



Vision Europe Summit



Redesigning European welfare states – Ways forward



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Ways forward



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Country codes

AT Austria	FI Finland	NL Netherlands
AU Australia	FR France	NO Norway
BE Belgium	HR Croatia	PL Poland
BG Bulgaria	HU Hungary	PT Portugal
CA Canada	IE Ireland	RO Romania
CY Cyprus	IT Italy	SE Sweden
CZ Czech Republic	JP Japan	SI Slovenia
DE Germany	KR South Korea	SK Slovakia
DK Denmark	LT Lithuania	UK United Kingdom
EE Estonia	LU Luxembourg	US United States
EL Greece	LV Latvia	
ES Spain	MT Malta	

Preface

In January 2015, seven leading think tanks and foundations joined forces to form Vision Europe Summit, a consortium created to address some of the most pressing public policy challenges facing Europe. Through research, publications and an annual summit, we aim to be a forum for debate and a source of recommendations to improve policy-making at both a national and EU level and to foster as appropriate European integration. The convening organizations are: Bertelsmann Stiftung (Gütersloh), Bruegel (Brussels), Calouste Gulbenkian Foundation (Lisbon), Chatham House (London), Compagnia di San Paolo (Turin), Jacques Delors Institute (Paris), and the Finnish Innovation Fund Sitra (Helsinki).

In this first year, the Vision Europe Summit conveners chose to explore the future of the welfare state. For many in Europe, the welfare state is at the heart of what it means to be European. The values which underpin it are deeply embedded in European societies. Compared to the rest of the world, what unites European welfare states is stronger than what separates them.

Yet all welfare states in Europe face common challenges. If they are to be competitive assets in the future, welfare states have to be reformed. By analyzing the history and different models of welfare states and by outlining current challenges, the first chapter “The welfare state in Europe – Visions for reforms” highlights why this topic was selected: The financial and economic crisis has accelerated the structural problems many welfare states face. Governments should seize this as a chance to implement structural reforms, investing in the long-term sustainability of their welfare states. In addition, the EU has

developed a social agenda, but the role that the EU should play in welfare policy remains an open question, particularly as most aspects of welfare are likely to remain national prerogatives.

This publication suggests ways forward on a national and EU level in order to ensure sustainable welfare states which are able to fulfill their core functions and ensure the well-being of European citizens. Throughout the year experts from the seven think tanks and foundations collaborated in working groups chaired by Eeva Hellström and Mikko Kosonen (The Finnish Innovation Fund Sitra), Frank Vandenbroucke (Jacques Delors Institute) and Guntram Wolff (Bruegel). Each working group focused on one specific aspect of welfare state reforms whilst Iain Begg (Chatham House) outlined the overall challenges in the introductory chapter. This publication reflects that process: Four chapters – diverse in methodology and focus – but with the common aim to contribute to the discussion on the future of European welfare states. Our intention is to provoke debate and discussion. There is no single approach to reform, neither in content or process. Every system has to change, but in different ways and using different means.

The first chapter outlines the background and general challenges, whilst the following three focus on specific aspects of these challenges and suggest reform options: On social equality and convergence (chapter 2), on the distribution of contributions and benefits across generations (chapter 3), and finally on the governance processes behind policy decisions (chapter 4).

The second chapter “Social Inequalities in Europe – The challenge of convergence and cohesion” takes a comparative perspective, highlighting how different types of inequality have increased rather than decreased between and within member states in recent years. The EU has ceased to be a convergence machine and the chapter thus suggests policies on a European and national level that could make the engine run again and tackle different forms of inequalities.

The third chapter “The growing intergenerational divide in Europe – What role for the welfare state?” focuses on one specific type of inequality, namely between different generations. It shows how the financial and economic crisis has had an impact on public spending toward younger and older age groups: Relative spending on retirement increased while relative spending on education, families, and children decreased. The authors take an even more focused view in analyzing one specific avenue of solution, namely reforms of pension systems to ensure their intergenerational fairness.

The final chapter “Governing the welfare state and beyond – Solutions for a complex world and uncertain future” suggests how governance mechanisms can be adapted in order to be able to meet the upcoming challenges and to be efficient catalysts of reforms. If governance is to be the oil of societies, its fluidity needs to be enhanced. The chapter differs from the preceding ones as it takes a broader focus, looking at welfare as just one policy field where innovative governance structures are needed in order to meet the evolving needs of citizens today and in the future.

All four chapters are the fruit of an intense exchange between experts at our think tanks and foundations. The papers therefore represent a diversity of views, rather than one agreed roadmap for reform. We see these differences as our strength, reflecting the different approaches and methods available to policy makers and the varied national traditions of European states.

These papers form the basis for discussions between high-level experts, politicians and stakeholders from the national and the EU level at the Vision Europe Summit in Berlin in November 2015. I look forward to a fruitful debate.



