Conflict between „freedom of labour“
and national policy goals:
The example of the Austrian pension system

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Abstract

A most important goal for the European Union has always been to foster labor mobility within the union. The reason is that efficiency gains are possible if labor moves to places where its marginal product is highest. Now in developed welfare states, the incentive to move between countries is biased by the social welfare system. In order not to let social security claims become an impediment for mobility, the European Union has started to “coordinate” social security systems, broadly meaning that workers should immediately be included in the welfare system of the host country. Furthermore, claims against the public pension system should be exportable.

Now the EU has not restricted the regulations to workers, but has gradually extended these rights to all groups of people, including self-employed, students, retirees and of course family members of all these groups. Applying the coordination of social system to all kinds of people, however, while leaving governments with the national responsibility for social security systems, leads to a violation of fiscal equivalents, negative externalities and possibly an under provision of public goods as it has often been mentioned in the literature.

The presents contribution picks out the Austrian pension system to show why international labor mobility might imply a heavy burden for the social security system. Due to political reasons, the pension system does not only insure the risk of age, but is burdened with many tasks: it should redistribute between women and men, between poor and rich, and between healthy and sick. Hence, linearity between individual contributions and expected pension payments is poor, even after the pension reform in 2004. As soon as due to the nondiscrimination principle of the European Union social services are extended to all Union citizens, the Austrian pension system might run into problems sooner or later. Given the well-known demographic problems, this might lead to additional difficulties in hard times.

We show that at present, social security statistics are not adequate to correctly forecast the long-run burden of international labor mobility on taxpayers, even for claims that have already been acquired. There is substantial uncertainty as to future payments for health, care allowances and pensions.

More empirical insights into the problems seem necessary to induce a possible path of rethinking social security policy both at the EU and the national policy level.

Introduction

Freedom of labor within the union has been one of the basic principles of the EU from its very beginning. According to a simple labor market model, allover efficiency and welfare will be increased if workers move to places where their marginal product is highest.

Now with developed welfare states, labor mobility would be hampered if agents loose social security rights if moving between member states. The most important areas in this respect are the pension system, the public health system (including care for the old) and family grants.

Hence, to foster mobility, the EU has increased the rights of mobile workers substantially by "coordinating" social security of individual member states. Today, there is a rather complex system of regulations concerning social security rights for European citizens (which are gradually extended to third-country members as well). The basic document is decree 1408/71 (EU 1971) (together with implement ting regulation 574/72; EU 1972) and a variety of judgments of the European Court. A new version of the decree has been written down in 883/04 (EU1983), but it will still take years until this document will finally replace its predecessor since a variety of conflicts about the new implement ting regulation are waiting to be resolved (after all, this is a vivid signal that the Unions´ goal to coordinate the social security systems is not a simple task).

Basically, for European citizens, the coordination of national laws implies inclusion to the rights of the national population in the host country ("residence country principle"): Upon taking a job (or being self-employed or being a student) in another member country, union citizens (and their family members) should immediately and in a nondiscriminatory way be included in the social security system and hence get all rights that are linked to social security contributions (compulsory social insurance systems). Moreover, decree 1408/71also applies to a variety of social security services that are not linked to social security contributions but that are paid out of general taxes. Social assistance for the poor ("Sozialhilfe") is generally exempted from this legislation, and only citizens which are inhabitants of a country have access to this subsidies. In this respect, however, the Commission has strictly (but generously) regulated the rights of citizens to reside permanently in other member states (see EU 2005). These rights have been determined both for members of the labor force (including students) and their family members as wells as for retired people.

Interestingly, the EU has continually extended social security rights that should foster labor mobility of workers to many other groups: The validity of 1408/71 has been more or less extended to self-employed people, civil servants, students and retirees as well by new regulations and the jurisdiction of the European Court (see consolidated version of 1408/71, EU 2005). Further, family members are always encompassed by the regulations.

For groups outside the labor force, however, the question of whether mobility is efficient has not been put into question at all. In particular, there has been little discussion of whether the new freedom of citizens to work and reside in member states leaves welfare states with heavy burdens.

