

## EU ENLARGEMENT AND THE FUTURE OF THE WELFARE STATE\*

*Hans-Werner Sinn*

### ABSTRACT

*The eastern enlargement of the EU resembles German unification in its momentousness. Whereas the latter led to a 26% increase in the population of the Federal Republic, the former will increase the population of the EU by 28% if all ten entry aspirants are accepted. A special problem will be posed by migration. Given the existing wage differences between eastern and western European countries, a massive westward migration can be expected after enlargement. A temporary east-to-west migration until the eastern countries create an efficient capital stock makes economic sense if this is driven by wage differences and meets with a flexible labour market. Migration does not make economic sense, however, in: and to the extent that, it is induced by the current social assistance systems. Moreover, welfare-motivated migration would create competition among western European states to frighten off potential migrants, and this would lead to an erosion of the traditional social welfare state. If the EU plan incorporated limitation on the free movement of labour, beneficial migration would also cease. A better solution would be to limit access to the western social systems, at least for a transitional period, in order to filter out migration induced by differing social standards. An EU-wide application of the home-country principle in the granting of social benefits would achieve this goal.*

### I INTRODUCTION

With the introduction of the euro and the eastern enlargement of the EU, the European Single Market is nearing its completion. Within the foreseeable future, 25 European countries will be joined in a unified economic region in which the four basic freedoms guaranteed by the Treaty of Rome will be largely fulfilled. People, capital, goods and services will be able to cross European borders unimpeded, and when Cyprus and Turkey are EU members, these freedoms will be extended into Asia Minor. Economic freedom is the foundation for the

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utilisation of trading advantages and specialisation benefits that result from a prospering European economy, but it will also cause problems that need to be recognised and solved at an early stage. Eastern enlargement is not insignificant. It will increase the EU population from 375 million to 480 million or by 28% and this does not include Turkey with its 70 million people. It would be disastrous to stumble into EU eastern enlargement as unprepared as Germany was for its own eastern enlargement. Then the population increased by 26% and this led to considerable economic problems.

One of the problems of eastern EU enlargement is the fiscal burden that will result when the existing assistance programmes are extended to the new EU citizens. The agricultural subsidies that comprise 45% of the EU budget are prominent among these. In Poland there are ten times as many people of working age in agriculture than in Germany, and a linear extrapolation of current EU subsidies results in expenditures of an additional 0.8% of the western European GDP for the agricultural sector when all eastern European accession candidates are accepted. This is a problem, albeit a minor one. Of greater importance is the adjustment pressure that will be placed on the national political decisions of the western EU countries from the mobility of people and businesses.

Europe stands at the threshold of a new phase in its development, characterised by a fierce competition of systems between the institutions of the old national states. In a Europe of 25, the national states will no longer be able to act in the isolated fashion as they once could. Opening the borders forces them, on the one hand, to compete with lower taxes and a good infrastructure for the investment and location decisions of private firms. On the other hand, every state will be on its guard because a generous social system may induce migration streams of the needy that may turn it into a 'poorhouse' of Europe. Competition among countries has its strengths, but its impact on the institutions of the social welfare state is not promising. The migration of people and businesses threatens to trigger off deterrence measures that could lead to an erosion of the social welfare state.

Often it is argued that the competition between countries is similar to that of firms in the market, that Adam Smith's Invisible Hand is operative here, too. I doubt that, particularly when it comes to the competition among welfare states, and I shall try to explain my doubts in this lecture.

## II THE EXTENT OF MOBILITY

Guest workers and poverty refugees from eastern and south-eastern Europe are already flocking into western Europe, either enticed by the extremely high wage differences or forced to migrate because of catastrophic conditions in their home countries. In the large EU member states such as Germany and France, the foreign population is more than 6%, and all estimates point to further increases in the coming years.

Particularly high mobility is expected for people in the ten eastern European countries that are negotiating for EU membership, since their standard of living will not approximate that in the west for some time to come. Wages in eastern Europe are one tenth to one fifth of those in western Germany or one fourth to one half of German welfare payments, at least according to present exchange rates. In Munich the average hourly wage in the engineering industry is DM 28.50 compared to DM 4.80 in west Poland and DM 2.70 in east Poland. In real terms, the discrepancy is not quite so large due to the lower prices of non-traded goods, but it is still considerable. Given the size of the discrepancy, it seems likely that eastern EU enlargement will lead to substantial westward migration.

