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SOCIAL UNION, MIGRATION AND THE CONSTITUTION: INTEGRATION AT RISK

Social Union, Migration and the Constitution: Integration at Risk
Munich Economic Summit 18 June 2004

Welcoming address by

Kai M. Schellhorn,
Board of Directors, BMW Foundation Herbert Quandt

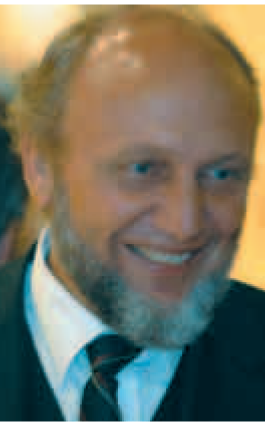
Excellencies, ladies and gentlemen,
distinguished guests,

On behalf of the BMW Foundation Herbert Quandt I cordially welcome you as guests of the Third Munich Economic Summit in the Bavarian capital. I am delighted to note that the conference has become increasingly more attractive during the three years of its existence. This is not least proven by the impressive increase in the number of participants since the inaugural meeting in 2002. Today, approximately 150 guests of the Summit have convened in Munich, coming from the 25 Member States of the European Union and further candidate countries as well as from non-European states. Compared to the first Summit, this is an increase of about a third, both with respect to the number of participants and the represented countries. The goal of this conference is also receiving more and more attention: to offer leading representatives from business, economics, media and politics a Munich-based forum, at which to discuss central questions about the economic present and future.

In the past two years, the Summit focused on economic and political developments in an international framework. The titles of these summits – "Europe after Enlargement" and "Europe in the Global Economy: Matching the US?" – took into account both facets of integration, that is, the economic and political growing-together of Europe.

This year, we will add a third dimension, which has so far been largely neglected in the political debate: social integration in the enlarged Union. Thus, the Third Munich Economic Summit is entitled "Social Union, Migration and the Constitution: Integration at Risk". I cannot deny that this title already implies a certain scepticism on behalf of the organisers, CESifo and the BMW Foundation Herbert Quandt, vis-à-vis uniform social standards and an unchecked flow of migration.

This year has already witnessed or is about to witness a number of important events that will set the course for European policy: Whether one thinks of the accession of ten new member countries on May first, the elections to the European Parliament hardly a week ago or today's EU summit in Brussels to agree on the constitution – all these major events impressively document the dynamics and speed of the European unification process. Therefore, it seems all the more important to us to create a forum for a competent – and if necessary critical – exchange of arguments and views about the goals and consequences of this process. To this end we provide for you the Third Munich Economic Summit, which I now open together with the president of CESifo, Professor Sinn. Professor Sinn, may I invite you to address the audience.



Introduction by

Hans-Werner Sinn
Professor of Economics and Public Finance, University of Munich
President of the Ifo Institute for Economic Research and CESifo, Inc.

Minister Wiesheu,
excellencies, ladies and gentlemen,

Speaking on behalf of the Ifo Institute for Economic Research at the University of Munich, I also welcome all of you, hoping that we will have a stimulating conference on a topic that is of great importance for Europe. I thank the BMW Foundation Herbert Quandt and its chairman, Kai Schellhorn, as well as all our sponsors for their help and cooperation.

This year's Munich Economic Summit parallels the meeting of the European Council in Brussels where the new EU constitution is to be agreed by the representatives of 25 EU countries. We will have to see whether all parliaments will ratify the constitution and, in particular, which result the British referendum will yield.

Having a constitution is a matter of urgent necessity for Europe. I very much hope it will help to speed up European integration and to move us closer to my childhood dream of a United States of Europe. Even today I am deeply convinced that this is where Europe should go, but I also hope that a United States of Europe will be a liberal Europe. Unfortunately, I see more and more signs that my dreams will not come true. There may neither be a United States of Europe nor may the Europe that will come be similar to the one of which I have dreamt.

The new constitution does not define the United States of Europe. There is still a long way to such a union. But the constitution does give direction. Some people say that the constitution does not imply anything new in addition to what has already been laid down in previous EU treaties, including the Treaty of Maastricht. I do not share this view. If it were right, we would not need a constitution. Even though there are no radical changes, the constitution has the important function of ennobling some of the European rules and regulations, making them superior to others. The constitution narrows the scope of interpretation in cases where the existing rules are vague, and it ranks the rules that are potentially conflicting.

Important examples of what I mean are articles I-4, I-8 and II 34 that define the basic rights of EU citizens. I cite from these articles:

- … any discrimination on grounds of nationality shall be prohibited …
- … every national of a Member State shall be a citizen of the Union …
- … Citizens of the Union shall have the right to move and reside freely within the territory of the Member States …
- … the Union recognises and respects the entitlement to social security benefits and social services …
- …Everyone residing and moving legally within the European Union is entitled to social security benefits and social advantages …
- … the Union recognises and respects the right to social and housing assistance so as to ensure a decent existence for all those who lack sufficient resources …

These articles will greatly affect the future of Europe. The non-discrimination clause together with the explicit social inclusion rights and the right of free residence will reinforce the evolution towards a Social Union of Europe that, according to experts in EU law, has already started in the past due to various EU directives and decisions of the European Court of Justice.

For many, Social Union is the next logical step after Economic Union and Monetary Union. From a German perspective, however, I hesitate to follow this logic, as the social union of Germany has not been a success. The social union has meant that the German welfare state created excessively high replacement incomes in east Germany like social assistance, unemployment benefits and early retirement benefits that have pushed up the wage scale. The welfare state's replacement incomes are minimum wages. If these minimum wages exceed labour productivity, the result is unemployment. East Germany has been suffering from mass unemployment which is intensifying year by year, and there has been no convergence of the two parts of the country since 1997. In fact, the gap between east and west Germany has been widening. I attribute the economic failure of German unification primarily to the social union which has made the welfare state into a competitor of private business in the labour market. Private business is losing the contest. Since the competitor has to be paid for with west German taxes, even the west German economy has been suffering from this development.

If Europe establishes a social union of the German kind with harmonised replacement incomes throughout the continent, there will be twenty regions like east Germany in Europe. No one can afford that.

Thus, the social union for which the constitution paves the way, can only be one with non-harmonised welfare benefits whose size is determined by each individual country. However, as the theory of fiscal competition has demonstrated very clearly, it is not possible to maintain the European welfare state when there is free migration, full social inclusion as defined by the Constitution and separate policy decisions of individual states. The reason is that welfare states are magnets that attract poor people who receive more resources from the state than they pay in terms of taxes and social security contributions. By attracting the needy, the welfare state will not be able to keep its expenses under control. Thus there will be a kind of competition of deterrence among the welfare states where each state scales down its benefits so as not to become the target of poverty migration. With all countries behaving in a similar way, the welfare state will erode and shrink far below its efficient size, whatever that is.

Europe will become more like the United States of America in this respect. Remember New York City. John Lindsay, the mayor of the city of New York had implemented a generous welfare program in the sixties in order to get the poor off the streets and help calm down social unrest. However, as a result of his policy, New York attracted the needy from all over the United States and the city was almost driven into bankruptcy. In 1975, the programme had to be abandoned because the banks were no longer willing to extend credit to the city. The Washington D.C. welfare program suffered a similar fate.

I do not want to be misunderstood if I point to these problems. I am not arguing that migration is a danger and that we should impose constraints on migration flows. Migration as such is a good thing for Europe. To the extent that migration is driven by wage differences, it improves the allocation of labour in Europe, because wage differences reflect productivity differences. It is good that people migrate from low productivity to high productivity countries, because this will generate additional GDP growth for Europe. In particular, mass migration from eastern Europe to western Europe is necessary to efficiently allocate the available labour force to the various countries during the transition phase until the eastern countries will have caught up with the west. There is nothing wrong with migration as such.

Neither am I saying that the forces of systems competition will necessarily imply large migration flows. In a symmetrical world of similarly advanced countries with perfect labour mobility, there would be no visible migration, but nevertheless the forces of systems competition would be eroding the welfare states.

What I am saying, however, is that, from the point of view of the theory of fiscal competition, it is hardly possible to construct Europe along the lines prescribed by the draft constitution. Free migration, full social inclusion and the maintenance of the European welfare state are three goals that simply cannot coexist. One of these goals has to be sacrificed.

EU politicians are not following this logic. They tend to downplay the problems, arguing that we are far away from inclusion rights that would trigger the erosion of the welfare state. The truth of the matter is, however, that we are already in the middle of welfare state erosion in Europe. For me, Agenda 2010 is only one step among many that are coming. Competitive forces take decades to take effect, but they are strong and persistent.

It is true that such erosion should be welcomed to some extent. Maybe eastern enlargement and the migration flows resulting from it will be the Trojan Horse for Europe through which the fighters against an exaggerated welfare state will enter, as Michael Burda once argued. However, I would rather prefer a planned reform of the welfare state, as the forces through which the erosion is to work are not overly convincing.

There are three kinds of forces that must be distinguished.

First, there is direct migration of employed people into the welfare state. This migration is one of the fundamental rights of the EU, and in fact the EU has experienced massive labour migration of this kind over the last thirty years. Migration of workers has been a direct migration into the welfare state because the migrants have less than average productivity, earn less than average wages and are therefore beneficiaries of the redistributive activities of the welfare state. They pay taxes and contributions but receive more public resources from the state than they paid for. According to a study by the Ifo Institute, in 1997 the average migrant, who had been in the country for less than ten years, received a gift of about €2,400 per year. This average migrant includes the people in the workforce, their non-working relatives and just everybody who happened to live in Germany. The sum is enormous. For a family of five it amounts to €118,000 over ten years. People, who stay longer, receive less from the state because their productivity and wages are higher, but only those who stay in Germany for more than 25 years are net contributors to the government budget. Unfortunately, however, there are not so many of them, since 80 percent of the immigrants had died or had left the country 25 years after entry.

The second erosive force is indirect migration into the welfare state by crowding out nationals from their jobs. This kind of migration has been the reality in Germany for three decades at least. From 1970 to 2002 there was net immigration into Germany of seven and a half million people. Of these about 3.1 million found official employment. The increase in unemployment among nationals over that same period of time happened to be nearly the same, namely 3.2 million.

Germany has been unable to provide the immigrants with additional jobs. Because of wage rigidity at the lower end of the income scale, which itself has been caused by the replacement incomes paid by the welfare state, immigration was unable to stimulate the creation of additional jobs. There would have been more jobs only if politics had accepted declining wages, because only declining wages induce employers to create more jobs. Because of wage rigidity, there was indirect migration into unemployment. The immigrants took the jobs, and instead of entering low wage competition that could have resulted in declining wages and additional jobs, the nationals preferred to sit down in the easy chairs offered by the welfare state.

Indirect immigration into unemployment has also been indirect immigration into the welfare state. The benefits of the welfare state have kept wages high. That attracted excessive immigration. And the increasing unemployment among the domestic population incurred substantial budgetary costs for the state.

The third kind of welfare migration has been the least important, but things may change. It is the migration of non-employed (inactive) people, including students, pensioners and others. This type of welfare migration has not been quantitatively important in the past, since non-working foreigners who applied for welfare could be denied the right of residence. Under current German law, they can be sent back to their home countries.

Things have indeed changed, as on May 1st of this year the new Directive on Free Movement became European law. That directive has to be implemented into national law by May 2006. It gives an immigrant the right of residence for up to five years if he or she can show sufficient resources so as to make it unnecessary to apply for social aid for the planned period of residence and if the immigrant has health insurance coverage.

There are two points where the directive differs from current German law and where German law and the law of a number of other countries will therefore have to be changed.

First, the immigrant will have the permanent right of residence after five years, even if he has no resources to live on. He will then be fully entitled to all the social benefits that are granted to nationals. An immigrant family with two children planning to stay in Germany for fifteen years will therefore be entitled to ten years of social benefits, which under current conditions would amount to more than €180,000, undiscounted.

Second, it is impossible for the host state to shorten the time of residence to less than the period granted upon entry if the immigrant becomes needy and claims social aid, unless the claim is unreasonable. However, it is the government's responsibility to prove that the claim is unreasonable.

These two changes are substantial, but they have passed without any notice being taken in the European public debate. They imply that the door of the welfare state has been opened further. There is not only the direct immigration of working people into the welfare state and the indirect immigration of working people insofar as they push domestic residents into unemployment. There is now also the possibility of a direct migration of non-employed people into the welfare state.

All in all, this means that Europe will be subjected to the destructive forces of deterrence competition among its welfare states that I described above. I therefore expect a gradual erosion over the next few decades. And I also expect tendencies to harmonise minimum standards for social benefits in Europe with the consequences for wage equalisation and increasing unemployment that I described.

Neither of these expectations is pleasant. Both raise doubts about the wisdom behind the new draft constitution and the paragraphs I cited. The fathers and mothers of the constitution certainly wanted to preserve the social framework of European society, but I am afraid that they might contribute to its destruction instead.

As I said, the welfare state, social inclusion and free migration are three goals that are incompatible. One has to be sacrificed.

If we do nothing, the European welfare state is likely to erode. If we want to preserve the welfare state, we will have to sacrifice either free migration or the inclusion principle. As a ban on free migration of the type Germany has enacted for the countries of eastern Europe is detrimental to European growth, I would opt for a limitation of the inclusion principle.

The principle of selectively delayed immigration, as suggested by the Council of Advisors to the German Ministry of Finance and the Ifo Institute, is one useful kind of limitation. The principle says that immigrants pay taxes and social security contributions and in turn receive all contribution-financed benefits and have free access to the public infrastructure. However, certain tax-financed social benefits such as social aid and subsidised housing will not be granted for a transition period. In fact, Ireland and Great Britain have recently adopted a variant of this principle.

I would apply the principle of delayed integration to employed people, and in addition I would apply a home-country principle to non-employed people. Everyone can freely migrate, but if he does not work in the host country, the home country remains responsible for welfare benefits. With these provisions, Europe would be liberal and social at the same time, as the erosive forces of systems competition would effectively be banned.

This is my personal view on the matter, and I am sure that not all of you will share it. There is ample time during this conference to discuss the issues and exchange diverging views.

We have three main sessions that will touch upon this and other topics:

The first session deals with the problem of deterrence competition among the welfare states as such. The second will address the question of whether migration constraints could be the right means to prevent welfare erosion. The third will address the problem of migration into unemployment as described above, and thus the problem of indirect migration into the welfare state.

We have competent academic speakers to clarify the issues, and we have first-rate politicians and business leaders to comment from their perspectives. And then we have you, dear guests. We expect all of you to participate actively in the debates, and I am confident that there will be plenty of time for plenary discussions.

Thank you very much for your attention.

Appendix

New Legal Framework for Immigration into the Welfare State

Selected articles taken from the Directive 2004/38/EG of 29 April 2004
published in the Official Journal of the European Union No. L 158 on 30 April 2004

Text of the Directive:	Comments:
A. Right of residence for up to three months	
Article 6 (1): "Union citizens shall have the **right of residence on the territory of another Member State for a period of up to three months without any conditions** or any formalities other than the requirement to hold a valid identity card or passport."	During this initial period, entitlement to social assistance in the host country can be excluded in some cases by national law. This follows from the considerations laid down in the preamble of the Directive:
Preamble, No. (21): "However, it should be **left to the host Member State to decide whether it will grant social assistance during the first three months of residence**, or for a longer period in the case of job-seekers, **to Union citizens other than those who are workers or self-employed persons** or who retain that status or their family members, or maintenance assistance for studies, including vocational training, prior to acquisition of the right of permanent residence, to these same persons."	Exclusion is possible only in the case of individuals who are inactive or self-employed persons. The specific rule by which they can be excluded from receiving social assistance (only!) during the first three months of their stay reads as follows:
Article 24 (2): "By way of derogation from paragraph 1, **the host Member State shall not be obliged to confer entitlement to social assistance during the first three months** of residence or, where appropriate, the longer period provided for in Article 14 (4) (b) [i.e., job-seekers], nor shall it be obliged, prior to acquisition of the right of permanent residence, to grant maintenance aid for studies, including vocational training, consisting in student grants or student loans **to persons other than workers, self-employed persons**, persons who retain such status and members of their families."	With respect to the category of persons and the period of time defined here, there is no "equal treatment" with nationals that is otherwise required by Article 24.
Article 14 (1): "Union citizens and their family members shall have the right of residence provided for in Article 6 [for up to three months], **as long as they do not become an unreasonable burden on the social assistance system of the host Member State**."	Nevertheless, even during this initial period of residence expulsion is possible only if individuals become an "unreasonable" burden on the host country's social assistance system, not a burden as such (see below).
B. Conditions for a right of residence for more than three months	
Article 7 (1): "All Union citizens shall have the **right of residence** on the territory of another Member State **for a period of longer than three months** if they: (a) are **workers or self-employed persons** in the host Member State; or	Rules regarding longer stays are clearly more important. Employed persons have a right of residence subject to no further conditions. For other individuals, the right of residence is subject to a proof of having "sufficient resources" and comprehensive sickness insurance cover, as in the

(b) have **sufficient resources** for themselves and their family members not to become a burden on the social assistance system of the host Member State during their period of residence and have **comprehensive sickness insurance cover** in the host Member State; (…)"	pre-existing law. Closer examination reveals, however, that these conditions have now been weakened.
Article 8 (1): "Without prejudice to Article 5 (5), for periods of residence longer than three months, the host Member State may require Union citizens to register with the relevant authorities." Article 8 (4): "**Member States may not lay down a fixed amount which they regard as 'sufficient resources', but they must take into account the personal situation of the person concerned.** In all cases this amount shall not be higher than the threshold below which nationals of the host Member State become eligible for social assistance, or, where this criterion is not applicable, higher than the minimum social security pension paid by the host Member State."	After three months, individuals can be required to register and give proof that they satisfy the relevant conditions (cf. Article 8 (3)). However, the term "sufficient resources" shall not defined as a fixed amount in national law. Furthermore, no criteria are being given for how to determine the relevant amount of resources taking into account the "personal situation of the person concerned". Clearly, any specific requirement would have to be made transparent before, and eventually accepted by, the ECJ.
Preamble, No. (31): "This Directive respects the fundamental rights and freedoms and observes the principles recognised in particular by the Charter of Fundamental Rights of the European Union. In accordance with the prohibition of discrimination contained in the Charter, Member States should implement this Directive **without discrimination between the beneficiaries of this Directive on grounds such as** sex, race, colour, ethnic or social origin, genetic characteristics, language, religion or beliefs, political or other opinion, membership of an ethnic minority, **property**, birth, disability, age or sexual orientation."	There may be yet another restriction: It is unclear how absence of discrimination with respect to property, a fundamental commitment stated in the preamble of the Directive, could interfere with a personalised definition of sufficient resources. An extreme implication could be that denying individuals with few resources the right of residence is effectively impossible. In any case, there is a conflict here implying that the amount of resources required for a given individual may have to be set substantially below the social assistance threshold.
Article 14 (2): "Union citizens and their family members shall have **the right of residence provided for in Articles 7**, 12 and 13 **as long as they meet the conditions set out therein**. In specific cases where there is a **reasonable doubt** as to whether a Union citizen or his/her family members satisfies the conditions set out in Articles 7, 12 and 13, **Member States may verify if these conditions are fulfilled**. This verification shall not be carried out systematically." Article 14 (3): "**An expulsion measure shall not be the automatic consequence of** a Union citizen's or his or her family member's **recourse to the social assistance system** of the host Member State."	The condition of having sufficient resources is relevant during a period of residence of up to five years. Verifying whether it is met is possible if there is "reasonable" doubt, but there shall be no systematic checks. In principle, EU citizens are given access to the host country's social assistance system from the very beginning, even though this entitlement is temporarily suspended through the condition of holding sufficient resources (cf. Article 24 (1) below). If resources are being run down faster than expected, claiming social assistance benefits is not in itself a legitimate reason for expulsion (as with Article 6).
Preamble, No. (16): "**As long as the beneficiaries of the right of residence do not become an unreasonable burden on the social assistance system of the host Member State they should not be expelled**. (…)"	This is again evident from the Preamble: Expulsion of individuals claiming social assistance benefits is the exception rather than the rule, restricted to the case where paying benefits is an

	"unreasonable burden". Claims that are reasonable are justified. There are no criteria for what would be unreasonable. In the case of a dispute, the host country would have to prove that specific claims are unreasonable. In the future, Article II (34) of the EU Constitution would have to be taken into consideration stating that non-employed persons are entitled to full inclusion in their host country's social protection system. Expulsion is in no case possible in the following two cases C and D:
C. Special regulations regarding employed persons	
Article 14 (4): "By way of derogation from paragraphs 1 and 2 and without prejudice to the provisions of Chapter VI, **an expulsion measure may in no case be adopted against** Union citizens or their family members if: (a) the Union citizens are **workers or self-employed persons**, or (b) the Union citizens entered the territory of the host Member State **in order to seek employment**. (…)"	First, expulsion is ruled out if individuals have the status of employed persons, also in the case where they are seeking employment (not necessarily being entitled to social assistance benefits in this sub-case, cf. Article 24 (2) above).
Article 7 (3): "For the purposes of paragraph 1 (a), **a Union citizen** who is no longer a worker or self-employed person **shall retain the status of worker or self-employed person** in the following circumstances: (a) he/she is **temporarily unable to work** as the result of an illness or accident; (b) he/she is **in duly recorded involuntary unemployment after having been employed for more than one year** and has registered as a job-seeker with the relevant employment office; (c) he/she is in duly recorded involuntary unemployment after completing a fixed-term employment contract of less than a year or after having become involuntarily unemployed during the first twelve months and has registered as a job-seeker with the relevant employment office. In this case, the status of worker shall be retained for no less than six months; (d) he/she embarks on vocational training. Unless he/she is involuntarily unemployed, the retention of the status of worker shall require the training to be related to the previous employment."	What also matters in this context are the rules by which the status of an employed person can be retained for an extended period of time. In particular, the fact that after one year in employment the status of an employed person is retained, effectively implies a right of permanent residence even in the absence of sufficient resources. The only restriction is that individuals have to register as unemployed (and may thus be required to accept a new job that is offered).
D. Right of permanent residence	
Article 16 (1): "**Union citizens who have resided legally for a continuous period of five years in the host Member State shall have the right of permanent residence there.** This right shall not be subject to the conditions provided for in Chapter III [i.e., Articles 6–15, among these the existence of sufficient resources and comprehensive sickness insurance cover]."	Second, expulsion is ruled out if individuals have acquired a right of permanent residence. Formally, this right is granted after a maximum of five years of legal residence without interruptions of more than six months per year. (Only in the case of absence of two or more years in continuity is the right lost).