Now the basic ideas underlying social security jurisdiction go back to a Europe of highly homogeneous countries with little mobility of workers, where they could be justified in economic terms as well, they have been carried over to a substantially more heterogeneous Europe that developed after several steps of enlargement towards the east. In fact, jurisdiction has not taken account of moral hazard and adverse selection processes that might arise with this new type of heterogeneity among countries.

In particular, citizens are allowed to retain certain rights in case of mobility. One of the most important issues in this respect is the pension system. If a workers has acquired periods of contributions to the pension system in different countries, his rights to get a pension should more ore less be fully retained. Basically, each country pays for the periods of contributions that the worker has been employed in this member state (for at least 12 months).

Hence, we find that European law strongly interferes with the national jurisdiction concerning the rights of workers by extending these rights to all union citizens. Yet according to the „subsidiary principle“, it is still the member states that remain responsible to organize their own social security systems. The influence of EU social policy, however, limits their freedom, partly in an unpredictable way, as the European Court jurisdiction often is in conflict with the interests of individual member states, in some cases even in an unforeseeable manner (e.g. in some cases, the European Court has argued against rules that have explicitly been determined in the implementing rules 1408/71 and 547/72, see e.g.case C-160/96 Molenaar).

As a result, sovereignty of national authorities is shrinking substantially. Still, the political responsibility for this sector remains with the national member states. Since in central European democracies like Austria (or Germany or France), the majority of voters are net gainers of the welfare system, it turns out to be quite difficult to reconcile EU-law with national goals in an efficient manner as democratically chosen policies do not have correct incentives to restructure the system efficiently.

Not only does it seem difficult for national policy makers to communicate necessary restrictions in the social security system to the voters, but also it seems difficult to communicate problems to the European Union: If it is not shared by the majority of member states, it might not be respected at all. Hence, democracy both at the national and the supranational level runs into problems. The conflict mainly remains at the national level, where inefficient decisions are produced.

Many contributions have stressed in general terms that under these circumstances, welfare states will run into substantial deficits due to moral hazard and adverse selection processes. In the long run, social security standards will be eroded and a “race to the bottom” will take place (see e.g. H.W. Sinn 2000, 2003, 2004a, for an overview, see J. Brueckner 2000). Many students have challenged this scenario (see e.g. Lazear 2001). Yet, outside labor market studies (see e.g. Salvador et.al. 2001) or studies investigating international tax competition, little research has been done. In particular, details of the social security system that might lead to a race to the bottom have not been investigated sufficiently in the economic literature (though many contributions concerning the judicial side of this topic have been published).

The present contribution picks out the Austrian pension system as a particular example of this problem. We isolate several aspects showing the conflict between national law and EU-law. In fact, we believe that this example is not only characteristic but also important: (according to private information from the “Österreichischer Hauptverband der Sozialversicherungsträger”, which is the leading institution in the social security system) in 2006, about one third of applications for pensions in Austria contained some spells of employment in another country, in Vienna the corresponding share is near to 50 percent.

Of course, if migration between European member countries were more or less balanced, Austrian people could get access to foreign social security services to a similar extent as citizens from other member countries would enter the Austrian social security system. On average, migration and immigration would balance, and positive and negative externalities between systems would cancel.

Unfortunately, this is not the case. Looking at migration patterns it appears that – just as predicted by economic theory (see Borjas 1988, 1994, 1995, 1999) and proven empirically (see e.g. Constant and Zimmermann 2005, Bock-Schappelwein 2006) – adverse selection processes do take place: the Austrian welfare state is a strong magnet for immigrants seeking social welfare subsidies. The stronger the rights that are provided to Union Citizens by the

European Court and the European Commission, the more pronounced adverse selection processes will be. They might not occur from one day to another, and no “race to the bottom” might take place, but they will gradually be irreversible, as Sinn has argued several times (see e.g. Sinn 2002).

The paper proceeds as follows. Firstly the economic problem behind the conflict is described as one of violating fiscal equivalence between national and supranational regions. Secondly, a short description of ideas governing EU-law concerning pensions of mobile workers as well as the Austrian pension system is presented, where we show that EU-law imposes negative externalities on Austrian tax payers. In particular, we focus on aspects of the Austrian pension systems that are leading to spillovers, and a quantitative estimation of the possible externalities is made. Moreover, we argue that in the light of the nondiscrimination regime, the usual method to measure the future burden of the pension systems (that relies on net-migration streams) might be biased, since it takes account only of expected burdens in the home country while neglecting claims from other member countries. Finally, some concluding remarks are given in the last chapter.

