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NOTES AND COMMUNICATIONS

SOCIAL JUSTICE AND OPEN COORDINATION IN EUROPE. REFLECTIONS ON DRÈZE'S TINBERGEN LECTURE

Summary

In his Tinbergen lecture Jacques Drèze broaches two interesting themes. He argues, firstly, that we have failed to develop an efficient instrument for income insurance on behalf of potentially low-skilled workers; wage subsidies are such an instrument. Secondly, he argues that labour market integration in an economic union like the EU entails externalities, resulting in underprovision of insurance; coordination or matching grants could overcome that second inefficiency. I largely share Drèze's policy paradigm. Yet, I believe enhancing social justice in the European Union requires, at this stage of European cooperation, a different methodology of policy coordination, which has recently been coined 'open coordination.' I will develop my argument in favour of 'open coordination' with reference to the two themes Drèze discusses.

1 FIRST-BEST, SECOND-BEST AND THIRD-BEST WORLDS

Drèze is right in construing the problem of social security in the 21st century as an insurance problem, where moral hazard considerations prevent us from choosing the first-best solution. Note that, in this context, 'insuring' is given a broader interpretation than usual. For Drèze and myself, the veil of ignorance is quite thick: it includes not only the uncertainty of specific contingencies such as illness or premature death, but also the *ex ante* ignorance about our abilities and personal characteristics, which are decisive for our success in society. So we share the same, largely Rawlsian paradigm.

Moral hazard is one of the well-known problems of our world, which economists solve by looking for 'second-best solutions.' However, when it comes to European cooperation we are not in a second-best world, but in a world we might qualify as 'third-best.' Different views on the implementation of social justice – views on how to run a social security system – coexist in Europe today. Behind the system of every member state lies a distinct history. Each member state actually embodies a welfare state *sui generis*, and nearly every member state wants to keep it this way. Thus, the social welfare functions that inform the govern-

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ments' policies may be very different. Still the national welfare states face highly similar challenges.

In such a third-best world, the design of a coordination mechanism or the implementation of matching grants, as proposed by Drèze, cannot be reduced to a mere economic calculus. It is the result of a political negotiation and decision-making process. I use the expression 'third-best' since apart from the compromise between commonly shared objectives and individual incentives (this is the usual subject of second-best analysis) an additional and preceding political compromise is necessary on the European level: we need a process to establish a common understanding of the relevant objectives, both at the national and the European level. In my opinion, the importance of the so-called 'open method of coordination,' an expression first used in March 2000 at the Lisbon Summit, should be seen against this background.

Before I turn to the relevance of 'open coordination,' I'll briefly comment on the idea of wage subsidies, to illustrate my point.

2 THE NORMATIVE RATIONALE FOR WAGE SUBSIDIES

I very much support Drèze's case for wage subsidies. My support is not just academic, as some policy measures implemented by the Belgian government may illustrate. Now, the choice a particular government makes between alternative policy instruments – for instance, minimum wages *cum* unemployment benefits *versus* wage subsidies – is not a 'technical' one; such a choice presupposes an implicit or explicit normative stance, that is, a conception of distributive justice and well-being. Therefore, it is useful first to assess alternative instruments by examining the conceptions of distributive justice and well-being underpinning their use, without reference to the specific problems created by tax and benefit systems in economies beset with involuntary unemployment.

Elsewhere I have presented a model that admits a systematic discussion of the normative rationale behind the use of two instruments, which are not mutually exclusive: negative income taxation, creating an unconditional basic income, on the one hand and wage subsidies on the other hand.¹ The model presupposes an egalitarian government which aims at making the worst-off citizens as well off as possible (maximin). Individual citizens have different 'productive talents,' for which they are not held responsible. Different levels of market reward are associated with different productive talents; the worst-off citizens are those with lowest productivity. The citizens have also different preferences for 'time for non-market activity' on the one hand, and income on the other hand, or, in other words, for their propensity to work in the formal labour market (below, I will summarize this as 'individual preferences'). The model integrates two opposite

1 F. Vandenbroucke (2001), *Social Justice and Individual Justice in an Open Society. Equality, Responsibility, and Incentives*, Springer Verlag, Berlin, chapter 3.

conceptions of personal responsibility for one's preferences and a whole range of alternative conceptions of the person's individual well-being into one single framework. The opposite conceptions of responsibility hinge upon the question whether or not citizens are to be held responsible for their individual preferences. The alternative conceptions of well-being entail a different 'metric' of the citizens' well-being which is used by the government, with different relative weights attached to 'time for non-market activity' on the one hand and 'income' on the other hand, in the government's metric of individual well-being. One may also say that the alternative conceptions of well-being reflect alternative views on the 'burden of working time.' The more the government considers 'working time' a burden for its citizens, the higher it will value 'time for non-market activity.'