	After five years, a right of permanent residence is also given to persons who are not employed. It is granted without any further conditions, even if these individuals do not have sufficient resources or comprehensive sickness insurance cover.
Article 17 (1): “By way of derogation from Article 16, the **right of permanent residence** in the host Member State shall be enjoyed **before completion of a continuous period of five years of residence** by: (a) **workers or self-employed persons who**, at the time they stop working, **have reached the age** laid down by the law of that Member State **for entitlement to an old age pension** or workers who cease paid employment to take **early retirement**, provided that they have been working in that Member State for at least the preceding twelve months and have resided there continuously for more than three years. If the law of the host Member State does not grant the right to an old age pension to certain categories of self-employed persons, the age condition shall be deemed to have been met once the person concerned has reached the age of 60; (b) **workers or self-employed persons** who have resided continuously in the host Member State for more than two years and stop working there as a result of **permanent incapacity to work**. If such incapacity is the result of an **accident at work or an occupational disease** entitling the person concerned to a benefit payable in full or in part by an institution in the host Member State, no condition shall be imposed as to length of residence; (…)”	Employed persons who entered the host country before reaching the statutory retirement age have a right of permanent residence, and are thus entitled to receive social assistance benefits, as soon as they reach this age threshold. A minimum period of stay before this entitlement becomes effective is specified only for the case of early retirement (three years of residence, at least twelve months in employment). In cases of incapacity to work, the right of permanent residence is also granted after fewer than five years of stay (in principle, after two years; without any time limit if incapacity to work is a consequence of work injury or occupational disease giving rise to a related benefit entitlement in the host country).
Article 24 (1): “Subject to such specific provisions as are expressly provided for in the Treaty and secondary law, all Union citizens residing on the basis of this Directive in the territory of the host Member State shall enjoy equal treatment with the nationals of that Member State within the scope of the Treaty. The benefit of this right shall be extended to family members who are not nationals of a Member State and who have the right of residence or permanent residence.”	After a maximum of five years, Union citizens are thus entitled to claiming all kinds of benefits that the Welfare State offers its nationals.

Excerpt by Ifo Institute, Munich.

Welcoming Address by

EDMUND STOIBER
Minister-President of the Free State of Bavaria,

presented by Otto Wiesheu,
Bavarian State Minister of Economic Affairs,
Infrastructure, Transport and Technology

EU enlargement, integration and policy options

Professor Sinn, Mr Schellhorn, Minister Miklos, excellencies, ladies and gentlemen,

Dr. Stoiber, the minister-president of the State of Bavaria, regrets very much that urgent business has detained him in Berlin. He has therefore asked me to represent him today at the opening of this year's Munich Economic Summit and present to you the address that he had prepared for you. I would first like to extend a very warm welcome to you here in Munich, the capital of Bavaria. I am happy to note that this summit is already tradition. In Bavaria we say that anything that happens for the first time is an innovation and everything that happens more than twice is tradition. This tradition augurs well for the conference and its high-ranking participants. I am very glad that so many outstanding personalities from every part of the world have gathered once again at this year's Munich Economic Summit. I hope that you will feel at home here in Munich and that you will take away a lasting impression of Bavarian hospitality; I further hope that you will find an opportunity to enjoy one or another of the cultural events that are being offered in our great city.

On May 1st, 2004, the European Union underwent a sea change. Ten new member countries with approximately 75 million citizens joined the European Union, which is not only a community of states, but also of values. That is beyond doubt an historical milestone in the process of European unification. It is an historical event whose importance goes beyond the borders of Europe, for it not only changes the map of Europe, but also changes the direction of Europe's development, turning the continent in a direction that is quite different from the direction pursued in past centuries. It opens up a chance that one should acknowledge and respect and also examine critically. I personally believe that if this development is handled well, then this project will redound to the benefit of all. But this requires that possibly undesirable developments should be identified and discussed and timely action taken in order to forestall them. The extent of the change we are facing – its breadth and its depth – is still not recognised by everyone. The accession of the new member countries brings about an entirely new situation. It is not just a matter of extending the area covered by the EU, or the size of its population, it is not just a matter of an organisational change. It is much more than that: Eastern and Western Europe are growing together; the historical situation that prevailed in post-war Europe is ended, enormous differences in the economic performance of the member countries will be overcome, and this extends to the differences in wages and living standards, as well as to differences in mentality and ways of life. The tasks that we are confronted with are not only singular in the forty-five year history of the European Union, they are unique in all of economic history. On May 1st, 2004, old Europe, if the expression is permitted, took an enormous step in the direction of a new and much larger Europe, and if this new Europe is to be a success for the old and the new member countries, then great changes are necessary, particularly in the old member countries. To continue being capable of taking necessary action, the European Union must concentrate its resources and must – more than in the past – focus more sharply on basic problems. The core tasks of the European Union lie in

- a common policy in the area of foreign affairs, defence and internal security;
- a closer co-operation between the member countries particularly with respect to internal security and especially the fight against terrorism;
- the cross-border dimensions of environmental and infrastructure policy;
- completing and ensuring the continued efficient functioning of Europe's internal market;

- and last but not least, the reform of regional and structural policy.

Regional and structural policy can serve as an instrument that can make a great contribution to evening out excessive welfare differentials within the European Union, not along the lines of communicating tubes where the improvement in one part is at the cost of another part, but with the objective of raising, in the medium term, the economic level of poorer regions or sectors disproportionately. In this way, the incentives for migration from poorer regions to the rich centres should be weakened. However, one must not lose sight of the fact that this is a medium-term process, possibly even a long-term process, and hence this policy area must have a longer time frame. We can learn quite a bit from the experience gained from the reunification of Germany. Despite the considerable volume of transfer income and investment that has flowed to east Germany, the convergence has not gone forward nearly as rapidly as was forecast ten or twelve years ago.

The enlargement of the European Union will put Germany at the centre of the largest internal market in the world. And since in an East – West perspective Bavaria is at the centre of Germany, it will draw in particular measure advantages from this development. It makes Bavaria an extremely interesting location for innovative and growth oriented enterprises from all over the world. Bavaria's geographical position is without a doubt an important reason why the enlargement of the European Union offers Bavaria great opportunities. But it is also brings with it a series of problems which at a conference such as today's Munich Economic Summit can and should be addressed.

EU enlargement will offer new markets and new market chances for enterprises located in Germany. In almost all of the new member countries, annual economic growth rates of higher than three percent are forecast. That is a figure that is, to be sure, not overwhelming, but compared with current growth in Germany it is nevertheless surprisingly high. This trend is good for us. It has made itself felt in a pronounced increase in Bavarian and German exports in recent years. For the Free State of Bavaria, the new member countries of the EU will, taken as a group, form the largest export market after the United States and such long-standing trading partners as Italy, Austria and France.

This increasingly closer economic integration helps to preserve and to create employment opportunities and prosperity. The new Europe thus gains in economic potential and in stability. But at the same time competition arises with countries where labour costs are scarcely a fifth of German labour costs, or even less. It is true that this competition has existed during the past ten years, and that the labour cost differential has been a factor contributing to the transfer of jobs. Viewed in this light, the entry of the new members in the European Union has not brought about fundamental change. But we shall observe that particularly in border regions, entrepreneurs will face competitors from the new member countries when they submit tenders for contracts. Since the 1st of May, freedom to provide cross-border services is guaranteed, with the exception of construction, housing repair and house cleaning. This represents a change in the conditions of competition. And this means that we shall have to face up to lower tax rates, lower social standards, less strict environmental norms, and a much more flexible labour market in these countries. This situation is made more critical by the difference in the level of subsidies, which aggravates the competitive situation, particularly with respect to the competition for investors. We shall learn that structural change can also involve problems. Now structural change is nothing new: we have experienced the challenge of structural change in the past decades and have met it by new domestic investment. But in coming years the competition for new investment will be keener, largely because it will be more international. This is a theme that is often subsumed under "globalisation", and among the aspects of globalisation that play a role here are the possibilities of assistance and subsidisation that are available to the new countries. This is in addition to the other differences – tax rates, social standards, wage levels – which work in their favour and which will lead to loss of jobs and shifts in location of production activity. This will be felt especially in border regions, although it will extend to other regions further from the border as well.

When people's employment is threatened, then the welfare state is automatically threatened. In the past year, around 620,000 jobs covered by social security were lost in Germany. Total employment fell from just under 27 million persons to 26.3 million.

Now the responsibility for this development cannot be assigned to the eastern enlargement of the EU.

But it should be taken as a warning signal, not only because of the personal misfortune of those directly involved, but also because 100,000 jobs covered by, and paying into social security, represent yearly receipts of the social security system of approximately €1 billion and tax revenue of €300 million. And to the labour office they represent once again €1 billion of unemployment benefits and other costs related to unemployment. Taken together, 100,000 jobs lost represent a burden to the state of €2.3 billion; 620 000 lost jobs sum up to nearly €14 billion in costs and foregone revenue. This affects the welfare state in a massive way, as Professor Sinn has pointed out, and makes radical reforms in the areas of economic and social policy unavoidable and not only in Germany. And in this context I would add that this is Germany's homework, and we've got to do it ourselves, the EU cannot – and should not – take it on for us. And let me add the personal remark: in the last ten years, out of around thirteen million jobs in the industrial sector, we have lost three million. This is a process that cannot only be explained by rationalisation and outsourcing. It is a process that has assumed the form of progressive deindustrialisation. And for these reasons, the figures concerning exports which I mentioned deserve to be studied very carefully; as professor Sinn pointed out in one of his studies: the increase in the volume of German exports can no longer be taken as giving a clear indication of economic performance and international competitiveness, because a substantial part of the value embodied in the products exported was created in foreign countries and because subcontracted parts make up a considerable part of our exports.

The eastward enlargement puts pressure on the adaptive capacity of our welfare systems in other ways. We were successful in advocating a seven year interim arrangement with respect to the freedom of workers' movement across borders. This has been criticised by the new member countries. As has already been mentioned, there are also interim arrangements in areas of services such as construction, house repair and house cleaning. For the rest, all citizens of EU countries, including those that are not economically active, enjoy freedom of movement. Despite the legal hurdles that have been set up, this carries with it the threat of abuse of these systems, especially since the very considerable differences in income levels provide sufficient incentives for migration to those countries with well developed systems of social security. Professor Sinn has dealt with this problem in detail.

The new EU guidelines on freedom of movement provide that the immigrant must have sufficient health insurance coverage and sufficient income to ensure that he or she will not become a burden on the social security system of the host country. But if these conditions are no longer fulfilled and the immigrant does claim – and is granted – social assistance, then according to European law the fact of claiming and receiving assistance does not, by itself, constitute grounds for expulsion.

I shall leave it as an open question whether this legal arrangement with respect to freedom of movement in Europe will induce a race to the bottom in social policy, a dumping competition with respect to social standards. In any case, to the extent that it gives rise to migration that is motivated by hopes of taking advantage of higher social standards, to that extent it will make it harder to maintain the old standards of the welfare systems. We have accumulated considerable experience in this respect during the last decades; the abuse of the right of asylum is a theme that we have been discussing for the last twenty years. That is why my personal opinion is that we should change to the country-of-origin principle, as Professor Sinn mentioned. This seems to me to be a sensible regulatory alternative, which moreover would permit constructive competition between national welfare systems at the European level. However, I have my doubts whether such a paradigm change would be politically feasible at the European level.

Another of today's topics will deal with immigration from outside the European Union, which usefully supplements the questions I have just referred to. In our view, this theme does not belong to the core tasks of the European Union. Different from policies on asylum and refugees, immigration policy does not represent an international legal obligation, which has been voluntarily and constitutionally assumed by the member countries of the EU, but rather the willingness to admit immigrants is voluntary and the decision with respect to immigration must be based on the interests of the individual member state. In this respect, the member countries may have quite different interests.

With these considerations in mind, it must be left up to each individual member state to decide how many immigrants it is prepared to admit, which persons are eligible for admission and what requirements for entry it will impose. The proposal that was discussed at today's governmental conference in Brussels for an EU constitution takes considerations concerning immigration from outside the European Union only partly into account.

The flexibility and the absorptive capacity of Europe's labour markets are the decisive factors that will determine how we must deal with migration within Europe and with immigration from countries outside Europe. And in this context, Germany and many other parts of Europe are having labour market problems. In 2003, the EU of 25 had an average unemployment rate of 9.1 percent. The extremes were 3.8 percent in the Netherlands vs. 17.1 percent in Slovakia.

Another worrying indicator is the growth gap of almost 11 percent between the EU of 15 and the United States during the period 1995–2003. If this development of the recent past continues, as it seems likely to do, then the so-called vision of Lisbon will turn out to be the illusion of Lisbon.

We are in the process of becoming a knowledge-based industrial and service society. Periods of social transition are always difficult, and one of the greatest difficulties is the changes that citizens experience at their place of work. Industrial jobs are disappearing or have already disappeared. Our economic and social policy objective must be to promote the creation of more complex jobs which produce higher value. This requires more mobility, more flexibility, more innovation, more research and development, more transfer of knowledge, and more aggressiveness in all of these areas. But in all of these areas there is too little movement in our country.

To attain any of these objectives we need to intensify our efforts in the area of industrial policy at EU and national levels. It is not a matter of the state determining the direction in which the economy should develop, but rather of creating the framework that will ensure that we preserve and expand the industrial base we need; that we can develop and produce new products and new methods of production; that we accept the challenges and not give up in the face of the difficulties.

Europeanization, globalisation and other demographic and social manifestations of change affect all of Western Europe's industrial nations to the same degree. This means that in Europe the welfare state will only survive if it resolutely faces up to the challenge. The role of the European Union must be strictly based on the principle of subsidiarity: as much centralism as necessary, and as much decentralized, on-site decision-making as possible. For in an era of globalisation and flexibility, efficient decision-making processes are vital. This also applies to decision-making in the political area.

With respect to social and labour market policy, the consequence to be drawn from this analysis is that, with the exception of problems with a cross-border component, e.g. cross-border commuters within the EU, these areas of government responsibility should not be assigned to the EU. There is another reason for coming to this conclusion: social policy is above all redistribution policy. Within a solidarity community like a national state this is acceptable and can be designed and implemented.

The draft constitution does not provide for additional legislative powers for the European Union in the field of social or labour market policy. However, it must be pointed out that the open method of coordinating social policies provided for in the draft opens the way for the Commission to establish guidelines and indicators in areas such as employment, labour law, as well as social security, the right to form coalitions, and collective negotiations between employers and employees, i.e. in nearly all areas of social and labour law. Furthermore, the Commission is authorised to set up and develop the instruments necessary for a continual monitoring and evaluation of the policies of the member countries. The instrument of the open method of coordination is already being used to assign goals concerning labour market, social and other policy areas to member countries as part of coordination processes, although the treaty provides no authorisation for this. All the measures taken by the EU – from the Lisbon strategy to the general coordination of the economic policy of member countries, on through to the open method of coordination – do not absolve the member states from their obligation to carry out the necessary reforms on their own. Passing on the responsibility to Brussels may seem to be the line of least resistance, but in fact it does nothing to solve the problems, but rather tends to slow down the reform processes that are needed. No member country can avoid doing its economic and social policy homework, and since it has to be done, it should be done promptly and thoroughly. The competition between the individual member countries that will arise out of this process of finding the best labour market, tax and social policies will redound to the benefit of all.

For us here in Germany this means that fundamental reforms in our social security systems must be carried out, otherwise we shall no longer be able to afford these systems. And this means that the welfare state must not only be insulated against demographic developments, but also against influences coming from Europe or from the process of globalisation: here I say that the key is economic growth and job creation. We shall not succeed in getting the problem under control if the loss of jobs causes the number of persons paying into the social systems to decline more rapidly than the pace at which the reforms are being carried out; it is clear that a decline in the number of people in employment, and hence a decline in the number of those paying into the social security system, goes hand in hand with an increase in the number of people claiming benefits from the system, and that such a process imposes a huge burden on the social security system and the state. If this vicious circle cannot be stopped, then, ladies and gentlemen, we shall be confronted by a situation in which the reforms are constantly trailing behind actual developments. And that means that it is not five minutes before noon, it is already high noon. This and the flexibilisation of the labour market are the central themes which demand a prompt solution. This is turn means that we need a simple tax system that is internationally competitive. To attain that, we must quickly reduce supplementary wage costs; at present, social security contributions amount to a 42 percent supplement to basic wage costs in Germany.

Higher supplementary wage costs make labour more expensive here, and this aggravates the danger that jobs will be transferred abroad or that more work will take place in the informal sector of the economy. This has become the experience in Germany recently: the underground economy is booming and the transfer of jobs to other countries is flourishing. If the supplementary wage costs are not brought under control, then with the present system, demographic developments will bring about an explosion in supplementary wage costs in order to support the social security system; under a status quo assumption they will increase to 50 percent by 2030!

Our objective must be to bring about a short-term reduction in supplementary labour costs that gets them below the 40 percent level; we must give market mechanisms more scope in our welfare system. This implies, of course, that people must accept more responsibility for their fate, that they themselves must make provision for their welfare. Stated bluntly, we must say farewell to a mentality that demands comprehensive protection against all of life's risks if we are to preserve the indispensable core of the welfare state. And there is another consequence that follows from demographic developments: in future we shall not be able to do without the abilities and the experience of our older fellow citizens. Today, people retire at age 59 or 60. It is necessary – and hopefully it will be possible – to put an end to this. Working time over one's entire life span must and will be lengthened. In the first instance, we must make 65 years the normal age of retirement in practice. It is up to the private sector of the economy to offer suitable jobs to older people. Once 65 has been established as the normal age of retirement, we can begin to discuss the possibilities of raising the standard retirement age further, thus extending people's period of employment over a greater part of their lives. But it is no use to discuss the extension of life-time working time, if at the same time working time on a weekly or yearly basis is being reduced.

Beyond these reforms, we need reforms in the labour market which promote formal work at competitive prices. We can only charge more to the extent that we are better. Our objective must be to get those now working in the informal sector into regular employment and this requires that union wage scales be reduced, and that in some areas of the economy agreement be reached on paying low wages. At the same time, we must stop considering unemployment as a form of leisure that deserves public support.

The objective of a subsidiary, active social policy must be to promote and encourage the instatement or reinstatement of unemployed people into gainful employment, if necessary by means of complementary benefits. And the theme of activating social policy is a central theme, if it is our serious intention to reduce the burden of income-substitution payments. Here again, Professor Sinn has formulated a series of proposals which hopefully will be turned into legislation in the near future. We need, as soon as possible, a tax reform which rewards performance and strengthens the international competitiveness of Germany.

If we can accomplish all this, then we shall have succeeded in making Germany a more attractive location for enterprises and jobs. This is the way to prepare our labour market and our welfare state for the future. Here, all levels of government, the EU and the nation states in the context of their competencies, must pull together and implement the reforms that are needed. This is the central task that confronts us here in Germany. It will require considerable spending cuts, and the government's Agenda 2010 will not be sufficient. This seems to be the view of the Chancellor, of the private sector of the economy, of the Council of Economic Experts, and of all the other advisory councils; and in the face of this unanimity, one can only say today: enough of analysis, it's time to get on with the job and implement the decisions.

If all of the measures that I advocate are implemented, then the risk of massive migration within Europe from the poorer regions, and particularly the new member countries in Central and Eastern Europe, to the prosperous social states will be mitigated.

Ladies and gentlemen, the celebration of D-Day on June 6th has made unmistakeably clear that there is no alternative to the European Union. This community of nations is beyond a shadow of doubt the most successful project in the service of freedom, peace and prosperity that Europe in its long history has ever known. And the European Union is also the most successful project ever put in the service of reconciling former enemies, and of gathering them together in a community of values, having as its common objective the growth of all the countries within the Union. For all these reasons we welcome this development. The new challenges, and most of all the enlargement to the East, give rise to massive economic pressure to carry out comprehensive reforms. These reforms are needed at the EU level, and in the member countries as well. This challenge is also an opportunity – a chance to carry out wide-reaching reforms in Europe and we must not frivolously let it slip through our fingers.

And above all, we must carry the citizens of Europe with us on the way to the further development of the EU. The poor participation in the European elections showed that this will not be easy. But one should not just push aside the theme. Many say that "Europe" is an intellectual construct, having its existence mainly in a few peoples' minds, and there is without a doubt a measure of truth in that observation. But many political decisions were initially not supported by the majority of the population. In Germany we must not forget that the introduction of the social market economy found little or no approval at the beginning and that Ludwig Erhardt, in the years immediately following 1949, was one of the best-hated politicians in Germany, but is now one of our most admired historical figures. This merely shows that it is up to the politicians to show responsibility and take the unpopular course when it is necessary. Nor should it be forgotten that Germany's decision to join NATO was extremely controversial at home; at the time the decision was made, opinion was much divided. Today, Germany's membership in NATO is regarded at home as something that is a matter of course. The establishment of the European Union, or the European Economic Community, as it was at first called, was a similar situation. The fact that the enlargement of the European Union demands a decision from those with political responsibility that does not enjoy the same degree of support everywhere is nothing unusual in a democracy. Nevertheless, it is important to engage in an intensive dialogue with our citizens in connection with the processes of extending the EU, to explain to them the implications of the decision, in order to avoid a situation in which decisions affecting Europe would have to be taken in a political atmosphere in which anti-European attitudes predominate. After all, it must be possible to discuss the pros and contras of the necessity and the consequences of decisions affecting the EU.