Pension Systems: Spillovers and Violation of Fiscal Equivalence

As long as contributions to the public pension system are strictly linked to expected payments in each country, and each worker can retain pension claims towards a country in case of mobility, labor mobility should not give rise to externalities: Workers could move free between member states and retain pension rights wherever they have been working. On average, contributions of workers and expected benefits should cancel out at the level of nations if a sufficient amount of workers is mobile (to allow for the insurance of the age risk), and fiscal sustainability is assured.

The pension system being part of the social security system, however, it not only insures for the risk of age, but also for other risks (see below). Hence, a variety of nonlinearities between individual contributions and expected benefits arise. As a consequence, a country might spend significantly more (in the case of Austria) than contributions retained. Moreover, as we shall see below, the existence of claims against the national pension system might imply claims against the national health care system. Since national taxes have to be used to pay for claims that are not linked to contributions, and since the rights of workers can partly be exported in case of mobility, negative externalities arise. Labor mobility implies costs for national governments that were not intended by the national law system.

From an economic point of view, these problems are well known: They simply reflect a violation of fiscal equivalence among national and supranational fiscal authorities. According to the theory of federalism (see Buchanan and Tullock 1962, Musgrave 1962) and other contributions (Olson 1969, Oates 1972, Breton 1965), the provision of a public good should be decided by a regional authority so that all consumers and payers of the public good are just encompassed in that region. If too large (too little) a region is chosen, spillovers to a supranational level take place, and externalities will lead to an inefficient level of provision of the public good. In the case of negative (positive) externalities, too little (too much) of the public good will be provided. The optimal size of groups is determined when all types of externalities are internalized.

At a first glance, the latter condition would automatically be fulfilled if the largest group size would be selected (see Brennan and Buchanan 1980). Hence, if all decisions concerning social security systems would be shifted to the European Commission, a more powerful coordination would result.

Indeed, many scholars have argued that common social standards in Europe could solve the problem of social dumping in Europe. Two arguments can be raised against this position, however. On the one hand, heterogeneity between European countries remains even if a central decision unit is introduced, and it might be too expensive to finance a common standard of the social security system that seems to be acceptable according to Central European countries (see e.g. Sinn 2004b). Moreover, Olson (1969) has pointed out that politicians do not maximize welfare of inhabitants, but rather pursue goals according to the preferences of majority voters. Interests of minorities might be ignored, and welfare losses would result.

Concerning the pension system, European law enforces negative externalities upon national governments. While governments try to organize the national social security system according to the preferences of national voters and tax payers, the European Union requires that all European citizens should get access to these services in a nondiscriminatory way.

The present contribution picks out the pension system in Austria as an example of coordination problems between national and supranational policy.

Pensions: EU-Regulations and the Case of Austria

EU-Regulations concerning the Pension system

Roughly, the following EU-rules apply to the pension system. In order not to deter workers from labor mobility within the Union, a variety of decrees and judgments of the European Court have been established to coordinate the pension systems between member states. Basically, according to regulation 1408/71, a worker acquires pension claims corresponding to the period of contribution as soon as she works at least one year in a member state (for shorter periods, the "responsible" institution has to pay for this time span). The amount of claims in each country of contributions is derived by calculating the "hypothetical full pension" that would be paid if the worker had always worked in that member state. If she has spent only a part of her working life in this country, the hypothetical full pension is adjusted accordingly.

All types of benefits (such as allowances for raising children, spells of unemployment, periods of education etc.) that are granted by the pension system have to carry over to each Union citizen and her family members according to the nondiscrimination principle. Moreover, the worker and her family members gets access to the health care system of the "responsible institution", which either is the country where she has worked throughout her working life (whether she determines to live in that country or another member state) or which is the country where she decides to reside after retiring if she has at least worked for one year within that country (so that she has some claim against the national pension system). If contributions to the health care system for retired people are not proportional to expected costs, a further source of negative externalities arises.