I assume that government taxes labour income at a constant rate t (with $t \leq 1$). To this income tax scheme is added the possibility that government taxes or subsidises individuals in a uniform way (i.e. independently of earned income). That is, we allow for the possibility that individuals must, next to their earned income taxes, all pay the same tax or receive the same benefit. Denoting this fixed amount as a transfer B , it follows that the complete income tax scheme studied here can take the form of a negative income tax, thus creating an unconditional universal basic income (*in casu* when the transfer $B > 0$). The government can also use a wage subsidy, with the subsidy rate s proportional to the time spent in paid work. The choice between different policies hence boils down to a choice between different instrument vectors (t, s) , with B a function of t and s . Given the characteristics of the population, one can then construct a figure such as the one reproduced below. This figure displays the 'optimal policy track,' i.e. the locus combining optimal values of the instruments s and t for different conceptions of personal responsibility for preferences, and different conceptions of individual well-being. In the model, the conceptions of responsibility and well-being can be captured by one single 'policy stance' variable α . (I have here reproduced a situation where the population characteristics are such that maximin entails full equality for some values of α .)²

The horizontal axis of Figure 1 measures the earned-income tax rate t , the vertical axis measures the subsidy rate s . The bold line is the optimal policy track for these instruments: each point on the track between α_0 (lowest value of α) and α_1 (highest value of α) is an optimal combination of income tax rates and wage subsidy rates. The optimal policy maximises the position of the worst-off citizens, depending upon (a) the government's conception of personal responsibility for preferences and (b) the government's conception of individual well-being.

2 The conditions under which the optimal policy yields full equality are described in Vandembroucke (2001).

For a given conception of well-being, a government that does *not* hold people responsible for their preferences will have a lower α , except for some limiting cases. The model yields the following conclusions:

- (i) Other things being equal, a government that considers people responsible for their preferences will propose a higher earned-income tax rate and labour subsidy rate than a government that does not hold people responsible for their preferences.
- (ii) Other things being equal, a government that considers people responsible for their preferences will propose a lower basic income level than a government that does not hold people responsible for their preferences.

For a given conception of responsibility, α increases when working time counts less as a burden in the government's conception of people's individual well-being. For instance, at the starting point α_0 the government considers paid work a heavy burden, giving it a heavy weight in its measurement of people's well-being. At the other end of the track, at α_1 , government thinks paid work is not a burden at all. At that point it only considers people's income when measuring their well-being. In other words, at α_1 , maximising a citizen's well-being amounts to maximising that citizen's income. The model again yields two conclusions:

- (i) Other things being equal, the optimal earned-income tax and wage subsidy rate increase as working time counts less as a burden in the government's conception of people's individual well-being;