Europe and the European Union must not be allowed to become a project that in the eyes of the citizens is seen as a project that principally concerns the political elites. Thus it is important to draw the necessary conclusions for the political decisions; and it is equally important, ladies and gentlemen, that the problems that are related to Europe and the European Union should be openly addressed and discussed. And for these reasons I am very happy that the BMW Foundation Herbert Quandt together with CESifo have arranged and carried out a conference such as the Munich Economic Summit, in which controversial topics, including those that often have a label attached to them, can be discussed in an open and friendly atmosphere. I earnestly request of you not to put labels on the themes related to migration, but rather to discuss them seriously and thoroughly. For the most serious danger facing Europe is that problems are not recognised and that discussion is not opened up early enough to ensure that solutions are identified in time for them to be of use. If this process of recognition, discussion and solution finding is not started in good time, then an attitude of aversion may develop in the new member countries, which could have been avoided if a process of clearing up the problem would have started early enough. We must also take care that the process of European unification should be designed in such a way that despite all the problems of adaptation that we have, we keep frictional losses to a minimum, and the utility to those immediately concerned as large as possible; this applies to the area of economic policy as much as to any other area. We must try as best we can to recognise problems with foresight, to analyse them, and to take the right decisions early on, in order to eschew, to the extent possible, the unwelcome effects of avoidable or remediable problems. That is my understanding of the theme and the concept of today's conference and thus – despite all the controversies that might arise – we should focus our efforts on identifying the problems and attempting to formulate solutions in time to move forward in a constructive way in the process of European unification. We should not just seek formal unification in governmental areas, but unification in a more profound sense: agreement with respect to what we see as a reasonable path of future common development. And let me say as, I draw to a conclusion, that it is deeply gratifying that since the Second World War Germany has experienced the longest period of peace in its history. Today the younger generation, and the older generation of Germans as well, regard the countries on our borders as neighbours, and not as "traditional enemies" or "arch enemies" as the old expression was. Thank God for this development. Only fools could believe that we should, or would, or must, return to the old attitudes vis-à-vis the countries that surround us or that one or another unavoidable development would inevitably lead to the former hostility. Together with our East and South-East European neighbours, we have the chance to set in motion a process of peaceful development, in which all the countries of the European Union and all their neighbours can participate.

It is my hope and wish that conferences such as this may influence political decisions. So you have my best wishes for fruitful discussions, for an interesting day in Munich and for a pleasant stay in Bavaria. Thank you.

Panel 1

Economic Integration and the Welfare State

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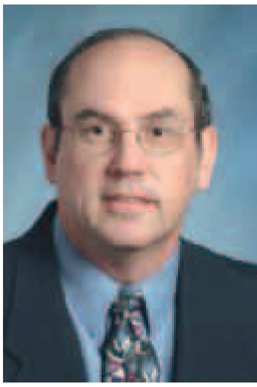


The "future of the welfare state" in Europe is becoming a common theme for discussion among policymakers and academics. This is well illustrated by the 2003 CESifo Munich Economic Summit, at which several participants commented on the prospective demise of the welfare state, or at least some of its elements, or on ways that it, or at least some of its important features, might be preserved.

The "welfare state" can of course mean many things. For the purposes of the present discussion, I propose to focus on fiscal policies. It is of course simplistic to speak only of the financial aspects of the welfare state, since a wide range of regulations (on wages, working conditions, etc.) accompany welfare state policies.[1] When viewed from this perspective, the most essential feature of the welfare state is that it redistributes economic resources. This redistribution takes many forms: redistribution from rich to poor (through taxation and cash transfers) is one part of the total picture, but so is redistribution from the healthy to the sick (through publicly financed health systems), from the employed to the unemployed (through unemployment insurance programs), and from the young to the old (through public pension systems), to name only a few.

These policies and programs are seen by some as crucial elements of a fair and compassionate society, protecting people against many of life's hazards, providing encouragement and hope to those who are disadvantaged by birth or by random forces beyond their control. Others look at the same welfare state and see powerful interests using the coercive force of government to take resources from the weak and transfer these resources toward themselves. It is all very well to invoke justice and fairness in a political debate, but we can all cite instances where entrenched industrial, labor, demographic, regional, and other interest groups use the tax, expenditure, and regulatory powers of the state to protect themselves at the expense of others who are politically, and often economically, relatively disadvantaged. In this, as in so many cases, we do well to remember the old adage about the alignment of policy opinion and self-interest: "where you stand depends on where you sit." Or, as that iconoclast H.L. Mencken once wrote, "Altruism, when analyzed, usually turns out to be self-interest dressed up in a long-tailed coat."

In this discussion, it is my intention neither to praise the welfare state nor to bury it. Rather, my goal is to discuss how economic integration, and particularly the integration of labor and capital markets, affects the fiscal systems of Europe's welfare states. Competition for increasingly mobile labor and capital affects the benefits and costs of these policies, especially when undertaken at the level of the individual nation-state. Competition may pressure governments to limit redistributive policies. There is a potential role for coordination of welfare-state policies among countries, possibly through "upward reassignment" of welfare-state policies to EU-level institutions.[2]

Economic integration: Why factor markets matter

The process of economic integration does not fit easily within the usual "boxes" of traditional specializations in economics. One part of economic integration takes the form of trade in goods and services; another part takes the form of financial flows through

[1] These in fact are often closely connected with welfare-state fiscal policies; for example, wage and employment regulations that raise the cost of labor can lead to unemployment, and thus to greater unemployment insurance expenditures.

[2] In order to spare readers any "trial by footnote," this paper makes no reference to a now-vast literature on its topic. Interested readers are invited to review "Economic Integration: Implications for Equity, Efficiency, Political Economy, and the Organization of the Public Sector," available on the author's web site, and "Public Pensions and Demographic Change in Developed Countries: Fertility Bust and Migration Boom?", available on request. Readers may also wish to consult statistical tables and charts that appear in an accompanying PowerPoint presentation.

capital markets; another part deals with monetary policy; another part concerns the migration of labor; still another part has to do with the organizational structure of businesses; and all of these, and their interactions, affect overall economic performance, fiscal systems, urban and regional economic development, and environmental quality.

The integration of the markets for factors of production – the markets for labor and capital – is of particular importance for the welfare state, and will be the focus of attention here. To see why, let us return to our sweeping generalization that the fiscal policies of the welfare state are devoted largely to affecting the distribution of income. Labor and capital market integration affects both the rationale for these policies and their costs. Consider what some might think of as a "worst-case scenario" for the welfare state. Some fear that an unrestrained influx of low-skilled workers may depress wages and raise unemployment in West European economies, putting increased pressure on costly social policies designed to protect the incomes of low-income people. At the same time, the increased mobility of capital may limit the ability of governments to capture income from business activities or from wealthy individuals, thus constraining the revenue-raising capacity of the fiscal system. The integration of labor and capital markets might thus undermine the foundations of the welfare state, that is, its ability to take resources from some members of society and transfer them to others.

What for some is a "worst-case scenario" is for others a "best-case scenario." Countries facing competition for labor and capital may be restrained from using the coercive power of the state to extract resources from the politically weak and to transfer these resources to the politically strong. Competition, in this scenario, is a force for good: it induces governments to limit their costly and frequently unfair interventions in markets, reducing some of the many distortions of economic incentives created by high taxes, generous subsidies, and restrictive regulations. Competition leads to more efficient resource allocation, rising incomes and production, and economic growth.

Note that these two opposing characterizations of the effects of labor and capital market integration differ not in terms of their predictions of the economic effects of integration but in their evaluations of whether these effects are desirable or undesirable. In brief, they agree that integration of labor and capital markets might "unravel" the welfare state, but differ as to whether this would be a welcome or an unwelcome change.

As noted in the introduction, it is not my purpose to opine on the desirability of the welfare state. Instead, I would like to focus on the reasons why I consider factor market integration to be of fundamental importance for the welfare state, why it is occurring, and what some of its implications are likely to be in the shaping of the European economies of the decades that lie ahead. Some of these implications are surely favorable ones, others are perhaps less so; thinking about these broad issues helps to bring into focus some of the basic institutional and policy choices that will confront the citizens of Europe in the coming years.

Europe and the world: Demographic, economic, and fiscal status and prospects

The background

To help lay a foundation for discussion of fiscal policy, it is helpful to summarize a few relevant facts about demographic and economic conditions in Europe and elsewhere. Each of these basic facts is well known in itself, but, taken together, they carry important implications for economic policymaking in Europe. First, Europe is in the midst of a "fertility bust," the opposite of a baby boom. For some years now, fertility rates have been at very low and historically unprecedented levels. This is true both in Western and Eastern Europe, and in some of the other developed countries of the world. Less-developed countries exhibit higher fertility rates and higher mortality rates. Mortality rates are also at historically low levels. The combination of low fertility and low mortality means that the native European population is aging rapidly, both in absolute terms and relative to the world as a whole.

Second, Western Europe is rich, by world standards. Incomes in Western Europe are well above the levels found in poorer parts of the world. Per capita incomes in neighboring regions in the Middle East and North Africa, as well as in the Asian giants of India and China, have been far below West European levels for decades, and will remain so for decades to come, even if these economies develop rapidly. Incomes in Eastern Europe are also substantially lower than in Western Europe, though living standards there are certainly higher than in the truly poor countries of the world.[3]

Third, governments play a major role in the European economies. Government spending in these economies accounts for about 40 percent of GDP. This was certainly not true before World War II, when the public sector was much smaller; even as recently as the mid-1960s, total government spending was closer to 25 percent of GDP. Unlike in pre-twentieth century historical periods, the large governments of modern economies engage in massive income redistribution. Today, "social expenditures" (i.e., "welfare state" spending) alone amount to some 25 percent of GDP in advanced economies. While this redistribution takes many forms, an important share of redistributive transfers is accounted for by transfers to the elderly.[4]

Fourth, and partly in consequence of the previous three factors, international migration plays an increasing role in the demographics of Western Europe. For the OECD European countries as a whole, net immigration has outweighed natural increase as a source of population growth for more than a decade. Flows of immigration vary among countries and over time: Germany experienced especially large immigration flows in the early and mid-1990s; Ireland, traditionally an emigration country, experienced a remarkable migration turnaround during the mid to late 1990s; and, in recent years, Spain has experienced a rapid increase in immigration. While the magnitudes of immigration vary by country and from year to year, the overall trend for Western Europe as a whole is unmistakable: more than one million people per year have been arriving in Western Europe, legally, every year for more than a decade, with a cumulative inflow of over 13 million immigrants during the period 1992–2001.[5] Illegal immigration is intrinsically hard to measure but surely amounts at least to hundreds of thousands annually. Over the past decade and a half, immigration has become the major determinant of population change in Western Europe.

Fifth, increased international flows of capital accompany rising migration flows. What is especially noteworthy about capital flows is not merely that one country or another experiences net inflows or outflows of capital, but that West European countries are experiencing large gross flows of capital in both directions. Gross inflows and outflows of foreign direct investment have amounted to 10 to 20 percent of total investment or more in many OECD countries for well over a decade. Foreign-affiliated firms account for 25 to 35 percent of employment, value added, and investment in the manufacturing sector in major West European economies.

In short, the economies of Western Europe are rich and aging; their governments engage in large programs of redistribution, especially but not only toward the elderly; they are quite open to international capital flows; and they are the destination for millions of immigrants from other countries, most of which are relatively poor.

Fiscal systems, demographic change, and economic integration: Current trends and prospects

Public pensions and demographic shifts. The aging of the European populations, coupled with massive systems of redistribution from young to old, is placing major stress on the fiscal systems of these countries. The obligation to provide cash, health, and other benefits to old people, financed by taxation of the working population, is just like government debt: it imposes fiscal burdens on future workers (i.e., redistributes away from these workers) in order to confer benefits on current retirees (i.e., redistributes toward the current elderly). This problem is not new. For at least a decade and a half, knowledgeable observers have drawn attention to the stresses that demographic change can create for public pension systems. The baby boom by itself, even if followed by replacement-rate levels of fertility, would have given rise to significant variations in the relative sizes of different age cohorts.[6] The remarkable declines in

[3] A few figures based on World Bank data: In 2001, the EMU countries had a per-capita GDP of US $26,579. Per-capita GDP in Eastern Europe and Central Asia was $2,316, in the Middle East and North Africa it was $1,992, and in South Asia, $471. Decades of rapid growth in poorer countries will be required to shrink these differentials markedly.

[4] Spending on old-age pensions presently amounts to about 7 percent of GDP for OECD countries and is projected to rise to about 11 percent by 2050 under mid-range demographic and economic assumptions. For France and Germany, current pension spending is much higher and is projected to rise from the current 12 percent of GDP to about 16 percent by 2050. (To illustrate that generalizations can be treacherous, it should be noted that the UK only spends about 4 percent of GDP on public pensions, an amount that is projected to fall by perhaps 0.7 percentage points by 2050.)

[5] It should be emphasized that this represents immigration from beyond the boundaries of the EU. Intra-EU migration is comparatively modest (though intra-EU sojourns for work or for pleasure are very much larger).

[6] History casts long demographic shadows. The age distribution in European countries in 1950 reflected the loss of life – especially by young and middle-aged adults – during World War II. The ensuing baby boom represented a fertility resurgence following the reduced fertility rates of the Great Depression and the interruption of family formation during the war years. For both reasons, age distributions were favorably aligned for underfunded public pension systems during the 1960s and 1970s.

fertility during the 1980s and 1990s mean that age distributions are becoming exceptionally unfavorable for underfunded public pension systems as well as for other elements of fiscal policy – explicit government borrowing is noteworthy in this respect – that shift fiscal burdens to future working populations. The old-age dependency ratio in Western Europe (the ratio of elderly to working-age populations) is today already at a historically-high level of about 25 percent, and, barring either a major increase in old-age mortality, emigration of the elderly, or immigration of younger people, this ratio will increase to about 50 percent by 2050. This means that the fiscal burden of supporting the elderly will increase markedly in coming decades.

Migrants to the rescue? Assuming, hopefully, that the European populations will not suffer major increases in mortality from war or disease, and that older Europeans will not relocate, on a large scale, to other countries, immigration provides the only path available to redress the age imbalances embedded in past fertility and mortality experience. Immigration to Western Europe is now quite substantial, and has been so since about the time of the collapse of the Soviet Union. Immigration rates in Western Europe have exceeded those in the U.S. during the past decade, and immigrants to Western Europe, as has traditionally been the case for international migrants, are indeed disproportionately young, working-age adults. Recent immigration has thus eased the age imbalances of Western Europe, and can continue to do so for the indefinite future. Realistically, however, only truly massive inflows of migrants could fully offset the future aging of the populations of Western Europe.[7]

Migrants: Part of the solution, or part of the problem? While migrants to Western Europe are generally young, they are not generally rich. This is naturally a consequence of the high incomes of the destination countries of Western Europe relative to the low incomes of the destination countries of the rest of the world. It is also a consequence of the relative youthfulness of immigrants: twenty-somethings do not attain the high earnings levels of more mature workers, nor have they had enough years of savings to have built up the personal wealth that older people tend to have, on average.

Whether immigrants are net fiscal contributors or net fiscal beneficiaries is a matter of the greatest importance for the fiscal systems of Western Europe. In static terms, and as a broad generalization, it appears that immigrants may well be net fiscal beneficiaries, that is, that they may impose fiscal burdens in excess of their fiscal contributions. Studies of immigrants in Sweden, Germany, and Denmark find that while immigrants account for a bit more than 10 percent of the total population, they are the recipients of upwards of 30 percent of total cash welfare expenditures. Of course, a static view is necessarily an incomplete view: as young immigrants assimilate into local populations, gaining employment experience and enjoying increased earnings, their contributions to the fiscal system will increase relative to the benefits that they derive from it.

But this is only a broad generalization. Some immigrants definitely make enormous fiscal contributions, and others definitely impose enormous fiscal burdens, depending on their individual characteristics and on the characteristics of the fiscal systems in the countries where they reside. These are linked: the characteristics of immigrants – their ages, incomes, skill levels, wealth, health, and family status – are influenced, to some degree, by public policies. When relatively poor, low-skilled, low-wage, sick people arrive in a modern welfare state, they tend to pay relatively little in taxes and to receive relatively high levels of fiscal benefits. When rich, highly-skilled, high-wage, healthy people arrive in modern welfare states, they pay a lot in taxes and qualify for relatively little in welfare-state benefits. For these reasons, welfare states stand to gain by attracting the well-off, and to lose by attracting the badly-off, and for these very same reasons, generous welfare states are attractive locations for the poor and are less appealing to those who are better off.

An important question for public policy is whether to attempt to attract more "attractive" immigrants, by reducing fiscal burdens on those who are net fiscal contributors, and whether to reduce the flows of "unattractive" immigrants by reducing fiscal benefits for those who are net fiscal beneficiaries. This indeed could amount to a scaling back or unraveling of welfare state redistributive policies – the "best-case" or "worst-case" scenarios described above. Tax cuts for the rich, benefit cuts for the poor, better fiscal terms for young workers, and reduced retirement and health benefits for the elderly are all examples of fiscal reforms that would reduce the fiscal burdens on

[7] A UN study found that immigration inflows would have to rise from current levels of about 1.5 million annually to about 13 million annually to keep old-age dependency ratios at current levels through 2050, by which time cumulative immigration in Western Europe would have risen by about 700 million people.

net fiscal contributors as well as the fiscal benefits received by net beneficiaries.

Fiscal Competition: Labor and capital both? Just as countries might alter their fiscal treatment of individuals in response to the migration of people, so they might also wish to alter their fiscal treatment of businesses. Investment can be attractive in part because businesses pay taxes, or because it stimulates growth in employment, output, and income that lead to rising tax revenues and declining welfare-state expenditures. How, then, to attract investment? Lighter tax burdens, coupled perhaps with subsidies or with public expenditures on infrastructure or other public services that raise profitability, provide a set of policy tools that can influence investment flows. Of course, the process of reforming fiscal policies to attract investment is likely to reduce the net fiscal contribution generated by investment, in the same way that fiscal competition for people will tend to limit the net fiscal contributions and benefits paid or received by migrants.

To summarize the discussion so far: the aging and rich societies of Western Europe face present and prospective fiscal imbalances associated with their extensive programs of redistribution. Thanks to their high incomes and perhaps also, in part, thanks to their fiscal systems, they are attracting millions of immigrants from around the world. Capital mobility is also now a well-established characteristic of these economies. Since capital and population flows are affected by economic conditions, nations must compete for labor and capital, and fiscal policies – tax and transfer policies, especially – are one principal means by which they can do this. Competition encourages countries to reduce the amount of burden that they impose on people and businesses that are net fiscal contributors, and to reduce the amount of benefits that they provide to those that are net fiscal burdens. In this way, competition tends to bring fiscal benefits and contributions into alignment for people and for businesses, and thus to reduce the extent of redistribution – that is, to reduce the size of the welfare-state.

Policy and institutional responses to fiscal competition

Is the welfare state doomed? Will competitive pressures lead to a "race to the bottom" in which taxes and expenditures are driven down to dramatically lower levels? There are several reasons to think not. First, the phrase "race to the bottom" is highly misleading. To see why, think about competition among businesses. Do businesses in competitive industries race to a situation of zero prices? Certainly not, even though it is possible for any one business to attract many customers by reducing its prices. In business, competitive pressures lead to prices that reflect costs, rather than the pricing power associated with monopoly. Competition keeps the prices of Rolls Royce automobiles or 20-room mansions very high: their prices will never approach zero because these cars and dwellings are costly to produce. Similarly, in the fiscal sphere, competition does not lead to zero public expenditures or to zero taxes. Rather, it leads to a revenue system that reflects the costs of public services. When governments incur heavy costs from providing public services to businesses or to households, competitive pressures would lead them also to recover these costs through taxes, fees, and charges that reflect these costs. This may mean reductions in social benefits to the poor. But it may also mean privatization of loss-making public enterprises (whose customers are no longer the recipients of subsidies from taxpayers), reductions of subsidies to politically favored regions or industries, or higher tuitions and fees for students attending universities. Furthermore, political resistance to productive public expenditures – on education, infrastructure, health services, or transportation – is bound to diminish when these activities are financed not by transfers from the general taxpaying population but from revenues derived from those on whose behalf these expenditures are made.

By way of example: state and local governments in the U.S. vary widely in their provision of public goods and services and in their levels of taxation. In general, the fiscal systems of these units of government tend not to be highly redistributive – at least, not by comparison with the redistribution undertaken at the national level.[8] Competition among these governments has not led to a "withering away" of public expenditures and taxation. There are some places where some types of public services are very good – and costly – and other places where public services, and the taxes that support them, are more limited. In other words, competition sometimes leads to high levels of public service provision.

[8] As one simple indicator of the amount of redistribution embedded in the federal tax system, one may note that the top 2 percent of taxpayers paid over 40 percent of personal income taxes in 2002. No state or locality imposes fiscal burdens of this magnitude on its high-income taxpayers.

Second, and more importantly, it is crucial to recognize that economic integration is not, or at least need not be, a zero-sum game. When driven by market forces, migration and capital flows tend to raise productivity and incomes, as workers and businesses are attracted to places and uses where they are highly valued and away from places and uses where they are less productive. The importance of this basic observation should not be underestimated. From its inception, liberalization of markets has been one of the underlying foundation principles of the EEC/EU. This certainly includes liberalization of trade in goods and services, through the progressive reduction of trade barriers, but it also includes liberalization of labor and capital markets. Economists struggle to understand the process of economic growth and development, but none would dispute the role of markets as fundamental resource allocation mechanisms that have raised West European living standards far above those found in poorer regions of the world. Increased scope for freedom of commerce and employment, embodied in the Treaty of Rome and extended to ever more countries as the EU has gone through successive expansions, contains the promise of continued economic growth and increased prosperity.

In European experience to date, migration from outside the EU has featured more prominently than intra-EU migration. The recent accession of numerous East European nations means that significant amounts of erstwhile extra-EU migration will now become intra-EU migration. Quite aside from the impact of eastward EU expansion, however, labor and capital mobility will play an important and growing role in the future development of the European economic region, at least if US experience is any guide. Interregional flows of labor and capital are a durable feature of the U.S.'s highly-integrated market economy, and mobility is especially prevalent among the better-educated workers that comprise a persistently rising fraction of the workforce.[9] To date, migration from outside of the EU has been especially important, but Europe's young professional classes will surely follow career paths that are increasingly EU-wide, especially as they work in modern business enterprises with EU-wide operations.

[9] The U.S., like the EU countries, is the destination for significant numbers of international migrants. International migration, however, is small in magnitude compared to migration among regions within the U.S. For the past half-century and more, each year has witnessed large movements of people among states and regions (gross migration flows dwarf net migration flows), showing no tendency to subside over time. Reallocation of labor and capital among regions is evidently part of the US economy's response to ever-shifting market conditions.

While the linkage between economic development and the growth of the welfare state is complex, it is an inescapable fact that welfare states flourish in rich countries, not in poor ones. "Unwinding" some welfare-state redistributive policies, for example by reducing taxes and transfers, may be an important element in growth-promoting economic reforms, and fiscal competition in increasingly integrated markets for labor and capital will likely create pressures for such reforms. Perhaps more prosperous economies will be more unequal ones. But there is no reason to expect that the political forces that have made the modern welfare state such a characteristic feature of prosperous democratic societies will disappear over time.

