Chapter 3
Free Factor Mobility and Fiscal Competition: Can the National Welfare State Survive in a "United Europe"?

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3.1 Introduction

Providing social protection is an important task and ambition for many European governments. In 2003, for example, the 15 old member states spent on average over 28 percent of their GDP on social protection (Eurostat, 2006). Even though the variation within member states is wide, the government's role as a provider of social protection is generally greater than in other parts of the world. In the US and Japan, for instance, the governments spend about half as much (as a share of GDP) and in Korea only a fifth (OECD, 2001a). That the government should provide generous social protection is well rooted among the European citizens, who in general are positive to current levels of welfare spending and negative to cutbacks (Boeri et al., 2001).

Another important goal in Europe, integration, has been a priority dating back at least to the end of the Second World War. While the motivation for European integration was initially primarily political, including the desire to avoid future warfare in Europe, contemporary discussion often centres on the economic benefits of free factor mobility. Indeed, the Lisbon Strategy aims to make Europe the most competitive and dynamic knowledge-based economy in the world by 2010. To meet the challenges of the Lisbon Strategy, however, many believe that the mobility within EU must increase considerably, and 2006 was, in fact, designated the "European year of workers' mobility". Unfettered mobility has been credited, for instance, with increasing efficiency (lowering costs) by removing barriers to the realisation of scale economics and with increasing competition, thus increasing the range of products offered to consumers while lowering prices (Emerson et al., 1988).

It has become increasingly apparent that these two goals–generous social protection and free mobility–may be hard to combine. Free factor mobility permits economic actors, both labour and capital, to locate where their economic welfare is maximised and, consequently, member states may find it increasingly difficult to levy taxes exceeding those of other Member States without losing capital and

the most productive workers or to offer generous transfers without attracting less productive individuals. Over time, the competition for mobile production factors threatens to lead toward a downward spiral in tax rates (Zodrow and Mieszkowski, 1986). In short, not only may generous welfare states struggle to survive as net contributors leave and net beneficiaries enter, but the provision of public services may decline generally across even the initially low-tax countries. As a consequence, many argue for the need to harmonise or coordinate tax and transfer policies within the EU in order to maintain acceptable levels of social protection (Sinn, 2002, and Tanzi, 2002).[1]

It is not obvious that coordination within EU is feasible or even desirable, however. First of all, regional coordination may be fruitless in a world where capital is globally mobile and labour increasingly so. A large threat to the national welfare states in Europe is competition from outside the EU, for instance, firms outsourcing to Asia. Second, there are important efficiency arguments favouring competition (Wilson, 2005). Coordination may also require that nations give up yet another tool available for guiding their economies. Clearly, any gains from coordination must outweigh the gains from competition to justify coordination. As the globalisation process increases the cost of the welfare state the benefits from the welfare state must increase accordingly.

This chapter discusses the consequences of increased integration on the ability of Member States to conduct independent fiscal policy with a focus on redistribution and the survival of the national welfare state. The chapter begins with a short description of the "welfare state" in Europe. The next section discusses how free factor mobility may threaten the national welfare state both by providing downward pressure on tax rates and, thus, the means to finance social spending and by forcing governments to spend strategically in ways attractive to desirable production factors. The chapter then moves on to examine possible countervailing factors which may ensure at least some ability for conducting independent fiscal policies. For instance, labour mobility is so far limited enabling member countries to still conduct some independent fiscal policy. In addition, the need for a welfare state may be reduced as the benefits from integration in terms of increasing market size and efficiency gains are utilised, which may compensate for some of the lost fiscal autonomy. Finally, the chapter discusses the trade-off between coordination and competition where the positive effects of competition are set against the negative externalities of fiscal competition.

3.2 The Welfare State in Europe

Europeans generally agree on the value of extensive social protection. Indeed, relative to other continents, welfare transfers are considerably larger in Europe. In 1998, for example, public expenditures on social protection constituted almost 25 percent of GDP in EU15 compared to less than 21 percent for the whole OECD and on average 17 percent for the US, Canada, Australia, New Zealand, and Japan (OECD, 2001a). In Korea and Mexico, corresponding numbers were only 5.9 and