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The welfare state in Europe – Visions for reform

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Executive summary

- For many in Europe, the values and norms that underpin the continent's social model are at the heart of what it means to be European.
- Welfare states perform a number of redistributive functions and protect the vulnerable. Contrary to negative portrayals, welfare states also invest in human and social capital. All European citizens both use and contribute to the welfare state at different stages of their lives.
- Pressures on public finances, and the burden that social spending imposes on the 'productive' parts of economies, raise questions about whether European countries can still afford their welfare states.
- Welfare systems first designed 50 or more years ago need to be recast to confront today's challenges. They must accommodate the extensive societal transformations associated with population ageing, closer global economic integration and the spillover effects of climate change.
- Welfare states will also have to adapt to new social risks resulting from the changing nature of European economies, especially evolving patterns of work and employment. They will have to use resources more efficiently and make the most of relevant technological advances, without unduly sacrificing key principles such as solidarity.
- A number of dilemmas about appropriate forms of decision-making and democratic oversight surround efforts to reform welfare, but there are reasons to be optimistic about the future of the European social model. Well-designed welfare states can promote sustainable growth in Europe and be a competitive asset.

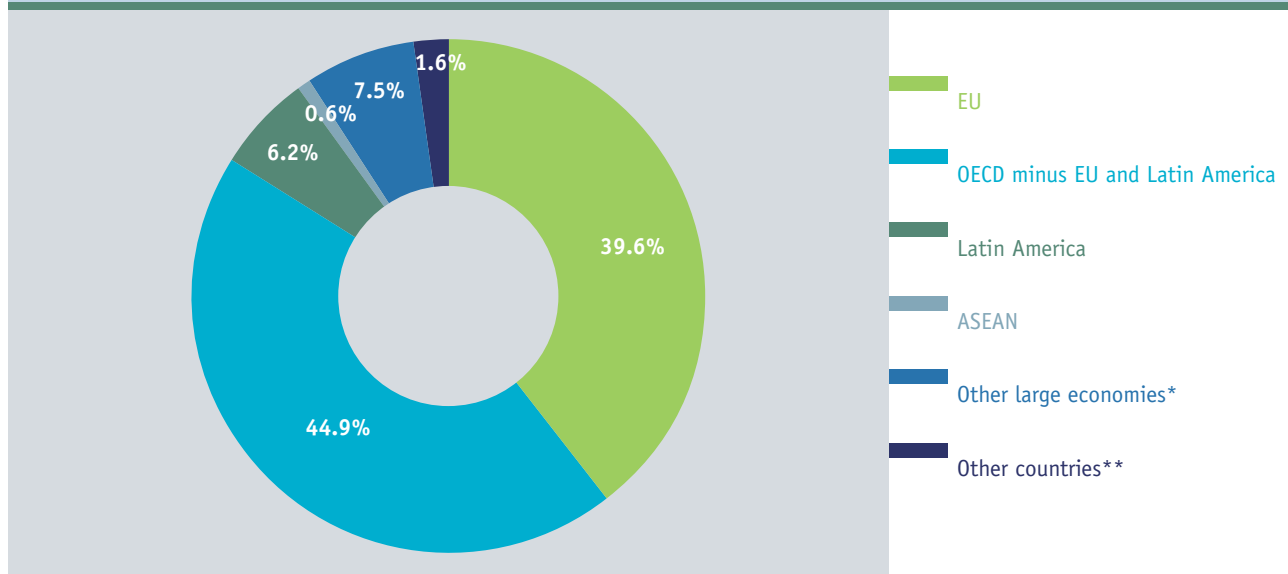
1. Introduction

There is a growing sense that the European social model is unsustainable and in need of reform. As the German chancellor, Angela Merkel, is fond of claiming, the European Union (EU) accounts for roughly 7% of the world’s population and 25% of its GDP, but over 50% of its welfare spending. The implication is that Europe’s welfare states are not only generous in comparison with provisions elsewhere, but will become unaffordable without major recasting. They undeniably face a range of demographic, fiscal and other pressures, exacerbated by weak economic growth or recession since the 2008–09 financial crisis. Changing work patterns and competition from

emerging economies with lower labour and social welfare costs are also raising fundamental questions that Europe’s leaders have struggled to answer. These include dilemmas about the extent of the state’s responsibility to its citizens and, specifically, whether governments can or should maintain comprehensive welfare systems in the future.

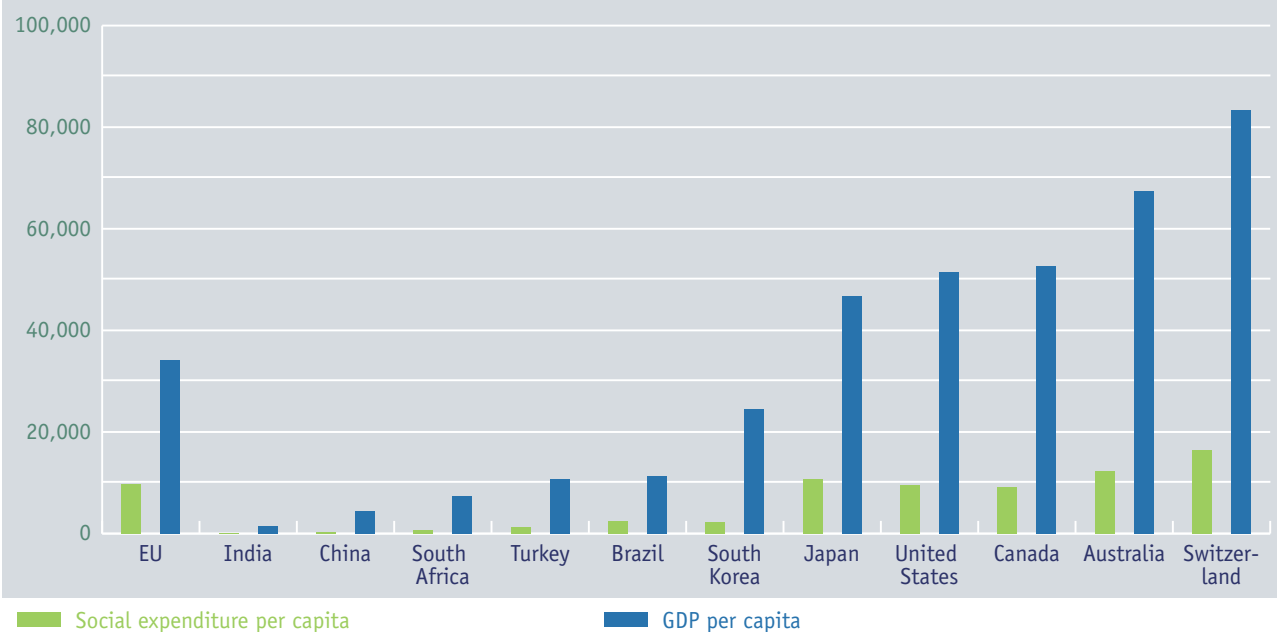
In fact, Merkel’s data are somewhat inaccurate. The EU’s welfare spending was 40% of the world total in 2012 (Figure 1), while its share of nominal world GDP in 2014 was 24% (at current prices and current exchange rates, and thus making no