Third, however, implementation of welfare-state policies may become increasingly difficult for individual countries due to competitive pressures. As mentioned earlier, competition among states and regions within the U.S. has not resulted in a race to the bottom in taxes and public services, but it may well have contributed to limits on the amount of fiscal redistribution by lower levels of government. Public pensions in the U.S., which (as in many EU countries) are a major element in the system of intergenerational redistribution, are a responsibility of the national government. Government borrowing, another form of intergenerational redistribution, is also far larger at the national level than at the level of subnational governments. The national government gives generous financial support to the state governments in their expenditures for major programs of cash and health benefits (AFDC/TANF and Medicaid) for the poor, and perhaps these benefits would be far smaller if their financing were left entirely to the states.

It is possible that the Member States of the EU will increasingly find themselves in a competitive environment like that facing states in the U.S., and that nations that were able to sustain large redistributive programs in earlier decades will find themselves under increasing pressure to reduce the scale of redistribution. Under these circumstances, national governments may decide to resist competitive pressures by coordinating their redistributive policies, for example by maintaining high income tax rates or by maintaining standard levels of income, housing, or health benefits for the poor. Detailed coordination of policy is difficult, however.

An alternative would be to reassign major redistributive functions upward to the level of EU administrative units. Of course, this just transfers the political problem of coordinating policies among countries to the political problem of deciding how to share the costs of redistribution among countries and how to set the levels of benefits on an EU-wide basis.[10]

Neither solution is a politically easy one, nor are these alternatives mutually exclusive. The experience of US states indicates that coordination of fiscal policy, even in the presence of a powerful superior government, is challenging, to say the least. To take one example, in the sphere of business income taxation, the states generally define business income in somewhat different ways, apply different rules to the division of income among jurisdictions for tax purposes (apportionment/ allocation rules differ widely), and choose quite different rates of taxation (from zero to about 10 percent on corporate net incomes). This is true even though these states share common legal and administrative traditions, and even though they generally rely on Federal government income taxation to determine the starting point for state income taxes. How much harder will it be for the EU countries to negotiate consistent principles and practices for the taxation of income from business activities?

On the other hand, delegation of responsibility for fiscal policy to higher-level institutions like the EU is also a difficult undertaking. The establishment of the social and regional development funds represent halting first steps toward EU-wide expenditure policies. The recent accession of East European nations to the EU will complicate the already problematic implementation of EU-wide social and development expenditure policies. The building of the institutional structures for the redistributive policies of modern welfare states took place over centuries. The establishment of EU-wide institutions that could supersede national government authority in this area, if it occurs at all, surely will require some decades of institutional evolution.

[10] To illustrate just one of the many difficulties that arises in the "upward reassignment" approach: the mix of old and young people differs among EU Member States. Those with disproportionate numbers of old would benefit from off-loading costly public pension programs to other EU countries by making public pensions an EU-wide responsibility, but those with higher proportions of younger workers would then bear disproportionate shares of the fiscal burden. In the give and take of political haggling, these problems are potentially soluble through the use of direct or indirect compensatory transfers or other forms of logrolling.

Conclusion

Labor and capital mobility are important elements in the overall process of economic integration in Europe. People from Eastern Europe, the former Soviet Union, the Middle East, South and East Asia, and Latin America are attracted to the high present and future earnings, and in some cases to the social benefits that life in Europe can offer. Migration and capital mobility within Europe, and especially within the expanded EU, are likely to be increasingly significant features of the EU regional economy. Because the welfare states of Europe .redistribute incomes on a large scale, inflows and outflows of capital or labor can expand or contract the sources of revenues, and the populations of welfare state beneficiaries, in ways that can enhance or undermine fiscal balance and thus the sustainability of redistributive policies.

In order to attract workers and investment that are positive net contributors to the fiscal system, a nation can choose combinations of tax and expenditure policies that offer more favorable fiscal treatment. Less favorable fiscal treatment for net fiscal beneficiaries – the poor, the sick, the elderly – can discourage their entry into a country. The fiscal stresses associated with population aging, the increasing ease of migration resulting from improved transportation and communications and the falling costs of information, and large and persistent income differentials between Western Europe and the poor countries of the world all can be expected to intensify fiscal competition and put pressures on EU nations to limit, to some degree, the extent of redistributive policies that they undertake. Coordination of redistributive policies can limit the extent of fiscal competition. Delegation of responsibility for redistributive policies to EU-level institutions can also mitigate competitive pressures on the welfare state. It would be difficult for the original EC Member States, or even the Benelux countries alone, to sacrifice the policy-making autonomy implied by such coordination or upward delegation of fiscal responsibilities. For the now expanded EU, a very diverse population of nations with quite different administrative, legal, political, and fiscal traditions and institutions, coordination or delegation of policy-making authority is likely to be especially challenging, and will certainly evolve, if at all, only gradually.

The positive impacts of economic integration must never be neglected. Mobility of labor and capital expands economic opportunities for workers and promotes economic growth and development. Prosperity is a critical underpinning of the welfare state. Enhanced economic growth in Europe, partly attributable to liberalization and integration of factor markets, can contribute to the future prosperity not only of native Europeans but of people around the world. The process of sorting out the proper functions of government in an integrated world is complex and time-consuming, and this evolution will not produce universally-shared benefits. But growth-enhancing economic reforms increase the opportunities for widely-shared improvements in living standards, and the experience of modern advanced democracies should reassure us that concern for fairness will always figure prominently in the evolution of economic policy.

Ivan Miklos
Deputy Prime Minister and Minister of Finance, Slovak Republic

Let me start by saying that the best social policy is to have as many well-paid jobs as possible and that economic growth is the best way to get more and better jobs. This is a quote from the Lisbon Strategy. It is a very nice and ambitious goal, but the problem is reality. Regarding economic growth and competitiveness, from 2000 on the gap between the United States and the EU has not shrunk but has rather widened. And this has not been only due to different developments in employment. GDP per employed person is also decreasing in the EU as compared to the U.S.. Another fact is the composition of growth in past years: EU potential growth is declining as compared to the U.S., and even more alarming is the decline in competitiveness as measured by the quality of technology and the quality of institutions, i.e. institutional conditions for higher growth.

Comparing the old and the new member countries, i.e. EU15 and EU25, we see a big difference in economic growth between the two groups of countries. There are two major reasons for this difference. First of all, in the new member countries there is converging growth from a much lower level. More important, however, are the structural reforms. The lack of structural reforms is the biggest problem of the EU 15. This is, of course, closely related with the sustainability of the welfare system.

Let me tell you what I think are the greatest obstacles to achieving higher and sustainable economic growth in the old Member States and to an increase in competitiveness. Firstly, it is the lack of economic freedom in general. It is very difficult to understand how a country, whose public expenditures are 55 percent of GDP, like for example France, should be able to be competitive in the present conditions of globalisation and an increasingly competitive environment. Secondly, it is insufficient market flexibility, especially labour market flexibility, but also financial market flexibility, the lack of venture capital financing, etc. Thirdly, it is long-term fiscal sustainability. High fiscal deficits have very negative direct and indirect effects on the competitiveness of business. This is closely connected with important structural reforms, of course, like pension reforms, health care reforms and others. Fourthly, competitiveness is also very closely connected with the business environment. It is necessary to have structural reforms for a more business and investment friendly environment in the EU.

One good example is the tax system.

Let me just briefly outline the basic features of the Slovakian tax reform. In Slovakia, from January of this year, we have a new tax system that is much more business friendly and has reduced the tax burden from direct taxes significantly. We have cancelled the dividend tax, the gift tax, the inheritance tax and the real estate transfer tax. We have changed the progressive taxation of personal income, which ranged from 10 percent to 38 percent, to a uniform rate of 19 percent. The corporate tax, which was 25 percent, is now also 19 percent, and we have also unified VAT to 19 percent from previously 14 percent and 19 percent. We have cut direct taxes and raised indirect taxes. These changes have created a more business friendly system, they have provided a very neutral, very simple, very transparent system, which has improved the business environment and is attracting more and more investment to Slovakia. Of course, there have been other reforms as well, which I have no time to discuss here, however.

From the point of view of enlargement, it is my opinion that enlargement is a win-win strategy. I am deeply convinced of that. Of course, enlargement is also showing up weaknesses and deformations of the present system. But one should not blame the messenger. The problems are internal. The weight of the new member countries is only 16 percent in terms of population, but only 8 percent in terms of GDP in purchasing power parities. In nominal terms it is much less. Globalisation is here, competitive pressure is here, and enlargement is only making the weaknesses more visible. If enlargement exerts the pressure for undertaking the necessary structural reforms it will benefit the old member countries, too. Therefore I am convinced that enlargement is a win-win strategy; it is not only good for the new member countries but also for the EU15, because without structural reforms we can forget about becoming the most competitive economic region of the world.

AART-JAN DE GEUS
Minister for Social Affairs and Labour,
Kingdom of the Netherlands

Excellencies, ladies and gentlemen,

Migration has always occurred. But mass migration is rare. It is something that we have not witnessed in the Netherlands for a long time. In the second half of the twentieth century we saw only two relatively modest flows of labour migrants. First, Dutch people who, in search of space, opted for a future in large and sparsely populated countries such as Canada or Australia and, second, workers from the Mediterranean countries who came to the Netherlands to work.

Between 1950 and 1960 more people left the Netherlands than entered it. But even at the peak of emigration the net outflow remained limited to just under 50,000 a year.

Since 1960 the number of immigrants has exceeded the number of emigrants from the Netherlands. Indeed, in the last 40 years of the twentieth century the number of immigrants exceeded the number of emigrants by between 25,000 and 50,000 annually. Less than a quarter of the immigrants came as labour migrants. The majority entered the Netherlands for the purpose of family establishment or family reunion, asylum or study.

As yet there have been no large migration flows to or from the Netherlands within the European Union. In recent years only one in six of the people settling in the Netherlands from abroad came from another Member State of the European Union.

Mobility within the European Union is low. Each year only 0.2 percent of the population of the EU migrates to another Member State. This is just one tenth of the migration within the United States. Migration to the Netherlands from the other countries of the European Union amounts to only 0.12 percent.

People are relatively averse to relocation. This is partly due to the limitations inevitably imposed by language. But another factor putting a brake on migration is that in more and more households both partners go to work.

Most businesses, too, are averse to relocation. But what we are seeing to an increasing extent is that they are transferring their production to other countries. In recent years, this shift has mainly been to Eastern Europe or to Asian countries because labour there is cheap. 40 percent of Dutch industrial companies expect to move operations to low wage countries in the next six years.

Nor is this phenomenon new. In the 1960s and 1970s we saw the textile and leather industry relocate from the Netherlands to other countries, particularly Italy, where labour was much cheaper. I do not regard the relocation of businesses as a bad thing, certainly not as long as other – and preferably more – businesses and jobs take their place.

A factor that is of much greater importance to the economic development of the European countries than the extent to which they allow immigration is the proper functioning of their labour markets. That is to say, we should reduce unemployment and provide growing employment.

This means that there is a need for workers to be geographically mobile within countries. Unfortunately, factors such as a working spouse or partner, an attractive home and children of school age may mean that people decide to draw benefits rather than accept work outside their own region in an effort to resolve all the problems facing them.

I recently heard that after the fall of the Berlin Wall many people from the former East Germany maintained that they could not find work in Berlin, even though the city was booming. So they claimed benefits. It was only when they were told that there was work for them in Baden Württemberg that it suddenly transpired they could also find work in Berlin!

What is certainly every bit as important for a properly functioning labour market as geographic mobility is job mobility. Nowadays, it is no longer sufficient for most people to learn a trade or profession just once in their lifetime. Instead of first learning and then working, people will have to learn and work throughout their working lives in order to ensure that they remain employable.

This has meant that expenditure on training per employee almost doubled in the Netherlands between 1990 and 1999 from €417 to €826. Moreover, the number of employees receiving refresher training increased from a quarter in the period from 1992 to 1994 to over a third in the period from 1998 to 2000 and to 40 percent now.

Nonetheless, we Europeans have too often decided to cease investing in older employees. Instead, we have sent many older staff home. We have not retrained them or given them refresher training, but have simply replaced them by young people who have the advantage of more recent training. This is easier and cheaper – so the employers have reasoned. But this is now definitely a thing of the past. In the coming years there will be fewer young people joining the labour market, which will instead be dominated by older people.

As is evident, for example, from a study carried out by the World Economic Forum on the effects of ageing societies, labour migration does not provide a solution to the problem of an ageing population. The Dutch Central Planning Office (CPB) shares this opinion. It notes that labour migrants are often followed by other migrants – in the context of family reunion and family establishment – who tend on average to participate in the labour market to a lesser extent.

In 2001, over 13 percent of the working population in the Netherlands was drawing benefits. But the proportion of immigrants receiving benefits was 22 percent. The proportion of social security benefit claimants among immigrants is much higher than average, especially among first generation, non-Western immigrants. It would therefore be advisable to take further steps to promote participation in the labour market, before examining the possibilities of labour migration as a solution to labour market problems.

We must increase participation in the labour market by making much better use of existing knowledge, expertise and energy. In short, we must keep more older people working longer. We must enable more women and men to combine paid work with duties in the home. We must help more people with a partial incapacity for work to find and retain employment. And we must help more young people to find work.

Good education is necessary for this purpose, education linked to work trial placements, education that can make use of practical training periods. A well-educated younger generation offers the best prospects for a prosperous future.

Our Invalidity Insurance Act (WAO) is renowned way beyond our borders. Almost one in seven Dutch employees is to some extent incapacitated for work. This high proportion is due mainly to the fact that over a period of many years we have looked only at what people could no longer do: the incapacity for work took precedence. Now we wish to look first and foremost at the possibilities which people still have. This is why there is to be a new system for people with a disability, a system that encourages all parties to regard the preservation of employment as the highest priority.

The participation of women in the labour market has been increasing in the Netherlands for many years. But it is still mainly women who take the small part-time jobs and are most likely to combine their work with care and household functions. Women are still hardly represented in top positions in companies and other organisations. Here, too, we see a potential pool of knowledge and expertise that is still insufficiently tapped by Dutch businesses.

This is also true of the potential of older employees. In the 1980s we introduced early retirement in order to provide room in the labour market for a greater number of young people. But in an ageing society we can no longer afford to promote early retirement at or around the age of sixty by means of tax incentives.

To be able to keep older staff in employment for longer and to enable people to combine work better with other functions, the Dutch government is introducing a "life-course scheme". This is a programme that will enable men and women to develop their talents to the full, both at work and in their private lives, at study and during leisure time, in providing care for their children and close relatives and in times of deliberation and reflection, in short, throughout their entire working life.

The maximum amount that people can save with the help of tax incentives is one and a half times their annual salary. Anyone who does this can take over two years' leave at 70 percent of their salary. Tax is paid only at the moment that leave is actually taken. After using up all or part of their entitlement, employees may build up the entitlement to the maximum again.

The scheme provides people with a larger number of up-to-date alternatives. It provides, above all, freedom of choice. There is less emphasis on the collective and on obligations, and greater freedom to save – according to one's own inclination and needs – for different forms of leave, even and above all during one's career.

Striking the right balance between learning, work, care and leisure throughout one's life, this is what we want to achieve – rather than focusing entirely on early retirement.

The scope of labour migration in Europe is small (just 0.2 percent). The Dutch Central Planning Office (CPB) has calculated that if there were to be completely free movement of workers from the new EU Member States, between 5,000 and 10,000 extra labour migrants and 10,000 extra seasonal workers would come to the Netherlands by 2006.

These can hardly be said to be startling numbers – in any event, not numbers that are sufficiently large to solve problems in the labour market, nor numbers that could cause the 'meltdown' of social security systems.

The European labour market still hardly exists. However, the countries of the European Union do have labour markets that closely resemble one another. The problems in these labour markets must be solved first and foremost by raising the degree of labour force participation, particularly at the lower end of the labour market. Almost a fifth of the people looking for work received only basic education. The number of jobless in this category who are looking for work is 22 percent higher than in all other educational categories.

It follows that the prospect of finding work will be extremely unfavourable for the least educated in the next few years. Once we have improved this prospect, we can then remove the obstacles to labour mobility within the European Union.

We are facing three major challenges in the next few years. First of all, we must improve the operation of the social security system and ensure that it focuses on inducing people to find work. Second, we must invest in training. Lifelong learning must become commonplace. And, third, we need a radical change in attitudes. People must once again consider it perfectly normal to be in work.

If we succeed in this, the European welfare state need not be jeopardised. After all, the welfare state can be maintained only if we have a well-trained working population, a smoothly functioning labour market and a system of benefits designed to induce people to find work.

GUNTAR KRASTS
Former Prime Minister, Republic of Latvia
Chariman, European Affairs Committee,
Latvian Parliament (Saeima)
Member of the European Parliament

Excellencies, ladies and gentlemen,

The largest EU expansion in history has caused extensive debates about the need for EU reform. The most significant reflection of these efforts has been the preparation of the Constitutional Treaty and the discussions surrounding it. Less attention has been paid to making the socioeconomic effects a success both for the EU-15 and the new Member States.

Countries with a different level of economic and, consequently, a different level of social development have joined the EU, which means the enlargement requires new ways of thinking of how to ensure the development of the EU's social policies. The Common Market was founded with a view to facilitating the competitiveness of the Member States and it is based on four fundamental freedoms. Almost all EU-15 Member States have introduced transition periods for the free movement of labour. The only exceptions are the United Kingdom, Ireland and Sweden. Moreover, the Swedish parliament has voted against a government proposal to introduce such restrictions.

There have been voices from some quarters, especially in Germany, raising the issue of "tax dumping" and "unfair tax competition", which are supposedly being implemented by the new Member States. The idea of tax harmonisation is still in the air, despite the fact that the European Convention has repudiated it. These are concerns about the movement of capital to the new Member States causing possible losses of jobs in the old EU countries with less attractive corporate tax policies. What is the most adequate tax level in each country and in each socioeconomic situation? These are questions which keep inciting debates among economic analysts and will continue to do so. As far as I know, only Austria has reacted in an adequate manner to the possible movement of jobs to the new Member States – it intends to reduce corporate tax levels.

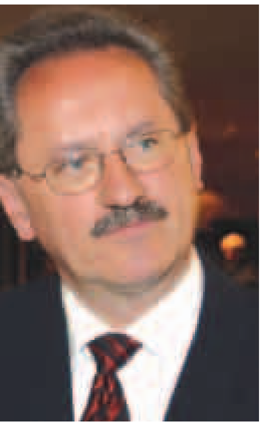
It seems to me that the decisions taken by the Swedish, British, Irish and Austrian policy-makers reflect a healthy attitude to the challenges posed by enlargement. Only in that way will the expansion of the European Union open up unique possibilities of unification.

We should be looking at these things realistically. I highly appreciate the financial support extended from EU funds to the new Member States. Although it is well intended and has multiplier effects, it cannot be the only "tool" to overcome the existing social and economic differences with the old Member States.

Restrictions of the free movement of labour, tax harmonisation, extension of qualified majority voting to social policy are ideas raised by short-term policy considerations. These "instruments" serve only to postpone the problems. Such decisions would substantially diminish the effective utilisation of resources provided by the Common Market, as only new jobs and the following increase in the level of incomes would boost the imports of the new Member States, creating jobs in the old Member States.

EU policy-makers should more seriously consider what trade theory suggests on the economic merits of the movement of labour and capital across borders, instead of speculating about possible political implications. Our common goal should be to move labour and capital quickly into productive sectors, not to defend labour allocations and industrial structures that are no longer appropriate. In the framework of EU social and economic construction possibilities we have to create highly flexible labour markets, closely linked with the educational system, and we must be able to listen to the signals coming from the market. Social welfare systems have to be endowed with sustainability. That is going to cause painful reforms in the welfare states. EU enlargement is the right time for substantial reforms not only in the new Member States, but also in the EU-15.

This is the most appropriate time! The Common Market is the "instrument" that will help the Member States find the solutions for the implementation of reforms. Our ability to utilise EU enlargement and the synergy effects it will provide to generate dynamism in the EU will, to a large extent, determine the future of the European Welfare State in the countries where it has existed for decades, and EU social policies will be postulated among the new Member States.



Luncheon Address by

Christian Ude,

Lord Mayor of Munich

Excellencies, ladies and Gentlemen,

May I extend a very cordial welcome to all of you here in Munich!

Munich, in fact, is not just a very beautiful and attractive city with many sightseeing attractions that provide an excellent setting for international conferences, but it is also one of the economically most successful cities in Europe, a fact that is confirmed by international studies and the ranking of top cities.

But of course, Munich has also felt the effects of a weak economy. Unemployment is up, many companies are planning further cut-backs of staff and, for the first time in many, many years, there are vacancies in office buildings.

I insist on mentioning these alarm signals which should not be swept under the carpet.

Nevertheless, Munich's economic situation is quite good when compared with other German or European cities. Even last year, Munich's average annual unemployment figures were the lowest of all German cities, at 6 percent. At times we were beaten by the city of Stuttgart, that is true. But no other city is rated higher for its growth potential in the years ahead.

And there are a number of reasons for this:

- Munich has a sound economic mix, the so-called Munich mix, involving various branches of industry. It is not just the IT sector that is particularly strong here, it's also the media, financial services and lately bio-technology.
- Munich also shows a sound mix of different sizes of firms. The global groups of Siemens and BMW are headquartered here, and we still have a number of manufacturing industries, but we are also strong in tourism and the trades.

  As far as international visitors are concerned, Munich is even ahead of Berlin. Every seventh workplace and even every fifth training place is accounted by the trades. In contrast to certain global players, the trades tends to stick to the location, which is an important stabilising factor for the job market. Thanks to its universities, colleges, vocational schools and public research institutions, Munich has an enormous potential of excellent and highly qualified labour.

  This is playing a big role when it comes to locational decisions taken by high-tech enterprises.
- Over the last decade, Munich's position was greatly enhanced as a result of enormous capital investments by the city and state in the construction of a large-scale airport at close to the city, as well as a new trade-fair centre which ranks among the most advanced facilities in the world.
- Finally, I would like to mention the factor of social stability, and the high quality of life as a locational asset. The positive social climate has a lot to do with the social activities of our city. And the high quality of life is partly due to the proximity of mountains, lakes and forests, and partly to the enormous variety of cultural and recreational attractions.

However, in spite of these assets, Munich is also facing big challenges:

- As a result of the globalisation of the economy, competition among the cities has intensified. On the one hand, Munich is benefiting from concentration processes, especially in sunrise sectors which are all well represented here. On the other hand, Munich is also under threat by completely new competitors in the finance and IT sectors, by locations that have also highly qualified staff but lower costs, ranging from wages to taxation. This means that we have to make great efforts, in spite of our leading position in Germany, to attract and keep businesses and by no means to discourage them.
- The continued evolution of the information society is accompanied by higher demands on the cities and their residents. The promotion of a

knowledge-based municipal economy is considered a key element in this respect. Life-long learning is of outstanding importance here, just as a higher degree of interdisciplinary cooperation, new forms of knowledge dissemination and the promotion of networks.

