The Employment Principle in the EU

Pro: Before Proposing to Phase it out, we Should Try to Enforce it

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The Scientific Council of the German Ministry of Finance has recently proposed to replace the Employment Principle (EP) with a Delayed Integration Principle (DIP) in the assignment of individuals to jurisdicions in terms of taxation, social insurance and social assistance in Europe. This proposal is intellectually appealing, but has a major flaw: it does not take into account that the EP is not yet enforced and that the DIP will be even harder to implement than the EP.

EU rules concerning access to welfare to EU citizens changing country of residence (within the EU) are inspired by the principle of *Equal Treatment* (stated by art 51 of the EC Treaty), which bans differential access to welfare by natives and EU foreigners. In presence of significant differences in the generosity of welfare systems across Europe, the implementation of this principle is problematic, if not altogether impossible. Suppose, for instance that a worker having contributed to unemployment benefits for, say, 10 years and having consequently gained access to benefits for two years in case of job loss in country A moves to country B where unemployment benefits (replacing the same fraction of her earnings than in the country of origin) are offered for a person with the same contribution length only for six months at most. If the principle of equal treatment is interpreted as stating that the entire contribution record, the *stock* entitlement, of the individual should be evaluated according to the rules in the country of destination, one would treat citizens coming from A less favourably than citizens of B (who have always the option to move to country A gaining potential access to a longer maximum duration of benefits).

Alternatively one can interpret the equal treatment principle as stating that migrants should gain access to the welfare of the country of destination only on a flow, *pro rata*, basis. In other words, past contributions are rewarded as in country A (that should face any residual claim of the individual concerning that period of her life), while new contributions (and taxes) paid in country B yield the same rights as citizens of that country. This second, more restrictive, interpretation of the equal treatment principle reduces the incentives of migrants to exploit cross-country differences in the generosity of welfare systems. It also allows individuals to choose the welfare system, the combination of taxes and transfers, that they prefer. However, its enforcement is problematic. Difficulties arise for the defined benefit schemes, such as unemployment insurance and many occupational pension schemes. Even more serious problems arise for the non-insurance components of welfare systems, such as the unemployment assistance benefits offered to persons under long-term unemployment (the European plague) and social assistance, which is typically open-ended (in which case only the stock interpretation of the equal treatment principle is applicable). Needless to say, the same enforcement problems, if not more serious ones, apply to the DIP, which essentially amounts to postponing access to welfare for a given "transitional period", e.g., five years.

Due to these enforcement problems, the equal treatment principle is often applied only in its stock version. This means that a more favourable treatment is offered to individuals moving from countries with a less generous welfare system to a country with a more generous system, whose immobile workers have to bear the costs of a larger social security budget.

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A pragmatic way to cope with this problem is to restrict migration more than access to welfare. This means offering residence permits only to workers, individuals paying taxes and contributions in the country of destination. This is consistent with EU rules: the Treaty allows EU countries to deny residence permits to EU foreigners who cannot prove to be able to finance their living and/or to their families. This *Employment Principle*, advocated also by the OECD Model Convention for the taxation of labour income, has the appealing feature of increasing incentives to work. This is not a minor advantage in presence of employment rates which are currently too low to finance the ageing of the European population and Governments committed to raise employment to population ratios by roughly ten percentage points by 2010.

The actual enforcement of the EP requires reducing the costs which are still associated with migration of EU workers. In three crucial areas action is needed: i) co-ordination of regulations concerning pension funds (notably in terms of length of vesting periods, indexation rules and bilateral agreements as to the actuarial valuation of accrued benefits); ii) the phasing out of national restrictions in the allocation of the pension fund portfolios, and iii) the adoption of common rules as to the taxation of private pensions, e.g., specifying that the tax base is represented only by benefits and lump-sum payments (rather than contributions and capital gains).

EU citizens move very little from country to country: less than half-a-percentage point of the European labour force changes region of residence within a year (compared with 2,5 per cent moving across states in the US). These are small numbers. The growing share of non-EU citizens residents in the EU is instead more mobile than the rest of the workforce. The Equal Treatment principle does not apply to non-EU citizens. Indeed the European Social Charter provides a preferential treatment to EU vs. non-EU citizens on many grounds. However, principles of “fair” treatment of non-EU nationals, considerations related to the integration of migrants, and political economy factors (the US experience is enlightening in this respect) prevent Governments from excluding altogether non-EU citizens from the access to benefits, forcing them to stay with the system of the country of origin (the so-called Origin Principle, OP).

Even if applicable to all migrants, the OP has undesirable features insofar as it discourages labour mobility in response to negative regional shocks. From a macro perspective, this blocks an important channel of labour market adjustment in presence of idiosyncratic shocks. From a microeconomic perspective, it prevents workers to insure against labour market risk by taking the advantage of the fact of being in a larger single market.

A main rationale for the OP is the desire to discourage “welfare shopping”. Is this a real danger? In the European countries with the most generous welfare systems in place, the non-EU population is receiving proportionally more cash transfers than the EU population. However, when account is made of personal characteristics of individuals (educational attainments, number of children in the family, etc.), the take-up of welfare by migrants is just in line, if not lower, than that of EU citizens. This means that also this problem can be prevented by adopting selective migration policies.

In a nutshell, neither the DIP nor the OP appear to be superior to the EP and are much harder to enforce. Before abandoning the EP, EU countries should try harder to enforce it and give to researchers the task of empirically assessing its effects on mobility, tax competition and "welfare shopping".