Figure 1 | Global social protection expenditure aggregates, 2012 or latest (% of total)



* Large economies are China, Egypt, India, Nigeria, Russia, Saudi Arabia, South Africa, United Arab Emirates.
 ** Other countries exclude American Samoa, Andorra, Bermuda, Cabo Verde, Cayman Islands, Channel Islands, Comoros, Curaçao, Djibouti, Faeroe Islands, French Polynesia, Gabon, Greenland, Guam, Haiti, Isle of Man, North Korea, Kosovo, Liberia, Liechtenstein, Macao, Malawi, Micronesia, Monaco, Montenegro, New Caledonia, Northern Mariana Islands, Palau, Puerto Rico, Republic of the Congo, Romania, San Marino, Serbia, Sierra Leone, St Martin (Dutch and French parts), Somalia, South Sudan, Suriname, Syria, Taiwan, Timor-Leste, Tonga, Turkmenistan, Turks and Caicos Islands, Tuvalu, Virgin Islands (US), West Bank and Gaza.
 Sources: EUROSTAT (for social expenditure in EU member states); OECD SOCX database (for social expenditure in non-EU OECD countries); ILOSTAT (for social expenditure in non-EU non-OECD countries); World Bank Data (for GDP and population data).

Figure 2 | Social protection expenditure and GDP per capita in EU and selected countries, US\$, 2012 or latest



Sources: EUROSTAT (for social expenditure in EU member states); OECD SOCX database (for social expenditure in non-EU OECD countries); ILOSTAT (for social expenditure in non-EU non-OECD countries); World Bank Data (for GDP and population data).

allowance for differing price levels).¹ In addition, as Figure 2 shows, per capita spending on social protection in the United States and Japan was broadly the same as in Europe, higher in Switzerland and Australia, and very slightly lower in Canada.

The real gap in social spending is between the 'old' industrial economies and the emerging markets, including China, India,

Brazil and South Korea. For these countries, social spending is a small fraction of that in the more advanced economies, but it is likely to rise as their prosperity increases and they seek to strengthen welfare provision. As a result, the EU's share of global social spending can be expected to fall simply because the share accounted for by the rest of the world will rise. It is already clear, for example, that China will soon have to take steps to deal with its rapidly ageing population by introducing higher social support to maintain the incomes of older people.

¹ An alternative means of measurement, converting national data using 'purchasing power standards (reflecting differences in price levels), would lower the EU's shares of global GDP and social protection spending by about 20%, and push up the corresponding shares of emerging market economies.

While Merkel's point is that something will need to 'give' in Europe's approach to its welfare model, the affordability of the welfare state is a tricky concept. The linked concern that high welfare spending is undermining European competitiveness has to be looked at with care, even if it is accepted that adjustments need to be made. Today's political and economic context for such an adjustment is not benign. In the wake of the financial crisis and a protracted recession in parts of Europe, national politics is fragmenting in both the more and less wealthy members of the EU.

Populist parties are on the rise, as seen in the results of the 2014 European Parliament elections and several national elections since then. There is a pervasive concern that neither national governments nor the EU as a whole will prevent globalization from further constraining median wages while widening income inequality.

This paper aims to lay out the scope of the challenge ahead. It starts by describing the core functions of the welfare state. Second, it outlines the evolution of particular welfare models across Europe and introduces the concept of social investment. Third, it assesses the ways in which socio-economic change threatens welfare state sustainability. It then considers the dilemmas for the welfare state and the potential for recasting the welfare model to cope more effectively with the challenges it faces.

Three areas for deeper research are suggested. These will form the basis of an additional series of papers, focusing on the economic, social and governance dimensions of the welfare challenge. These papers will suggest changes in strategy and specific policy approaches to welfare provision, with the aim of enabling European countries to achieve sustainable welfare systems for the coming decades.

