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RECONCILING THE WELFARE STATE WITH SOUND PUBLIC FINANCES AND HIGH EMPLOYMENT

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Contents

Many intellectuals in the US and Asia believe that European social welfare policies should be a blueprint for action in their own countries. But those policies, financed by high taxes and costly mandates on business, are mainly responsible for the enormous increase in European unemployment during the past decade and a half. This 'European disease' is hardly a model for other nations.

Gary Becker, 1992 Nobel laureate, Chicago University
Business Week, 8 April 1996

Yet, as the UK and western Europe contemplate adapting more to the 'American model' it is worth noticing a more menacing side. Economic inequality has continued to widen. All the rungs on the economic ladder are now further apart than a generation ago, and the space between them continues to spread. This widening of inequality leads to distress and misery for those at or near the bottom and anxiety for those in the middle. Left unchecked it could also undermine the stability and moral authority of the nation.

Robert Reich, former U.S. Secretary of labour, Brandeis University
Financial Times, 3 March 1997

1. Introduction (*)

The reform of the welfare state is high on the political agenda in most European Union Member States. There is a general need to adjust social policies to new demographic, economic and social conditions while safeguarding their essential achievements[1]. Traditional solidarity and social protection objectives need to be better reconciled with economic efficiency and the long-term viability of welfare systems. Such a task raises difficult economic problems and requires hard political decisions.

At the European Union level, the reform of social protection schemes, by increasing incentives to work, education and job creation, would allow to exploit more fully the potential benefits of the Internal Market. By contributing to fiscal consolidation, it would help to ensure the twin objectives of sound public finance and stable money. The combined result would be higher employment and economic welfare.

This introductory paper, aims at focusing the debate at the European level. It highlights common problems and policy trends and examines some reforms that might contribute to tackling these problems. However, it does not enter into the specific problems of individual EU Member States. This represents a limitation of the study, since the problems and future prospects of national social security systems differ substantially. This situation is due to differences in the institutional set-up, budgetary situations, economic conditions, social attitudes, and demographic trends. Recent policies have also varied. Therefore, although European welfare states share some

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1 These issues are extensively considered also in several documents produced by the Directorate General for Employment, Industrial Relations and Social Affairs. See European Commission (1993a, 1995a, 1995b, 1997a). See also OECD (1988b, 1994a).

fundamental objectives, as well as some important challenges, they may require different institutions and reforms.

In reviewing the pressures on European welfare states, it is important to distinguish essentially 'domestic' factors from increasing integration worldwide and in Europe. The former are dealt with in Section 2, while the latter will be considered in Section 3. Section 4 examines the reform process. It points to the reforms underway in many countries and examines some changes that could be implemented in the future. Section 5 draws some conclusions.

2. Achievements and challenges

Backed by strong economic growth, social policies have contributed to making Europe, on the whole, a 'nice place to live' over the past half century. In a historical perspective, economic growth was exceptionally high in the 1950s and in the 1960s and the subsequent period up to the 1990s still compares favourably with previous experiences in most industrial countries (Maddison, 1995). The pillars of European social policy - pension, health and education systems, unemployment benefits, labour market regulations, the entitlements for the poor and the disabled and the tax systems needed to finance them - were largely put in place or greatly extended in the years of very high growth.

By helping to distribute the benefits of growth, social policies have sustained a high level of social cohesion and favoured the research of co-operative solutions between social actors. However, as growth slowed down, a number of strains began to emerge, endangering welfare state achievements. Population ageing, changes in household structures, high unemployment, the negative effects of high tax rates on employment and rising concerns about European competitiveness in a globalised economy are adding to the pressure on social programmes throughout the EU.

This section examines the achievements and challenges facing the welfare state in Europe[2]. It begins with a brief review of the social achievements and the economic rationale of welfare systems, with particular emphasis on the comparison between the EU and North America. It then analyses two major problems that call into question the long run sustainability of European social programmes, namely expenditure pressures and negative incentives in the labour market.

2.1 Why the welfare state? Social achievements and economic rationale

2 As already pointed out in the introduction, it should be stressed that the social protection systems of EU Member States are not homogeneous. According to Rhodes (1996), at least four models can be identified: the Scandinavian Model (high degree of universality and institutionalisation), the Bismarckian Model (labour market-based solutions, social insurance arrangements), the Liberal Anglo-Saxon Model (flat rate provisions, extensive means testing), the Southern Model (protection for regular workers, lack of general safety net, role of family in redistribution). On the specific features of the Southern Model see also Ferrera (1996). On the issue of convergence of European social protection systems toward a common model see Chassard and Venturini (1995) and Grahal and Teague (1996).

This section examines three related questions: the relative effectiveness of European welfare states in limiting poverty and inequality, their justification in terms of economic efficiency, and the relationship between welfare state and economic performance.

2.1.1 Combating poverty and discrimination **-** One of the greatest achievements of the welfare state is the extent to which it has reduced the incidence of poverty, by preventing individuals and households from falling below a minimum income level, and promoted social integration, by making merit goods available to every citizen irrespective of socio-economic status. In order to evaluate the achievements of the European social protection system, it is interesting to compare Europe with North America, which has followed a rather different approach[3].

A more developed system of social protection has allowed Europe to combat poverty and discrimination in a much more effective way than the US. As shown in Table 1, not only has Europe, on the whole, a lower incidence of 'primary poverty' (i.e., poverty before taxes and transfers), but benefit and tax systems are more effective in alleviating it than in North America[4]. The countries with the lowest levels of poverty and, more in general, income inequality, tend to be also those with the greatest degree of social protection for the population of working age (Gottschalk and Smeeding, 1997). The difference between Europe and the US is even more striking if one focuses on groups most at risk of poverty, namely large families and lone-parent families. Child poverty is also particularly high in the US: about one American child in five lives in poverty. This percentage is significantly higher than those recorded in European countries (Coder *et al.*, 1989; Förster, 1993).

Other indicators, beside poverty incidence, also point to more serious social integration problems in the US. While in EU Member States nearly all citizens are entitled to health insurance, in the United States about 15% of those under 65 years of age have no insurance coverage (OECD, 1992a). Most individuals included in this group live in a precarious health care situation and receive low quality health care. Also, the share of the American population serving prison sentences is much higher (from eight to fifteen times) than in any EU country[5].

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3 For a comparative analysis of the development of the welfare state in Europe and the US, see Flora and Heidenheimer (1981). See also Emerson (1988).

4 A caveat is in order when assessing the effectiveness of the welfare states in reducing inequality: the standard approach, comparing the distribution of net income with the distribution of income before taxes and transfer, fails to take into account behavioural responses to taxation and social transfers that are likely to result in pre-transfer and pre-tax income being more unequally distributed than it would be in the absence of redistributive policies (for example, relatively generous pension benefits inducing people to withdraw from work and hence forego market income earlier than would otherwise be the case). The magnitude of these feedback effects is the object of considerable controversy, even if they do not seem to be anywhere as large so as to negate the effect of redistribution. Moreover, the intensity of the welfare state redistributive effort cannot be plausibly taken as independent from other factors affecting income distribution (for example, trade unions' strength). These factors will tend to reduce the inequality of market outcomes and at the same time increase the intensity of redistribution (Pedersen, 1994).

5 In 1990, 0.52% of the US adult male population was in prison. Overall, in the US 6.6% of the work-force was under supervision of the criminal justice system (in prison, on probation or parole) in 1993. Moreover, the prison population has been increasing by nearly 9% a year since the 1980s so that "at current rates, in the year 2000 the US will have a larger share of male in working age imprisoned or long-term unemployed than Europe will have long-term unemployed on the dole" (Freeman 1995b, p. 70).

The better performance of Europe compared to North America, on social grounds, is confirmed by data on trends in poverty and on the individual duration of poverty. In the US, the share of population under the official poverty line has increased by over three percentage points since the early 1970s (Haveman, 1996). In Europe, by contrast, the overall incidence of poverty has remained generally stable, even if a number of countries have seen an overall increase in (post-tax and transfer) income inequality since the 1980s, while changes in the opposite direction have been rare.

Longitudinal analyses confirm that, while there is considerable movement in and out of poverty, "a rapid escape (after one year) from financial poverty seems more likely in countries with low poverty rates (like the Netherlands and Sweden) than in countries with high poverty rates (like Canada and the United States). In other words, there appears to be a marked inverse relationship between the incidence of poverty and escape rates" (Cantillon, 1996)[6]. Moreover, according to Gramlich (1989), in the United States the spatial concentration of poverty is high and increasing[7].

Table 1

Incidence of poverty in the EU and North America: Sen poverty measure (a)
(non elderly families - percentage points)

	before taxes and transfers			after taxes and transfers		
	all	large	lone-parent	all	large	lone-parent
Germany (1984-85)	9.8	9.6	37.1	2.8	4.3	12.8
France (1984)	10.8	24.1	27.8	4.3	3.5	8.5
Italy (1986)	NA	NA	NA	3.9	NA	NA
UK (1986)	18.4	28.4	61.2	5.1	8.5	9.0
Austria (1984-85)	NA	NA	NA	2.1	NA	NA
Belgium (1985)	8.7	11.7	27.2	2.1	2.3	8.0
Denmark (1992)	14.6	NA	NA	3.1	NA	1.0
Ireland (1987)	19.8	23.8	38.1	5.9	6.7	13.8
Netherlands (1987)	11.7	9.9	44.4	2.0	4.1	6.6
Sweden (1987) (b)	13.3	11.3	28.2	6.7	1.2	2.0
EU (c)	13.2	17.0	37.7	4.4	4.4	8.7
US (1986)	13.0	24.0	42.9	10.0	19.1	29.9
Canada (1987)	12.0	16.6	43.6	7.1	8.5	21.0

Source: adapted from OECD (1995c).