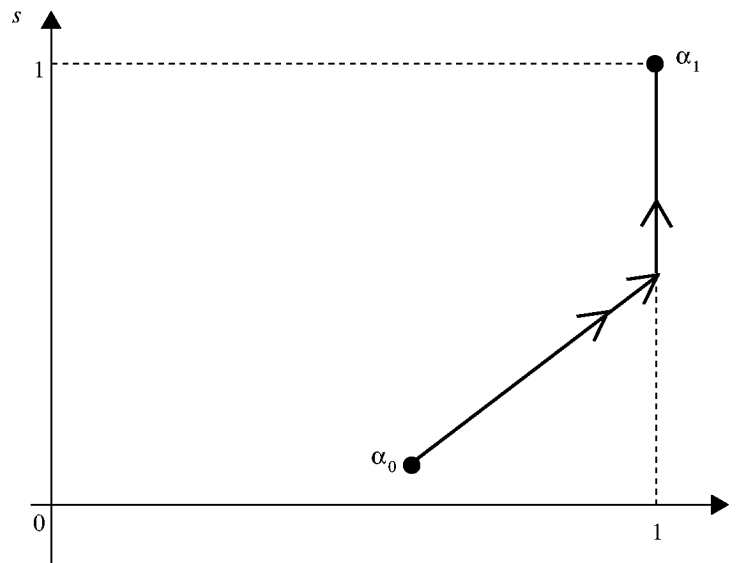


Figure 1 – An optimal policy track

- (ii) Other things being equal, the government will propose a lower basic income level as the burden of working time becomes less important in the government's conception of individual well-being (in yet other words, the more exclusive the importance the government attaches to income, the lower the basic income will be).

Finally, the model points to an irreducible conflict between the level of the labour subsidy and the basic income level, when searching for the optimal policy; other things being equal, basic income will decrease and the wage subsidy rate will increase (until it meets an upper limit) as the normative policy parameter α rises.

I hope this summary presentation suffices to illustrate my point: the design of policy depends upon a complex set of normative conceptions; in this respect, each government may be *sui generis*. This is so, even when we restrict our analysis to highly similar egalitarian 'maximin' governments, which only manipulate a negative income tax and a wage subsidy in a clearing labour market. The real world is obviously much more differentiated.

Drèze implicitly assumes a European form of governance that can overcome this differentiation, and proposes a formal mechanism, matching grants, to counter the underprovision of insurance caused by labour mobility. Such a formal mechanism requires regulation ('hard law') at the European level. It presupposes a commonality of objectives at the European level, and a common understanding of national objectives (or, 'social welfare functions,' to use the economist's jargon), which is lacking today. I therefore think the European Union first has to engage in a methodology of cooperation, which is based upon 'soft law' rather than 'hard law,' but which may create the necessary common understanding.

3 THE OPEN METHOD OF COORDINATION AS A LEARNING PROCESS

The expression 'open method of coordination' was coined in March 2000, at the Lisbon Summit, although an interesting example was already set in 1997 in the field of employment by the 'Luxembourg Process.' Open coordination is a process where explicit, clear and mutually agreed objectives are defined, after which peer review enables member states to examine and learn from the best practices in Europe. This method respects local diversity, is flexible, and simultaneously wants to ensure progress in the social sphere. Commonly agreed indicators help member states to find out where they stand. The exchange of information aims at institutionalising 'policy mimicking,' at least to a certain extent.

Intelligent policy mimicking needs to be actively managed and – to put it in the words of Anton Hemerijck and Jelle Visser – 'contextualized.'³ Well thought-out 'benchmarking' requires three elements:

3 A. Hemerijck and J. Visser (2001), *Learning and Mimicking: How European Welfare States Reform*, mimeo.

- first, the gathering of information on social policy and its results;
- second, the evaluation of this information in the light of the commonly defined objectives;
- third, the evaluation of this information in the light of the local context that policy is being pursued in.

The latter is important, because otherwise benchmarking would soon have a ‘compulsive’ flavour for actors who find themselves in a completely different local situation. This could damage the credibility and consequently also the chance of success of the whole exercise.

This contextual element is explicit in the open method of coordination. Member states, regions and the civil society can make vital contributions to the formulation of objectives and standards. On the other hand, member states can still decide themselves how (and how quickly) they want to make changes to their own systems in the light of the acquired information. These (sub-) national adaptations are in turn the basis of a next round in the common learning process, which the European Commission organises by means of monitoring, evaluation and peer reviews. A renewed architecture of the European welfare state is not directed ‘from the top,’ but is made possible through the intensive interaction between member states. Moreover, the exercise is systematically repeated, which facilitates systematic progress towards common medium term objectives and simultaneously leaves scope for development ‘at different speeds.’

Vis-à-vis sceptics, I should stress that the open coordination applied in the field of employment since 1997 turned out to be a substantive exercise. It so happens that some of the employment guidelines implicitly constitute an argument for ‘wage subsidies,’ as developed by Drèze. It would be interesting to examine to what extent these guidelines have effectively encouraged member states to implement various types of wage subsidies. On the whole, the employment guidelines certainly had some impact on national policies.