2. What is the welfare state?

European countries developed their welfare systems during a period when the region's benign demographic profile could support extensive social spending and when solid economic growth made it affordable. The political economy of Europe has been defined since the 1950s by the development in each European country of a more or less comprehensive welfare model, whereby the state has taken a central role in providing a range of social benefits, the most costly of which are pensions, support for the poor, social housing and healthcare. In parallel, all EU countries have sought to regulate labour markets and ensure a fair deal for workers. One of the most complex challenges currently facing European governments and societies is to reconcile these commitments to welfare provision, which are widely supported politically, with pressures that may make them unsustainable economically.

Purposes and design

The European 'welfare state' eludes concrete or universal definition. Its principal purpose, however, has been to help governments reconcile the often competing dynamics of capitalism, equity and democracy. Free-market economies have an inherent tendency towards income inequality and distribute economic power unequally, while democratic government seeks to distribute political power more evenly and to promote notions of social equality (Hay and Wincott 2012). In relation to European integration, the underlying challenge can be seen as a variant on Dani Rodrik's 'trilemma', in which there is mutual incompatibility between global economic integration, the nation state and democracy (Rodrik 2011). In his analysis, only two out of the three can simultaneously be sustained.

The result is that much of the debate about designing a welfare state and judging the pros and cons of its different components is influenced by political ideology. For some, the state should

play a central role in income redistribution in order to sustain welfare budgets. For others, the capacity to deliver social welfare is a by-product of a less interventionist approach to economic governance. Inevitably, the particular political outlook then influences the methods by which a government seeks to deliver welfare policies.

A good example lies in healthcare. In the United States, the political consensus long held that this should principally be a private responsibility, leaving the state to provide support only to those unable to afford private health insurance. The deeply politicized and increasingly contested nature of this settlement was exposed by the difficulties that President Barack Obama faced in passing the Affordable Care Act. In the United Kingdom, the prevailing political consensus is that the state should have principal responsibility for healthcare, providing universal coverage through the central government budget and thereby avoiding the market failures that have long blighted the US system.

Welfare state functions

Overall, the welfare state fulfils three analytically distinctive functions (drawing on, and extending, Nicholas Barr 2012):

- **The 'Robin Hood' function** of redistributing in various ways from better-off members of society to those faced with material or other deprivation or subject to higher social risks. Welfare states comprise institutions and mechanisms designed to protect against these risks by delivering poverty relief, providing social housing, redistributing income and reducing social exclusion. Labour market regulations protect against unfair dismissal and ensure rights for temporary workers. Social risks have evolved over time and now include aspects such as one-parent families and the isolation of old-age pensioners from their families.

- **The 'piggy bank' function** through which the welfare state enables citizens to insure themselves against social hardship and to spread their income more securely over their lifetime, with pensions being the main element.
- **The social investment function** that enables the state to invest in the nation's human and (harder to define) social capital (Hemerijk 2012). This includes kindergarten care, state education from primary level through university, out-of-work training and various types of work-related tax benefits.

In macroeconomic terms, state welfare budgets serve as 'automatic stabilizers' against the effects of economic disruption at the individual and national levels. More specifically, they address a number of policy priorities, including those listed below.

Macro- and microeconomic efficiency

A welfare state reacts to market failures wherever there are deviations from optimal outcomes, in particular uninsurable risks. Government intervention is therefore justified, even in the most libertarian systems, because it increases economic efficiency over time. Improving aggregate as well as individual economic efficiency lies at the heart of most aspects of welfare provision.

Consumption smoothing

Through the provisions of cash benefits for pensioners and for families with young children, a welfare state allows individuals to smooth out their financial expenditure and consumption over their lifetime.

Pension schemes allow individuals to redistribute income from their younger to their older selves in a secure manner. Student loans enable students to consume more than their current income allows through claims on their future income. Child benefits allow families with young children to consume more than they could otherwise at a financially constrained point in their lives.

Risk-sharing

The welfare state provides insurance against unexpected and unacceptable changes in individuals' living standards, through mechanisms such as unemployment and disability benefits. At the same time it has to guard against eliminating incentives to take well-judged risks that offer rewards for individuals and society alike. An example would be overly generous unemployment benefits that discourage the search for new employment. Different modes of risk-sharing are:

- **Actuarial insurance:** individuals pool risks to be insured against losses from certain events. Benefits from actuarial insurance are strictly related to one's own contributions. There is no systematic redistribution from rich to poor but rather from 'lucky' to 'unlucky', i.e. from those people who pay for the insurance but never suffer from the insured loss to those who do.
- **Social insurance:** the same pooling principle as actuarial insurance, but typically with compulsory membership, perhaps justified because the market would not insure against the risks in question.
- **Redistribution from rich to poor:** risk-sharing mechanisms can entail redistributive elements, such as pension schemes that provide higher benefits relative to paid contributions for lower-paid than for higher-paid workers.

Relieving poverty

An essential objective of the modern welfare state is poverty relief, with nearly all EU countries offering some form of minimum income guarantee and many undertaking to offer basic shelter. Whether this entails elimination of poverty or alleviation of poverty is subject to political decisions and depends on a number of factors.

Reducing inequality

Reducing inequality entails both vertical redistribution (from rich to poor households through progressive taxation) and horizontal redistribution (ensuring that households with similar characteristics, such as age, family size, etc., are treated equivalently).

Addressing social exclusion

Addressing social exclusion is a broader and more normative objective of the welfare state. It includes increasing social solidarity and the dignity of welfare clients by delivering benefits without unnecessary stigma.