(a) Sen index combines the share of persons in households with income below 50% of median income (*low-income rate*), the severity of poverty as measured by the difference in income of poor relative to the poverty line (*average low-income gap*) and the dispersion of income between the very poor and the not-so-poor (proxied by the *Gini coefficient*). The value of the index lies between 0 (no poverty) and 1 (incomes of the poor clustered around zero).
(b) As pointed out by OECD (1995c), Sweden may overestimate the number of poor families as it considers persons over 18 living with their parents as independent households.
(c) Unweighted average of available data, excluding incomplete cases.

Data on the incidence of poverty over time are consistent with the much higher rise in earnings inequality in the US than in (continental) Europe since the 1970s, and with

6 Similar conclusions are reached by Duncan *et al*, (1993). According to this study, upward mobility is similar in Europe and the US.

7 The share of the population living in areas defined as poor, according to strict definitions, rose from about 0.5% in 1970 to about 1.5% of the population in 1980 with further subsequent increases; poor areas account for more than 12% of the poor population.

the finding that the probability of moving upwards (and downwards) in the earnings distribution over time does not increase with the degree of earning dispersion (OECD, 1996b). Increased earnings inequality (among men) has probably been the most important factor behind rising income inequality in industrial countries since the 1980s.

Studies comparing indicators of socio-economic mobility suggest that countries with the most developed welfare states show also a lower degree of inequality in the long run. Calculating indicators of the inequality of income - such as the Gini coefficient - over a multi-year period instead of over a single year tends to reduce inequality, but leaves the United States markedly more unequal than other countries on all measures of income (Aaberge *et al.*, 1996). Studies measuring the correlation of long-run economic status between father and son tend to suggest that the United States (and Britain) have relatively low economic and social mobility (that is, relatively high correlation between father's and son's position in earnings distribution) compared to Germany and the Nordic countries (Björklund, 1996). In other words, empirical research does not seem to support the view that there is a trade-off between 'static' and 'dynamic' equality, whereas greater equality of opportunities can be bought at the price of higher inequality of outcomes.

Cross-country comparisons of poverty and inequality typically refer to relative income differences, as countries differ substantially in terms of (average) per-capita income. However, recent calculations show that "low income" persons[8] living in the United States are poorer, in terms of absolute purchasing power, than similarly situated persons in each of other 13 industrial countries, in spite of the clear advantage of the United States in terms of average and median per capita income (Gottschalk and Smeeding, 1997).

2.1.2 Reducing social risks and promoting economic change - Viewing the welfare state, and more specifically the extensive European social protection systems, mainly in terms of poverty relief and, more generally, promoting equity would be a mistake not only on economic, but also on historical grounds. Indeed, the development of public transfer systems in most industrial countries was related not so much to the fight against poverty, *per se,* as to the general objective of providing security against the risk and hazards of life (Atkinson, 1993)[9].

Failures of private insurance markets - From an efficiency point of view, there is a strong case for government intervention to provide social insurance against risks which private insurance cannot adequately cover. A large body of theoretical literature has analysed the conditions under which private insurance markets fail. Its main conclusions with respect to welfare provisions can be summarised as follows (Barr 1992 and 1993):

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8 "Low income" persons are defined as individuas in the bottom decile of the income distribution, with incomes calculated using the household as unit of aggregation and weighting units by the numbers of persons in the household.

9 As pointed out by Varian (1980), redistributive systems can also be interpreted in terms of insurance, if the interests of the unborn are taken into consideration. If agents are risk-averse and "luck" determines the likelihood of being born in a wealthy or a poor family, a system guaranteeng a certain degree of equality may be preferred on insurance grounds.

a) Adverse selection and moral hazard problems may prevent private insurance from covering some risks. For instance, this applies to important medical risks, where the insurer cannot readily distinguish between high-risk and low-risk individuals. In this case a private market solution would fail to materialise if the low risks are free to opt out. While compulsory membership, making possible a pooling solution, may avoid the worst effects of adverse selection, moral hazard problems may require more extensive public intervention, such as the introduction of a social insurance scheme. More specifically, the powers of compulsion of the state are necessary to monitor and penalise the behaviour of individuals influencing the risk against which they are insured. This applies to unemployment insurance that cannot be provided by the market even for the 'best' risks.

b) Private insurance requires a predictable number of winners and losers over a given period of time: it cannot cope with common shocks - in which uncertainty concerns aggregate and not just individual outcomes - or with events characterised by unpredictable probabilities. Inflationary and other macroeconomic shocks are examples of such problems.

c) Social insurance can supplement market demand when non-insurance by the individual imposes costs on others, such as in health care or provision for the aged.

A social insurance system covering the entire population may also enjoy significant cost advantages, in terms of economies of scale and scope, over competing private insurance schemes. As the failures of private insurance markets typically imply an inability to tailor premiums to individual risks, social insurance will tend to contain an element of redistribution from good risks to bad risks. Compulsory membership allows governments to engage in redistribution according to equity or other objectives.

How can the efficiency effects of the welfare state be assessed?

If protection against risk, in alternative and/or in the absence of private insurance, is recognised as an essential function of the welfare state, an economic evaluation of the welfare state should focus on the effects of the increased security. Bearing in mind that risk is an unwanted activity (individuals will require an increasing compensation for taking more risk), the effects can be seen both from the production and the consumption side.

From the *production* side, risk-taking can be considered as a 'factor of production'. Up to a certain point, risk can be transformed into higher income, as, for example, when an enterpreneur invests in a new market or a worker prepares for a new job. By reducing the amount of risk associated with any given activity, social insurance induces individuals to take up income opportunitites that they might have otherwise foregone and therefore can increase welfare for society as a whole (Sinn, 1994 and 1995).

From the *consumption* side, the effects of increased security can be seen in terms of added 'peace of mind' for a given expected income. Under certain assumptions, these effects can be quantified. On the basis of data on German and American households for the period 1983-1986, and assuming an income utility function with constant risk aversion, Bird (1995) calculates that the welfare cost of risk (that is, the amount that individuals would be willing to pay in exchange for securing their income at their expected level) corresponds to 5.4% of disposable income in Germany and 8.5% in the US. This reflects the higher protection against income fluctuations available in Germany compared to the US. According to the study, tax and transfers reduce income risk by 43% in Germany and 21% in the US.

In assessing the role of the state in the provision of social protection, one should also be aware that total level of spending on welfare services in industrial countries is not greatly influenced by whether expenditure is undertaken by the government or the private sector. For example, the difference in spending on welfare services between the US and the Scandinavian countries is much more limited when both public and private spending are taken into account. Specifically, total spending is 35% of GDP in Sweden and 28% in the US. The difference between the two countries becomes even smaller if one considers the amount of private spending on social protection plus taxes as a share of total expenditure by private households: in 1990 this attained 41.2% in Sweden and 39.6% in the US (Esping-Andersen, 1996).

The case of health care is particularly noteworthy. The US health system is much more expensive than the European systems. While in 1991 in most EU Member States total expenditure for health (public plus private) was in the 6.5 to 9 per cent range, in the US it was about 13.4 per cent of GDP (OECD, 1994a). In spite of that, the US system does not seem to fare better in terms of the final output, that is the health status of the population. Moreover, US public expenditure levels are close to European levels (5.9 per cent of GDP in 1991 for the US), but, as already mentioned, the US system does not ensure that all citizens are entitled to health insurance (OECD, 1992a).

Welfare state and economic growth - If, to some extent, social protection can be considered as a factor of production, existing social protection systems need not imply negative consequences on output and growth. Historically, not only did the development of the welfare state actually accompany unprecedented economic growth in Europe, but also the two developments were long seen as mutually reinforcing rather than in contrast. Specifically, the welfare state was seen as strengthening economic performance, because of two widely shared perceptions: the stabilising effect of social transfers on the economic cycle and the positive contribution of social insurance to workers adjusting to economic change. More recently, the perceived relationship between economic efficiency and social justice has become more problematic and the welfare state has increasingly come under attack as being detrimental to economic performance (Pfaller *et al.*, 1991; Boyer, 1991; Snower, 1996a).

The relationship between income distribution and growth illustrates these controversies. The topic has recently been the subject of considerable academic interest[10], but the results are not clear-cut. Some studies conclude that inequality in the distribution of (pre-tax) personal income has a significant negative effect on growth, both in developing and developed countries (Persson and Tabellini, 1994). Inequality would reduce growth by feeding redistributive conflicts. According to other studies, once country-specific effects are removed, there is no discernible effect of pre-tax inequality on growth (Fölster and Trofimov, 1996). Both groups of studies indicate that the effects of social transfers on growth are negative. Yet another set of findings

10 For recent reviews of economic research on the subject, see Atkinson (1995) and Agell *et al.* (1997). See also Bénabou (1996).

suggests that countries with larger transfer programmes tend to grow faster (Sala-i-Martin, 1996).

This section has illustrated that European welfare states have been relatively effective in limiting poverty and inequality and that their existence is also consistent with economic efficiency considerations. Moreover, it has been shown that the relationship between welfare state and economic performance is more ambiguous that many seem to believe[11]. This broadly positive assessment of the welfare state does not necessarily imply that the present size and structure of European social protection systems are in any way optimal, or that the present efficiency and equity objectives could not be achieved with a leaner welfare state. Nor does this assessment imply that the present structure is the best suited to tackle future economic and social challenges. It only implies that, in outlining reforms of the European social protection systems, one should be careful in safeguarding its most important achievements (see Section 4).

2.2 Pressures for change

Today's economy and society are dramatically different from those at the time in which modern welfare states were established. A snapshot of the demographic and other structural changes that have affected Europe over the past three decades is provided in Table 2. The most evident implications of these changes on the working and the sustainability of the welfare state are related to budgetary and labour market imbalances[12].

2.2.1 Budgetary strains - Over the period 1970-1994, the ratio of social protection expenditure to GDP in the EU increased from 19 per cent to 28.5 per cent[13]. In most Member States social protection expenditure now represents more than a quarter of GDP and about half of public expenditure.