The Austrian Pension system

In the light of the well-known demographic developments to come, the Austrian pension system has been reformed recently (in 2000 and, more important, in 2004), substantially strengthening the link between individual contributions and expected pension payments. "Pension accounts" have been introduced for each citizen.

In what follows, we completely neglect the old system (though it will continue to influence the amount of pensions for decades), where contributions and pensions were linked to a lesser degree. Still the new system not only insures the risk of age, but continues to redistribute from men to women, from rich to poor etc. The following reasons give rise to nonlinearities between individual contributions and expected payments:

- Periods of raising children: According to the new pension system, for each child four years (for twins five years) of contributions are granted for a monthly gross income of 1.350 € (as soon as another child is born, a new period of at maximum four years is started). If the person that raises the child earns less than this amount, a higher basis for contributions is assumed as well and paid by the government. For a mother that remains out of the labor force for the full period of four years, the costs per child are roughly 14.800 € (apart from other family grants, which are partly restricted to people residing in Austria). According to the jurisdiction of the European Court (RS C-28/00, Kauer) periods of raising children have to be accepted as contribution years to the Austrian pension system also if children were raised in another member state as long as the mother was not employed in another member state before giving birth to the child (or to her children). Moreover, according to the recent pension reform, a woman (or a person that has raised children) is entitled to a pension from the Austrian state if she has 15 years of contributions, where 8 years can be derived from raising children and not from paying contributions to the pension system herself.

  From an economic point of view, accrediting spells of education in the pension system can be justified as children are expected to pay the pensions of the next generation. Hence, they can be viewed as providing a positive externality to the pension system which is going to be remunerated accordingly. Of course, the link between children and future contributions is significant only if children stay in the country where they will pay contributions after having been educated. The weaker the link between having a mother that has been employed in Austria and paying contributions to the pension system (which might be weak for Austrian and foreigners as well), the lower the positive spillovers from children to the pension system.

  Given the high costs of the system, one might ask whether the judgment of the European Court, that automatically grants contributions to the pension system for spells of education as long as some “link” to the Austrian social security system is present can be questioned from an economic viewpoint.

- If a union citizens decides to retire in Austria, she gets a permission for permanent residence if his income is sufficiently high (otherwise, he must have been working at least three years in Austria before retiring, and one year immediately before retiring; we come back to this case below). If she has e.g. worked for at least one year in Austria, the state becomes responsible for her health insurance as well (“responsible institution” according to 1408/71). In this case, she and her family members are insured with contribution rates of less than 5% of a pension for at least one year of work. In Austria, many cases are known where monthly contributions are negligible, while the expected cost per person above 65 years is roughly 300€.

  Of course, this type of redistribution mainly concerns the structure of the health system, and not of the pension system. Nonetheless, Union Citizens get access to the public health system in Austria by EU-regulations concerning residence permits for retirees. Since by this cannel, Union Citizens get access to the Austrian redistribution system, a negative fiscal externality is produced for Austrian taxpayers. If adverse selection processes of a significant size would take place, the population mean would change and the viability of the system would be threatened even more.

- If a person is insured in the Austrian public health system, she also has access to claims for care allowances (in Austria, care allowances are mainly provided in the form of monetary transfers up to about 1.500€ per month). Expected costs at the moment are about 100€ per month and head but they are rising significantly since the system is going to be completely reorganized in 2007/08, even a new type of tax is under consideration to finance the system.

  For this argument, the same kind of consideration is present: as soon as adverse selection processes start to take place, negative externalities of EU-laws are present, and heavy burdens to the system must be expected. At the moment, there is strong evidence that moral hazard processes have not concerned this type of social security services: In fact, care allowances are exported only for a small number of people.

However it is easy to think about constellations where this could be changed systematically.

- If a person that has always been insured in Austria decides to reside in another member country for retirement, Austria remains the responsible state not only for pensions, but also for health insurance and car allowances. (Care allowances are exportable according to a recent judgment of the European Court (RS C215/99, Friedrich Jauch).

  For this case, it is difficult to locate a negative externality, since people have been contributing to the Austrian social security system throughout a long time period, and there is no negative spillover at all if they decide to consume their claims in another country than Austria.