The first wave of accession, which will include five countries, is now expected to come by 2004 at the latest. Estonia, Poland, the Czech Republic, Slovenia and Hungary with a total of 63 million people will then be members of the EU. Latvia, Lithuania, Slovakia, Romania and Bulgaria with another 42 million people are determined to follow soon. Even under the most optimistic assumptions of the growth rates of the EU candidates, it will not be possible to raise average wages to 20% of western German wages or to one half of German social welfare assistance by the scheduled time of entry.

According to recent estimates by Zimmermann and Bauer<sup>1</sup> in the case of a longer restriction of the freedom of settlement, a total emigration of 2.7% of the population of the new member states can be expected. However, for the case of EU membership with free migration, the study arrives at a much higher figure (Table 10, p. 51). No less than 6% of all Poles, 16% of all Bulgarians and 27% of all Romanians can be expected to leave their countries. On average, 10.6% of east Europeans will leave their countries if they can, and this is a total of 11 million people if all 10 applicants are admitted.

These figures are confirmed in a poll carried out by the International Organization for Migration (IOM).<sup>2</sup> The poll reveals that about one fifth of Slovenians, Poles, Hungarians and Czechs, and even one third of Romanians would choose to emigrate for several years if they could.

For the case of a politically non-restricted emigration, the Ifo Institute<sup>3</sup> came to somewhat more modest estimates of about 6% to 7%, of which about 4% to 5%, or 4 to 5 million people, would have Germany as their goal. In contrast to the numbers of Zimmermann and Bauer, these results are estimated on the basis of an approach that adjusts for eastern Europeans already living in the EU, and

<sup>1</sup> Bauer and Zimmermann (1999). In Table 10, which presents the results of the econometric estimates, the authors only publish country-specific emigration numbers. The aggregate numbers quoted in this article are the direct result of weighting with individual population shares. The authors relativize their results and reach the conclusion that a migration of between 2-3% of the home population is to be expected. They do not mention whether this number refers to the case of free or restricted migration. Since the first column in Table 10 has a value of 2.7% for the case of at times free migration and at times restricted migration in the form of quotas, it can be assumed that the summary only refers to this case.

<sup>2</sup> International Organization for Migration (1998).

<sup>3</sup> See Sinn, Flaig, Werding, Munz, Düll, and Hofmann (2001).

they also refer to a longer period of estimation which extends from 1974 to 1997 instead of 1985 to 1997. A look at the migration from Turkey is also instructive. Today, about 5% of the Turkish population lives in western Europe. If, like the Turks, only 5% of the new eastern European EU citizens came to western Europe, this would be more than five million people. Because eastern Europeans will enjoy the freedom to settle in Germany, this is probably at the lower end of plausible estimations for the case of unrestricted migration over a 15 year period.

It is sometimes argued that the previous experience with Spain and Portugal suggests that there will not be much migration from the east, when the freedom of settlement is granted. However, this is a misinterpretation of the Iberian experience for a number of reasons. First of all, there was a six-year transition period after joining the EU during which migration was largely forbidden. Second, the wage gap then was much smaller than it is now between eastern and western Europe. In the years before membership started, Iberian wages were about 47% of the west German wages; by contrast, the average wage in the five eastern applicant countries is currently only 13% of the west German wage. (The respective figures for all 10 applicant countries are certainly much smaller, but reliable information is not available.) Third, and most importantly, much of the migration potential may already have been exhausted before Spain and Portugal became members. In the sixties, both countries had dictatorships but did not forbid their citizens to travel abroad. Thus many people fled and sought protection in EU countries. Between 1960 and 1974, the accumulated Iberian net emigration was 5.5%. When Spain and Portugal applied for EU membership in 1977 and became members in 1986 most of the potential migrants had already left, and many of them actually took the opportunity to return. This scenario is very different from the situation in eastern Europe. When the eastern population lived under communist dictatorship a tight Iron Curtain effectively prevented emigration, and when the Iron Curtain was lifted, the west decided to no longer accept easterners as political refugees. As of today, therefore, the migration pressure has not yet been released. Indeed a mass migration can be expected when the right to settle freely is granted to the people in the east.