Box 1 | How do governments distribute social benefits?

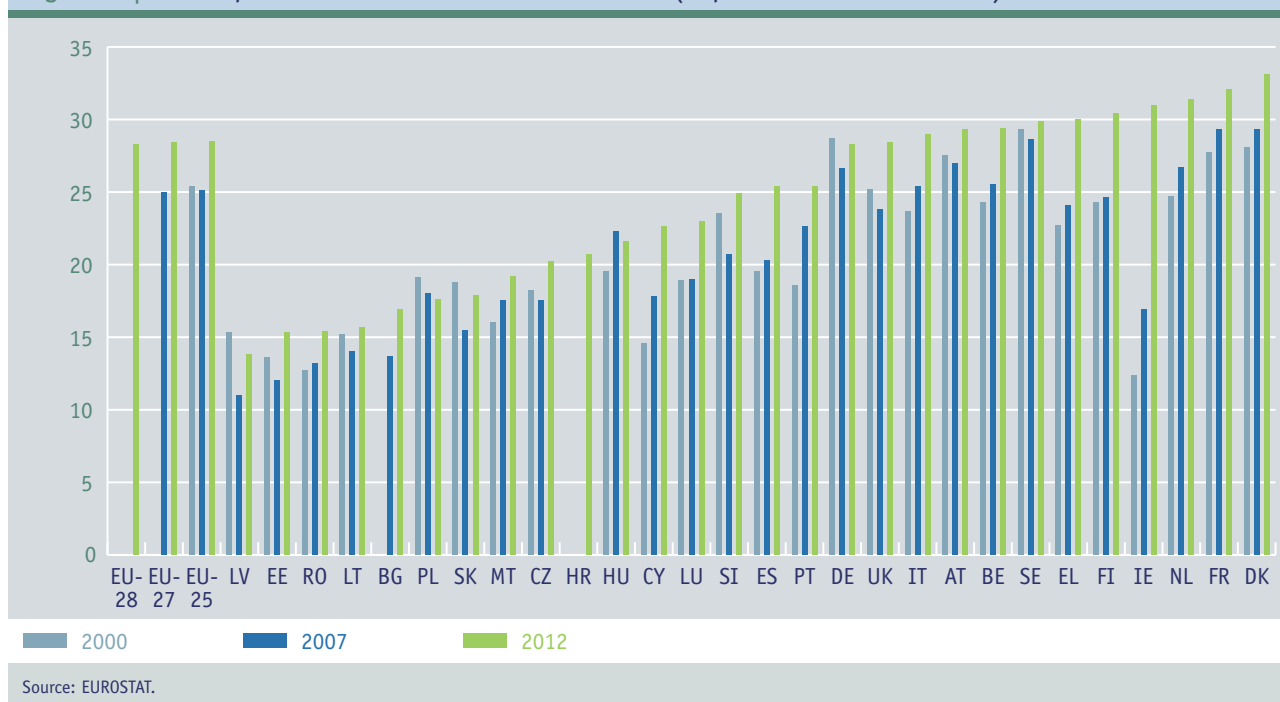
Cash benefits

- Social insurance: entitlements to benefits are based on past contributions, with payments triggered by specific contingencies (e.g. unemployment, retirement or ill health). Examples include replacement incomes for the unemployed, pensions and disability allowances.
- Non-contributory benefits: benefits available to all, without any obligation to contribute or means-testing (e.g. child benefit in many countries).
- Social assistance: means-tested benefits for those in poverty.

Benefits in kind

- Benefits in kind provide welfare through the free provision of services, such as healthcare, social housing (either free or at rents below market levels) and education. The three main issues that policy-makers need to address are how these benefits are financed, how they are delivered and how quality can be assured.
- In most countries healthcare is financed to a large degree through the state, since the market for healthcare does not conform to the principles that are expected of a well-functioning market (being subject, for example, to imperfect information or incomplete provision of insurance that can deny protection to many of the most needy).
- This explains why the United States, which relies heavily on private finance, spent almost twice as much (16.2% of GDP) on healthcare in 2012 as the average for other OECD countries (8.8% of GDP). By contrast, the figures were 8.9% for the United Kingdom, 9.1% for Sweden and 10.9% for Germany. The mode of delivery, on the other hand, varies in different countries (from mostly public to mixed forms to mostly private) since it interferes less with efficiency.
- For similar reasons, school education is predominantly both financed and delivered publicly in most countries, while the provision of university education is more diverse.

Figure 3 | Social protection benefits – all functions (expenditure as % of GDP)