4 THE OPEN METHOD OF COORDINATION AS A DEFENSIVE INSTRUMENT

This ‘open’ pragmatic approach can effectively lead to social progress, precisely because it is pragmatic. Thus, we have found a way that implies a credible commitment for a social Europe. Until recently, effective cooperation was anything but obvious in this field, contrary to for example the field of monetary cooperation. So, we send an important message to the European citizen. We signal that member states are establishing a countervailing power against the possibility of ‘social dumping.’

The explicit formulation of a European social agenda can in fact be seen as a ‘defensive weapon’ against a possible retrenchment of our welfare states in the light of economic unification. With regard to the fear for ‘social dumping,’ there is need for nuances though. First of all, the unification of the European welfare states is only one of the many challenges. Today, adjustment is necessary be-

cause (a) the traditional fields of social protection, such as pensions and health care, will require more resources and (b) new social risks and needs emerged. Secondly, so far history does not teach that European unification necessarily leads to retrenchment. This was exemplified by the actual reactions in member states such as the Netherlands, Denmark, Ireland, etc. In these countries, the single market led to renewed agreements between the social partners and consequently to the rethinking – rather than the retrenchment – of their welfare states.⁴

Nevertheless, it is naïve to just extrapolate our historical experience. The growing importance of factor mobility within the Union will leave a bigger mark on the architecture of our welfare states in the long run. Besides, in the short term, we are at the eve of the expansion of the Union. In the light of these developments, the need for an explicit definition of the objectives for the European social model is now greater than ever.⁵ This brings me to what I consider to be the principal added value of the open method of coordination.

5 THE OPEN METHOD OF COORDINATION IS MORE THAN A LEARNING PROCESS AND A DEFENSIVE TOOL

What kind of added value can this method possibly have for the future of social protection in Europe? I believe this added value goes beyond both a mere learning process and its contribution to prevent a social ‘race to the bottom’ in Europe.

Defining common objectives is much more than just ‘useful’ in view of the intended progress in the Member states. Common objectives are essential, because they allow us to translate the much discussed but often unspecified

4 With regard to barriers to retrenchment, it seems to me that the broad societal consensus on safeguarding the welfare state is just as important as the open method of coordination *per se*. (Cf. for example T. Boeri, A. Börsch-Supan and Guido Tabellini (2001), ‘Would you Like to Shrink the Welfare State? A Survey of European Citizens,’ *Economic Policy*, 32).

5 In ‘Income Redistribution in a Common Labour Market’ (*American Economic Review*, 81, 1991), David Wildasin pointed out the need for internalisation of fiscal external effects that arise in a federation where a decentralised redistributive policy is being pursued. With regard to the increased factor mobility, he stated ‘it may increase interest in devising mechanisms at the EEC level (or perhaps by other means) that support redistributive activities by member states in order to internalise fiscal externalities.’ In the context of the EU expansion, it seems plausible to arrange such external effects through direct mutual compensation. (Wildasin gives the example of the German unification). In theory, this bears close resemblance to the Coase theorem, including the important notice that we cannot have a mutual compensation without income effects. Contrary to the plainest Coase model, the basic principle of ‘right of ownership’ does play a role in the final outcome of negotiations (see e.g. E.J. Mishan (1981), *Introduction to Normative Analysis*, Oxford University Press, Oxford). If we were to apply this to the issue at stake, this would imply that a ‘straightforward confirmation of the European social model’ entails a completely different starting point, and, consequently, completely different outcome of the negotiations on accession, compared to the situation where we would not consider that social model as a European ‘heritance.’

'European social model' into a set of agreed objectives, to be entrenched in European cooperation. For the first time, thanks to the open method of coordination, the rather vague idea that the European Union embodies a distinct social model, based on common values, is interpreted by means of more precise definitions. Echoing Hemerijck, I would say that open coordination is both a cognitive and a normative tool.⁶ It is a 'cognitive' tool, because it allows us to learn from each other. In my opinion, this learning process is not restricted to the practice of other member states, but is at least as important in the field of underlying views and opinions of each member state. Open coordination is a 'normative' tool because, substantively, we start from the conviction that no European citizen must be left to fend for himself under difficult circumstances. Member states are pressurised to translate this belief into practical policies. Thus, open coordination gradually creates a European social policy paradigm.