To some extent, the increase in welfare spending reflects the rise in European living standards: "after all these welfare services are not inferior goods, the demand for them rises as peoples' incomes and wealth increases" (Orszag and Snower, 1997). However, this trend in spending, which has already contributed to substantial increases in tax and contribution rates, cannot continue indefinitely. Reforms are urgently required to check expenditure growth, which is fuelled by several factors common to most industrial countries: population ageing, changes in household structure, high unemployment and cost increases.

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11 As suggested by Atkinson (1997), research is likely to yield more definite conclusions at disaggregate level.

12 These issues are extensively examined in European Commission (1995b, 1997a). See also Grahal and Teague (1996).

13 The estimate for 1994 does not include Austria, Finland and Sweden. That for 1970 also excludes Greece, Portugal and Spain. See Eurostat (1996).

Table 2 Demography, household structure and the labour market in the EU

	1960	1990
Life expectancy at birth (number of years):		
males	69.1(a)	73.7
females	75.3(a)	79.8
Life expectancy at 65 (number of years):		
males	--	14.6
females	--	18.4
Total fertility rate (number of children for each woman)	2.6	1.5
Incidence of single-parent households (%)	7	16
Incidence of one-person households (%)	14	27
Number of divorces / 1000 inhabitants	0.5	1.6
Unemployment rate (%)	2.4	10.9(b)
Workers on temporary contracts (%) (c):		
males	4	8
females	6	11
Workers on part-time contracts (%) (c):		
males	1	3
females	22	28
Social expenditure / GDP (%)	19.0(a)	27.5(d)

Sources: DG II database, EUROSTAT (1995), European Commission (1995b and 1995c). Data refer to EUR15.
(a) Data refer to 1970.
(b) Data refer to 1996.
(c) Data refer respectively to 1975 and 1991.
(d) Data refer to 1993.

Population ageing - Changes in birth rates, life expectancy and migration flows are changing size as well as structure of the population of EU Member States (European Commission, 1995c and 1996c, and Eurostat, 1996). The increase in the old-age dependency ratio, which is reaching historically unprecedented levels, is one of the most evident and important trends.

In the coming decades, demographic changes will affect public budgets, through their effects on the demand for public services and transfers and, indirectly, through their effects on macroeconomic and structural factors[14]. Public health and pension systems will bear much of this pressure, since their expenditure is highly dependent on the population age structure. According to national pension expenditure projections, over

14 The economic effects of ageing have been examined by an extensive economic literature, see Börsch-Supan (1991 and 1993), Cutler *et al.* (1990), Hagemann and Nicoletti (1989) and OECD (1988a, 1988c, 1996a).

the period 1995-2030, under unchanged policy, the ratio of public pension expenditure to GDP in the EU will increase on average by 3 to 4 percentage points[15].

Substantial pressures are expected also on expenditure for health care (Leibfritz *et al.*, 1995) and services for the elderly[16], especially in the light of the growing number of very old citizens with costly need for care. Although the expected decline in the share of young people in total population might reduce the demand for public services and transfers in other areas - namely basic education, maternity and child allowances - there is a widespread consensus that overall demographic changes tend to increase public expenditure and produce negative effects on public budgets (see, Heller *et al.*, 1986; OECD, 1988a; Leibfritz *et al.*, 1995; Franco and Munzi, 1997). These effects will vary considerably across the EU according to different national demographic trends and public expenditure structure.

Changes in household structure - Family structures are rapidly changing. Households are becoming more fragmented (see Table 2). The increase in the number of lone-parents and, more generally, the reduction in the size of households, tend to increase the proportion of households facing difficult economic conditions and the demand for welfare state services and transfers (OECD, 1990a and 1994b). The impact of changing family patterns is visible in most industrial countries through the relative increase in the social assistance or safety net component of the welfare state, particularly concerning young people and lone parents[17]. Household fragmentation tends to justify greater individualisation of welfare benefits, also on grounds of horizontal equity (equal treatment for equal situation), which in turns implies higher spending.

High and persistent unemployment - Unemployment rates in Europe are considerably higher than those recorded in past decades: in 1996 the average rate in the EU (about 11%) was almost 5 times higher than that of the 1960s (see Table 2). Unemployment spells are also much longer than in the past (see Section 2.2.2). High unemployment increases public expenditure on unemployment benefits and social assistance and reduces tax revenues. It also tends to increase pension expenditure, as the actual retirement age falls under the pressure of demands for early retirement or disability pensions. As a consequence, the effectiveness of reforms, aimed at cutting pension expenditure by increasing statutory retirement age, is reduced.

Cost pressures - The production of services directly provided or financed by the welfare state is subject to the 'Baumol disease of personal services'. As they consist mainly of personal services whose productivity grows slowly - because they are essentially provided through labour input - the cost of welfare state services is bound to increase relative to the cost of other commodities. This implies that in order to

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15 The estimate refers to the projections carried out in the 11 EU Member States that produce projections up to the year 2030. Austria, Greece, Luxembourg and Portugal are not included. See Franco and Munzi (1996). This issue is also covered in Kopits (1997) and Thomas (1997).

16 According to Prognos (1995), the contribution rate required to finance the German long-term care insurance scheme is likely to increase from 1 per cent in 1995 to 1.7-1.8 per cent in 2010 and 2.3-2.6 per cent in 2040.

17 In the early 1990s, a significant proportion of the population was relying on social assistance in all European countries: from 2% in Portugal and in Luxembourg, to about 10% in Finland and in France, up to 15% in Ireland and the United Kingdom (van Ginneken, 1995). However, as social assistance systems complement in various ways social insurance systems, cross-country institutional differences are too great to allow for accurate international comparisons.

satisfy a rising demand, society should allocate a rising share of national income to the welfare state (Snower, 1993 and 1994b). While globalisation of services and intelligence-intensive technological progress may, in principle, help in keeping costs down in some services, recent experience seems to show that these developments also entail 'product innovation', which stimulates an even greater demand on the part of the public (e.g. in health care).

In conclusion, given the expected changes in demographic structure and the other factors mentioned above, the preservation of present benefit levels and eligibility rules will require a substantial increase in national resources allocated to social security systems. Alternatively, the stabilisation of social expenditure will entail severe cuts in benefit levels and substantial restrictions in eligibility. Both these options are difficult: the first implies persuading citizens to pay higher taxes and accepting higher disincentives effects; the second implies a revision of present objectives and a scaling down of citizens' expectations.

2.2.2 Labour market problems - The labour market and the welfare state are closely linked. While labour market changes affect the demand for benefits and the sources to fund them, tax and benefit structures influence the behaviour of individuals in the labour market (see, for instance, OECD, 1995b). Demand and supply of labour are also affected by employment protection legislation, which can be considered an integral part of the European welfare state 'package'[18].

The changing relationship between welfare state and labour market - Present European welfare systems - based on budgetary transfers to support workers during spells of unemployment, and job security legislation to ensure a relatively high degree of employment stability - were conceived in a situation of low and essentially cyclical unemployment; standardised production carried out by a relatively unskilled workforce; collective bargaining arrangements with various degrees of centralisation and compression of wage structures; and one breadwinner per family (see, e.g. Esping-Andersen, 1996). In this context, it was natural to have welfare services and transfers largely concentrated in the first and last part of a worker's life (covering basic education and retirement pensions) and in providing social insurance for temporary unemployment spells.[19]

The current and foreseeable features of the economic environment are gradually undermining all these elements.

In the EU there are about 18 million people unemployed. In most countries unemployment has been increasing from one economic cycle to the next. According to surveys, a further 9 million people are not registered as unemployed, but would be willing to sign up for a job if labour market prospects improve. The average participation rate in Europe is around 60%, compared with more than 70% in the US.

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18 Some relevant issues are examined in the studies included in Gual (1996).

19 Significant differences exist between the main type of social protection systems (see note 2). The Scandinavian Model tends to allocate a relatively large fraction of social protection outlays to the working-age population, including benefits and services to encourage job search among the unemployment and support for lone-parent work seekers and secondary earners. The other models, and in particular the Mediterranean model, tend to concentrate social benefits on the elderly population.

Furthermore, half of the unemployed have been out of work for more than a year and half of them have low educational levels.

Mass production is quickly being replaced by flexible, customer-oriented production: traditional taylorist factories are giving way to 'holistic' firms characterised by more horizontal structures. As argued by Lindbeck and Snower (1996), the premium on workers' versatility, entailed by the new firm organisation, is leading to a widening dispersion of wages within seemingly identical workers groups, over and above the inequality-enhancing effect of skill-biased technological progress. This process, by increasing the importance of 'personalised' wage incentives, is putting strain on collective bargaining arrangements, based on the principle of 'equal pay for equal work'. The weight of services, accounting for more than half of private employment and continuously increasing, adds to the difficulties of collective bargaining, as production units tend to be smaller in the tertiary sector. The reduction in firm size, evident since the 1970s even in manufacturing, works in the same direction.

The one-breadwinner-per-household model, which dominated in the 1950s and 1960s? is being progressively eroded. As documented by Webb (1995), in the UK, where this process has gone relatively further, in the period 1961-63 almost 7 households out of 10 included only one worker. This share has collapsed to just above 3 out of 10 at the beginning of the 1990s. On the contrary, the share of the two-worker household has increased over the same period from 28% to 55%. This process has gone hand in hand with a rising polarisation of work distribution: the share of households without people working increased from 4% at the beginning of the 1960s to 13% in the early 1990s. At the same time, the second earner is often a part-timer, with a less stable job, being paid a relatively low wage (Gregg and Wadsworth, 1996).

Unemployment compensation - Unemployment benefits and unemployment assistance fulfil the basic objectives of, respectively, social insurance against loss of income due to (involuntary) job termination and social assistance, ensuring a minimum living standard. As explained above, the provision of public unemployment insurance can be justified on efficiency grounds, since private unemployment insurance may not be feasible due to information asymmetries in the insurance market. Unemployment compensation can also bring economic benefits in terms of more efficient job matching, as job-seekers can spend more time on searching the job openings in which they will be more productive, and increase human capital accumulation by workers facing uncertain demand for firm-specific services.