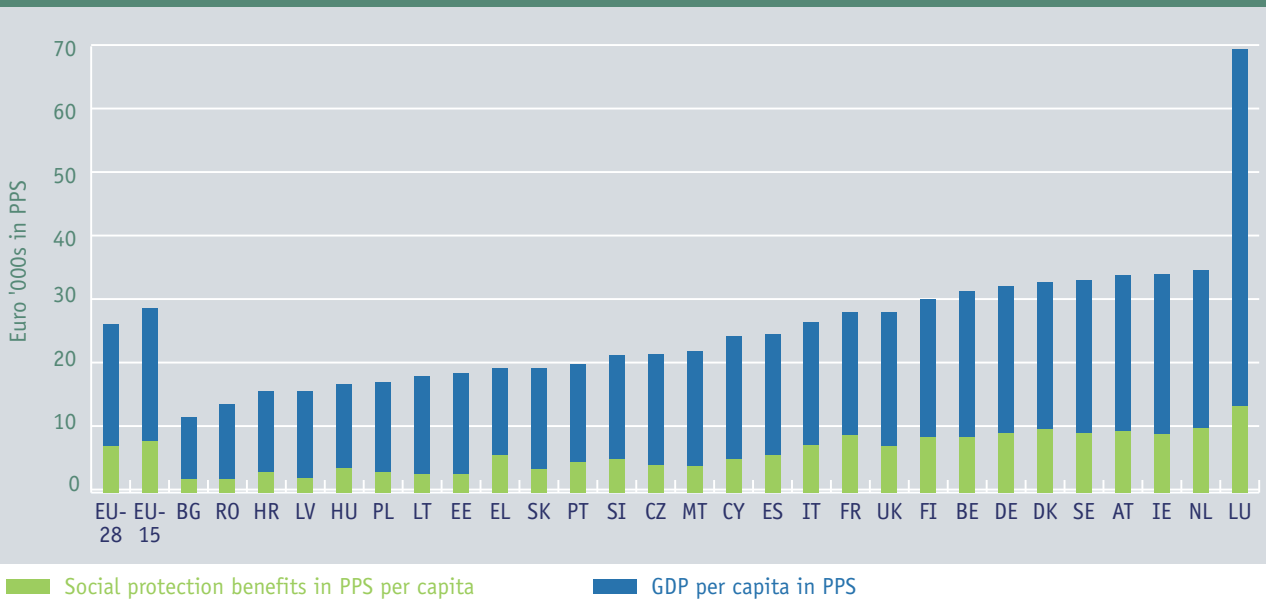


Welfare spending in Europe

It is clear from recent data that governments continued to allow spending on social protection to increase before and after the financial crisis, whether because it played its automatic stabilizing function or in order to protect particular segments of the population for political reasons, and that all of this occurred despite the pervasive ‘austerity’ narrative (Figure 3). More generally, it is hard to cut or even restructure social benefits for the simple political economy reason that those who lose out protest loudly. This leads many governments to opt instead for less conspicuous cuts in public investment when public finances are under pressure.

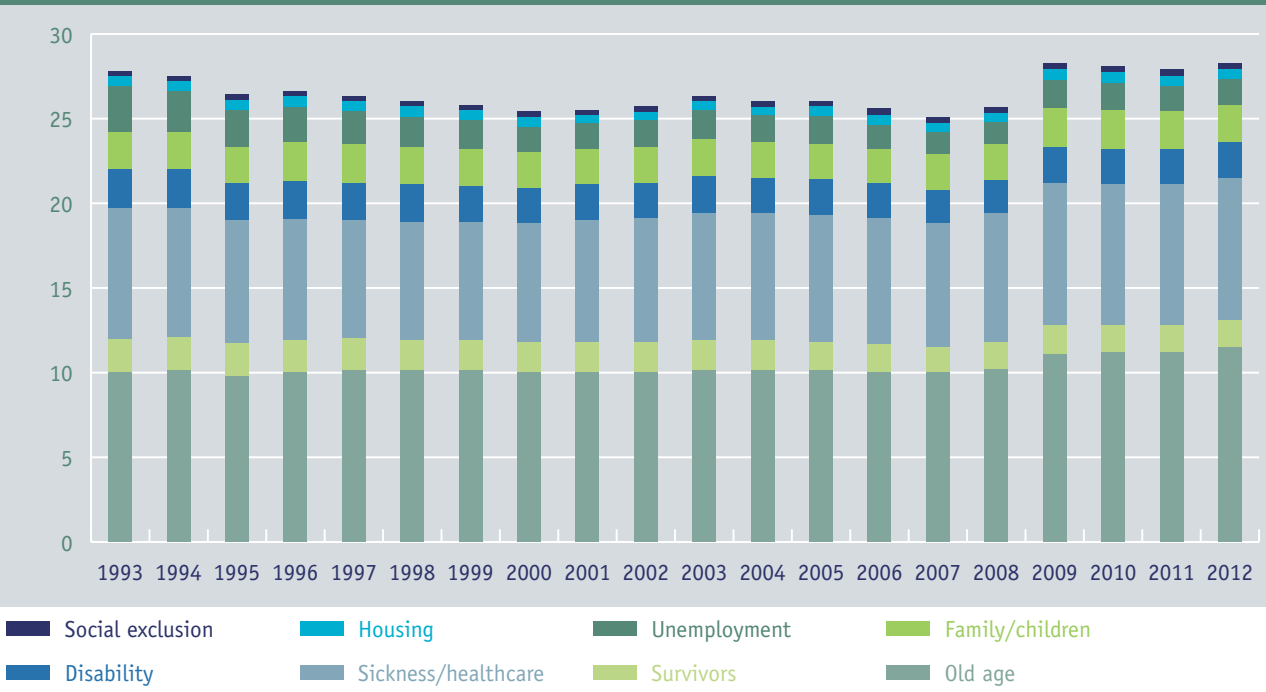
Some of the differences between EU countries can be discerned from considering the scale and mix of welfare spending (Figures 4 and 5). These differences partly reflect national traditions and preferences, but also the differing economic conditions in countries. Per capita spending on welfare is lower as a share of GDP in the lowest-income EU countries, but clearly higher in France than in the United Kingdom, two countries with similar levels of GDP. Yet it is also noteworthy that per capita spending levels are similar across the northern European countries. Among the headings of welfare spending, it is striking just how stable the shares of old-age outlays were up to the crisis and how they appear to have been protected (and have indeed increased) since 2008. Healthcare, similarly, has been gently