- The European process of unification also brings along a liberalisation of former monopoly markets. This entails a threat to the institutions providing municipal services. Liberalisation has already occurred in electricity generation. Our city-owned power plants have done extremely well in keeping up with big private competitors, but not without undergoing painful adjustments. At present, negotiations are taking place regarding public transport. And new steps are being taken towards the privatisation of municipal water supply. Munich is fighting, like other cities in Europe, to retain the right to organise its public transport in the city. This model has worked well over a century and it is also expected to continue by the citizenry. Looking at the privatisation of British railways, that seems to have been a disaster so far. In addition, we find that new monopolies are often created after privatisation, namely regional monopolies which are in private hands and without public control. In such cases, city hall would be reduced to an office handling complaints for the mistakes and failures committed by private contractors, without having control over the quality of its public services. Let me be very clear about it: This is what we don't want to happen.
  Well, we are quite serious, when it comes to water supply in Bavaria, and that goes beyond all differences between political parties. We have the highest quality of water, at reasonable prices, and we want to keep water management in the hands of the city.
  Water should not be allowed to become a commodity sold by big industrial players. The same applies to municipal hospitals and other services we are trying to stay in control of. The cities must be able to guarantee the provision of services to the population and maintain the quality of life for which we need suitable instruments. However, if a city wants to open up to privatisation it is free to do so. But, if a city wants to stay in control of its services, this should also be possible in a liberal Europe.
- Munich is also facing severe financial difficulties, of course. The financial plight of German cities also presents a problem for business because two thirds of public investments are made by the municipalities. If the cities are to provide an adequate infrastructure to business and if business expects to get contracts from the cities, it should also help create a sound financial base for the cities. A prospering Europe depends on the cities as engines of economic and social development.
  In my capacity as mayor of Munich, and being the only municipal representative at your conference, I wanted to point out this aspect in all clarity.

I wish you success for your conference and kindly ask that you not forget the cities when dealing with future issues of Europe, as more than 80 percent of the people of the European Union are living in cities. And the cities are the future workshops for social, cultural, economic and social development.

Thank you.

Panel 2

Enlargement: The Challenge of Migration from the New Member States

Georges de Ménil*
Delta, Ecole des Hautes Etudes en Sciences Sociales, Paris
Stern School, New York University

Enlargement is the final act of the reunification of Europe, which began when the Berlin Wall came down. It is, fourteen years later, and written large on a Continental scale, the reunification of Germany again. As Hans-Werner Sinn points out, the relative sizes of the parts that are being joined are similar in the two cases: the population of the Eastern laender was 26 percent of the population of West Germany; today the population of the ten CEEC countries – eight of which entered May 1, and two of which remain candidates – is 27 percent of the population of the European Union before enlargement.

Now, as then, enthusiasm for the end of division is accompanied by concern for the population movements that the removal of barriers will permit. The combination of dramatic differences in standards of living, geographic proximity, and common EU citizenship gives credence to the prospect that these movements will be large.

The magnitude of the potential flows

How large? Three recent studies[1] project potential flows from Central and Eastern Europe into Germany, which has been, and may well remain, the principal recipient of immigration from this region. These studies share a common conceptual framework. Potential flows are related to income and business cycle differences between the sending and the host country. The elasticity of migration to these differences is estimated from patterns observed during the last quarter of the twentieth century. The three studies allow for and find strong evidence of stock adjustment dynamics: after an initial catch-up period, the immigrant population in the receiving country tends to approach an equilibrium level, and net migration falls off.

Though differences in scope and econometric methodology between the studies generate substantial differences in their estimates of total immigration over ten or fifteen years, their projections of flows during the first five years are reasonably similar. The three studies can be interpreted as projecting a cumulative inflow of 1.0-1.5 million immigrants into Germany from the CEEC-10 in the first five years after labor markets are opened. (see Table 1).[2] This implies roughly a cumulative inflow over the same period of 1.5 to 2.5 million immigrants from the CEEC-10 to the EU-15.

Table 1
Annual net flows of potential immigration from CEEC-10 into Germany
(Year from removal of restrictions)
(000's)

	1	3	5	Sum first 5 years
DIW, (2003) (CEEC-10)	180	221	169	992
Sinn et al., (2003) (CEEC-5)	193	248	225	1143
Boeri et al., (2002) (CEEC-10)	225	280	150	1170

CEEC-5 : Poland, Hungary, Czech Republic, Slovakia, Romania.
CEEC-10 : Poland, Hungary, Czech Republic, Slovakia, Slovenia, Lithuania, Latvia, Estonia, Romania, Bulgaria.

Notes : In 2002, the population of CEEC-5 was 83.5 percent of the population of CEEC-10.

* This paper has benefitted from the excellent research assistance of Karin Thomsen and the efficient secretarial assistance of Marie-Helene Lebreton. I am grateful for the comments of Thierry Verdier and Jose Pinera. All errors and opinions are mine.

[1] DIW (2003), H.-W. Sinn et al. (2003), and T. Boeri et al. (2002).

[2] The Sinn et al. study refers to immigrants from Poland, the Czech Republic, Hungary, Slovakia and Romania (CEEC-5). The population of these sending countries, was 84 percent of the population of the CEEC-10, in 2002.

These flows are substantial. Arrivals into Germany in the first five years are projected to add up to 1 to 2 percent of the host population. Since arrivals will tend to cluster, regions like Bavaria and countries like Austria could well find that the already high shares of immigrants in their total populations might double.

These numbers are not, however, without precedent. They are dwarfed by the influx into West Germany of German nationals from East Germany and Poland before the erection of the Berlin Wall. (10.6 million of these refugees stayed in West Germany. More came and moved on.) The Poles, Romanians, Hungarians and others who move to Germany in the coming decade, may be fewer in number than the 2 million ethnic Germans, who were repatriated from former Soviet states and given automatic citizenship in the first ten years after the fall of the Berlin Wall. Relative to the size of the host country, their number is roughly the same as the number of French citizens repatriated from North Africa at the end of the Algerian War.

The concerns of policy makers in the EU-15

Sizeable but within the realm of recent experience, these flows are nonetheless substantial enough to be disruptive if they are not well handled. Policy makers have focused on two economic concerns.

1. Labor markets in the host countries must be flexible enough to assimilate the immigrant workers.
2. To the extent that immigrants receive more benefits than they pay taxes, they are a net burden on the state budget. If these deficits are large and well-known, they may act as welfare magnets and attract further immigration, which will, in turn, magnify the total burden.

The potential difficulty of integrating new workers in the labor market

This is the classical concern associated with the arrival of low-paid immigrants. The fear, bluntly put, is that "They will steal our jobs." The implicit scenario is one in which standard wage rates are rigid, and the natural mechanisms which would otherwise ensure that new workers find jobs, do not function. Indeed, if wages are rigid, an increase in the supply of labor inevitably generates increased unemployment. Existing workers fear that, by undercutting them, the immigrants will get the jobs, and they will become unemployed.

If real wages are flexible, it is not likely to take much of a wage reduction to absorb a 1 percent increase in labor supply due to immigration. If the elasticity of employment to reductions in the real wage rate were 0.8 (a number broadly consistent with the observed range of econometric estimates), a real wage reduction of 1.3 percent would suffice to absorb such an influx. The problem is that if real wages are rigid, a 1 percent influx of immigrants may indeed lead to a 1 percent increase in the unemployment rate, say from 10 percent to 11 percent. Though the former development would be imperceptible, the latter would constitute a serious deterioration.

The potential burden on the budget

The possible budgetary costs of a surge of immigration from the new Member States elicit a second, different kind of concern. This is the fear that immigrants may draw more in benefits from the state than they contribute in taxes. The possibility that these net benefits may differentially attract immigrants to the host countries with the most generous welfare provisions, and potentially bankrupt those very provisions, adds to the worry. In order to evaluate this concern, it is necessary to examine, one by one, the principal components of the budgetary balance of the immigrant population. I will base my comments on the detailed analysis of this question by Sinn et al. (2003) for the case of Germany.

The *social security taxes and transfers* from and to immigrant workers clearly constitute a positive net contribution to consolidated state budgets. By its nature, a new immigrant group consists mostly of young workers paying taxes, and only to a small degree of retirees receiving benefits. On a cash flow basis, the immigrants are positive contributors until their population matures demographically. It has been estimated that in 1989, the German social security budgets received DM9 billion more in taxes than they paid in benefits to the resident immigrant population.

To an individual immigrant, the expected lifetime balance of his personal social security account matters more than the magnitude of aggregate intergenerational flows. For this reason, Sinn et al. (2003) advocate estimating the budgetary balance of the social security system by comparing the present discounted value of lifetime contributions with the present discounted value of lifetime benefits for representative individuals. On this basis also, immigrants are net contributors, for the simple reason that, under present demographic conditions, the internal rate of return of the social security system is substantially below the rate of return on private savings. Like most workers in the system, immigrants never get back, in present discounted value terms, what they contributed. The total estimated positive contribution of each immigrant is less than it appeared on a cash flow basis, but it remains substantial (see below).

By contrast, *unemployment compensation* payments to immigrants do cost the state more than working immigrants contribute in related taxes, because unemployment rates are higher among immigrant workers. The higher rates are partly a reflection of the youth and relatively low skills of the immigrants. But there is also evidence, in some countries, that particularly generous unemployment provisions have attracted more than the natural share of the unemployment prone. In an econometric study using household survey data from several nations of the EU-15, Boeri et al. (2002) find significant evidence of what they call "excess unemployment dependence" in Denmark, Austria, the Netherlands and France.

Similarly, *tax based welfare benefits* paid to immigrants also constitute a net cost to the consolidated state budget of the host country. Because they initially work for lower than average wages, immigrants are net recipients of redistributive welfare measures such as supplemental assistance, housing bonuses and allocations to public housing. Because they also have more than the average number of children, they benefit disproportionately from child allowances.

Highly progressive benefits of this nature often generate resentment even within a homogeneous community of native born nationals. The visible nature of the differences between immigrant and non-immigrant dependency exacerbates these sensitivities, and often causes the distribution of these benefits to become charged political issues. Notwithstanding the intensity of the sentiments they arouse, neither these tax based welfare payments, nor the unemployment compensation mentioned above are the largest contributors to budgetary imbalance.

In an informative table, Sinn et al. (2003) summarize the net positive and negative contributions per individual of the immigrant population to the consolidated German state budget, as of 1997. Table 2 (Table 4.14 in the text cited), *decomposes the budgetary balances* which can be associated with the immigrant population into their component parts. One sees there the net positive contribution that Germany's immigrants made to social security balances. In 1997, the average immigrant paid DM5,290 in social security taxes, and as a result became entitled to additional benefits whose present discounted value was DM1,778. In present discounted value terms, the average immigrant lost and the state gained the difference between those two numbers – DM3,512.

Unemployment compensation, a highly politically sensitive element, generated a net cost to the state of only DM196 per person per year.

The largest net cost to the State was for the *provision of public goods* and tax financed benefits. Sinn et al. (2003) estimate the cost of these provisions by specifically allocating the benefits which can be allocated, and distributing the rest uniformly over the entire population. The result is a large number, DM12,337 per immigrant in 1997. The number includes education, fire, police, military expenditures and the services provided by all other government employees. The counterpart is general tax payments. Since the average income of immigrants is lower than the average income of non-immigrants, their tax payments are also lower. In 1997, they were DM7,576 per person. The difference between these two numbers represents the net cost to the state, per immigrant, of the supply of general public goods and tax financed benefits to the immigrant population. The study does not distinguish between the portion of this cost which is attributable to public goods, and the portion which is attributable to welfare payments, but the relative size of these elements in the overall state budget suggests that public goods are the larger component. In short, the biggest source of the net cost to the budget of the immigrant population was the provision of basic public goods.

A Diversity of Policy Proposals

Concerns for labor market disruption and budgetary costs have generated two kinds of policy prescriptions.

Delays and Quotas. The first response has been to seek to delay 100 percent immediate implementation of the right of new EU members to work any-

Table 2

Direct Fiscal Effects of Immigration per Immigrant[1)]
– West Germany 1997 –

	Immigrants[2)]			
	Length of stay			
	0-10	10-25	25+	Total
	– in DM –			
Revenuese				
Statutory Health Insurance (SHI)	1.817	2.237	3.792	2.773
Statutory Pension Insurance (SPI)	4.053	4.731	6.330	5.290
Social Nursing Insurance (SNI)	252	311	470	368
Unemployment Insurance.	701	1.091	1.393	1.157
Taxation revenues	6.044	6.046	9.687	7.576
Total Revenues	12.866	14.415	21.672	17.164
Expenditurese				
SHI	2.970	2.321	3.696	3.018
Implicit debt of SPI[3)]	1.362	1.590	2.128	1.778
Implicit debt of SNI[3)]	67	83	126	98
Unemployment Insurance	452	667	2.408	1.353
Tax financed transfers and benefits[4)]	12.646	12.358	11.644	12.337
Total Expenditures	17.498	17.019	20.001	18.584
Balance				
SHI	–1.154	–84	96	–245
SPI	2.691	3.141	4.202	3.512
SNI	185	228	344	269
Unemployment insurance	249	424	–1.015	–196
Tax financed transfers and benefits	–6.602	–6.312	–1.957	–4.760
Overall Balance	–4.631	–2.603	1.670	–1.419

1) The numbers in the table only reflect the relative positions of those immigrants who were in West Germany in 1997. A direct transfer to the expected immigrants from the Eastern European countries is not permissible as the structure of future immigrants may be different from that of the stock of immigrants in 1997.
2) Immigrants cover people living in Germany who are not German nationals, but also people who have been nationalized and people whose mothers are not German nationals, not including the *Aussiedler* and *Übersiedler* groups as well as asylum seekers.
3) Calculations of the SPI and SNI expenditures use the concept of „implicit tax“.
4) Benefits of the government units to private households and average costs of the provision of public goods.

Source: SOEP; calculations of the Ifo Institute.

where in the Union. The accession agreements, which the Commission negotiated with each candidate country, reserve the right for any of the EU 15 to postpone free access to its labor market for five years, and after review, to ask for an extension for another two years. Any citizen of a new member country who is granted a work permit is to benefit immediately from all of the employment and social rights to which EU citizens are entitled. The delay is optional, not mandatory, and may be applied in part as well as in full. Germany, Austria and France have announced that they are freezing work permits for two years, at the end of which time they will decide on possible partial or full extension of the freeze. Other countries have decided to offer labor market access during the transition period on a staggered, quota basis, sometimes differentiated by skill, sector or region.

Limiting Benefits. Britain and Ireland, on the other hand, have announced that work permits and residence status will be given to citizens of new member nations immediately.[3] However, both countries propose to depart from the inclusion principle, broadly applicable in EU law, in that they will deny public housing and employment related social benefits (the most important of which is unemployment compensation) to immigrants who have not yet worked contin-

[3] The only requirement is that immigrants register, once they have found a job.

uously for a minimum period of months (sometimes said to be 12, sometimes 24). Current EU judicial practice allows member nations to withhold benefits to immigrants from other EU states if they are not working. However, they are deemed to become entitled to the full benefits of the national welfare system, once they have a job. British authorities argue that their benefit limitation is implicitly consistent with the accession treaties framework, because the later permit exclusion from employment, and therefore benefits, during the transition period.

The purpose of the British and Irish policies is clearly to discourage migration in the pursuit of welfare benefits. In the words of UK Home Secretary David Blunket, "Hard working immigrants are welcome. Benefit tourists are not."[4]

Hans-Werner Sinn, who advocates a similar policy of no job restrictions combined with benefit limitations for Germany, argues that the transitional period of exclusion from benefits should be five to seven years.

The likelihood that benefit exclusions of any significant duration will be challenged as contrary to nondiscrimination provisions in EU law will increase substantially if the new EU constitution is adopted and ratified in its present form. As is widely known, the draft constitution elevates the provisions of the Social Chapter (which includes entitlements to many welfare benefits) to the status of inalienable constitutional rights.[5] The ability of the British and Irish to sustain their justification of exclusion before the European Court will have a major impact on the character of immigration policies and the course of migration flows. If the new constitution further entrenches "social rights," liberal policy makers will be able to draw temporary comfort from the delays which will likely accompany ratification. However, such comfort would only be temporary, and would be unlikely to last long enough to be of any avail when it comes time to admit the next group of new members – including most likely Romania, Bulgaria and Croatia.

An appraisal

Any appraisal of polices toward migration from the new members states must start with a general evaluation of the benefits and costs of the migration itself. Clearly, from the point of view of the receiving countries, the potential benefits far outweigh the likely costs.

The wave of migration which the EU 15 stand ready to receive during the coming decade is unique. A million or more young, disciplined workers, who share a common, cultural and historical heritage, and who are not marked by any of the ethnic "color lines" that can make social integration more difficult, are preparing to join the EU 15 labor force. They will bring with them a level of educational attainment, which, though it may be low by Western European standards, is higher than the average educational attainment of immigrants from North Africa, Sub Saharan Africa and the Caribbean.[6]

This dramatic increase in labor supply is even more significant than its numbers suggest, because the newcomers, like all migrants, will be more mobile and flexible than the existing population. In a prescient book on the importance of labor supply to *Europe's Postwar Growth,* C.P. Kindleberger noted, almost forty years ago, "Having already cut his roots to his native land, the foreign worker is peculiarly mobile. ..Foreign labor is highly mobile. ... It can transfer readily from firm to firm, occupation to occupation, and region to region within a country and between countries and between abroad and home."[7] Europe's most conclusive example of the growth dividend of a large influx of skilled labor is the German miracle itself, and the depth of its debt to the repatriation of German refugees from the East.

Not surprisingly, the greater horizontal mobility of immigrants also correlates with greater vertical mobility, over time. The social and economic upward mobility of immigrant populations tends to exceed that of long-time resident populations. Though recent immigrants tend to work for lower average pay levels than long-time residents, after twenty years in a country, established immigrants, tend to work for higher average pay levels than their native counterparts. Sinn et al. (2003) note this pattern in the life earnings profiles of the cross section of immigrants working in Germany in 1997.[8] If anything, this

[4] Statement of the Home Secretary, March 25 2004.
[5] I have addressed the fallacy of this judicial approach to social policy in several recent opinion pieces in the Financial Times, Suddeutsche Zeitung, and the Wall Street Journal Europe.

[6] See Boeri et al. (2002), p.104
[7] See C.P. Kindelberger, *Europe's Postwar Growth,* pp.181 and 210.
[8] This pattern is implicit in Table 2, in the comparison of the average income tax payments of recent immigrants with those of immigrants with more than 25 years of residence in Germany. The larger than average tax payments of the latter group lead the authors to conclude that, after 25 years, immigrants are net positive contributors to the fiscal balance of the German State.

pattern may become more marked in the future than it has been in the past, as intensifying technical change and global competition increase the sectoral variability of growth.

In short, admitting a large supply of qualified workers entails on the part of the host country, an initial investment. Schools, hospitals and housing must be built, and public services expanded. This is much of what the initial fiscal deficit, calculated by Sinn et al. (2003) pays for. But in time, the addition to the work force, because it is flexible and motivated, produces a growth dividend which raises living standards for all of the population, residents and immigrants alike.

In favor of modest, qualified restraints

If immigration from the new Member States has the potential to be as beneficial in the long term as I have argued, care should be taken not to obstruct it. Delaying the arrivals for seven years would clearly be a mistake. Both of the concerns that have been elicited by the immediate prospect of new arrivals, would be better addressed by other measures than delay.

If labor market rigidities threaten to channel a large share of the immigration into unemployment, the correct response is to dismantle the rigidities, not stop the immigration.

If some tax financed welfare benefits distort location incentives and the incentive to work, those distortions should be corrected. The inefficiencies they generate have the potential to be as great for the native population and for non-nationals coming from the EU-15 as they are for immigrants from the CEEC-10. In short, proposals to transform some welfare provisions into workfare provisions are more promising candidates for the agenda for reform than extended immigrant exclusions.

This being said, the frictional costs of adjustment can be significant, and phasing in what would otherwise be a large surge of immigration and large demands on the budget, may have merit. Smoothing the potential arrivals of the first three years over a five year period could, while keeping the pressure on, allow a little time for reforms. Similarly, the British decision to withhold unemployment compensation and public housing for at least a year seems to provide a minimal, reasonable safeguard against what Home Secretary Blunket has called "welfare tourism". In both cases, however, gradualism should not become an excuse for avoiding reforms. The objective should be flexible procedures of admission, not dams to stop the flood.

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Brunson McKinley
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Excellencies, ladies and gentlemen,

Migration is coming into focus as one of the big issues of our time. Currently approximately 175 million migrants are living and working outside their native countries – three percent of the world's population. Long-term social and economic trends – the declining birth rate in the richer countries and the aging of their population – encourage the growth of migration for work. Today most senior business people and many policy-makers understand that migration is both necessary and inevitable, especially in the modern version of temporary migration for work. We at IOM want to help governments, corporations, employers and civil society to cope better. We are convinced that migration can be useful and beneficial if managed intelligently. In this field, Germany is taking the lead and deserves much credit.

Looking at the new Europe of 25, IOM anticipates the following trends.

- We expect to see some new migration flows from East to West inside the EU, but these will be neither sudden nor massive. They will take place largely through regular channels of employment and work permission and are likely to be more of a temporary nature than permanent. Such flows should be easily manageable in terms of social and economic integration.
- The example of Spain's accession is likely to be repeated in the new Member States. Beginning in the mid 1970s, some 200,000 Spaniards left their home country to work in EC countries every year. After EU accession in 1987, Spanish emigration dropped quickly. Today Spain is a net immigration country, attracting labour migration to its growing economy, especially from Latin America and Northern Africa.
- At the same time, the new EU Member States of Central and Eastern Europe will rapidly become new countries of destination for migrants from further East and from other continents. A recent IOM study called "Migration Trends in Selected EU Countries", shows that this development is already well under way.
- For migrants from outside the enlarged EU, the temptation will continue to use irregular channels, including smuggling, trafficking and inappropriate use of asylum systems. The existence of growing non-EU communities in all 25 Member States makes irregular entry and unauthorized stays easier.
- Security concerns naturally accompany irregular migration flows. In this area adequate control measures demand international cooperation. Biometric technology to monitor movements is a good example. Germany has a leading position, but one-country solutions are not viable.
- All in all, there is a great need for effective migration management policies throughout the territory of the enlarged EU. In many areas, common policies are likely to work more effectively than a series of different national policies. Especially important will be the possibility of regular migration for work.
- That said, national differences will remain, both on the policy level and in implementation choices. German businesses are more open to Eastern Europeans; the Mediterranean countries naturally look to Northern Africa. Spain has affinities with the New World.
- A major test of EU migration policy will be to strike the optimal relationship with the wider migration world in terms of migration for work.