However, unemployment compensation and, more generally, tax and transfer programmes, are perceived as having potentially serious distortionary effects on the working of the labour market, resulting in an increase in the equilibrium rate of unemployment. More specifically, high level and duration of benefits can reduce search effort on the part of the unemployed, work effort on the part of the employed and increase the bargaining power of insiders. In particular, at the low end of the wage scale, the effect of net transfers may be such so as to remove any pecuniary incentive for the jobless to become employed ('unemployment trap') or for the low-paid to increase work effort ('poverty trap'). These effects will generally result in an increase in the reservation wage. Furthermore, taxes and charges levied to finance unemployment compensation and the welfare state will tend to decrease the real wage that businesses can afford to pay to workers at any level of employment, thereby affecting negatively the demand for labour.[20]

Are these potential effects borne out by empirical evidence? Attention should be drawn to the following points[21]:

a) The estimated effects of the levels of benefits on the length of unemployment are relatively modest (estimated elasticity of unemployment with respect to benefits below one) according to a number of studies. In some European countries, replacement ratios are high and, as a consequence, the disincentives potentially important, mainly for low wage and 'fringe' workers as well as families with children.

b) The duration of benefit is generally estimated to have a significant effect on the length of unemployment[22].

c) National institutional characteristics can considerably influence the effect of unemployment compensation: the tighter the administration of benefits, especially concerning job-search requirements, the lower the effect.

d) Unemployment compensation does not only affect the probability of leaving unemployment for employment but the whole range of labour market transitions. For example, a cut in benefits (or a tightening of eligibility requirements) will tend to reduce unemployment also by increasing withdrawals from the labour force (or participation in government training schemes).

In conclusion, although the recent surge in unemployment has gone hand in hand with a reduction in the generosity of benefit systems and it is difficult to attribute the bulk of European unemployment to benefit-induced disincentives, welfare systems and their financing appear to aggravate unemployment and have a significant effect on its persistence. The effects of benefits on work incentives become greater if account is taken of the corresponding increase in the tax burden (i.e. by considering the marginal effective tax rates), with taxes on earned or labour income being the most damaging. This applies especially to low-skilled workers.

Labour market regulations - The general case for relaxing labour market regulations, for example pertaining to hiring and firing workers, is similar to the case for streamlining unemployment compensation, and is subject to analogous qualifications. Besides possibly increasing the equilibrium rate of unemployment by raising the power of insiders, employment protection is generally supposed to reduce the speed of

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20 Implicit in this reasoning is a model of unemployment as equilibrium outcome in imperfectly competitive labor and product markets (Phelps 1994b). The equilibrium employment rate, and by residual unemployment, is represented by the intersection of a wage-setting curve and a labour demand curve. The wage-setting curve represents the effect of efficiency wage considerations (or, alternatively, bilateral bargaining between firms and unions). It is upward-sloping as the premium over the market-clearing wage is increasing in the employment rate. The labour demand curve depicts firms' optimal price and employment decision given the wage they face. It is downward-sloping as firms' unit costs are typically increasing in the wage paid economy-wide (or, alternatively, because firms set prices as a mark-up to marginal costs).

21 See Atkinson and Micklewright (1991) and Blöndal and Pearson (1995) for a survey of the literature.

22 According to some studies (referring to the US situation), for a given expenditure cut in unemployment benefits, a reduction in duration has as much as twice the effect of a reduction in level (Katz and Meyer, 1990).

adjustment of (un)employment to its long-run level following a shock (Jackman *et al.*, 1996).

At the same time, some forms of labour market rigidity can be rationalised as substitutes for insurance that the markets cannot provide[23]. Employment stability provisions can also be seen as enhancing investment in match-specific human capital, which would not be undertaken in a *laissez faire* world for fear of opportunistic behaviour (Alogoskoufis *et al.*, 1995). Finally, it is also argued that the monopsony power of employers - the power to restrict labour demand in order to push down wages - is important and labor market regulations are required to restrain its use (Gregg and Manning, 1996).

To the extent that both labour market regulations and welfare provisions respond to the same type of market failures, they can also be seen as substitutes. It has been observed that "labour market policy regimes work like communicating pipelines" (Schmid, 1995, p. 57): the relative underdevelopment of one set of policies tends to result in others being put in place to replace it. Thus, for example, the relatively high degree of labour market rigidities in some countries may be related to the limited development of the unemployment compensation system.

At the same time, it must be recognised that current labour market rigidities in Europe are too pervasive to be justified on efficiency grounds alone. Efficiency considerations would suggest compensating uninsurable losses through taxes and transfers rather than by placing constraints on the allocation and/or price of labour. Even more than welfare provisions, therefore, labour market rigidities probably call for a 'political economy' rationale, i.e., one that explicitly recognises the need for policies to be sustained by sufficiently strong coalitions[24].

Views on the importance of regulations on labour market outcomes differ among economists. Empirically, it has proved difficult to establish the existence of a significant long-term effect of specific regulations on labour market adjustments (Blank and Freeman, 1993). Restrictions on hiring and firing, by increasing turnover costs, tend to make employment and unemployment more resistant to cyclical fluctuations. The result is a reduction in the variability of employment, but not necessarily the average level of employment (Bentolila and Bertola, 1990).

This 'neutral' view of the impact of labour market regulation on employment and unemployment has been challenged recently on the basis of a number of relatively new features of the economic environment in the industrialised world. Specifically:

i) Hiring and firing costs result in a 'zone of inaction' following a demand shock. But if a large shake-out of labour does occur, for example in the case of a deep and prolonged recession as experienced by many countries in the 1980s and in

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23 For example, in the presence of uncertainty over future product demand, it is efficent for risk-averse workers and risk-neutral firms to opt for contracts with redundancy pay. Informational constraints about workers' productivity or demand conditions, or the simple possibility of firm bankruptcy, may then require some form of state intervention on firing costs (Booth, 1996).

24 Thus, for example, minimum wage regulations, coupled with restrictions on hiring and firing, can be interpreted as devices to increase the convergence of interests within the 'core' of employed workers at the expense of the 'periphery' of the unemployed and the workers with the highest qualification (Saint-Paul, 1995a and 1995b): wage compression tends to make the median voter richer relative to the average and job security tends to make the minority of losers identifiable in advance.

the 1990s, a return of demand to its pre-shock state may be insufficient to restore employment to its earlier levels (Diaz and Snower, 1996).

ii) Restrictions such as seniority rules, by treating workers as close substitutes for each other, may hamper the organisational innovations required by new technologies (Lindbeck, 1994c).

iii) High turnover costs may reduce technological innovation and hence productivity and competitiveness in the long term. A country with regulations making the reallocation of labour very costly will tend to produce a lower share of innovative, but riskier, goods and have a relatively lower investment in R&D (Saint-Paul, 1996)[25].

In conclusion, a critical examination of labour market regulations would probably concur with the view that "existing legislation was better adapted to conditions in the past than to today's world with large macroeconomics disturbances, high and persistent unemployment, rapid structural change, great uncertainty, and increasing heterogeneity of jobs and workers" (Lindbeck, 1994c, p. 73).

3. Implications of increasing economic integration

European welfare states will also be affected by increasing economic interdependence. The deepening of integration worldwide and in Europe will intensify some of the pressure highlighted in the previous section and add some additional constraints.

The implications on European welfare states of increasing integration can be analysed from three different standpoints:

a) Increased factor and consumer mobility.

b) Economic adjustments in an integrated economy.

c) The quest for budgetary discipline.

3.1 Factor and consumer mobility

Economic integration increases the mobility of productive factors and may also increase the mobility of the consumers of social services.

Factor mobility - Economic integration, which is expected to deepen in Europe after the introduction of the single currency, by stepping-up factor mobility, may increase revenue losses arising from the movement of tax bases towards countries applying lower tax rates. A situation of fiscal degradation could be made worse by fiscal competition among countries and regions, which might reduce tax rates in order to attract productive factors. These trends would primarily affect capital income taxation and corporate taxation, but labour and consumption taxes would also be influenced.

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25 This prediction is consistent with widespread - but largely anecdotal - evidence on the different type of R&D spending in Europe and in the US (more process innovation in the former, more product innovation in the latter). For an opposite view on the effects of labour market regulations on productivity, one may point to the widespread interpretation of the 'German model' according to which firms have been induced to invest heavily in productivity-enhancing technologies to cope with the high labour costs. In this approach, flexible labour markets, by leading to a fall in the price of low-skilled labour, may give rise to Snower's "low-skill, bad-job trap" (Snower, 1994c).

The empirical research on the effects of tax degradation and competition on revenue trends in the EU Member States is still in its infancy (Hoeller *et al.*, 1996). Although, over recent years, tax to GDP ratios have remained broadly constant, the distribution of the tax burden on different factors in the EU has changed substantially along lines consistent with fiscal degradation and competition. Over the period 1980-1994, while the implicit tax rate on employees' income has increased on average from 34.7 to 40.5 per cent, the implicit rate on other productive factor income has declined from 44.1 to 35.2 per cent (European Commission, 1996b).

Future trends are also uncertain. Some economists take the view that, if unmitigated tax competition is allowed in the Internal Market, "the New York city effect will be the death of European welfare states" (Sinn, 1990). While this view is perhaps extreme, in a context of mobile tax bases and competition between jurisdictions, further increases in the tax to GDP ratios appear unlikely. Attempts to shift even further the burden of funding public expenditure on labour would reinforce the negative effects on employment highlighted above.