Figure 4 | Expenditure on social protection benefits – all functions (PPS* basis per capita, relative to GDP per capita, 2012)



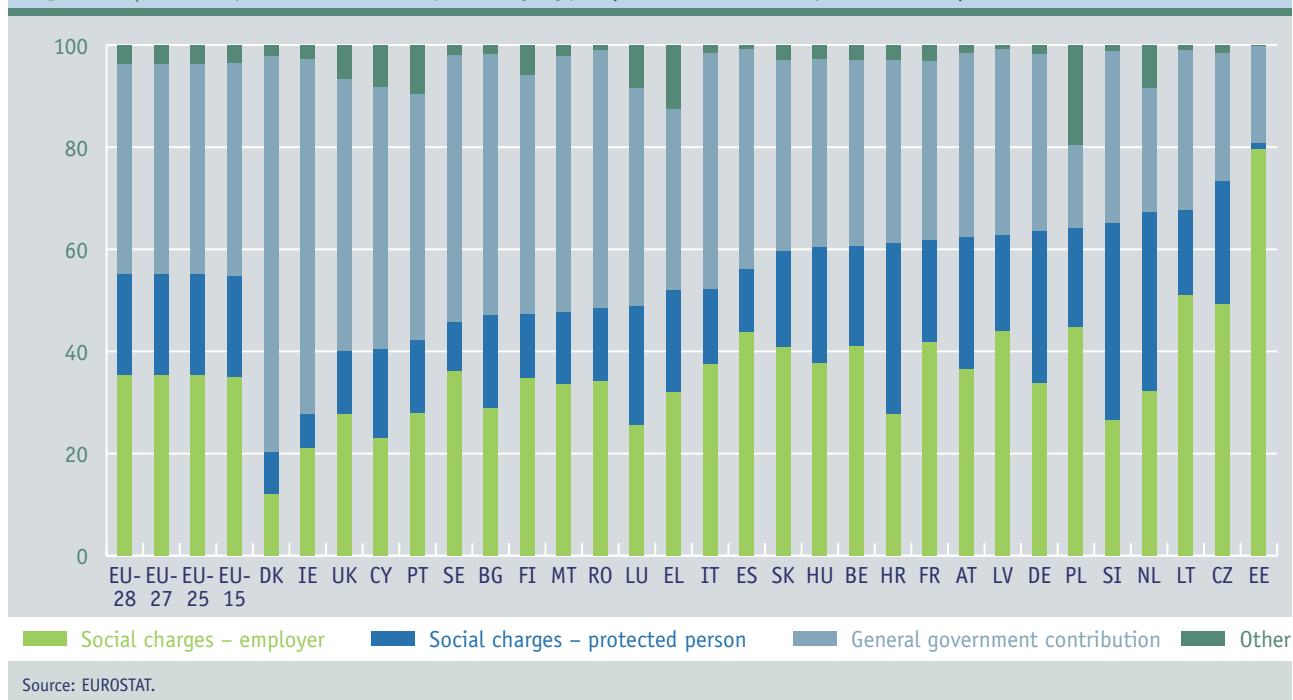
* Purchasing power standard.
Source: EUROSTAT.

Figure 5 | Expenditure on social protection benefits – by function (% of GDP in EU*, 1993–2012)



* EU is taken as EU-15 for 1993–99, EU-25 for 2000–04, EU-27 for 2005–07, EU-28 for 2008–12.
Source: EUROSTAT.

Figure 6 | Social protection receipts – by type (% of total receipts in 2012)



increasing its share. The share going to unemployment benefit, albeit small, jumped after 2007 as the number of unemployed people rose. Overall, as a share of GDP, social spending has varied less than might be expected, only jumping in 2009 when GDP, the denominator of the ratio, fell sharply.

Governments across Europe raise the revenue needed to meet their welfare commitments from a mix of explicit social charges levied on employers and employees, general taxation and some charges for specific benefits (Figure 6). Even in the United Kingdom, for example, ‘free at the point of need’ healthcare includes a flat charge for some drug prescriptions and various fees for dental care. With public finances under

pressure, how to fund welfare states will be an increasingly delicate governance issue.

The main differences between EU countries are in the proportion of revenue raised from explicit social charges, the consequence of which is that general taxation has to make up the difference. At one extreme, Denmark generates only a fifth of the income through charges on employers and workers, whereas in Estonia the proportion is four times as high. Differences between the share paid by workers as opposed to their employers are also noteworthy, with Slovenia and Germany among those asking workers to shoulder more of the burden.

3. Evolving European models of welfare states

Welfare states in Europe were largely constructed in their present form following the Second World War, but reflect longer-term national traditions and accommodations. Despite considerable diversity in the core values of the respective national welfare systems in Europe, many norms are common across the continent. It is reasonable, therefore, to speak of a distinctive European social model, often most easily defined in terms of what other parts of the world lack. Pascal Lamy has referred to the model as embodying ‘a European way of life’ and described it as ‘a civilized version of globalization’ (EurActiv 2014). Its key features include protection of workers and a commitment to social protection of the vulnerable and to limiting inequalities. There are, indisputably, components of national social provision which have special status: to Britons, the National Health Service has totemic status; in France the word ‘solidarity’ is central to welfare politics; and citizens of the Nordic countries set great store by a broad definition of equality.

