.

authorities deriving from the use of "transfer prices" by the multinationals and from the likelihood that some of these enterprises manipulate these transfer prices to move profits to the jurisdictions where taxes are low. Under present tax arrangements this problem is likely to grow. The tax authorities of many countries are now worried about this trend but are often at a loss on what to do about it.

g. The growing reluctance or **inability** of countries **to tax**, especially with high rates, **financial capital** and also incomes derived by individuals with highly tradable skills. High tax rates on financial capital or on highly mobile individuals provide strong incentives to taxpayers to move the capital to foreign jurisdictions that tax it lightly or to take residence in low tax countries.

h. The gradual substitution of **real money** with **electronic money** in transactions requiring money. The money accounts of individuals are embedded in the chips of electronic cards which are used to make payments and settle accounts. This trend would surely increase the difficulties of the tax authorities. See King (1997).

These are examples of the brave new world we are entering and of the fiscal termites that I mentioned above. It is possible that the world community might be able to develop ways of dealing with some of them or of introducing new taxes. However, it is unlikely that these actions will succeed in killing the fiscal termites. Thus, the conclusion must be that it would be prudent for many countries and especially for the welfare states to begin preparing themselves for what could prove to be significant falls in tax levels in future years.

The fall in revenue might come at the same time when governments experience the need for more spending in particular areas, either as a consequence of the aging problem or of globalization itself. Under current policies the ongoing demographic changes will create strong pressures on governments to spend more for health and pensions. These effects will become particularly pronounced, in many countries, in about a decade from now when the baby boomers will begin to retire. But by that time the effects of globalization on the tax systems could become particularly strong.

Globalization may create pressures for increased spending for education, training, research and development, the environment, infrastructures, and for institutional changes partly to increase efficiency and partly to comply with international agreements. These expenditures are consistent with the traditional or basic role of the state in its allocation function. Thus, expenditure for social protection, which is a newcomer in the role of the state, could be

squeezed between falling revenue and increasing needs for more traditional types of spending. In such a situation, the state will need to rethink its role in the economy.

Impact through Tax Expenditures and Regulations

WHILE THE MAJOR IMPACT OF GLOBALIZATION ON SOCIAL PROTECTION AND ON THE WELFARE STATE IS LIKELY TO COME FROM THE TAX SYSTEM AND FROM ITS REDUCED ROLE IN FINANCING SOCIAL SPENDING, TAX EXPENDITURES AND REGULATIONS ARE ALSO LIKELY TO BE AFFECTED.

To the extent that globalization reduces the level of taxation and especially the role of the personal income tax, it will also reduce the possibility that tax expenditures can be used to promote social protection. Tax expenditures have been essentially tax incentives given through the income taxes. And tax expenditures for social purposes have been given mainly or almost exclusively through the personal income tax. This tax has been the fundamental instrument for pursuing social engeneering through the tax system. Lower rates and more tax coordination among countries will reduce its role as an instrument of social protection.

AS FAR AS REGULATIONS ARE CONCERNED, THEY WILL ALSO BE AFFECTED BY AN INCREASINGLY MORE GLOBALIZED WORLD AND BY THE PRESSURE IT WILL CREATE FOR COUNTRIES TO BECOME MORE COMPETITIVE. FOR EXAMPLE THE PRIVATIZATION OF PUBLIC ENTERPRISES AND THE LIBERALIZATION OF LABOR MARKETS WILL BE PUSHED BY THE NEED TO BECOME MORE EFFICIENT.

The New Architecture of the International Financial system is promoting common standards and codes for financial and other markets that will tend to make the use of regulations more uniform and thus it will reduce the freedom that governments have had to use regulations as instruments for pursuing social protection.

CONCLUDING REMARKS

The discussion in this paper leads to the conclusion that a process of deep economic integration among countries will require a change in the role of the state in pursuing social protection. The end process would be a world where industrial countries will have to do less

public spending, will reduce the use of tax expenditures for achieving particular social objectives, and will also have to reduce the role of specific socially-directed regulations.

The state would have to reduce its role as a direct provider of social protection but, perhaps, it could (a) supervise compulsory systems of social insurance, as for example, in the area of pensions; and (b) it could play a larger role in developing markets where they do not exist. The state could also subsidize those who cannot afford buying privately-provided social protection.

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