I know the 'soft' character of open coordination meets with scepticism. Yet by means of 'soft' co-operation and consensus-building we can go far beyond the usual solemn but vague declarations at European Summits. This is, at this stage, the most promising way to give concrete shape to 'social Europe,' as a large region in the world in which sustainable social justice will thrive. I am convinced that open coordination can fulfil that (hitherto maybe underrated) ambition, if we use it in a judicious way.

6 FIVE KEY PRINCIPLES FOR A JUDICIOUS USE OF THE OPEN METHOD OF COORDINATION

During the last two years, the Belgian government has, along with others, advocated the development of a social dimension in European politics by means of the open coordination method. We managed to start up a process of social inclusion, and now we wish to start one of open coordination in the field of pensions. I would like to underline that open coordination is not some kind of fixed recipe that can be applied to whichever issue. Our methodology in the field of social inclusion differs from the open coordination that has been developed since 1997 in the Luxembourg employment process. Our methodological proposals with regard to pensions will also be somewhat different: a fairly 'light' process, where member states report to each other every three or four years on how they include common objectives in their national policy, with a yearly update which will enable us to integrate common conclusions on pension policy into the Broad Economic Policy Guidelines, drawn up by the Union every year. (In the employment

6 Hemerijck defines the European social model on the basis of 'cognitive' and 'normative' dimensions in 'The Self-transformation of the European Social Model(s)' in G. Esping-Andersen et al. (to be published, 2001), *A New Welfare Architecture for Europe*, Report submitted to the Belgian Presidency of the European Union.

process, a report is submitted every year. On the basis of this report, individual recommendations are made to individual member states). In other words, open coordination is a kind of cookbook that contains various recipes, lighter and heavier ones.

If we want to use this cookbook judiciously, five key principles have to be kept in mind:

Firstly, this is only one method amongst others. It is not a magic formula we can apply to all European social issues. We cannot fly on the one wing of open coordination to reach social Europe. We also need another wing, namely legislative work. I should refer to, for instance, the necessary reform of regulation 1408/71, which guarantees our social security rights when we move within the EU. The simplification of this regulation and its possible enlargement to meet new social needs and claimants are of vital importance because they take an important part in defining the practical scope of the much commended freedom of movement. This regulation can also contribute to offsetting the negative effects of increased mobility of labour in the field of social protection. Let me emphasize that there is no opposition between ‘soft’ and ‘hard law’ approaches to European policy, on the contrary, open coordination can also serve as a heuristic device to discover tensions or weaknesses in the legal architecture of the EU.

Secondly, and here I focus specifically on the open method of coordination, it should be obvious that we must not mix up the objectives and instruments of social policy. Mixing up these elements goes against the spirit of subsidiarity – an important principle in European politics – that is interwoven with the open method of coordination. But that is not the only reason why I insist upon this. How we achieve something is undeniably important, but it seems to me that thinking ahead about what we want to achieve is at least as significant. I am well aware of the fact that this second principle – as I put it here – has a rather trivial undertone, but in practice it sometimes tends to be forgotten. For instance, the debate on the future of our pensions has been dominated for a long time by elaborate comparative analyses of pay-as you-as go *versus* funded systems. Such analyses on instruments tackle for instance the question of their relative efficiency given macro-economic and demographic hypotheses. True, this is an important question. We must make sure though that the pension debate does not get bogged down in a debate on instruments. When we apply the open method of coordination, we really have to keep an eye on the objectives.⁷

Now, with respect to instruments, my *third* principle is ‘comprehensiveness’: we have to include all the instruments possible in our analysis, and in the comparisons between member states. Income redistribution can be achieved by

⁷ I develop my ideas on open coordination and the European pension challenge in my address to the Royal Netherlands Economic Association, *Sustainable Justice through European Cooperation*, Amsterdam, 12 October, 2001; available at www.vandenbroucke.fgov.be

income taxation, minimum wages, unemployment benefits, wage subsidies, ... etc. A comprehensive approach with regard to instruments is also of particular importance in the field of pensions.

Principle number *four* concerns the choice of 'benchmarks' we use when we want to put the objectives into practice: when we define our standards, we have to be realistic and ambitious at the same time. We definitely need best practices in the learning process: feasible 'standards of excellence' instead of already acquired standards of mediocrity. If we do not, we are presenting the European citizen an empty box.