  Nonetheless we shall argue below that one should carefully observe this type of migration of retirees. Because of its mere number, it can become a substantial factor for the pension system that is easily overlooked by politicians and economists. In fact, basically two groups of people are involved. Firstly, many guest workers decide to return to their home country after being entitled to a pension in Austria (irrespective of whether they got the Austrian citizenship during their stay). Secondly, a growing number of people that have been born in Austria decide to move to another place upon retirement.

- If a foreign Union Citizen decides to reside in Austria for retirement and does not earn enough income for subsistence, according to EU-law (EU 2005), she still gets a permanent permission to remain if she has been working at least for three years in Austria, where one year she must have spent in Austria immediately before she decided to retire. Now having a residence authorization, access to welfare aid is open as well.

  It is worthwhile to point out that this regulation is unique from a historical point of view. In Austria men older than 65 years (and women older than 60 years) are not required to work any more if their income is too low for subsistence. They receive a minimum pension of about 730€ per month, 14 times a year (which is increased to about 1030 € p.m. if a family member is present) and costless access to the public health insurance system for an unlimited time period. (In contrast, in welfare states like Sweden, Denmark or the Netherlands, a basic income is granted fully only for people who have been residents of the country for 40 years; for shorter stays, a share of 1/40 is deducted from this amount for every year less.). If all types of costs are added together, an annual sum of about 25-28.000 € per year can be expected for this type of retiree.

From an economic point of view, adverse selection processes that might be induced by this possibility might be substantial. In fact, they might dominate all arguments mentioned above. In particular, given the restrictive policy of other states (Germany, Sweden, Denmark etc.) with respect to a basic income, severe problems might arise.

To sum up, in spite of the recent pension reform, the degree of proportionality between contributions and expected payments might be weak, in particular for Union members who decide to reside in Austria after only short periods of employment in Austria. Furthermore, union citizens who have been employed in Austria for at least one year might take with them claims against the public pension system that substantially exceed the value of their contributions. Since the Austrian tax-payer has to finance the difference, negative externalities are present.

According to the European Court, this type of negative externality does not constitute a problem. Since Austria would gain substantially from the advantages of labor mobility (no proof is given for this statement, however), it is usually argued, sacrifices are seen as completely adequate. The goal of fostering labor mobility in any case is more important than fiscal problems of an individual member states (in fact, fiscal problems normally are not counted as an argument by the European Court).

Consequences for Calculating the Burden of an Ageing Society

In Austria, the future burden of the pension system is usually estimated by using population projections of the national statistics institute (Statistik Austria). Similar as in other European

countries, it shows that the share of people above 65 years relatively to the workforce is increasing substantially.
With increasing labor mobility in Europe, the burden of the social security system is not adequately measured by the share of retirees relatively to the workforce within the country any more. According to the above arguments, pensions that are paid to other states and that are received by other states should be taken account of as well.

Looking at information available, we find that impact of labor mobility on the pension system might be substantial. According to the relevant institution in Austria (Hauptverband der Österreichischen Sozialversicherungsträger), in 2006, about 146.000 people filed an application for pension payments in Austria. Out of these, about 43.000 (or 30%) had spells of contributions in other countries. In Vienna, 27.000 cases out of 53.000 spells of applications (more than 50%) comprised pension claims in other countries. Moreover, during 2004 and 2006, the number of pensions involving periods of contributions in more than one country rose by more than 10%.

Unfortunately, statistics do not tell in detail how many years have been spent in how many countries by how many retirees.

Another indicator of the impact of pensions on the system is the total amount of pensions paid from or to Austria to people who are already retired. Tab. 1 shows detailed data for 2006, and Tab. 2 shows the time trend going back to 1998.

Tab. 1: Transfers of Pension Payments from and to Austria, 2006, in 1.000 €

from Austria:		**cases**	**Total payments**	**monthly pension**
	EU, EWR	139.940	289.849.000	173
	Other nations	101.375	331.558.800	273
	Total	**241.315**	**621.407.800**	215
to Austria	EU, EWR	176.364	477.983.900	226
	Other nations	6.999	19.098.400	227
	Total	**183.363**	**497.082.300**	226

Source: Hauptverband der Österreichischen Sozialversicherungsträger

Obviously, more people living in Austria received pensions from abroad than vice versa. This might be a weak indicator that on average, more people with periods of employment in other countries choose to retire in Austria than vice versa, eventually increasing the burden on the social security system as argued above.