These observations cause me to reflect on how Europe can and should contribute to the creation of a better regulated international and interregional market in professional talent and skilled work.

The new German law is an important first step. Other European nations are likely to emulate Germany's achievement if it brings the desired results. German corporations and employers will be on the cutting edge. The German system could become the basis for an EU-wide attempt to regulate an international market in skilled workers and professionals.

IOM is in close touch with the important sending countries. In the developing world, many nations literally live off the remittances their workers send home. The sums dwarf foreign assistance, lending and even direct foreign investment. Qualified labour is the most important export of these countries.

Of course, we are not talking here about commodities, but about human beings. So whether the market works well or badly makes a huge difference. At present, one must admit that it could work better. What we need is a more comprehensive approach, one that embodies at least some of the following elements:

- A forward-looking analysis, country-by-country, of the skill gaps in industrialized economies. The private sector is perhaps more likely to succeed in this analysis than government. Today one finds foreign workers in the fields of computer technology, health care, construction and agriculture. What will be the needs five years from now? Twenty-five years from now?
- A system of validating credentials so that employers can have confidence in the quality of foreign-born workers and professionals.
- Pre-departure orientation programmes that help the newcomers off to a successful start in their new workplaces.
- Remittance systems that allow for savings, low-cost transfer and a socially useful investment of earnings.
- Re-integration assistance for the many workers and professionals who will wish to return home once their goals in overseas work have been achieved. Employment in a partner corporation may turn out to be the most appropriate form of reintegration assistance.
- Perhaps most important of all in the long term, an educational plan in the countries of origin that allows them to get ready to supply the needed workers and professionals in the foreseeable future.

In all of this, IOM can play a useful role in support of government, business, local communities and the migrants themselves. We have the global network of offices and contacts to support diplomatic and corporate efforts aimed at putting in place an efficient, fair and mutually beneficial system for managing international migration for work.

I've moved away a bit from the original subject, common European policies on migration, so let me come back to it now. For IOM the search for common policies is a worthy and sensible goal. That goes for all the main areas of migration management. One thing we know for sure: good policies develop from good practices, and the way to identify the best practices is to try different ideas and see what works.

So let's get started!

JÜRGEN STRUBE
Chairman of the Supervisory Board, BASF AG, Ludwigshafen
President, Union of Industrial and Employers' Confederations of Europe (UNICE), Brussels

Ladies and gentlemen,

The heated discussion on the subject of "immigration" in Germany and other Member States frequently leaves out the legal position at the European level and the economic necessities.

The influx of labour from the new Member States to Western Europe since May 1st is covered by the freedom of free movement of persons guaranteed in the EU Treaty, even though many Member States are presently applying restrictions on labour permits for the new EU citizens, in some cases up to 2011. According to the EU Treaty, "immigration" is solely immigration from third countries outside the EU.

To me, the key question is: How can the cross-border mobility of labour within the single market and the immigration of labour from third countries help to achieve the Lisbon target, in other words contribute to the strategy for more growth and employment in Europe?

The EU can only become "the most competitive and dynamic knowledge-based economy in the world" if Europe attracts and retains the best brains and the most skilled workers in the world. This is why we need

– greater mobility of labour in the single market,
– a managed immigration of qualified manpower from third countries, and
– more flexible labour markets including social security systems giving incentives to take also lower paid jobs and postponing full entitlement for migrants.

Europe cannot sustain any further immigration into its generous social security systems. But highly qualified immigrants scarcely have any integration problems and rarely become a burden on the social exchequers.

Europe has a considerable long-term demand for skilled workers. In Germany alone, a million positions cannot be filled currently – in spite of high unemployment.

The supply of skilled workers will drop by approximately 1.6 million by 2015, whereas the demand for such workers will increase by approximately 2 million during the same period. This means that there will be a deficit of more than 3 million skilled workers in Germany in the next 15 years.

Such a deficit of skilled workers also exists in most of the other EU countries. Furthermore, in comparison to the United States, Europe is not attractive for top researchers. For this reason, many European companies are unable to accept orders, carry out planned investments or initiate innovations. Thus, the shortage of skilled and highly qualified human resources is a genuine "growth brake" on the European economy.

This is why existing mobility barriers for skilled workers within the internal market must be dismantled as soon as possible. Otherwise "the best" from Eastern Europe could decide to go to other growth regions outside Europe.

For immigrants from third countries we need a coherent legal framework at the EU level that is primarily based on economic needs. But EU rules on the admission of "economic migrants" should respect subsidiarity and leave enough room for Member States to develop tailor-made solutions for their specific situation. Immigration communities and national labour markets are different in each Member State.

European business calls for simple, transparent and speedy procedures for the admission of economic migrants. We have to abolish the bureaucratic rules currently applied in nearly all Member States.

Ladies and gentlemen, I am an advocate of the "best practice approach". There is indeed a sector where Europe is already a successful global competitor for "high potentials": The market for professional football players. I am constantly amazed how quickly and without any bureaucracy the officials of the national employment administrations issue work permits for football stars from third countries when it is a question of strengthening the local soccer team.

Any football expert will agree that these soccer migrants from Brazil, Nigeria or other regions greatly help the teams of the European Champions League to be world class. However, from the German point of view, there is a sore point: The ball wizards from Brazil have been trained in Europe so well and with such discipline that the Brazilian team was able to beat Germany in the finals of the world championship in 2002.

I do wish that Europe would become just as successful in the "fight for brains" as it is in the "fight for legs" of soccer players. "Brain gain" could help European industry to play a role right at the top of the World Champions League.

Thank you.

BERND STECHER
Corporate Vice President, Chief Economist,
Siemens AG

Ladies and gentlemen,

As of May 1, 2004, some 450 million people within the European Union theoretically have the freedom to choose where they live and work. I say theoretically, because the European Union agreed upon a transition regulation with the new Eastern European members restricting the freedom of movement of workers and other groups. Yet by 2011 at the latest, citizens of the countries that joined the EU on May 1, 2004, will also enjoy full freedom of movement.

In view of the transition regulation as well as the longer-term substantial income gap between the old and new EU Member States, it is difficult to predict the future volume of migration. The per capita gross domestic product in the new Member States – calculated at purchasing power parity – is only 45 percent of the EU level. As a result, the prosperity gap is substantially bigger than in past EU enlargements.

This gap can be clearly illustrated with the cost of labour per hour of actual work. Software engineers in our company cost €40 an hour in Germany, €14 in Portugal, €13 in Poland, and only about €8 in the Czech Republic. And, let me stress, this is for the same quality of work. In this way, the new Member States are helping us compensate for the problematic lack of software engineers in Western Europe. Obviously, this is increasing the pressure on Western Europe. The currently plugged channels between the individual labour markets are straining to be opened up.

How can this pressure be controlled or at least reduced?

The first, purely administrative step was certainly the EU agreement reached on the transition regulation. This, of course, will help only in the short-to-medium term. The transition regulation changes nothing in the basic structural differences between the individual countries.

The transition period should at any rate help prevent a flood of migration into the welfare states of Western Europe. I believe we should carefully monitor developments here. Should problems actually arise, then one must act – and act quickly. Otherwise, the welfare state model would rapidly erode.

Greater flexibility in the labour markets – particularly in the biggest countries of continental Europe – is another possibility for improving the situation. High unemployment rates in the older EU countries are largely due to the generous negotiated wage agreements during past decades. In the future we have to be far more moderate regarding labour costs. In the end, the yardstick for determining wages must be productivity gains.

And longer working times – I am thinking here of the 40-hour week at the same pay – can no longer be taboo. If we want to secure our jobs, such measures are unavoidable. In this manner, companies can improve their competitive positions while net wages remain the same. Time accounts, elimination of wage supplements, work on Saturdays, etc. – there are no limits to the possibilities of changing the system.

I believe companies can make a key contribution toward reducing the migration pressure.

Long before May 1, companies focused on finding attractive locations, hiring new employees and expanding into new markets in the countries joining the EU. Let me illustrate this with some numbers from our own company: From 1990 to 2003, our company's sales in Eastern Europe climbed from €200 million to €3 billion. In the same period, the number of our employees in the region soared from 50 to over 21,000. In addition, our suppliers employ another 15,000 people. In 1990, we neither manufactured nor conducted research and development in Eastern Europe. By 2003, however, we were operating 20 production facilities and 16 local R&D centres.

Over the years, we have thus invested capital locally, provided substantial know-how transfers, helped establish supplier companies and, in the end, given many East Europeans attractive jobs. This is the positive side of Germany's often-cited "bazaar economy." Siemens has thus, if you will, brought work and value-added to people in the region. This is basically what companies can do to help solve the migration problem.

Let me sum up the most important points:

First: The older EU15 countries have to work on making their labour markets more functional. In the end, this means boosting productivity, but also lowering wages for less-qualified workers. And in any way this is possible, I should add. One must make this quite clear.

And second: West European companies have to continue using their market opportunities in the new EU Member States in order to help improve the lives of people. Our internal studies indicate that the new Member States have good potential for market growth and as attractive business locations.

In closing, I would like to note that we should also try to find the right sense of proportion in our discussions on the theme. After all, we have gathered valuable experience during earlier enlargements of the European Union.

And, by the way, I can well imagine that many East Europeans have close ties to their homes, would be content with significant increases in their income, and would not consider migrating due to language barriers.

Thank you.

Panel 3

CREAKING LABOUR MARKETS: MIGRATING INTO UNEMPLOYMENT?"

GIUSEPPE BERTOLA
Professor of Economics, University of Turin

The title of this Panel expresses pessimism about European labor markets' ability to withstand new challenges, a very common angst among those who contemplate the persistently high level of many Continental countries' unemployment.

European labor markets, however, were not always creaking. In the post-War period, and until the 1970s, unemployment was lower in Europe than in the United States. Growth also used to be fast in Europe. Between 1950 and 1973 GDP grew at an almost 5 percent annual rate (almost 4 percent per capita) in the EU-15 countries. Growth slowed to about 2 percent in the 1974–85 period in both the US and the EU, but until the 1990s EU labor markets, while generating less employment, consistently experienced faster real-wage growth and smaller increases in wage inequality than their American counterparts. Most European unemployment rates increased above the US one in the early 1980s – but unemployment, concentrated as it was in secondary portions of the labor force, was not an important source of social tensions as long as primary earners enjoyed stable employment at high wages.

At the end of the 1990s, unemployment in the European Union was twice as high as in the United States and growth was also an elusive goal for European policymakers (Sapir et al, 2004). Not only in the 1990s, but also in the first few years of the new millennium, EU countries on average – and Germany in particular – grew significantly more slowly than the US. One may well be entitled to feel sorry about this state of affairs. But stagnation should not evolve into depression, and angst feelings are not constructive. Europeans need to devise forward-looking solutions to the familiar problem of reconciling worker protection and economic efficiency in the current and future environments. Remembering past successes should not lead us to regret progress and justify defensive, backward-looking policy measures. Rather, a brilliant past can be a source of inspiration when devising such solutions.

Cyclical factors and structural features

If growth and labor market problems are relatively new in Europe, policy concerns are even more recent and occasionally misguided. For a long time, policy responses to high unemployment included public jobs, "active" labor market policies, and early retirement programs. Little attention was paid to the structural mechanisms underlying Europe's steadily deteriorating employment performance. Institutional reforms were only prompted by the fiscal problems of the 1990s, and by the unsustainability of low employment levels in the face of population ageing and declining competitiveness. The European Union's "Lisbon" objective of achieving the status of "most competitive knowledge-based economy" in 2010 has not led to appropriate reforms and supporting instruments and, not surprisingly, little growth has materialized in the EU since its formal adoption.

Poor growth performance was and still is often blamed on cyclically depressed conditions, reflecting fiscal and monetary stabilization in the early 1990s, and international financial-market swings and security concerns at the turn of the century. Structural factors, however, are clearly more important in theory and practice. The Single Market, enlargement, and EMU have vastly improved Europe's market size and macroeconomic policy environment. To yield the better efficiency and faster growth that theory would predict, however, competitive conditions must be pervasively improved. The structure of production needs to be re-oriented towards sustained growth, and this is clearly not just a matter of reducing taxation – a strategy that may well foster a country's development if other countries' taxes remain high, but hardly an option for a European economy where public expenditure and transfers pursue politically strong goals.

Competition and growth should be pervasive in all markets, not only in the labor market, whose institutional structure is often blamed for unsatisfactory employment performance. While such blame may be well-deserved in many respects and in many countries, it is easy to forget that labor market institutions serve potentially useful purposes in a world where labor income is difficult to trade in financial markets, and its stability is an important goal of collective action in general and public policy in particular. To understand why poor employment performance fails to trigger reforms in many European countries, consider that low employment is an unpleasant but not unintentional byproduct of many labor market institutions. Unemployment insurance, labor taxes and social transfers, employment protection, collective bargaining are all meant to prevent poverty and reduce inequality. Working is not a pleasure, and restricting employment to "good jobs" is attractive when unemployment is concentrated in secondary segments of the labor force. Hence, institutions that did support favorable wage level and dispersion developments in Europe relative to the US were and remain very popular among citizens and workers.

But high wages and labor income security do come at a price in terms of lower productive efficiency and lower employment, a price that depends on labor market characteristics. The performance of existing labor market institutions leaves much to be desired within existing national systems. Since unemployment benefits, which would have only minor effects in a highly productive economy, can dramatically reduce employment in a less developed one, larger and more diverse countries tend to display higher overall unemployment and much more dispersed regional unemployment. Nation-wide labor market institutions can be consistent with nearly full employment in North-eastern Spain, Northern Italy, and West Germany at the same time as they imply high unemployment in less developed regions, and for the whole country on average. And since the employment effects of a regulated labor market are more negative when product-market competition is more intense (Bertola and Boeri, 2002), cross-border integration also plays an important role: the same labor cost increase that would reduce employment only marginally in a closed economy with little product-market competition can dramatically worsen the employment performance of an economy where production can be easily relocated abroad and product-market competition is very intense.

Economic integration and the labor market

Since employment losses from labor market regulation are larger when competitiveness vis-à-vis trading partners is more important, economic integration – whether within the EU or on a global scale – threatens the sustainability of many European countries' labor market institutions. The tradeoff between lower employment and better employment conditions is not as favorable for current institutions when higher wages can lead firms to substitute domestic with foreign labor as it would be in a closed economy where unemployed workers participate in the same social security scheme as protected primary workers.

Enlargement of the EU to relatively poor Central and Eastern European countries adds new challenges of this type to the complex politico-economic reform problem facing European countries. Immigrants may of course be sensitive to the availability of welfare benefits in the destination country – in fact, more sensitive than current residents. Even small differences across possible destinations can determine the trajectory of individuals who have chosen to bear the largely fixed cost of migration, and empirical evidence does indicate that migrants are more likely than natives to take advantage of generous welfare provision (see Borjas, 1999 for US evidence, and Sapir, 2001, for a discussion of European data). Will many Central and Eastern Europeans "migrate into unemployment" – either feeding into such stagnant pools as may be found in regions of Germany and Italy, or putting such unsustainable pressure on existing welfare arrangements as to kill the planned creation of an area of economic freedom (after lengthy transition periods)? Or may CEEC accession instead bring the long 1970–90s phase of labor market rigidity to an end, and recreate the vibrant growth performance and labor market conditions of the 1950s and 1960s?

The answer to these crucial questions depends in part on cultural factors. It is often argued that European labor mobility is hindered by cultural and linguistic barriers. This is unlikely to shape future developments, because attitudes towards migration are not invariant to economic and institutional factors. Some 10 million European workers in search of better employment opportunities did move across the borders of countries in the European golden age of the 1950s and 1960s, and many more migrated from the countryside towards cities within each country. Cultural and political factors are unlikely to prevent efficiency-oriented migration if European labor markets return to their ancient dynamism, but such factors may well play an important role in shaping the Western European policy framework's reaction to migration pressure. Incipient and actual immigration is extremely unlikely to result in the demise of Western European welfare systems. Labor market regulation and collective welfare schemes are strongly supported by many Europeans' social and political attitudes, and public opinion would surely prefer barriers to personal mobility should "race to the bottom" tendencies initiate a transformation of Continental Europe's institutional landscape into, say, Texas's.

Hence, the interaction of *status quo* welfare schemes and economic integration endangers the latter much more than the former. Whether incipient opportunities for labor mobility will result in anti-integration resentment, or renew growth in Western Europe, will chiefly depend on whether policymakers will rise to the new challenges and find new ways to achieve social cohesion and economic progress in a new environment, without forsaking the social and labor market policy goals that are so politically strong in Continental Europe.

The challenges facing current social and labor market arrangements do arise from economic integration. But the labor market and social security arrangements that Europe inherits from its past are made obsolete by demographic trends and technological innovation, not just by economic integration. Economic integration offers important efficiency gains, and changes the balance of current institutions' pros and cons through many channels, not just through migration. Personal mobility is perhaps the most visible aspect of economic integration, but neither migration, nor the availability of benefits for non-nationals in the destination country are crucial. Trade and capital mobility can put much the same competitive pressure on workers as migration, which is all but impossible to stop (whether from within the EU, or from neighboring regions), and is much more likely to displace local workers from their traditional employment into subsidized unemployment than to draw on social transfers directly.

Reform directions

It would be wrong to regret economic integration because it undermines a tradition of low-employment, high-regulation labor markets. Integration of markets across the boundaries of families, villages, and kingdoms has fostered economic progress throughout history. Our willingness and ability to engage in economic interactions with counterparts that are geographically and culturally distant from ourselves is the main reason why we can afford a better standard of living than primitive men (Seabright, 2004). There is no reason to advocate stopping that progress at the borders of nation states as currently defined.

A reevaluation is in order of how labor market regulation is implemented, rather than of its objectives. Reforms should be motivated by new cost-benefit trade-offs. Economic integration opens new opportunities, but can have adverse welfare implications if markets' institutional structure is ill-equipped to accommodate new opportunities to trade and specialize. The EU's labor market and growth performances suffer from lack of appropriate reorganization under new competitive pressure. Hence, flexibility-oriented reforms are essential for both longstanding and new members of the EU to take advantage of new opportunities. If workers and other resources that can no longer be profitably employed in traditional industries are left idle in subsidized unemployment, and not reallocated to new tasks, then loss of industrial production is not compensated by new (service) production, and welfare is reduced.

Integration and deregulation are far from painless, of course, and it would be dangerous to neglect the politico-economic tensions generated by dismantling the current system of worker protection in Continental European countries. At the same time as protecting workers becomes increasingly difficult in light of more intense competition, demands for such protection can become more urgent. Hence reform should not simply deregulate, nor should defensive measures be put in place to stem the tide of progress. Policymakers should not, like cavalry generals in the 20th century wars, fight old battles with obsolete policy instruments. The German construction workers' unemployment benefits should not remain unchanged when their employability is threatened by competition from Central and Southern European workers, rather than by the weather and business-cycle conditions on the minds of Bismarckian scheme designers.

Rather, institutions should be reformed and modernized, at both the national and EU levels, so as to facilitate change and mobility, encourage work, and better deliver old objectives in a new environment. As economic interactions reach the scale and intensity of those experienced in the United States, the challenge facing individual countries and the EU as a whole is that of preserving a European tradition of attention to working conditions by means of an appropriately redesigned institutional framework.

Cross-market aspects

The U.S. differs from the EU in many respects, not just in its labor market structure. Not only labor markets, but all markets need to be reconfigured. Workers cannot be expected to accept labor market risk if other aspects remain unreformed that are relevant to their welfare. In some countries, but not in most European countries, redundant white-collar workers can easily find employment as taxi drivers: ease of entry in product markets and self employment can play a crucial role in making a deregulated labor market acceptable. The relevant processes can be fostered by economic integration and EU competition authorities, and make labor market deregulation more acceptable than it currently is. Even more importantly, competitive and efficiently regulated financial markets are needed to reduce workers' need of protection against market pressure – offering, for example, the same affordable consumer credit that allows American workers to protect their consumption from income shocks. Patterns of covariation are quite apparent across aspects of labor, product, and financial market regulation and development (Nicoletti, Scarpetta, and Boylaud, 1999; Bertola and Koeniger, 2004). Each market-specific regulation framework may well need to be reformed in each country, but evidence and theory both suggest strongly that reform processes should be coordinated across all markets.

Transnational aspects

The U.S. also differs from the EU in featuring a robust layer of federal policies, funded by a budget that dwarfs its European supranational counterpart. Not only in the monetary policy and competition policy areas, but also in the social and labor market area policies need to be coordinated to ensure that the relevant trade-offs are addressed at the relevant level (Bertola et al, 2001). Collectively administered schemes meant to replicate markets that the private sector cannot develop, such as old-age and unemployment insurance systems, need not be coordinated if they adhere to actuarial fairness standards. Appropriate design of the relationship between individual contributions and benefits can in principle ensure that such systems are robust to economic integration pressures, and competition among systems of the type analyzed by Sinn (2003) can foster efficiency in their implementation. Policies meant to prevent social exclusion of individuals who could not participate in insurance markets even if they existed, however, need to be designed and implemented at the level where benefit-shopping and race-to-the-bottom tendencies may materialize, namely at the EU-wide level where economic interactions take place.

Failing to recognize and face explicitly the policy spillovers introduced by an enlarged, diverse, and ever closer Union can only lead to calls for retrenchment in national or sub-national economic and perhaps ethnic entities, and to the elimination of welfare gains from economic integration. A minimal standard for welfare benefits, and for taxation of mobile capital and corporations, should have higher priority than intrusive schemes such as the Common Agricultural Policy. In an integrated economic area, addressing welfare-policy spillovers should have a priority at least as high as that of common monetary and competition policy, similarly meant to prevent uncoordinated policy reactions resulting in uniformly undesirable outcomes. A suitable welfare floor does not need to be implemented as part of a full-fledged "Social Union:" homogenization of minimal standards would be impossible without politically unrealistic cross-border fiscal transfers, and would be economically dangerous on a continent where uniform national standards (and large fiscal transfers) prevent the development of less-developed regions within large countries. Harmonization, however, does not imply homogeneity. Minimal standards specified in terms of local wages and price levels would prevent cross-border tensions and, since this is in the interest of richer members of the integrated economic area as much as in that of poorer members, might well be cofinanced by supranational funds.