The *fifth* principle for a useful application of the open method of coordination is situated at a practical level. We cannot possibly measure progress in the field of social exclusion and poverty without comparable and quantifiable indicators. For this reason, finalising a set of indicators with regard to social inclusion is a top priority for the Belgian Presidency of the EU, and we hope to reach a political agreement on this by the end of the year.⁸ (In the field of pensions, the Belgian presidency of the EU prepares the launching of open coordination, but indicators are not yet on the agenda.) It seems to me this fifth principle is the actual litmus test for the political readiness to engage in open coordination. Anyone who paid lip service to this method, should put their words into action when it comes to the development of common indicators.

Finally, let me insist, in response to some interventions, that the purpose of the establishment of a common set of indicators is not a naming and shaming exercise. If there is a 'rank order tournament' at some stage of the process, it should exclusively serve the purpose of improving the *overall* record of *all* European welfare states through, amongst other things, the identification and sharing of best practices. Indicators are not a vehicle for defining any pecking order among Europe's nations, but a tool to preserve and rejuvenate Europe's hallmark of social protection for its citizens.

7 CONCLUSION

Without considering it as a magic formula, I am convinced that the open method of coordination can be extremely useful to enhance social justice in Europe. But we have to make sure that we deal with this method in a well-considered way.

An effective open method of coordination is more than an intelligently managed learning process and a defensive tool. If we handle it judiciously, open coordination is a creative method that allows us to concretely define a 'social Europe' and to firmly anchor it into the European cooperation process as a common

⁸ An EU expert group is currently finishing a proposal. For an excellent discussion on common social inclusion indicators, I refer to A. Atkinson, B. Cantillon, E. Marlier, and B. Nolan, *Indicators for Social Inclusion in the European Union*, Oxford University Press, Oxford, (forthcoming).

good. This method can be the key for people to identify Europe with sustainable social justice. At this stage of European cooperation, this certainly is the most promising way to reach this objective. So we will have to take this path with all due speed.

Frank Vandenbroucke*

* Professor at the KULeuven (comparative social policy), Minister for Social Affairs and Pensions, Belgian Government. I thank Tom Van Puyenbroeck for comments and criticism.

POSTSCRIPTUM

In his communication 'Social Justice and Open Coordination in Europe,' published elsewhere in this issue, Professor Vandebroucke suggests that:

(i) my case for the superiority of wage subsidies over minimum wages *cum* unemployment benefits presupposes a conception of distributive justice; and (ii) my advocacy of EU matching grants presupposes a commonality of objective (welfare functions) at the European level. I plead 'not guilty' on both counts.

In support of (i), Vandebroucke refers to a model in his 2001 book, and applies it to a comparison between wage subsidies and unconditional basic income. I agree that such a comparison requires a value judgement because the first instrument subsidises work whereas the second subsidises leisure – to put it bluntly. That distinction is not relevant to my own comparison, because unemployment benefits are conditioned on willingness to accept employment (at the minimum wage in the case of unskilled workers). My comparison thus bears on two ways of protecting the income of a worker – either at work or *available for work*. I claim that wage subsidies are the more *efficient* instrument, given the prior option to provide income protection to workers. Efficiency analysis does not invoke a conception of justice.

Regarding (ii), I wish to point out that my analysis recognises that member states have idiosyncratic preferences for the distribution of aggregate income between their mobile and immobile citizens, as represented by national 'welfare functions' on which no special restrictions are imposed. The whole point of the analysis is to show that one can define, and possibly implement, an allocation that entails both production efficiency and risk-sharing efficiency at the EU level, while in addition entailing welfare gains in each member state. Nothing beyond the Pareto principle is invoked.

Of course, I do not claim realism for the assumption that member states have well-defined redistributive preferences, representable by a welfare function. Political decisions 'cannot be reduced to a mere economic calculus.' The remark applies both to the member states and to the EU, as also noted by Vandebroucke. I am thus in full agreement that a process like the Open Method of Coordination is needed at both levels. I am comforted by the careful thinking applied by Vandebroucke to the conditions of success of this method, and by his remark 'some of the employment guidelines implicitly constitute an argument for wage subsidies.' May the complementarity evidenced in our respective lectures find an expression tomorrow in policy formulation and adoption as well!

Jacques H. Drèze