The role of benefit-taxation (user charges, etc.) is bound to increase, while that of ability to pay taxation is likely to be restrained. An increasing share of revenue will come from taxpayers covering the cost of the specific services provided to them. To the extent that social protection provides insurance (rather than simply redistribute income), mobile but risk-averse workers will value it as a service. Therefore, while quasi-actuarial social insurance will survive labour market integration, social assistance will come under increasing pressure (Atkinson, 1992). Several recent pension reforms are moving this way (see Section 4.1), as well as the proposals by Fölster and Orszag and Snower considered in Section 4.2.3.

The gradual transformation of taxes into pure-benefit taxes seems a likely scenario particularly for the taxation of business, with firms increasingly 'shopping' across jurisdictions within the single market in search of the best tax and service package. Empirical evidence, based on the US experience, points to relatively low inter-regional (inter-state) elasticities of economic activity (employment or value added) with respect to (aggregate) tax levels (between 0.2 and 0.6); however, elasticities become higher when public services are included in the analysis, and intra-regional (intra-state) elasticities are much higher (four times as much or more) than inter-regional ones. This suggests that, with other cost variables similar among different locations, taxation plays an important role in location decisions (Wasylenko, 1997).

Consumer mobility - Increased economic integration may also increase the mobility of consumers of welfare state services. Citizens may have an incentive to move to countries that provide higher benefits and better services or they may demand services produced in other Member States.

Welfare migration, which may put pressure towards lowering the level of services, is not likely to reach sizeable dimensions (Ermisch, 1991). In the United States, it is discernible, but not important. States are therefore able to keep different levels of benefits. Labour mobility in Europe, both across and within countries, is markedly lower than in the US. Hence, it is likely that also in the future European governments will be in a position to pursue tax and transfer policies according to national preferences. This conclusion is supported by the experience of Switzerland, a small country with a linguistically diverse population, where local authorities (cantons) are responsible for a high (and increasing) share of government transfers (Begg *et al.*, 1993; Hoeller *et al.*, 1996)[26].

An increasing number of citizens is also likely to demand services produced in other countries, without necessarily living there. This may apply particularly to health and insurance services[27]. This trend would provide incentives to improve the quality of services and increase efficiency. In the long-run, it might also lead to some harmonisation of national social protection systems.

3.2 Economic adjustment in an integrated economy

Economic and monetary integration will affect the way European economies adjust to shocks. First, in EMU, the nominal exchange rate will not be available as an adjustment tool in the event of country-specific shocks. Second, globalisation and the Internal Market are likely to change the nature of shocks. Last but not least, the behaviour of wage and price setters is also likely to be affected. The functioning of the welfare state has important implications for the way these changes translate into employment/unemployment outcomes[28].

It is argued that in the short-term, following the occurrence of a given shock, the availability of the nominal exchange rate can enhance the effectiveness of the adjustment to the new equilibrium. Adverse country-specific shocks require a depreciation of the real exchange rate to avoid negative fluctuations in unemployment. If wages to do not adjust smoothly to the new conditions, a depreciation of the nominal exchange rate can arguably work in 'front-loading' the required real exchange rate adjustment. This presupposes, however, that exchange rates tend to move predictably in response to macroeconomic imbalances. Experience and empirical evidence indicate that, in a world of free capital movements, exchange rates tend to be driven by financial considerations, which are unrelated to such macroeconomic imbalances. Empirical evidence also suggests that European countries are characterised by relatively a high degree of real wage rigidity - i.e. relative fast response of wages to prices changes coupled with relatively low sensitivity to unemployment. If wages react quickly to price rises, a nominal exchange rate depreciation is bound to be less effective in inducing an equivalent change in the real exchange rate and more likely to trigger an inflationary spiral.

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26 Although cross-country labour mobility is likely to remain low throughout the European Union for the foreseeable future, regional mobility (e.g. between the Nordic countries) may be expected to reach significant dimensions. Tentative conclusions can be drawn from the experience of the integrated Nordic labour market (citizens of Denmark, Finland, Iceland, Norway and Sweden have had the right to settle anywhere in the area without either residency or work permits since 1954, Nordic immigrants are treated the same as native residents by the national authorities and information on work opportunities is shared across the area). Studies find that intra-Nordic migration is significantly responsive to real wage and unemployment differentials, with potential mobility being the strongest among the highest educated and the largest disincentive effect being the extensive safety net for the unemployed (Hutchinson and Kletzer, 1995). At European level, in the future, some form of co-ordination of national benefit systems might be necessary in order to prevent individuals from adjusting their geographical location over their life cycle on the basis of specific features of benefit systems (Lindbeck, 1997).

27 As to development of a Single Market in supplementary pensions, see European Commission (1997b).

28 For a discussion of adjustment under EMU, with particular reference to employment/unemployment outcomes, see Viñals and Jimeno (1996).

More generally, globalisation and higher trade integration are likely to have wider consequences for the 'dynamics' of European economies. More open and transparent markets may increase 'contestability' and spur organisational and technological innovation, thereby leading to a higher frequency of industry-specific shocks. Moreover, the Internal Market rules, coupled with a tough competition policy, will reduce the scope for defensive 'industrial' policies by member countries that have been intensively used in the past, in order to cushion negative shocks and preserve occupational levels. These effects, which cannot be tackled through nominal exchange rate variations, may require more frequent changes in relative wages and a smooth re-allocation of labour across sectors and regions.

At the same time, the competition-enhancing effects of economic integration are likely to impose more discipline on price and wage setters. This should mean both a more effective adjustment to shocks and a lower equilibrium level of unemployment.

Welfare state provisions have mixed effects in this context: employment protection legislation may hamper the shift of labour resources from declining to rising industries; analogously, unemployment compensation, by reducing job-search activity and enhancing insiders' power, may increase real wage rigidity. However, social insurance, by easing the transition, can render reallocation more feasible. Other welfare state programmes (namely, training and active labour market policies, as well as housing policy) also play an important role in fostering labour mobility and industrial adjustment.

Better 'mobility-friendly' welfare services, coupled with less rigid hiring and firing rules and an improvement of the conditionality of unemployment benefits (better incentives, job search requirement, etc.) would enhance labour markets' ability to respond to shocks. Although the 'mobility-oriented' revision of the welfare state should primarily involve labour market policies and unemployment benefits, all schemes should be re-examined. For instance, the obstacles to labour mobility arising from pension systems should be gradually removed (by reducing the segmentation of the system into different schemes or ensuring the portability of contributions). Housing policies should also be systematically reconsidered.

3.3 The quest for budgetary discipline

Solid budgetary discipline is an essential condition for the success of EMU. A sound budgetary position before joining the single currency and budgetary prudence once in EMU are at the core of the budgetary policy provisions of the Maastricht Treaty.

It should be stressed that, as pointed out above, European budgetary trends would anyway require substantial corrections. The budgetary framework for EMU outlines policy changes that several countries would anyhow have implemented. In some cases, it may accelerate policy changes by increasing the pressure to take a more long-term view in evaluating the costs and benefits of different policies.

Given that further increases in the ratio of tax revenues to GDP do not seem feasible, because of the implications of economic integration on revenues (Section 3.1), future budgetary adjustments will have to be concentrated on expenditure items. Any correction of present expenditure trends will necessarily involve social protection expenditure, which represents about two thirds of public expenditure net of interest payments in EU Member States and, for the reasons outlined in Section 2.2.1, tends to increase faster than other expenditure items.

Over the next few years, pressure on welfare spending will be exerted by the further reduction of the deficit towards a balanced budget, as provided for by the Stability and Growth Pact[29]. This implies that governments will have to run large primary surpluses in normal economic conditions. An indication of the size of the surpluses is provided by the amount of interest payments (an average expenditure of 5 percentage points of GDP is expected for 1997).

Over a longer time span, further substantial policy changes will be required in order to maintain the 'close to balance' position, particularly after the year 2010, and to avoid that population ageing will determine unsustainable deficits and debt levels (Franco and Munzi, 1997). More specifically, action should be taken to offset the budgetary effects of the demographic changes outlined in Section 2.2.1. In the long-run, welfare state transfers may also have to compete with competitiveness-enhancing spending priorities, such as infrastructure investment, and may require a revision of their internal composition, with a greater concentration on education and human capital improvement.

One point should be stressed. Although the 'close to balance' rule is introduced in connection with EMU, its implementation will also allow Member States to meet the worsening of the demographic situation after the year 2010 with smaller public debts and lower interest burdens. Governments will be forced to use the demographic 'breathing-space' to meet on a sounder fiscal policy position the ageing of the baby-boom generation.[30]

4. The reform process

According to opinion polls, throughout the Union there is widespread support for the essential features of the welfare state: universal rights to basic health and educational services, support for poor, sick, unemployed and disabled citizens, and an adequate level of intergenerational redistribution guaranteed by the state. It is widely felt that reforms should not impair these achievements and fundamental features.

However, the continuation of present social protection policies would require increases in tax rates that would negatively affect labour supply and unemployment, might have a negative impact on the long-term performance of European economies, and would conflict with the pressures towards lower tax rates stemming from economic integration and the globalisation of economic activities. Across Europe policy-makers are, therefore, confronted with the task of curbing expenditure growth while preserving the fundamental features of social protection systems and facing new needs, such as those of elderly citizens in long-term care and lone-parent families.

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29 The 'close-to-balance' rule would allow Member States to retain budgetary stabilisers without going beyond the 3% threshold in the event of recession (see, Buti *et al.*, 1997).

30 More specifically, part of the increase in pension and health expenditure determined by population ageing would be offset by a reduction in interest payments on the public debt. According to some preliminary estimates carried out in Franco and Munzi (1997), about half of the increase in public expenditure determined by population ageing in heavily indebted countries might be offset by the reduction in interest payments on public debt determined by the implementation of the 'close-to-balance' rule.

