Chapter 4
Fiscal Competition and Activist Social Policy

Ulrike Schneider and August Österle[1]

4.1 Introduction

More than a century ago national governments in Europe started assuming responsibility on a broader scale for safeguarding the population against major risks of life, such as sickness and old-age poverty, thus transcending the boundaries of a regulatory minimum state. The second half of the twentieth century witnessed the expansion and maturation of modern welfare states around the two core aims of risk insurance and distributional equity (see Tanzi 2002: 119). As observed by Wildasin (2000: 341), the development of social policy can be seen to "reflect the outcome of a democratic policy making process that has not been prepared to accept the market-determined distribution of income in an unaltered form." Recent survey evidence shows that the welfare state is still well rooted in equity preferences and risk aversion of European citizens at large (Osberg and Smeeding 2005, Heien 2000).

At the same time concern has been expressed that factor market integration and the ensuing fiscal competition in Europe create pressures for a downward adjustment of welfare states. More specifically, it is generally acknowledged that tax competition makes it much more difficult for governments to sustain high levels of redistributive activity. Against this backdrop, the contribution studies how social policies and tax policies in the European Union are related. More specifically, it inquires into potential adjustments when fiscal competition via undermining national social policies creates a downward trend on social standards in Europe. In contrast to the greater part of the public finance literature, the emphasis of this contribution is on active rather than on passive integration of social policy. Active social policy integration results from activities to harmonise or to coordinate social policies at the European level. Passive social policy integration, instead, is an adaptation of welfare systems as a response to indirect pressures on the welfare state arising from, e.g., market requirements or concerns of competitiveness (Leibfried and Pierson 2000).

As a starting point, Section 4.2 will depict cross-national differences in social policy in the EU. Sections 4.3 and 4.4 highlight how these differences might vanish in the context of unlimited tax competition. Against this backdrop, we will discuss the potential of coordination as well as harmonisation of social policy to

cope with fiscal competition in the 4.5 Section. In doing so, we will pay particular attention to the extent to which a more concerted approach to social policy might induce a backlash on tax policy. The final section summarizes the discussion and defines an agenda for future research.

4.2 United We Stand – Diverse We Move

At the beginning of the millennium social protection expenditure in the European Union amounted to 26.2% of GDP on average (see Table 4.1). However, expenditure levels varied widely across Europe, with the lowest levels in the Baltic States Latvia (12.2%), Lithuania (12.9%), Estonia (13.2%), in Ireland (below 16.3%) and in Slovakia (16.6%), and the highest level in Sweden (31.7%). The disparities are even larger when comparisons are based on purchasing power standards, again with lowest levels in the Baltic States and with highest levels in Luxembourg, Norway and Sweden (Eurostat 2007; 2006). While the figures indicate differences in social, economic and institutional conditions, they reflect even more so different traditions, policy choices and perceptions of the welfare state in European countries.

According to Esping-Andersen (1990), the different traditions have shaped three categories of welfare states. Each can be characterised by specific basic approaches to offering protection against income and consumption shocks from unemployment, longevity and sickness and to attain equity in society. To begin with, the universal welfare regime prevails in Northern European countries. It emphasises equality and represents a rights and citizenship-based approach in organising welfare. Traditionally, the state has a strong role in this welfare model and taxes are the primary source of funding for social policy. Countries following the corporate welfare model – e.g. Germany and Austria – are characterised by the social insurance principle. The major social risks are organised in para-fiscal institutional arrangements (social insurance funds) with funding based on social insurance contributions rather than taxes. Though coverage is extended beyond those paying contributions in most of these schemes, employment criteria still play a major role in defining the material and personal scope of benefits. Traditionally, family ties are strongly recognised in the organisation of this welfare model. The liberal welfare regime represents the third Esping-Andersen type, where state responsibility only comes into play when all other potential social nets fail. In this case, benefits are organised as social assistance requiring individual means-testing. None of the European countries follows a strict market liberal approach in organising welfare, but the UK, Ireland, as well as some of the new EU member countries, at least in some respects come closer to that model.

While this classification has been scrutinised and slightly adjusted by a number of authors (see e.g. Arts and Gelissen 2002, Esping-Andersen 1999, Castles 1993, Lewis 1992), it still highlights three simple yet important points for the discussion of social policy and tax policy. To begin with, there is a means-end relationship between taxes and social policy, and taxes are used to a differing degree in each of