Comprehensiveness and coherence

Europe's policy landscape is not everywhere as stagnant as in some of the larger member countries. Reforms of pension and unemployment benefit schemes, prodded by status-quo unsustainability, are often directed towards the actuarially fair configuration that, as mentioned, can be consistent with efficient systems competition. Labor market performance success stories do exist, ranging from the Netherlands' early experiences, to Ireland's and Finland's more recent booms. In all cases, and even more clearly in Mrs Thatcher's UK reforms, a crucial feature of successful reform processes was their comprehensiveness, ranging from labor market to financial and product market aspects. Many success stories took place in relatively small countries, where a comprehensive approach is easier to design and implement. Progress is lacking in larger countries, and at the European Union level. The draft constitution envisioned qualified majority voting on a number of shared-competence social and labor market policy aspects, where European framework laws may establish minimum requirements. While the relevant provisions have not survived intergovernmental negotiations, one may hope that better arrangements among a subset of more closely integrated countries may emerge if the current draft fails to be ratified, despite its weak contents, in some or all of the countries opposing coordination of the relevant policies.

Progress is difficult, but necessary. In order to let economic interactions at both the level of regions and of the whole European Union achieve the desired balance of competitive efficiency and individual welfare protection, all reforms, and not just labor market reforms, will need to be undertaken on a suitably comprehensive and coherent basis. Of course economic integration (free mobility of goods and factors), effective social protection, and policy decisions at the local level are an inconsistent trio, just like independent macroeconomic policies, fixed exchange rates, and capital mobility before Economic and Monetary Union: pursuing two of the three necessarily implies forsaking the third (Bertola, 2004). Forsaking integration, however, would be tantamount to forsaking economic progress. In a reality that sees large nations unable to cope with their own regions' economic heterogeneity, and all European policymakers concerned with possible cross-border spillover effects of local welfare policies, it is both theoretically and empirically difficult to see why national competence on labor market and social policies should be preserved by limits to personal mobility and other channels of economic integration.

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Georg Milbradt
Minister-President of the Free State of Saxony

Ladies and gentlemen,

I come from Saxony, the German state with the longest border with the new EU countries, 454 kms with the Czech Republic, 112 kms with Poland. For us in Saxony, enlargement is a chance, a chance for more jobs and more growth. But not for everybody and not in the short run. The chance for growth and, above all, new jobs is combined with a major challenge, as Germany, in particular, will not be able to avoid fundamental reforms in the existing employment and social security systems. Developments in many Western European countries have shown that growth is a necessary but not sufficient condition for the creation of new jobs. Official unemployment rates in the 25 EU states vary between just under 3 percent in the Netherlands and in Luxembourg and nearly 20 percent in Poland. Those Member States that have largely deregulated their labour markets in the past, like the Netherlands and the UK, have significantly lower unemployment rates than others. The new Europe is not a homogenous area, much less homogenous than the United States. Lack of homogeneity is no problem if there is enough flexibility. But here lies the problem. Continuing structural unemployment can be attributed, above all, to an inefficiently functioning labour market. We have experienced this in particular in east Germany where, in the past few years, unemployment has remained above 18 percent despite a large amount of public funds received from western Germany and the EU.

We are, for example, putting strain on the job markets with our high level of social security benefits that is unparalleled in any other country. In early 1990, we in Germany failed to realise that in order to conduct the process of transformation that would have an impact on employment levels, it is not enough to promote investment to stimulate growth. In east Germany, this policy has led to a situation where large parts of the manufacturing industry are now highly productive but very capital intensive, owing to the high labour costs and capital subsidies. In other sectors of the economy, productivity is lower and average labour costs too high to be competitive. One of the biggest mistakes in unification was to transfer western institutional structures one-to–one to the east, structures that were already outdated in highly developed west Germany.

I believe that after EU enlargement we may have the same problems on the European level. In Germany we pay people for not working rather than for working. We grant ourselves the luxury of giving away benefits instead of wages, benefits that in effect amount to a minimum wage. These are wages that weaker east German companies cannot pay. In east Germany we need more flexible arrangements in order to stay competitive, especially in view of EU eastern enlargement and the flexibility existing in the accession states. To a large extent, companies expand not into east Germany but into Eastern Europe. A good example of this is the Porsche Cayenne, the final assembly of which is done in Leipzig, Saxony, whereas most of the value added process takes place in Bratislava, where labour costs are 20 percent of those in Saxony. The fact that the final stages of production take place in Leipzig has to do with marketing, not with costs. They do not account for much value added, however, and provide little employment in Saxony. Because the problem is not confined to the Porsche Cayenne alone, we need other solutions, especially in the low-wage sector that will enable us to withstand the foreseeable competition as regards labour costs.

I do not believe that there will be a general lowering of wages, except for longer weekly working hours at the same wages, but there will have to be a greater variation in pay rates, particularly for jobs requiring low qualifications. I do not fear migration of workers, but I fear migration of jobs. Let me clarify this by offering you a few figures. Under the present system, a married man on social welfare with two children receives benefits equivalent to a gross income of €10 per hour. Under these circumstances it would not make economic sense for people with low qualifications to take on a job that provides a lower rate of pay than this. Over 40 percent of the unemployed in Saxony are already long-term unemployed, most of whom no longer have adequate job qualifications. We must find solutions to this dilemma.

Experience in eastern Germany has shown that what we normally do under the label of labour market policy, namely conducting job creation schemes in the so-called second labour market, has proved ineffective in bringing the unemployed back into regular work. Such schemes can actually only be described as parts of social welfare policy. Saxony is prepared to take a different approach. Based on the Ifo model of activating social assistance, we propose to subsidise work in the low-wage sector, so that someone who accepts a job at low pay compared to his value added can receive a higher income than he would from social security benefits. In general, we want to try our own solutions in Saxony, because our problems are different from those in western Germany. But I am not only an economist but also a politician, and I know that carrying out reforms, even if only as model schemes, is bound to meet with resistance. Interest groups insist on perpetuating rigid labour markets because they offer individual advantages. There is wide-spread scepticism and fear regarding the effect of the price mechanism on the labour market, especially on the part of those who have jobs. The public, especially in eastern Germany, believes in the state and in regulation more than in the market and its forces. In addition, the public primarily notices the direct effects of reforms like the removal of protection against dismissal or the reduction of benefits rather than the indirect medium-term effects of higher employment. So I am well aware of the fact that it will be difficult to put into practice what, from the point of view of an economist, is the right thing to do.

What we need is a reorganisation of the welfare state. We cannot abolish it. We have to put our emphasis more on the allocation side, on productivity, flexibility, research, technological and scientific progress, than on distribution.

If we alter our policy and accept the challenges, we can gain from the situation we are in. What we need is a real discussion of the future; we must compare a future with reforms with a future without reforms rather than comparing the future with the present or even the past.

Thank you very much.

André Leysen,
Honorary Chairman of the Board of Directors,
Agfa-Gevaert NV and Gevaert NV, Mortsel

Ladies and gentlemen,

For someone born in Flanders in the late nineteen-twenties, someone who vividly remembers the Second World War, the peaceful unification of Europe is the fulfilment of a dream. One feels that one's family has escaped from the curse of living in a region that has been border territory since the Treaty of Verdun in 843. How right Arnold Toynbee was when he wrote: „Flanders was the battlefield of Europe for over 250 years, before Europe itself became the battlefield of the world". The peaceful unification of Europe is my generation's mission. It is the reason I am here. And if it poses any problems they must be dealt with, however difficult they may be. It is an extraordinary feeling to have seen the last attempt to unify Europe by force give way to a Europe unified in peace.

Having been a member of the Chairman's Committee of the *Treuhandanstalt* for four years, where we were confronted with similar problems when the country was unified, I have acquired some experience in these matters. However, I think that the German case was much more difficult, as there was suddenly no frontier left between the two hermetically closed parts of the German state. As there was no language barrier either, it was feared that the whole of eastern Germany would go west for work, which would have been a disaster. Fortunately, west Germany was strong and rich enough to finance all kinds of schemes to induce the people to stay where their „*Heimat*" was. This aim has been more or less achieved, but it was much more costly than foreseen. The bill for reunification stands in direct relation to the time available for solving the problems.

In the case of Germany there was no time really, but this is not so with enlargement. As far as Europe is concerned

- there are still national frontiers,
- there are language barriers,
- and transitional measures have been agreed between the different countries, which should make it possible to control the flow of migrants.

Public opinion tends to underestimate or completely neglect the advantages that migration can bring – both for the migrants and for us.

Western European countries are rapidly becoming labour-scarce economies. They are confronted with the problems associated with aging populations, a diminishing labour force and, ultimately, population decline. Without an annual influx of at least 230,000 people per annum, Germany's population of 83 million will shrink to 51 million in 2050 and 24 million in 2100, according to the Berlin Institute for World Population and Global Development. And despite an unemployment rate of more than ten per-cent, many jobs are presently unfilled because of a shortage of skilled workers.

The first conclusion one might draw is that what may cause a problem in a transitory period, may become an opportunity in the future. I am convinced of this, although many Europeans, with their inborn pessimism, see it as an insurmountable problem.

We need to organise the influx in such a way that it does not cause undue disruption to existing structures but nevertheless leads to reform. The authorities of the European Union have to act like sluice-keepers who are confronted with greatly varying water levels. They have to open the sluice gates in such a way that they don't create a destructive flood, but allow enough water in to drench a thirsty countryside.

I know there are many arguments that can be presented against this, but we have no choice. This is an historical moment.

Thank you.

GIAMPAOLO GALLI
Director General, National Association of Italian Insurance Companies (ANIA), Rome

I want to draw on the experience I gathered in my previous position as Chief Economist of Findustria to give some thoughts on the politics of labour market reforms and dealing with the trade unions. Reforming the labour market and the welfare system is necessary, but it is tremendously difficult. In Italy, our problem is somewhat different from the key problem in Germany, where you have big benefits. In Italy, the main problem, more serious than in Germany, is the rigidity of labour markets which to a large extent means rules about firing. We have had two years of very long and very intense social conflicts over the issue of flexibility, and overall, we have been able to obtain relatively modest results.

Why is it so difficult to get a consensus on labour market reforms? Of course, the standard answer is that trade unions defend their co-workers who benefit from protection. That may be the main part of the story, but I think there are other important reasons and I want to list four:

1. The basic argument, that flexibility is good for employment, is intrinsically a very complex argument which is almost impossible to explain to the voters. Maybe people can understand that flexibility helps growth because it helps adapting to shocks, etc. But why employment? People will tell you that if you make it easier to fire, first you will fire and then maybe you will hire someone else. At best this is a zero-sum game in the long run. You hurt real voters in the short run and you benefit hypothetical voters in the long run. That is a lose-lose proposition. The true story is that if you have more growth and a higher GDP over time, you have a better trade-off between wages and employment. You can either afford higher wages at given employment or higher employment at given wages or a combination of the two. This is very difficult and there has been a lot of confusion, even in the economic profession, about this.
2. People in most European countries already experience a lot of flexibility in the so-called marginal labour market, in the grey market or the market with short-term contracts of various sorts. So you have to explain the link between excessive rigidity in the core market and excessive flexibility in the marginal market. If core workers are overprotected, markets will find their way around it. We have a paradox here, a paradox that exists all over Europe. People think that the flexibility we have in the marginal market is due to the reforms, because every government claims to have made reforms to make labour markets more flexible. And people think that due to these reforms you see all these young people with precarious jobs. But in fact they have precarious jobs precisely because the reforms have not been made. But people say: enough is enough.
3. Unemployment does not seem to cause much social unhappiness. This is true not only in countries with very high benefit levels, which is very easy to understand, but also in countries like Italy and Greece where unemployment benefits are rather low. Perhaps, more people work in the grey market there. Of course, there is a lot of unhappiness in all our countries about high taxes, poor social services, etc. but nobody seems to see the link between poor social services and high taxes on the one hand and low growth and low employment on the other. The big difference between the United States and Europe is that in the United States more people work and people work more compared to Europe. And it is even more difficult to link the symptoms of social unhappiness to labour market rigidity.
4. The most fundamental reason is that, at least in my perception, there is a growing demand for protection and welfare all over Europe. The articles of the European constitution, which Hans-Werner Sinn cited this morning, show this clearly. You should not think that the fact that the constitution writes down the things about rights to protection and to welfare is a mistake. This is Europe! In ECOFIN meetings and meetings of

the finance ministers they always talk about more flexibility and lower welfare. They talk. But ministers of labour and social affairs and the European Parliament take decisions that go in the opposite direction. Look at legislation on working time, on mobbing, on consultational workers, etc. And there is also, as George de Ménil has said, an important role for the courts. I bet that ten years from now we will not have a lighter welfare state and that, as far as the rules on labour are concerned, we may well have a heavier welfare state.

My conclusions: (1) I think it is important to try to carry out the necessary structural reforms. But if you want to do it, be aware that your arguments sound weak to the voters. They are very strong scientifically, but they sound weak to the voters. (2) Unless you are sure you can play Mrs. Thatcher, try to keep the unions involved in the process. Explain to them that they have a role to play in the reforms. (3) Be ready to pay. You must give something in exchange, like more money for some social welfare programme. (4) Invent something that is unpleasant for big business. (5) Do not blame it on the IMF or on Brussels. That is counterproductive. You must do the things that are good for your country, not for someone else. (6) Good luck!

Hans-Werner Sinn
President, Ifo Institute for Economic Research and CESifo

Closing remarks

Ladies and gentlemen,

Let me first express my gratitude to all participants of this year's Munich Economic Summit. It was a great conference with stimulating debates, even fascinating ones at times. This is what we had hoped, we being the BMW Foundation Herbert Quandt and CESifo. I am most grateful for the good co-operation of the Foundation. We are looking forward to more such conferences in the future.

It is very difficult to draw conclusions from the discussion, because opinions were so diverse. Just take the last panel. David Wildasin and I believe that the welfare state will erode and Giampaolo Galli thinks that the welfare state will grow during the next ten years. Georg Milbradt said we need jobs, not immigrants, and just an hour earlier, Jürgen Strube had said that we have 3 million unfilled jobs and need immigrants to fill them. These are interesting opinions and we will see who is right.

To some extent, the different answers result from different assumptions as to the segment of the labour market we focus on. It is true that there are parts of the labour market where we need immigration of high-skilled people. On the other hand, at the lower end of the qualification ladder the market does not function because wages are not flexible. There immigration would definitely be immigration into unemployment.

But we do agree at least on some things: If wages are flexible, immigration of working people is good. And we also agree that welfare migration of people, who are simply driven by the gifts they receive, is bad. The problem is that in reality we always have a mixture of the two and cannot know who comes for what motive.

The big theme of these days is the EU constitution. As I said at the beginning of the conference, I love the European idea and I believe we need a constitution. In the end we also need a United States of Europe. But I am doubtful whether I should support this particular constitution. In all likelihood, this constitution will not come into being in the first ratification round because the British referendum is sure to fail. In two years' time we may meet here again and discuss the constitution. I hope that today's discussions will be useful for adopting the necessary revisions.

The assessment of the constitution reminds me of a joke John Major told us here two years ago. He had asked Yeltsin about the Russian economy and to express his opinion in one word. Yeltsin answered “good”. When he asked him to voice his opinion in two words, Yeltsin answered “not good”. I feel the same about this constitution.

In closing, I would like to thank everyone who helped to make this conference possible, in particular Kai Schellhorn from the BMW Foundation. And I want to thank the people who did the real work, Thomas Leeb, Ulrich Hange and Christian Kelders and all the others who worked in the background. They deserve a big hand of applause.

I want to conclude with an invitation to dinner at the Royal Residence, which will be hosted by the Bavarian Government represented by Minister Otto Wiesheu.

Thank you very much.

Dinner Speech by

Otto Wiesheu
Bavarian State Minister for Economic Affairs, Infrastructure, Transport and Technology

Excellencies,
ladies and gentlemen,

It is a pleasure to host this dinner tonight. The Munich Economic Summit, which now took place for the third time, has received huge media response, nationally and internationally. The reason for this success is that you, Prof. Sinn, have a knack for choosing and presenting timely and controversial topics that directly affect business and politics. You not only succeed in finding highly qualified speakers but also numerous highly interested representatives from business, politics and economics who enthusiastically participated and contributed to this conference. As I stated this morning, when such a conference takes places in Bavaria for the first time, it is an innovation. When it takes place more than twice, it is a tradition. And since this is the third time, the tradition has been firmly established. I am confident that we will continue to host the Munich Economic Summit in the future. This conference has already radiated far beyond the borders of Bavaria, Germany and even Europe.

In choosing the location for this dinner, we of course looked for the most suitable venue. The Emperor's Hall of the Royal Residence was the logical choice. You will probably ask why Bavaria has an emperor's hall when it never had an emperor. Well, Bavaria has always been so generous that it built spacious rooms to host the German emperor on his visits to Bavaria. These rooms were built for famous guests, for the highest excellencies, for the most important national and international representatives. Therefore we believed this to be the ideal venue for this conference dinner. And in these rooms it is my privilege to extend to you a very warm welcome.

The Munich Economic Summit is an event that radiates way beyond Bavaria and Germany. I therefore would like to thank you, Prof. Sinn, for your efforts in organising this conference, and I would like to thank Mr. Schellhorn of the BMW Foundation Herbert Quandt for helping to make this conference possible. I thank both of you for staging this conference in Munich and for having made it a tradition.

This was a day of interesting presentations and fruitful discussions; it was a day that in my view was very rewarding for everyone and was especially interesting for political decision makers, as these topics will affect our future. I do not tell you anything new and I do not want to repeat today's discussions, which I was able to attend in part, but it is true beyond any doubt that European unification, EU eastern enlargement, intensified EU and international competition necessitate adjustment here and certain corrections, and that on the other hand timely corrections of certain regulations and conditions also mean that the process will yield chances, and this is what counts. It has always been our policy not only to analyse the problems but also to see the chances and seize the opportunities for future developments. That has been the economic policy in Bavaria, under all my predecessors as well. We have always recognised that change is a permanent law of economics, that the idea to be able to prevent change has always been wrong, that money that was spent to slow down change was misspent and that money invested in new opportunities, in new businesses, in new technology, in new developments has always earned high returns. That is the reason why Bavaria has been the only state in Germany that turned from a recipient of fiscal equalisation funds into a payer and that has long repaid everything it received with compound interest. That is also the reason why we had an increase in businesses and jobs in past years and that is also why we are offensively seizing the opportunities provided by eastern enlargement without hiding the difficulties and adjustment costs. It is important to recognise the opportunities and to make the optimism, which must also be present, borne out. In short: In Bavaria progress has tradition. That is the reason why in Bavaria there has been so much investment in new businesses, in new technologies, in research and development, in higher education, in all those areas that create new opportunities.

It is important that we offer solutions. This entails many decisions that are painful. This presently concerns the finance minister in particular, who has to balance the state budget. These are processes that are not easy, although Bavaria is the state with the lowest indebtedness in Germany. But we also know that in view of the demographics this problem cannot be addressed too early and that failing to do so will only make the problems bigger in the future. We also know that all the questions, including those discussed at today's conference, must be addressed early on and to see to it – and that is forward looking policy – that problems do not get out of hand. One must recognise them early and countermand them early.

It is also the task of a forward looking policy to decide on the course to take. That is what we in Bavaria have considered our responsibility, and though mistakes were made, we have still succeeded in keeping the state on a course that brings and sees new chances and seizes opportunities and solves problems early on. This is the course on which we want to continue.

I would like to tell you, Prof. Sinn, that the conferences you have organised, including today's conference, have been mile stones. The analyses presented have occupied us policy makers in a lasting way. Half a year ago, Prof. Sinn introduced us to his new book, "Can Germany Still Be Saved?" and the difficult decisions described there. I confess that I agree with most things described there.

We are well advised to take decisions early rather than too late when problems have become too difficult. That would be the wrong course. That is why we are grateful for conferences like today's Summit that are not only seminal but also a warning. But the warnings must be accompanied by the optimism that good decisions can change things for the better. This is also important for the people, because they will turn away if they are only presented with problems. One must not only describe the problems but also the solutions and the opportunities they entail for the future. In this way one will meet with agreement and acceptance and will be able to bring the people on board. It has always been the case with policy decisions, as everyone has experienced, that correct policy decisions are disputed at the time they are taken, but are confirmed in the medium term. That is why one must keep a cool head these days and must not orientate oneself on public applause, but on the correctness of the analyses.

The conference has made a contribution to this, and on behalf of the Bavarian government I want to thank you, Prof. Sinn and Mr. Schellhorn, and all the participants in this year's Munich Economic Summit.

VÁCLAV KLAUS
President of the Czech Republic*

Implications of this year's EU enlargement: A preliminary analysis

In recent weeks we could hear and read hundreds of comments on the historical significance of the enlargement of the European Union by ten new, mostly former communist countries of Central and East Europe. We could hear many words, but I fear hardly any serious, well founded analyses. It was the a priori position of almost all speakers that it was a clearly positive and productive change for all concerned. Any indication to think about this statement, any indication of criticism, question mark or comments regarding the costs involved in enlargement were considered short-sighted or ill-intentioned.

Appearing here today, and I must emphasise that it is not a political declaration of the president of one of the new Member States, but the academic appearance of a president in an academic environment, I can neither present an in-depth scientific analysis of the effects of this year's EU enlargement nor an empirical analysis. This remains a long-term task for other people, even though it will not be an easy task for them either for lack of a simple scientific methodology and tested instruments. Today, I would like to make at least an effort at an elementary structuring of the problem, based on the difference of the effects of enlargement on the new Member States, on the old Member States, and on the EU as a whole, as an institution.

Effects of formal membership on the new Member States

At the moment of accession – whether accession with many exceptions and restrictions (that are of advantage to the existing members) – the new Member States gain certain, for them very important, political recognition, For them it is a formal confirmation of the level of their present political, economic and general civil maturity achieved, a confirmation of their present state of development and their stability. Through EU membership they are again counted among the normal European countries after half a century of abnormality, after half a century under communism. This recognition is very important for these countries and their citizens. That is also the major benefit derived from EU membership, although not everyone knows that there is such a benefit that is rather symbolic and without concrete effects. These countries have striven for this recognition for fifteen years. In a certain sense their EU membership is for them – and for the entire rest of the world – a signal that the era of post-communist transformation has definitely come to an end and that they are countries that are institutionally comparable with the other countries of Western Europe, i.e. with countries that had the fortune of not being objects of the communist experiment.