This section focuses on three specific aspects of the reform issue. First, it shows that the adjustment process of social policies to the new demographic and economic conditions is already underway, although it is far from completion. Then it considers three possible reform lines: the transition from Pay-As-You-Go (PAYG) to funded pension schemes, the shift from unemployment benefits towards employment subsidies and changes in the design of social protection strengthening their efficiency. Finally, it examines some aspects of the implementation of the reform process and points to the problems of welfare state retrenchment.

4.1 Reforms are underway

In most countries, present social policies are quite different from those implemented in previous decades [31]. The phase of extension of coverage and improvement of benefits is over, although in a few countries the lagged effects of past extensions and improvements are still affecting expenditure growth.

This change is quite evident for *pension systems*. Since the mid-eighties most pension schemes have been reformed in order to reduce pension expenditure. Major reforms were introduced in Austria (1985, 1988 and 1993), Germany (1989), Italy (1992 and 1995), France (1993), Greece (1990 and 1992), Portugal (1993), Sweden (1994), the United Kingdom (1986, 1994). Reforms involve less generous benefit indexation rules, increases in standard retirement age, reductions in replacement rates, tightening of eligibility criteria for disability benefits and pension credits for years with limited or null contributions, curtailing or abolishing public sector employees' special pension benefits, lengthening of contribution periods required for pension eligibility. In several countries, reforms, by cutting eligibility and transfer ratios,[32] have brought the expected increases in the ratio of pension expenditure to GDP firmly below the expected increases of the old-age dependency ratio. Cost containment was just one of the objectives of the reforms, which also aimed at making the system more able to tolerate demographic change, more transparent in its distributive effects, and less distortive in its effects on individuals' choices. [33]

Health care systems are also undergoing substantial changes, although the general pattern of reform is less uniform (European Commission, 1995a; OECD, 1990b, 1994c and 1995a). This is due to substantial differences in the structure of national health care systems and the role of the public sector in the provision and financing of health care. While the principles of universality and equality in the access to services were not questioned, expenditure control has been pursued with a wide variety of instruments: tighter hospital budgets, restrictions on the supply of services (i.e., hospital beds, new entrants in medical education, new technologies), restrictions on the reimbursement of drugs (with negative and positive lists and reference price systems), increase in cost-sharing. Several reforms aimed at increasing efficiency in

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31 For a description of recent reforms see European Commission (1993a, 1995a). The reforms recently undertaken and planned in France are extensively examined in Darnaud (1997) which also highlights the problems raised by their implentation.

32 Respectively, the ratio of the number of pensions to the number of elderly citizens and the ratio of the average pension to the average wage.

33 This applies particularly to the recent Italian and Swedish pension reforms, which share the same general objectives and main features. See respectively Artoni and Zanardi (1996) and Ministry of Health and Social Affairs (1994).

the use of resources and quality of services by modifying incentives at the micro-level: giving patients more choice (Sweden), introducing competition within the public sector and between the public and the private sector (UK), separating the provision and the financing of services (UK), relying more on contracts as an instrument to allocate resources among providers, shifting responsibilities towards regional and local administrative levels (Finland, Italy).

Unemployment benefits are also being reformed throughout the EU, with the emphasis on curbing expenditure growth and dependency on social protection. However, institutional changes in most Member States fall short of a radical overhaul of the current systems. Efforts have also been made to curb abuses. Eligibility criteria have been tightened, with stricter definitions of availability for work and tougher sanctions on those refusing to take up a job (or a training course) applied in several countries (such as Denmark, Finland, Germany, Sweden and the UK). The duration of benefits and/or replacement ratios have been reduced in an attempt to curb alleged work disincentives (Denmark, Ireland, the Netherlands, Spain and Sweden). Countries featuring in-work benefits to top up low wages (Ireland and the UK) have introduced changes aimed at minimising the risk of 'poverty traps', such as higher earning thresholds and gradual phasing out of benefits. More generally, action to curb high marginal effective tax rates has been taken in several countries (such as Denmark, France, Ireland, the Netherlands, Sweden and the UK). Overall tax wedges on labour has also been reduced (e.g. in the Netherlands).

In conclusion, the adjustment of European welfare states to the new demographic scenarios is underway, with reforms gradually affecting expenditure dynamics, especially in the pension area. The changes that have already been implemented, while still not sufficient to arrest expenditure increase, offer some scope for optimism, since in many countries public opinion has been prepared to accept substantial changes in entitlements. The adjustment to a more competitive economic environment raises more difficult problems: while some reforms have improved the incentive structure in the pension and health area, much still remains to be done. Several pension schemes still provide incentives to retire early. The effects of the reforms in the health care sector are far from clear; moreover, the direction of further reforms is still not well defined. The incentive problems related to unemployment and other transfers would also require substantial improvements in tax-benefit systems.

4.2 Which new reforms?

Introducing further reforms to allow European welfare states to cope with new needs and constraints raises a number of difficult issues. How far can social expenditure be constrained without impairing the main objectives of present policies? Can reforms fully offset the effects of ageing on spending or should increases in revenues and cuts in other budgetary items also be planned? Which benefits could actually be reduced? Should more emphasis be put on systemic reforms or on punctual changes of the parameters of the present system (e.g., by tightening eligibility rules and reducing transfer ratios)? Should the targeting of benefits on the most needy be revised or the welfare state from the middle classes be withdrawn? Should the boundary between the responsibility of the state and that of the private sector be shifted? What is the scope for privatisation in the financing and the production of social services?

Providing answers to these questions goes well beyond the scope of the paper[34]. This section takes a narrower approach by considering three reform lines that aim at reducing the role of the public sector in providing pensions, overcoming the inefficiencies of unemployment benefit systems, and improving the incentives produced by social protection systems.

4.2.1 From PAYG to funding - The reform of pension systems, which absorb a large share of social protection expenditure and are particularly affected by population ageing, is at the core of the adaptation of the welfare state to new economic and demographic conditions. It is fundamental for ensuring durable fiscal consolidation and for improving the conditions of European labour markets.

As reported in Section 2.2.1, in spite of these reform efforts, which will partly offset the effects of demographic trends, in most countries the preservation of present pension benefit levels and eligibility rules will require a substantial increase in the national resources devoted to pension systems. Alternatively, the stabilisation of pension expenditure will require further severe cuts in pension benefit levels and substantial restrictions in pension eligibility.

The first option raises several problems. Although reforms strengthening the link between contributions and benefits might make the burden of contributions more tolerable and less distortive, adding 3 to 4 points to the present tax to GDP ratio would be extremely difficult for the reasons pointed out at the beginning of Section 4.

It would also be difficult to compensate the increase in pension expenditure with cuts on other expenditure items. The decline in the share of the young to total population offers some margins for cutting education expenditure, but health expenditure and expenditure for services to the elderly are likely to increase substantially (Franco and Munzi, 1997). So, in the end, containment of benefits is likely to be the primary instrument for guaranteeing the solvency of PAYG pension systems. This implies a scaling down of citizens' expectations and a revision of present objectives. Further reforms might involve changes in indexation rules, increases in retirement age, reductions in replacement rates, tightening of eligibility criteria (Thomas, 1997). As mentioned in Section 4.1, examples of such piecemeal reforms have, in the past, in several countries, demonstrated the effectiveness of such measures in slowing down pension expenditure dynamics.

The increasing role of funding - In several countries the relative weight of PAYG and funded schemes is changing, with the latter schemes gradually becoming more important. While there is a widespread consensus that the role of funded schemes should be increased, there are no clear indications about its optimum size (OECD, 1992b; World Bank, 1994; Davis, 1995).

Economic considerations point to the desirability of pension systems that include both PAYG and funded schemes, since both schemes are subject to different risks and returns (Fornero, 1995). PAYG schemes are superior in the alleviation of poverty and the provision of insurance against inflation and investment risks. On the other hand, they are vulnerable to population ageing and decline in employment. Governments may also default promises based on optimistic assumptions. Funded schemes produce

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34 For an analysis of the problems raised by the reform of the French welfare system, see Damaud (1997).

lower distortionary effects in the labour market. They may also contribute to the development of financial markets (Davis, 1996) and provide workers with higher returns to contributions in a situation in which the real interest rate is higher than the rate of growth of employment and real wages. On the other hand, they are vulnerable to inflation and investment risks and have relatively high administration costs.

The development of funded schemes does not alone provide a solution to the sustainability problems of the PAYG schemes, which can only be ensured through further cuts in their benefits. Supplementary funded schemes can, however, facilitate the reforms of PAYG schemes by offering to the workers the possibility to compensate for the reduction in the replacement rate resulting from the reforms. This development will lead to a partial shift of responsibility for retirement income provision from the government towards workers and employers.

As the importance of supplementary pensions increases as a share of total retirement income, it is increasingly important for governments to provide a secure environment for the efficient operation of supplementary funded schemes (European Commission, 1997a, 1997b). A regulatory framework that enables pension funds in all countries to properly diversify their assets, both domestically and internationally, should enhance returns, reduce risks arising from domestic economic cycles and reduce the negative impact on asset prices during periods of disinvestment (i.e. when elderly generations run down their wealth)[35].

As illustrated in Holzmann (1997), reforms implying a large scale switch from PAYG to funding are difficult to implement in the case of developed and mature public pension systems such as those prevailing in most EU Member States. In case of such a shift, government pension liabilities would become 'explicit', and create a stock and flow problem in public finances. The magnitude of the problem is indicated by the value of future pension liabilities already accrued by the workforce, which in most EU Member States is much higher than conventional public debt (Van den Noord and Herd, 1994)[36]. In order to assess the effect of a shift, it is important to examine how the deficit would be financed, as well as the timing of the shift. The burden of the transition could either fall on the current generation - which would have to pay twice through higher taxes, or lower public expenditure in other fields, in order to finance outgoing pensions, while having to pay contributions to the new funded scheme - or be distributed between current and future generations, through an increase in public deficit and debt. Both these solutions raise difficult problems.