International pensions on average are very low indeed. The last column in Tab. 1 gives the average pension per month. They neither include payments for the health system, nor for care allowances. Still, an average monthly amount of 215 € (from Austria) and 226 € (to Austria) is surprisingly low.

Regarding the development of pension payments over time, we consider Tab. 2:

Tab. 2: Transfer of Pension Payments from and to Austria, 1998-2006, in 1.000 €

	from Austria	to Austria	Index from Austria	Index to Austria
1998	488.143	375.262	1,00	1,00
1999	501.668	382.647	1,03	1,02
2000	511.101	394.511	1,05	1,05
2001	525.903	410.801	1,08	1,09
2002	546.422	425.820	1,12	1,13
2003	551.761	464.047	1,13	1,24
2004	559.896	479.498	1,15	1,28
2005	592.762	495.882	1,21	1,32
2006	621.408	497.082	1,27	1,32

Source: Hauptverband der Österreichischen Sozialversicherungsträger

During the time span under consideration, pensions paid to Austria grew slightly slower than pensions from Austria. No dramatic changes can be found for this time period for either inward or outward directed pension payments.

Nonetheless, there are signs that the picture might change sooner or later. Firstly, from Tab. 1 we can calculate that only 9% of retirees living in Austria get pensions from other countries, yet we know that the corresponding share for new pensions in 2006 was about 30%. Hence, the importance of internationally composed pensions is growing quickly.

A second estimation of future burdens to the pension system can be derived by looking at migration rates. Usually, the impact of migration on a country is measured by net migration per year. As Tab. 3 shows, however, this might give a very incomplete picture of actual migration streams by presenting the cumulative migration streams for the years 2002-05:

Tab. 3: Migration flows 2002-05 from and to Austria

Citizenship	Immigration	Emigration	Net migration
Total	**471.880**	**302.382**	**169.498**
Austria	71.780	121.301	-49.521
"old" EU member states	73.300	37.409	35.891
"new" Eu member states	52.216	29.084	23.132
Successor states Yugoslavia	80.367	38.991	41.376
rest of Europe	53.688	23.172	30.516
Turkey	36.996	11.755	25.241
"EU-relevant migration"	**368.347**	**261.712**	**106.635**
Rest of world	103.533	40.670	62.863

Source: Statistik Austria

Unfortunately, the period of consideration is quite short, as in 2001 a change in collecting data has been performed, so that data prior and after 2001 are hardly compatible.

Nonetheless, we find that net migration is roughly more than a third (36%) of total migration. Concerning EU-relevant migration we find that net migration even accounts for less than 30% of total migration. (Note that we have included successor states of Yugoslavia and Turkey in this position, since these countries are expected to enter the EU 2013-2015. Hence, according to the judgment of the European Court all claims will be active as if these countries had ever been a part of EU, even if they have been acquired decades before).

It is difficult to estimate by which amounts these claims will be able to burden the pension system in the long run since adequate data are missing. Nonetheless, two statements seem plausible: Firstly, it is necessary that more data about social security are going to be gathered and evaluated. Secondly, even with imperfect knowledge, we can expect high burdens from international mobility for the social security sector. In other words, the current share of social expenditures might be a poor indicator for future burdens, and even taking account of population estimations might still yield an incomplete picture.

Conclusions

The present paper takes the Austrian pension system as an example to show a possible conflict between national law and EU-regulations in favor of mobile workers, as fiscal equivalence is violated. We argue that EU-law imposes negative externalities on the systems that are hardly taken account of by myopic politicians, and many claims will be active only in the long run. This might possibly induced adverse selection and moral hazard processes.

Social security statistics are not sufficient go yield a reliably picture of what burdens have to be expected in the future. Since the share of pensions that is including international spells of employment is increasing quickly, more attention should be given to these questions. Hence, more statistics should be gathered, and more attention should be given to these developments both at the national and the supranational level.

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