Westward migration will have strong implications for the western European social welfare systems, since the decision of which western country to migrate to will primarily be determined by economic incentives. To be sure, a large income differential is necessary to induce people to leave their home countries, but once this decision has been made, the choice of the destination country will be influenced by even small differences in living standards. Thus, a nearly perfect *differential* mobility among the western European countries can be expected, and the pressure on present social systems will be enormous.

### III DETERRENCE MEASURES

The benefits of the social welfare state will become a problem in this situation, because they attract migrants who are net recipients of public resources. The western European countries will endeavour to examine their social benefits so as

not to provide unnecessary migration incentives. Since poverty refugees' choice of country will depend on where the most extensive social benefits can be expected, there will indeed be a competition for the most effective deterrents, and each country will try to be less attractive than its neighbours. In the competition for the lowest possible social standards, the European social welfare state will be exposed to strong erosive forces which threaten its very substance.

The competition for effective deterrents does not presuppose that migrants are attracted by social benefits alone. This connection is ruled out because recipients of social benefits need to have present or prior employment, according to present EU law. The marginal migrant makes a contribution to the GDP of the host country which is equal to his or her gross wage income, and the infra marginal migrant makes an even larger one. Thus his wage is not a burden for the citizens of the host country, and therefore no political deterrent measures are induced.

The problem arises, however, in the form of state income redistribution for the benefit of workers with lower wages. Low-income workers pay little or no taxes, but they are entitled to supplementary welfare payments for themselves and their families, their children enjoy free schooling, they have access to public housing programmes, they gain from the redistributive elements in the health insurance system and, last but not least, they profit from the infrastructure the state provides free of charge. These benefits imply that the marginal low income immigrant receives more than he or she produces or pays in taxes.

On the basis of the socio-economic panel, the Ifo Institute calculated the amount of net resource transfers from the state to the immigrants. Included were all social insurance contributions and taxes as well as all services received including the social benefits financed by taxes and payroll deductions and the proportional costs of the public infrastructure that the immigrants use. The results are that during the first ten years in Germany, immigrants register a net per-capita resource gain of DM 4,600 a year. This is no small amount; for a five-member family it adds up to DM 230,000 in ten years.<sup>4</sup>

The state, seeing the budget constraints caused by immigration, will reduce its social benefits fearing that these may act as a magnet in attracting immigrants. Its motto will be fairness but less generosity than its neighbouring states. Since all governments will act the same way, the benefits of the welfare state will be gradually reduced. The process of change in political values will take somewhat longer since the political climate, and with it the ideals of the socially oriented parties, will only change slowly. Perceptions and ideologies that have formed over the decades will be subject to creeping erosion, hardly noticeable at the outset but which will receive an additional push with every new generation of politicians and which will ultimately be expressed in a different understanding of the state, more like that in the United States than the one now common in Europe. It is true that the challenge to the social welfare state from the migration process is not harmful in every respect. The state's influence on the lives of it

<sup>4</sup> See Sinn *et al.* (2001).

citizen is too extensive and the false incentives it creates are too many. The traditional social welfare state creates a strong incentive to avoid the labour market. Typically, social benefits are received as long as one does not work, and they are lost when, and to the extent that, labour income arises. This type of welfare needs to be thoroughly reformed, and, if such reform is touched off by migration-induced financial problems, this can only be welcomed in principle.

The problem is, however, that even a well-constructed social system that rewards own initiative rather than idleness will be eroded by the systems competition. A well-constructed welfare system helps people help themselves, it provides workfare instead of welfare, because workfare makes wages flexible downward and creates additional jobs. Germany's traditional welfare system implies a minimum wage which is about 70% of the median wage. By way of contrast, the US earned income tax credit in itself implies no minimum wage, and the legal minimum wage is only about 30% of the median wage. The earned income tax credit shows how, from every dollar that the government is prepared to spend for welfare measures, a maximum of social policy objectives can be achieved. This is a prime example of a social system that encourages own initiative, although its level is far too low by European standards. Unfortunately, however, even a well constructed social welfare state is not protected from the erosive forces of systems competition. The essence of a social system is the redistribution from rich to poor, including the working poor, and it is this redistribution that will erode, for the reasons given above, regardless of whether it is well or poorly constructed.