4.2.2 Overcoming the inefficiencies of unemployment benefits - Unemployment benefits and assistance pursue efficiency and equity goals. However, as pointed out above, problems of incentive (in)compatibility and funding strain may give rise to unemployment and poverty traps. When these problems are particularly serious, unemployment benefits and transfers, instead of lifting the unemployed or the 'working poor' out of their disadvantaged status, actually contribute to its persistence.

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35 Several other problems raised by a larger reliance on supplementary schemes should be carefully examined (e.g. protection against fraud, effects on labour mobility, administration costs).

36 For a review, see Franco (1995), Chand and Jaeger (1996), and Roseveare *et al.* (1996).

The main policy alternatives to current unemployment benefits are the introduction of a 'conditional negative income tax' and the replacement of unemployment benefits with employment subsidies.

A conditional negative income tax could achieve higher equity and efficiency than unemployment benefits (Snower, 1995). Income redistribution would imply that the lowest income brackets would receive transfers, which would gradually give way to taxes at higher income levels. The 'conditional' character of the tax would be related, as for the current unemployment benefit systems, to evidence of active job search. Such a measure could be more effective for equity purposes because it can be argued that the income level rather than the employment status is a better criterion for redistribution. It could also be more employment-friendly because it discourages less job search, as becoming employed at a low wage would lead to a loss of only a fraction of the negative income taxes, rather than all the unemployment benefits. More generally, a negative income tax may be more appropriate in overcoming the inefficiencies generated by credit constraints, which are more closely associated with low incomes than with unemployment[37].

Several studies have argued that replacing unemployment benefits with employment subsidies would allow the same equity objectives to be pursued, while promoting employment[38]. Two main proposals have been widely discussed in the literature:

i) Low-wage employment subsidies or targeted reductions in pay-roll taxes have been proposed to tackle the unskilled unemployment problem (see, e.g., Drèze and Malinvaud, 1994; Phelps, 1994b and 1996; and Fitoussi, 1996).

ii) Giving the opportunity to unemployed people, especially the long-term unemployed, to use part of their unemployment benefits as employment vouchers to the firms available to hire them. Snower (1994a and b, 1996b), who first put forward such proposal, dubbed it Benefit-Transfer Programme.

If these schemes are effective in taking long term unemployed off the dole, the newly generated tax revenue and savings in social transfers would reduce their net cost. No inflationary pressure would arise from the fall in unemployment because the wage discipline exerted by the long-term unemployed is negligible. As in the case of unemployment benefits, these schemes would have a built-in stabilisation function.[39]

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37 In a simple numerical exercise, Snower (1995) finds that a switch from unemployment benefits to a negative conditional income tax in the EU would raise the average income of individuals receiving support by about 8 per cent and cut the number of unemployed by around 7 per cent. However, as recent reforms of benefit systems in EU countries (by foreseeing a gradual withdrawal of benefits) are attenuating the inefficiencies pointed out above, the estimated implications of an outright switch to conditional negative income tax are likely to be biased upwards.

38 The economic rationale for employment subsidies is the existence of a gap between social and private benefits from an increase in employment of disadvantaged workers in a situation of involuntary unemployment. From the point of view of the individual employer, it makes sense to avoid creating jobs for which the marginal product falls below (minimum) wage costs. But this calculation does not consider the additional benefits that accrue to the economy as a whole from putting to work an unemployed person willing to accept a job. The share of payroll taxes out of the minimum wage provides a first approximation of the size of the gap (Phelps, 1996, Drèze and Snessens, 1996).

39 The above proposals have entered the political arena both at EU and national level. The 1993 White Paper (European Commission, 1993c) proposed targeted reductions in non-wage labour costs amounting to 1% of GDP, financed through a CO_2 tax. The White Paper also proposed a complementary strategy, aimed at raising the demand for labour-intensive services in sectors sheltered from international competition (for example, assistance to the elderly, personal and public safety). A further study explored this strategy in

The low-wage subsidies and the employment voucher proposals are not mutually exclusive[40].

However, the above schemes are not without problems (see, *inter alia*, Nickell and Bell, 1995 and Snower, 1996b).

i) The increase in employment induced by subsidies should be assessed net of deadweight costs (jobseekers that would have been offered a job anyway, given the incumbent workers' average propensity to quit and the proportion of vacancies filled by the unemployed) and substitution and displacement between the target group and incumbent workers (firms substituting one lot of workers for another or employment expansion in one set of firms displacing employment in other firms).

ii) If the amount of the subsidy or the 'size' of the voucher is a positive function of the duration of period out of work, job search could be discouraged.

iii) The acceptance of subsidies or vouchers might be less than intended if they are perceived by the unemployed and the employers as carrying signalling or stigma implications.

iv) The employment impact depends on the endogenous reaction of wages: for employment to increase some part of the subsidy must act to reduce the cost of employing marginal workers and not to be passed on entirely to wages.[41]

v) By raising the take-home pay and/or the employment rate of low-skilled workers relative to that of skilled workers, subsidies reduce the expected private rate of return on education and thereby can depress human capital accumulation and productivity growth.

Part of those negative effects can be attenuated through a careful programme design: by giving the right to displaced workers to introduce a formal complaint leading to withdrawal of benefits; by transforming 'incapacity benefits' into employment vouchers - thereby incurring low dead-weight costs - as proposed by Orszag and Snower (1996); by foreseeing a not-so-steep temporal profile of subsidies/vouchers to

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more detail, including simulation of possible measures (European Commission, 1996d). More generally, the importance of the reform of tax and benefit systems in the fight against unemployment in Europe was retained as a major policy conclusion of the Ecofin report to the European Council in Madrid in December 1994 (European Commission , 1995d). A number of EU countries have included these policies in their employment strategies, though, so far, with programmes of rather limited scale (for example, the Benefit-Transfer Programme inspired the British Workstart pilot scheme introduced in 1993).

40 On the basis of a number of simplifying assumptions, Snower and Phelps (1995) estimated that converting unemployment benefits into employment vouchers could reduce EU unemployment by as much as 20 per cent, or 2 percentage points in percentage of the labour force. They also estimated that, by targeting on low-paid workers subsidies amounting to 1 per cent of GDP, unemployment could be reduced by 2 additional percentage points. The results depend on a number of parameters, notably the 'voucher effectiveness ratio' capturing the equivalence between a temporary voucher and a wage reduction of the same amount. For an exercise of the same type concerning most OECD countries, see Snower (1996b).

41 Subsidies produce different results depending on the degree of responsiveness of wages to unemployment. This is explicitly recognised by Phelps (1996, p. 240) in comparing the American and the European situation: "I suppose that the main benefit of wage subsidies in the USA will take the form of higher wage rates, with a less important effect on unemployment. The reason is that 'wage rigidity' is relatively small there, which means that the wage curve is relatively steep. And the main benefit of the wage subsidies on the European continent will take the form of lower unemployment rates - more workers demanded at those rigid real wages - with little improvement in wage rates. The reason, again, is that wage rigidity is relatively great in Europe, so the wage curve is relatively flat".

discourage job search postponement; by offering higher subsidies/vouchers to firms that use them for training. However, they cannot be completely eliminated. Indeed the experience of a number of EU countries that have implemented various forms of reductions in pay-roll taxes point to a rather weak net effect on employment[42].

***4.2.3 Improving the incentives of welfare state schemes* -** As pointed out above, many of the problems related to the working of social security systems, are unavoidable. However, their dimension is surely exacerbated by the structure of present social schemes (Orszag and Snower, 1997). Contributions are often loosely related to benefits, so that they are largely regarded as a tax; expenditure controls frequently rely on administrative constraints rather than on built-in incentives; redistribution and insurance features are frequently mixed and insurance schemes are utilised for inappropriate distribution objectives. As pointed out by Musgrave (1981), "To represent as redistribution what in fact is not is undesirable as a matter of social sensibility. Moreover the acceptability for redistribution measures is limited and should not be preempted by what in fact is not a part thereof."

In several countries, proposals have been put forward to redesign social security schemes along lines that are less distortive of individuals' choices and more transparent in their distributive effects[43]. Reforms have already been introduced or planned along the same lines. The strengthening of the contribution/benefit link is a crucial factor. These actions are expected to increase the incentive to work and, more specifically, to stay on in regular jobs (since benefits would depend on work record), to delay retirement, to move from benefits to work. These effects would reduce the demand for benefits and allow a reduction in contribution rates and tax-wedges. By making workers more aware of the value of the benefits for which they are paying contributions, they may also affect wage negotiations, for if workers are not aware of the value of non-wage benefits, they are not likely to trade lower wage increases for the continuation of present benefits[44].

In the case of pension schemes, this line of reforms increases the role of actuarial principles: this implies shifting PAYG schemes from 'defined-benefits' systems (which base pensions on earnings in final period of work) to 'defined-contribution' systems (which base pensions on contributions paid over whole working life) and increasing the role of funded schemes (where the contributions-benefits link is typically very strong). Some recent pension reforms have been explicitly designed on the criteria outlined above: the Swedish and Italian reforms in 1994 and 1995, respectively, are going to replace the present wage-related pension with actuarial pensions based on life-time contributions and expected life at retirement. Piecemeal changes introduced in several countries also strengthened the contribution-benefit link.

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42 However, in less than perfectly competitive labour markets, the rise in the number of 'employable' workers and a higher turnover of incumbents may be beneficial *per se*: a number of long-term unemployed would be brought back into the labour market and newly displaced workers, since they have a better chance to find a new job, would exert a more effective wage discipline pressure on insiders.

43 See, for instance, Ministry of Health and Social Affairs (1994).

44 In this respect, the US case, where contributions to company-based health and pension schemes are an important part of wage negotiations is particularly relevant. Any increase in health care costs can more easily influence wage negotiations..