I don't see any other indirect (or direct) effects. There is frequently mention of the effect of the opening, of the effect of the liberalisation of the movement of people, goods, capital and ideas. However, the extent of the opening of these countries vis-à-vis the EU countries and vice versa, the opening of the EU countries vis-à-vis these countries, did not change on May 1st, 2004. Effects derived from the mutual intensive relationships, have already grown stepwise since the fall of the Berlin Wall, since the barbed wires of the Iron Curtain were cut in November 1989, and these effects had already been "consumed" a long time before May 1st, 2004. The residual effect of formal membership will be relatively small from the point of view of these countries and their individual subjects.

Equally marginal will be the direct financial effect, especially for the more developed countries among the new members. Everything points to the fact that the Czech Republic will become a net payer, but not a net recipient of EU funds in the near future, which is quite different from the state of EU accession of such countries like Greece, Ireland, Spain or Portugal. That is why it is incorrect to mention these countries as examples. Many citizens of the new

* Presentation at the Annual Meeting of the Ifo Institute for Economic Research, University of Munich, June 22, 2004.

Member States did, however, believe the experiences of these, at the time less developed, countries and expect the same. But this will not happen.

I also do not see an important effect in the fact that the new Member States will obtain the possibility of influencing decision processes within the EU. They are ill prepared for this (and will remain in the role of "junior members" for a long time), they are small countries and their effective participation in decisions is in fact made impossible by the big brake exerted by the democratic deficit of the EU and the present extent of bureaucracy in the EU.

The new Member States already accepted EU legislation, the so-called Acquis Communitaire, during the time before EU accession and thereby also accepted the European (and originally German) model of a corporatist state, the model of a social market economy that is unambiguously connected with the low competitiveness of the firms, with the rigidity of the entire economy, with high unemployment and low economic growth. This will not lead these countries, whose level of development is lower than the European average, to real economic convergence. There is even the risk that, quite to the contrary, nominal convergence (the assumption of the EU legislative) will become the brake on real convergence. It should not be necessary to stress this in a country that experienced unification, in which the effects of unification (or rapid nominal convergence) are well known. It is necessary, however, to say that, in this sense, May 1st, 2004 did not usher in fundamental change, as EU legislation had already been accepted by the countries several years ago, or that, respectively, their acceptance was a prerequisite, not a consequence of accession.

This sketch of positive, neutral or negative effects is certainly neither complete nor sufficiently founded empirically, but it is my opinion that it may present an inspiration and guide for deeper analyses. I must emphasise that they are based on the experience of an active participant in the era before accession. It is by no means the view of an independent observer.

Effects of EU enlargement on the old Member States

Even if the effects of the asymmetric liberalisation and of the guileless opening of the new Member States vis-à-vis the more developed, older Member States was unambiguously of advantage for the old Member States before accession, I must state clearly that formal membership of the new states does not imply a true advantage for the old Member States. Even if during the entire era before enlargement, the benefits derived from the contacts with these countries exceeded the costs of the old Member States spent on them, after formal membership of the new states, the cost-benefit ratio will worsen.

The old Member States know this and therefore they were in no hurry to agree to EU enlargement. I cannot blame them for this position, as I respect authentic human interests. It is not surprising either that the Brussels bureaucracy pushed enlargement much more than the old Member States (a bureaucracy is always interested in increasing its scope of action). I repeat, from the point of view of the old Member States I consider this rational and therefore there is no reason to deny it. In view of the unwarranted but often repeated identification of the EU with Europe, the old member countries could no longer maintain the exclusive nature of the EU club. That is why enlargement happened – without consideration of the actual interests of these countries.

Analytically it is very difficult to separate the effects of the very close relationships of the old and the new Member States, which existed for more than a decade, from the new effects that will come into being following enlargement. Competition for EU funds will certainly intensify. There will also be an increase – though less than expected – of the migration of workers (and also students) to the richer countries, only few more cautious west Europeans "dare" go to the new Member States, coming as tourists, as businessmen, as investors for the first time. I am sure that cultural exchange will increase, but these phenomena are difficult to quantify. That is why I don't dare a quantitative estimate of these effects. But there should also be no cheap propaganda in the other direction.

In summary, I can say that the direct effect of this year's enlargement on the old Member States will not be large and only difficult to quantify.

Effects of EU enlargement on the EU

The increase in the number of members from 15 to 25 implies an enlargement of the EU as an institution. By stressing the word institution, I want to express that this is not just a significant increase in the size of the single market, as this already happened a long time before the moment of the formal enlargement. At the same time it is also true that the low mobility of labour, the rigidity of business relations and the administrative complications so typical for the EU did not end or change on May 1st, 2004. Therefore the quality of the single market did not change either.

The strength of the EU does also not change significantly, but this year's enlargement causes an increase in the illusions of those who have a block view, a continental view of the world, that is of those who assume that a Europe that is larger and more compact will have a bigger chance of standing up to the hegemony of the United States and the big ambitions of Asia. This block view of the world, which emerged so clearly in the draft of the EU constitution, is a fatal error. Europe is only a conglomeration of countries (and will hopefully remain so) and there is by no means an authentic European "people". There is also no proof that "big is beautiful". The so-called competitiveness of Europe is also nothing but a statistical artefact, as only firms can be competitive. There is no such thing as the competitiveness of a continent. A continent (not even the EU) is not an economic subject, it does not produce, trade, innovate, invest, save, rationalise production or lower costs. This way of looking at things, so widespread in politics and the media, stands in sharp contrast not only to the political, economic and demographic realities of present Europe, but also to the dominant globalisation trends.

EU enlargement to 25 members does significantly affect the decision processes in the EU. There will be an increase in transaction costs for the functioning of this institution, as ten countries are added to the existing mechanism without any change therein (corresponding to a 40 percent increase). This is a well known price of enlargement, but its size cannot be easily quantified. That is why it is rarely understood or seriously discussed. The volume of policies, of activities and interventions in the EU does not decline (acceptance of the constitution in its present form would rather increase it radically) and that has the consequence of non-zero costs, given the increase in the number of participating subjects. This is true of any centralised and hierarchically organised system. It is a law that cannot be entirely circumvented.

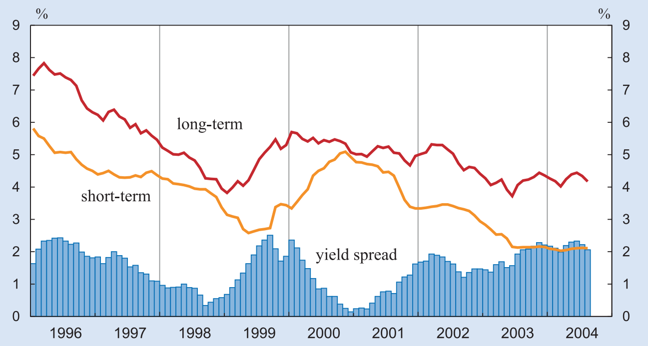
There is, however, a method to lower these transaction costs (or to slow their increase). It consists of an increase of the democratic deficit in decision-making, a reduction of the extent of democratic procedures, an increase of the role of the inner core of the Union, an increase in the number of areas in which majority voting within the EU is allowed. Without any doubt, it also includes an increase in the anonymity of decisions, a further increase in the distance of the citizens from the EU centre, a further depersonalisation of the EU. In any case, these are the negative effects of the last EU enlargement. Unfortunately they cannot be changed by well intentioned politicians and civil servants.

In order to be understood correctly I am repeating the argument. There are three variables – the number of member countries, the volume of EU policies and the mechanism of decision-making. These are not and cannot be compatible, only a trade-off. The increase in one variable (number of member countries), given an unchanged second variable (EU activities), necessarily has effects on the third variable (decision-making mechanism). I must insist that expressing this trivial conclusion is not euro-scepticism but logical thinking. And to do so is our duty.

With this I am drawing to a close. Formal EU enlargement is no radical change. But it can be the starting point for a strengthening of the processes that occurred in varying intensity during the past decade. Some of these were positive, some were negative. That will continue. The principal problem lies somewhere else. It lies in the necessary change of the basic model of the European social order. A year ago Europe was divided into new and old. I do not consider this a useful and fair division. But we ought to make use of the term "New Europe". This term should be given a different meaning – the meaning of a Europe of economic freedom, a Europe of a small and not expanding state, a Europe without state paternalism, a Europe without pseudo-moralising political correctness, a Europe without intellectual snobbism and elitism, a Europe without supernational, continental ambitions, a Europe without an ideology of Europeanism. If somebody were to call (or characterise) such a Europe on the other side of the ocean the "New Europe", that would be so much for the better. Unfortunately I must stress that the last EU enlargement by ten states does not and will not have such an implication.

Financial Conditions in the Euro Area

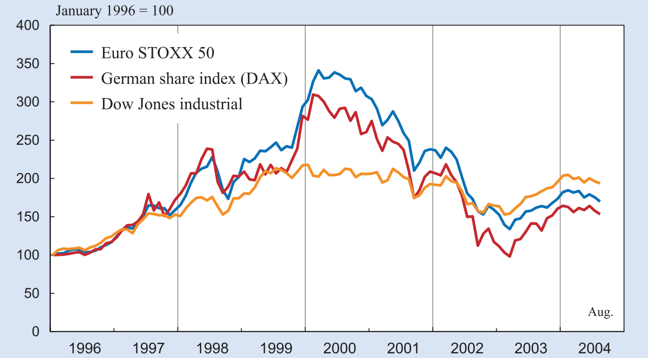
Nominal Interest Rates [a)]



a) Weighted averages (GDP weights).
Sources: European Central Bank.

Short-term interest rates have remained largely unchanged in past months, staying at a level in accordance with the minimum refinancing rate of 2% of the euro system. Parallel to US yields, long-term rates (yields on ten-year government bonds) in the euro area declined during the past three months, averaging 4.17% in August. The yield spread thus narrowed to 2.06%.

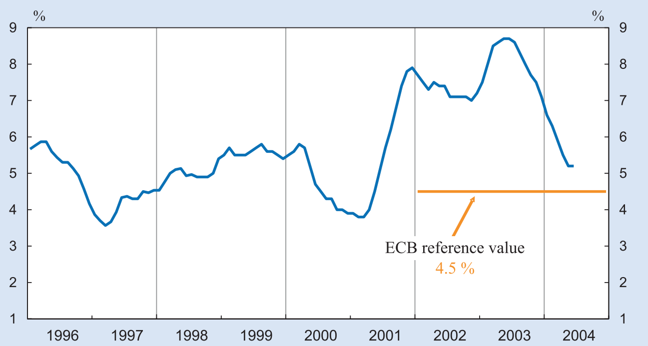
Stock Market Indices



Source: Deutsche Bundesbank, Dow Jones & Co., Inc.

After their peaks at the beginning of 2004, the stock markets in Germany, Europe and the United States have lost steam again. The DAX breached the 4,000 mark in June, but has not been able to reach this level again. Greater optimism about GDP growth in Europe has been offset by anxiety about rising interest rates in the United States.

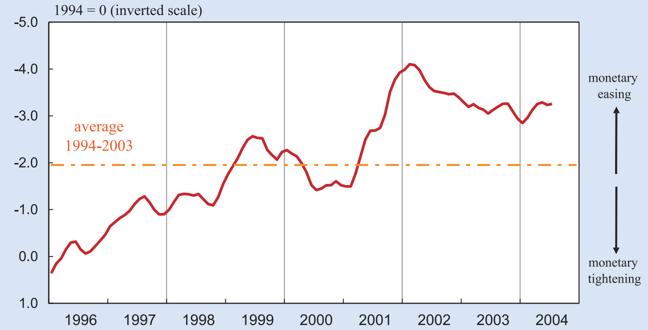
Change in M3 [a)]



a) Annual percentage change (3-month moving average).
Sources: European Central Bank.

The annual rate of growth of M3 increased marginally from 5.4% in June 2004 to 5.5% in July 2004, the latest month for which data are available. After the marked decline of monetary growth since mid-2003, the short-term dynamics of M3 has increased again. However, the three-month moving average of the annual growth rates of M3 over the period May 2004 to July 2004 stood at 5.2%, unchanged from the previous period.

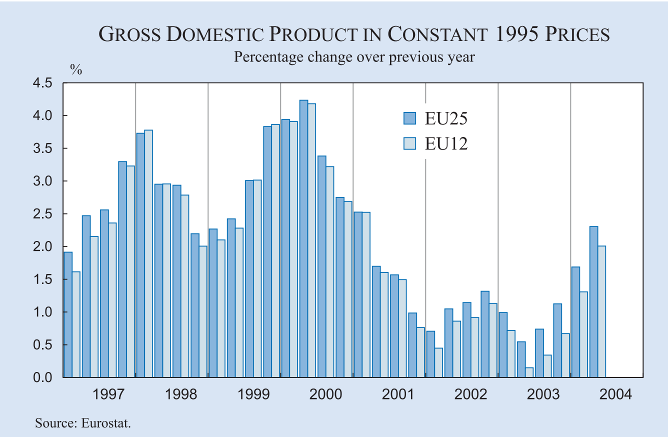
Monetary Conditions Index



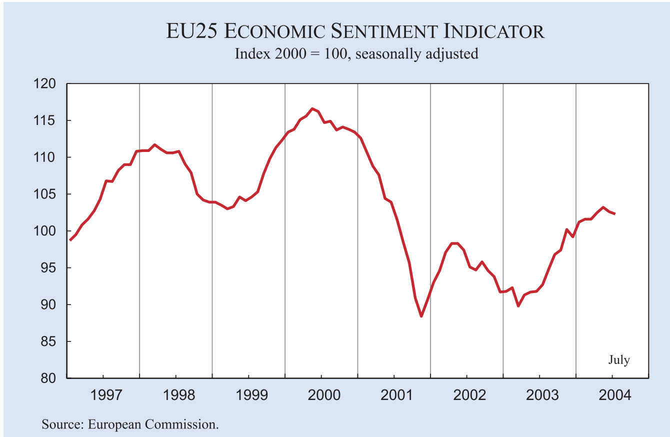
Note: MCI index is calculated as a (smoothed) weighted average of real short-term interest rates (nominal rate minus core inflation rate HCPI) and the real effective exchange rate of the euro.
Sources: European Central Bank, calculations by the Ifo Institute.

The monetary conditions index of the euro area has remained largely unchanged during the past four months, reflecting the steady monetary policy of the European Central Bank.

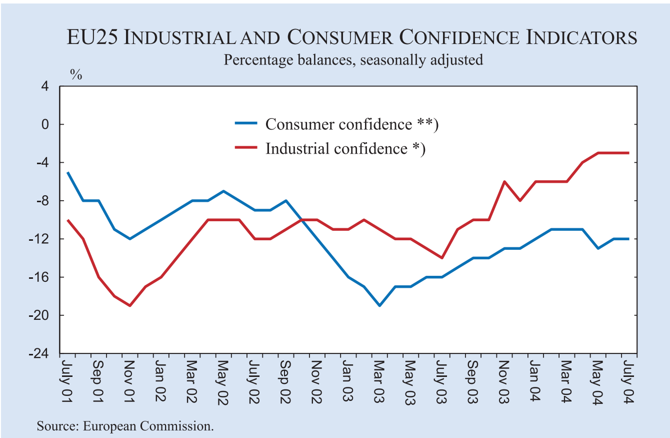
EU Survey Results



EU25 GDP rose by 0.6%, euro-zone GDP rose by 0.5% in the second quarter of 2004, compared to the previous quarter. In the first quarter of 2004, growth rates were 0.7% for EU25 and 0.6% for the euro-zone. Year-on year growth amounted to 2.3% in the EU25 and 2% in the euro-zone, after 1.7% and 1.3%, respectively in the previous quarter. Exports and government expenditures were the major factors in both groups of countries.

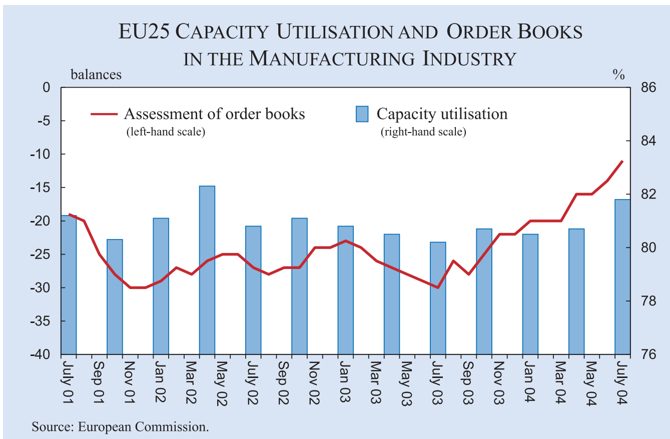


Following a small upturn in May and an equally small decline in June, economic sentiment in the EU experienced another small setback to 102.3 in July, the latest month for which data have been published. In Belgium, Ireland and Italy the indicator rose markedly, whereas in Greece, Estonia, Hungary, Poland and the UK it registered a significant drop.



* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).
** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

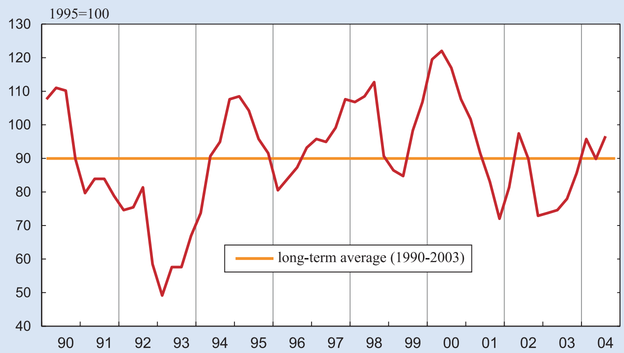
Industrial confidence remained unchanged in July at a level of – 3. Consumer confidence also remained unchanged from June at – 12. Consumer opinion has shown a very static picture for the last 12 months. This is also true at country level.



The assessment of order books saw a significant improvement in July. This improvement since summer 2003 has been the major factor behind the rise in overall industrial confidence. In the third quarter, excess production capacity declined to a value that is, for the first time in three years, below the long-term average. Capacity utilisation saw a clear rise in the third quarter to 81.8, compared to 80.7 in the second quarter and is now either close to or above its long-term average in the majority of Member Countries.

Euro Area Indicators

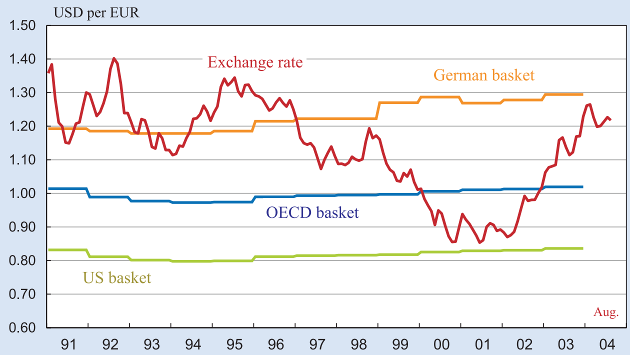
Ifo Economic Climate for the Euro Area



Source: Ifo World Economic Survey (WES) QIII/2004.

The latest survey of the euro-area countries showed a resurgence of the Economic Climate indicator in the July survey, due to markedly higher assessments of the current situation and continued optimism regarding the next six months. In Ireland, Spain and Finland present economic activity continued to be assessed very positively. In the Netherlands, Portugal, Germany and Italy assessments of the present situation improved compared to the April survey, but remained below the euro-area average. In all countries expectations continued to be very positive.

Exchange Rate of the Euro and PPPs

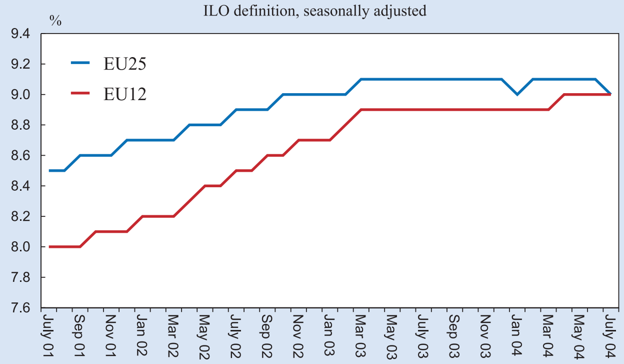


Sources: European Central Bank, Federal Statistical Office, OECD and calculations by the Ifo Institute.

The nominal exchange rate of the euro has been hovering around $1.22 for the past two months, thus moving away from the PPPs based on the German market basket.

Unemployment Rate

ILO definition, seasonally adjusted

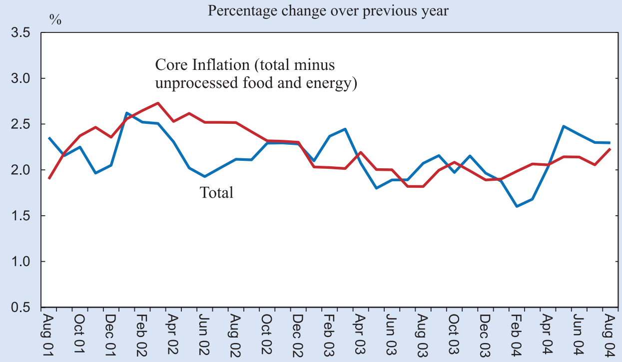


Source: Eurostat.

The latest Eurostat data for July show that euro-area unemployment has remained stable at 9.0%, seasonally adjusted, barely higher than a year ago (8.9%). The lowest rates were registered in Austria (4.2%), Luxembourg (4.3%), and Ireland (4.5%). They were highest in Spain (11%), Germany (9.9%) and France (9.5%). The Netherlands recorded the most important increase over a year ago (3.8% to 4.8%).

Inflation Rate (HICP)

Percentage change over previous year



Source: Eurostat.

The rise in consumer prices (HICP) in the euro area remained unchanged in August from July (2.3% on the previous year). It had peaked in May at 2.5%. Core inflation (adjusted for food and energy prices) rose slightly to 2.2% over a year ago.

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CESifo World Economic Survey

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World Economic Climate

World Economic Climate remains favourable

Economic Expectations

Current economic situation above satisfactory, economic expectations have weakened slightly

Inflation

Inflation expected to pick up somewhat

Interest Rates

More WES experts expect rising interest rates

Currencies

Euro still overvalued

Special Topic

WES experts divided concerning the impact of globalization on economic welfare

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