From a theoretical perspective, a more fundamental reason for the erosive force of systems competition can be seen in a policy externality that is created by a national redistribution policy. A country that makes gifts to the poor and forces the rich to finance these gifts induces the rich to go abroad and the poor to come from abroad. In this way the country reduces the real wage of the factors of production offered by the rich in other countries and increases there the real wage of the factors offered by the poor. Thus the wages for skilled labour and the rate of return on capital will fall abroad and the price for expensive real estate will rise. Conversely, wages for simple work abroad will rise and the price for basic real estate will fall. Moreover, the outflow of net payers of government benefits and the immigration of net recipients will produce government budget surpluses in other countries that can be used for social purposes. The degree of target fulfilment for foreign social policy will be increased without foreign governments' own efforts. At the same time, the degree of target fulfilment for domestic social policy will be weakened since the departure of the rich and the entry of the poor will increase the gap between the gross wage rates of the factors of production offered by these groups. From all this, it follows that some of the equalising effects of domestic social policy will be distributed abroad by factor migration and will be lost domestically. This policy externality reduces the domestic incentive to maintain the welfare state.

**In** the theoretically extreme case of a small country and perfect mobility of the affected population groups, the effects of national social policy would fall completely on other countries. The domestic net-of-tax income distribution

would then be determined exclusively by conditions abroad regardless of the national redistribution efforts, and it would be meaningless to pursue a national social policy.

#### IV A COMMENT ON SOCIAL STANDARDS

Some commentators have feared that the competition between countries touched off by migration will also erode the social standards in connection with the workplace. The 1989 European Social Charter refers to these standards and includes workplace safety, working conditions as well as in-company training and education. The fear of an erosion of working standards is unsubstantiated, however, as can easily be demonstrated since measures for workplace safety and comfort have little in common with state redistribution measures. They are a wage-equivalent compensation in kind that has a value for employees but that also, just as cash wages, makes the factor labour more expensive. In terms of this compensation in kind, an optimistic view of systems competition is justified since countries will endeavour to create an optimal mixture of monetary payment and compensation in kind in order to attract as many mobile workers as possible and thus maximise the income of immobile factors that co-operate with these workers and profit from them.

If a state increases its monetary transfers to poorer people, it diverts the migration streams into its own country and, as has been explained, it lowers the gross incomes of those it wishes to help. If, however, the same state increases safety standards marginally, it will not create any migration effects provided that wages are determined competitively and that the standards have been chosen optimally. Since, in the national policy optimum, the marginal cost of workplace safety equals its marginal benefit, an increase in standards will only lead to an equivalent lowering of monetary wages, and the migration incentives will remain unchanged. Of course, the full equivalence no longer applies when wages are not flexible or when workplace standards have not initially been optimally chosen. But this by no means presents a policy externality that would create similar doubts on the effectiveness of systems competition similar to those applicable in the case of redistribution measures of the social welfare state. This is a point that is overlooked not only by many critics but also proponents of systems competition. It is only the redistribution measures that can be eroded.

#### HAIDER, HARMONISATION OR HOME-COUNTRY PRINCIPLE

The looming erosion of redistributive policies calls for counter measures if one is in favour of redistribution in itself, for instance if the redistributing state is seen as insurance against career and life risks that are not privately insurable. A particularly simple, but just as problematic, protective measure is postponing the freedom of settlement and erecting a legal wall in place of the physical wall that was torn down ten years ago. Votes can be gained by proposing such a system,

as Haider's success in Austria has shown, but it involves throwing out the baby with the bath water . Preventing free migration thus also means not enjoying the welfare gains that such migration, in principle, can be expected to bring about. A migration free of artificial incentives would only lead to the number of guests from eastern countries that would make the marginal migration cost equal to the wage difference between east and west, and this is precisely the welfare-maximising rule for the allocation of the existing European work force, provided that the wages equal the marginal productivity of labour in the countries involved. If a Polish worker is induced to give up his Polish job for one in Germany, then Poland's GDP will fall and Germany's will rise. As long as the increase in the German GDP exceeds the reduction of the Polish one, the overall European GDP will increase, and, as long as the increase in GDP is larger than the Polish worker's migration cost, a welfare gain arises. Migration is in principle a good thing, especially since the initial wage difference leads us to expect an export of capital to Poland, an increase in wages there, and a later return of the guest workers. In the transitional phase up to the convergence of the eastern European economies to those in the west, a temporary westward migration of some of the working population is a welcome development. The problem is not that such migration takes place, but that the western European social welfare states create an excessive migration incentive.