All encompassing reform proposals of benefit systems with built-in incentives that limit the demand for benefits are put forward by Fölster (1997) and Orszag and Snower (1997). Fölster suggests the introduction of 'individual social insurance accounts'. In the same vein Orszag and Snower propose the establishment of 'welfare accounts' for each citizen covering the four main welfare functions, namely, provision for retirement, unemployment compensation, human capital formation and insurance against sickness and disability. Mandatory contributions - set in an actuarially fair manner and supplemented by a degree of redistribution across individual income situations - would be made to each account, and individual withdrawals - subject to prudential monthly limits - would replace current pension, unemployment and sickness and disability benefits.

The system would reduce the incentives to stay on benefits and increase the incentive to work, as the longer people remained unemployed the lower the net balances on their unemployment accounts available for subsequent use. It would allow a reduction in contribution rates and bring social security contributions back to their insurance origins, i.e. back to the benefit principle (the tax is the price for a specific public service or transfer). The scope for the benefit principle would be large, as a very large proportion of social transfers (80 % in Sweden) "merely smoothes income over the individual's life cycle" (Fölster, 1997)[45].

4.3 The implementation of reforms

As was pointed out at the beginning of this section, European welfare systems are undergoing substantial changes. However, even in countries that have experienced the so-called 'conservative revolution' of the 1980s (essentially, the UK and US), in spite of the widely publicised negative consequences of welfare dependence, there has not been a major overhaul of the welfare state. As Snower puts it, "while many governments focused less attention on alleviating poverty and unemployment, the welfare state services to the middle classes remained virtually untouched. While the welfare state withered, the Transfer State bloomed" (Snower, 1994b, p.2).

Why is it proving so difficult to reform the welfare state?

First of all, from a political science standpoint, Pierson (1996) stresses the generally 'conservative' character of democratic political institutions: the welfare state now represents the status quo. Hence changing it would require explicit political decisions (as opposed to non-decisions, more frequent in such sensitive matters).

Second, reforms may be hampered by the fact that their costs are felt straightaway, while their benefits are more uncertain and accrue in the future (possibly beyond the political horizon of policy-makers). With reference to labour market regulations, radical reforms may be opposed because there may be more losers than winners (the unemployed are still a relatively small minority), the coalition in favour of them is politically very heterogeneous (skilled workers, small entrepreneurs, besides the unemployed and the inactive) and there is uncertainty on the groups that will actually

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45 Some reforms along these lines have already been introduced in some non-European countries. Individual social insurance accounts have been introduced in Chile (unemployment insurance) and Singapore (medical insurance).

gain from reforms.[46] These 'political economy' considerations - that emphasise the pivotal role of the median voter - seem relevant for welfare state provisions at large.

Third, in the most developed welfare state systems, as economic agents are more 'tightly linked' than in decentralised market economies, reforms imply greater costs because changes in one part alter the efficiency of other parts of the system[47].

While the build-up of the welfare state has occurred through incremental policy changes over the years, 'decrementalism' (a gradual rolling back of the frontiers of the welfare state) may not be the most effective reform strategy. A number of arguments point to the benefits of bundling policy changes in a single, overall package. First of all, a global approach would help in exploiting policy complementarities that enhance the efficiency gains produced by individual policies (Coe and Snower, 1997).[48] Second, 'decrementalism' may induce 'rule instability' (Lindbeck, 1994b and 1995) by leading to uncertainty and expectations of further changes down the road with negative consequences on private consumption/saving behaviour. Finally, a comprehensive social pact aiming at overcoming the corporatist opposition of narrower special interests (Esping-Andersen, 1996) and a global package reform so that most voters both lose, on the benefit side, and win, on the tax side (Lindbeck, 1994a) appear more likely to gather political consensus[49].

5. Conclusions

Richard Musgrave, in his seminal work on the theory of public finance (Musgrave, 1959), identified three basic government functions: allocation, redistribution and stabilisation. The modern welfare state, especially in its Western European version, has played a central role in each one of these functions: by stepping into areas characterised by lack of private insurance it helped to correct significant market failures; a more equitable resource distribution was pursued through a host of mechanisms, both on the revenue and on the expenditure side of the budget; finally, a number of these mechanisms - namely unemployment insurance, as well as the large tax systems - acted as built-in stabilisers in recessions.

As this paper has documented, the achievements of the European welfare state are impressive: Europe's social fabric is, on the whole, much more cohesive than that of the US and, for a long time, a large welfare state has co-existed with rapid economic growth. However, important challenges are calling into question such achievements.

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46 See Saint-Paul (1995a and 1995b) and Alogoskoufis et al. (1995).

47 This seems particularly relevant in the fully fledged Nordic variant of the welfare state: with reference to Sweden, there appears to exist a "highly interrelated welfare state and economy in which many parts fit together (be they subsidies, taxes, collective bargaining, wage compression, etc.) in ways that maintained high employment and wage compression, that offset work disincentives from welfare benefits and high taxes, and that ultimately helped eliminate poverty" (Freeman, 1995a, p. 18).

48 However, as pointed out above in the case of unemployment benefits and job protection, welfare provisions may, in some cases, be substitutes instead of complementary. See also Atkinson (1997).

49 As Lindbeck points out, "by making sufficiently many decisions simultaneously, it would even be difficult *to* some unemployed workers, it conferred benefits on other firms and other workers, but the beneficiaries *calculate* the distributional consequences of a 'package reform'" (Lindbeck, 1994a, p. 17).

A number of developments are undermining the role of the welfare state in all three government functions:

a) High marginal effective tax rates distort incentives and hamper the functioning of the labour market; they may have a significant role in the scale and persistence of European unemployment.

b) The equity objective is questioned by the presence of a large pool of long-term unemployed, who often become permanently de-franchised from the official labour market.

c) Even the stabilisation function is jeopardised as high deficits and debts reduce the room for manoeuvre and the anti-cyclical effectiveness of budgetary policy.

It is likely that, without major changes, such negative aspects would be reinforced in the future, as demography and other factors are likely to heighten budgetary sustainability and labour market problems. The acceleration of European economic and monetary integration also calls for important changes in the current welfare systems in order to allow them to continue to pursue their equity and efficiency goals in a changing economic environment.

The process of welfare state reform has started throughout Europe, often motivated by the budgetary consolidation objectives of the Maastricht Treaty. In several Member States, recent reforms, especially in the pension area, have managed to slow down the increase of welfare spending as a share of GDP. On a number of accounts, however, the reform process has been unsatisfactory.

Besides taking still insufficient account of likely future developments and their implications in terms of implicit government liabilities, the reforms have often taken too long to be implemented. This has increased the cost of transition once the new regime has been put into place. 'Political economy' considerations may explain the protracted controversies surrounding reforms. They may also explain two other shortcomings, namely, the relative penalisation of the worst-off to the advantage of the middle classes in the reform of benefits and the insufficient attention to efficiency in the production of public services, such as health care.

What policy lessons can be drawn from the academic and policy debate that has been surveyed in this paper? Due to the lack of a country-specific approach, only a number of general principles that could underline future reforms can be highlighted:

a) Maintaining a sustainable fiscal position by adjusting welfare expenditure trends - Medium- and long-term expenditure trends should be closely monitored. Action should be taken well in advance to avoid pressure on public budgets leading to higher tax rates or deficits. More specifically, pension reforms should be announced early, so as to allow a gradual implementation; sudden changes in rules should be avoided, since they carry large adjustment costs as citizens have made their working and saving decisions under pre-reform rules. The breathing-space that pension expenditure projections outline for the next few years should be used to introduce reforms aimed at cutting benefits after the year 2010.

As future employment and productivity trends are uncertain, so are the resources available for financing benefits in the future. Whatever reforms are implemented, they should be flexible and allow for adjustments in expenditure dynamics. Flexibility should be built in the system with transparent and stable rules. For instance, pension replacement ratios could be automatically adjusted to changes in life expectancy, while pension indexation arrangements could take imbalances in revenues and benefits trends into consideration.

b) **Strengthening the actuarial elements in the welfare state system** - While the fundamental redistributive aims of social protection systems should be retained, their structure should be re-examined. Assistance functions should be more clearly separated from insurance functions. The design of insurance schemes should be modified on market-oriented lines, based on a closer link between contributions and benefits. At the individual level, the link between contributions and benefits should be transparent, easy to grasp and stable over time. Therefore, pensions, and, where possible, non-pension benefits, should be linked to past contributions by shifting from defined-benefit systems to defined-contribution systems. The introduction of individual social insurance or welfare accounts would substantially strengthen this reform process. All this would have favourable effects on incentives, wage settlements and budgetary sustainability and would limit the negative effects of contributions and benefits on employment.

c) **Building incentive-compatible systems also on the supply side of welfare state provisions** - Putting into practice the previous point would go a long way in improving the incentive-compatibility of the welfare state system. However, not only recipients, but also suppliers of welfare state services should have the right incentives in optimising available resources. Major improvements can be achieved, in particular, in the production of health services. Efficiency gains can also be achieved in active labour market policies, such as those aiming at improving skills and supporting job search, where 'bureaucratic' performance indicators may result in adverse selection (e.g. by making public employment services picking easy-to-place individuals).

d) **Reconsidering social transfer and taxes at the low end of the wage scale** - The economic position of the less skilled has deteriorated in both the US (lower relative wages) and Europe (higher relative unemployment). In the European setting, if both higher employment rates and minimum socially acceptable incomes are deemed equally important objectives, steps should be taken to eliminate those features of the transfer and tax system that tend to aggravate the situation. Specifically, low wage recipients should not be discriminated against by the benefit system relative to the long-term unemployed or to persons which are not working. In turn, taxation should not penalise workers at the low end of the productivity scale.

e) **Enhancing human capital formation** - Measures to reduce rigidities in the labour market, including reduction of wage-compression mechanisms, should be coupled with strong action on the improvement of knowledge and skills. A key objective should be ensuring that all labour market entrants are equipped with basic literacy, numeracy and vocational competence. Achieving a more even distribution of human capital is probably the best way to dispel the fear that, with higher labour market flexibility, Europe would run into the American working-poor syndrome.

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