To remove the excessive migration incentive, thought could be given to harmonisation of the social systems. There would indeed be no artificial incentives to westward migration if the same social standards prevailed everywhere. Harmonisation at the level of the eastern countries, i.e. at one tenth to one fifth of the current western level, would be tantamount to the state calling for a revolution in western Europe, and harmonisation at the western level could not be financed either by the east or the west. Extrapolating from the experience of German unification, the burden will amount to 5- 7% of the western European GDP, which surely no one in the west would accept, let alone the west Germans, who already transfer 4.5% of their GDP to east Germany every year.

Only two alternatives remain. The first is to select immigrants by their income, wealth or skill levels to make sure that no net recipients of public resources are allowed to enter. Although this approach is chosen by some immigration countries, it does not seem appropriate to the European Union. It is a crude interventionist approach, relies on the wisdom of bureaucratic decisions, and discriminates against weaker immigrants from the new EU countries.

A much more sensitive, market-oriented, and just approach is the application of the home-country principle wherever this is possible. Instead of restricting the freedom of settlement, bureaucratically selecting workers, or harmonising social standards, access to the benefits of the western social systems can be limited. Either the claims for social benefits should be directed towards the home country, or benefits in the country of residence should only be paid to the amount they would be paid in the home country. Benefit to the

migrants as well cannot be prevented for many redistribution elements. But, in a new EU treaty, social welfare, housing grants, the rights to be considered for municipal housing and similar benefits could be converted to the home-country principle so as to avoid a net fiscal incentive for the migrants. Calculations by the Ifo Institute indicate that this would be sufficient to generate a balanced fiscal stance for the migrants. Currently, one of the basic EU rules is that people are entitled to social transfers from their country of residence, where they either both live and work or have worked. Only tourists and visitors are treated according to the home-country-principle. If entitlements could only be claimed from the home-country under its conditions, there would be no more artificial migration incentives, and the hope that the free migration decisions people make would approach an optimum level would be justified. This would also be an effective check on the erosive forces of systems competition. The home-country principle in welfare benefits has been in use among the Swiss cantons for some time and has proven to be effective. How the home-country principle should be implemented in detail must be the task of thorough political and economic analysis. It is certain, however, that this principle in the EU-25 will be a prerequisite for creating the desired freedom of job selection in the first place. Without this principle, there will be such serious negative effects, both with regard to people's migration decisions and the stability of the western social systems, that fears will be raised as to the process of European integration itself. Haider's success should be a warning. Many may consider the application of the home-country principle as a historic step backwards that violates the principle of the inclusiveness of the social welfare net. It is also to be expected that the EU membership candidates will oppose the home-country principle, fearing that their guest worker families in EU countries will be at a disadvantage. It must be recognised, however, that the other available policy alternatives are by no means more attractive for the new EU countries. The restriction of the freedom of settlement or the selection of easterners who are allowed to migrate would mean even more exclusion than the home-country principle, and the harmonisation of the social systems to the western level would lead to an increase in the minimum wages of the new EU countries, which would induce mass unemployment. Even if the western countries were willing to pay the costs of mass unemployment in eastern Europe for several years, such a transfer of the German solution to Europe would not be in the interests of the new EU countries since their economies would then never prosper. Today we have two Mezzogiornos: one is in southern Italy, the other in east Germany. Harmonising social standards after EU enlargement will mean that we have another ten Mezzogiornos in Europe. The eastern countries will probably strive for a rapid integration without any 'ifs' and 'buts' in the framework of current EU law. This cannot be accepted by the west, however, because of the destructive implications for its own social systems. The membership candidates must be told where the negotiable limits are and it must be made clear to them that immediate integration on the basis of

the residence-country principle would have such socially explosive potential in the west that, ultimately, the social and political stability that the eastern European countries wish to participate in by their membership would be jeopardised. Here, the home-country principle is indeed the better alternative. It avoids the limits to freedoms that some are already proposing and it preserves the west's commitment to integration.

The home-country principle for tax-financed social benefits is based on economic principles that are incompatible with the juridical concepts that have shaped current EU law. The immediate inclusion of migrating workers and at the same time the exclusion of people who have migrated for other reasons has been the guiding principle of EU law. This is a political problem that must be overcome.

The problem is not really prohibitive, since EU eastward enlargement is in itself not possible on the basis of the current legal situation. Much change is needed, and the conversion from the residential to the home-country principle is only a small reform measure. To be sure, EU expansion can only be discussed on a *de lege ferenda* basis, i.e. in terms of legal reforms, and not *de lege lata*, in terms of what can be done without changing the laws. Since the enlargement of the EU and the underlying conditions must be agreed unanimously, every EU country can demand adjustments in the prevailing laws.

It is true that it would be desirable for political reasons that the home-country principle be introduced in such a way that only a minimum of legal changes are required. Attention must be given in particular to the already negotiated association treaties between the EU and the eastern European accession countries. These agreements call for integrating the migrating workers from the first day of their work in the contribution-financed social systems, i.e. in particular in the statutory health insurance system, the pension system, and the unemployment insurance scheme. Moreover, they are obligated to pay taxes, and they of course cannot be excluded from using the public infrastructure. The agreements do not stipulate how the tax-financed social benefits should be handled. An exclusion of the migrants from supplemental social benefits, from housing allowances and the already scarce municipal housing would not be in contradiction to the association agreements but would help to balance the net fiscal losses and would prevent a harmful competition among welfare states to reduce benefits.

Possible legal reservations can be countered by limiting the exclusion from certain social benefits to a certain period of time. Since the integration of the immigrant improves over time, his market income approaches the domestic average, thus eliminating the net fiscal losses for the state. A waiting period of 5 to 10 years up to full integration of the immigrant in the social welfare system of the host country should suffice to avoid the net fiscal losses.

For this proposal, the Ifo Institute has coined the phrase 'selectively delayed integration' of immigrants in the social welfare system. Integration is not prevented but only delayed, and it is not delayed in general but only selectively, namely for the tax-financed social benefits that are not covered in the association agreements. Selectively delayed integration is an alternative to the

quota system for integration favoured by politicians which calls for a selection of individuals and which deprives many eastern Europeans of the freedoms contained in the Treaty of Rome. In weighing up the various legal rights that are up for discussion, priority should be given to the rights contained in the Treaty of Rome and they should be protected from too strict an interpretation of the inclusion principle. This proposal is a variation of the home-country principle<sup>5</sup> and the 'delayed integration' for all social benefits that the Scientific Council of the German Federal Ministry of Finance called for in a recent study.<sup>6</sup> The proposal has arisen from efforts to create conditions for competition among social welfare countries to restrict the erosive forces of free migration with as few changes as possible to current EU law.

## VI FINAL REMARKS

Europeans have expressed great misgivings about the euro although it was clear that the euro would have no immediate consequences for actual commercial transactions. In contrast, eastern EU enlargement, which is currently attracting little public attention, is a very great problem which approaches German unification in terms of its significance and difficulty. German unification was carried out by political fiat without consideration of economic factors, and how expensive it was is clear today. Even after ten years every third mark spent in eastern Germany comes from the west, and the national debt continues to grow to finance unification. It almost seems as if similar mistakes are about to be repeated at the European level. Hardly anyone in Brussels is looking at the question of the reforms of European social law that will be necessary to master the challenges that will come. All attention is being focused on the progress the eastern European countries are making to adjust to western laws, as if the western European countries and the EU are ideally prepared for enlargement. The carefreeness with which people refuse to analyse the economic issues fatally resembles what was observed during German unification. 'Full steam ahead' is again the motto, and after the fact the accusation will again be made that economists failed to give advance warning of the problems.

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