Welfare systems in the postwar socio-economic paradigm

Welfare states in Europe were a key component of the postwar economic management paradigm, in what is sometimes referred to as a golden age of economic growth up to the early 1970s. Among the attributes of this paradigm were reconciling democracy and capitalism, allowing high growth and investment, and at the same time significantly reducing insecurities (poverty, unemployment, inadequate healthcare, etc.) for the working population. Full employment was an underlying objective. Welfare systems also contributed to the legitimization of the nation state in the postwar era, as explained by Alan Milward (2000) in a seminal book. What transpired was a division of labour between the European ‘project’ (providing economic integration and fostering growth)

and the nation state (providing social welfare and ensuring that the benefits of higher growth were equitably distributed among different social groups).

From the oil shocks of the 1970s onwards, the conjunction of rising inflation and slowing growth – what came to be known as ‘stagflation’ – called into question the prevailing economic orthodoxy, leading to what is sometimes called neoliberalism. This was characterized by renewed reliance on market mechanisms, and a belief in the need for smaller government and sound money (balancing fiscal budgets, low inflation, etc.). In subsequent decades, the paradox emerged of there being consistent pressure on, and questioning of, public spending on social policies while surprisingly stable amounts of money were spent on social protection systems.

‘Worlds of welfare’

Nevertheless, differing welfare models evolved over this period. In parallel with work on ‘varieties of capitalism’, these models have been categorized in various ways by academics, with perhaps the best known being Gøsta Esping-Andersen’s ‘worlds of welfare capitalism’ (Esping-Andersen 1990). He identified three distinct models of welfare state within Europe, marked by levels of ‘decommodification’ (i.e. income support for those outside the labour market), ‘stratification’ (i.e. the effects of welfare policies on social class and mobility) and the different providers of welfare (i.e. public, private, etc.). Later a fourth, Southern European ‘world’ was added based on work by Maurizio Ferrera (1996). (See Box 2.) It is a moot point whether the systems put in place in the course of the transitions from socialism of the countries of Central and Eastern Europe constitute a fifth model.

Box 2 | 'Worlds' of welfare capitalism*

Social-democratic/Scandinavian model

- Prevalent in Denmark, Sweden.
- Generous replacement of market earnings through the state.
- Stratification of universal social citizenship/social welfare as a universal right.
- State as main provider of social welfare.
- Characterized by high social expenditure, active labour market policies and increased public-sector employment.

Corporatist/Continental model, sometimes also known as 'Bismarckian'

- Northern-central Europe, typified by Germany and France.
- Varying degrees of decommodification and stratification, preserving the status of workers.
- Main provider of welfare is the family, but contributory principle ties many benefits to employment history.
- Basic security supplemented with contributory benefits (pensions, unemployment, etc.).
- Opening up jobs through earlier retirement.

Liberal/Anglo-Saxon model

- United Kingdom, Ireland.
- Minimal decommodification; stigmatizing stratification.
- Seeks to increase demand for labour through liberalization and wage flexibility.
- Mostly private forms of insurance.
- Benefits comparatively low and linked to means-testing.
- Poverty relief through minimum wages, but less of a focus on equality.

Southern model

- Spain, Italy, Greece, Portugal.
- Insider-based entitlements.
- Extended family as core unit.
- Income maintenance.
- Strong jobs protection – favouring, for example, full-time over temporary workers.

* Based on concepts developed by Gøsta Esping-Andersen and Maurizio Ferrera.

The 'worlds of welfare capitalism' approach sets out 'ideal-type' models rather than being a precise description of welfare approaches in specific countries. However, it has had an enduring influence, even though the reality is more nuanced and substantial changes have occurred over the past quarter of a century in many countries. Developments since the seminal work of Esping-Andersen was published often belie easy categorization, as the examples of France and Germany show, given that they display very different characteristics in their welfare regimes, despite being part of the same 'world'. Germany, in particular, has undergone extensive welfare reforms since reunification; these have facilitated a much increased employment rate compared with France.

Social investment as a new European model

Since the mid-1990s, a shift in welfare provision towards social investment has become evident. Although the term allows for different interpretations (Vandenbroucke and Vleminckx 2011), the 'social investment state' can be understood as a concept in which the state tries to foster adaptability, flexibility, security and employability. It has many roots, including the activation policies already prominent in Sweden from as early as the 1930s and the notion of social protection as a productive factor that became prominent in Belgium, the Netherlands and Luxembourg in the 1990s. It can also be regarded politically as a means of legitimizing the welfare states in a context of taxpayer resistance to the rising cost of programmes perceived (however inaccurately) to be predominantly redistributive. What distinguishes the social investment approach is that its focus is much more on 'capacitating' interventions than on those which compensate. In this sense, social investment is about raising human and social capital to prevent future problems that could require costlier interventions (Morel et al. 2012).

An interesting way of looking at this stronger role of the state is that it provides an active approach to the challenges posed by many long-term socio-ecological transitions. Ageing needs to be managed, as does climate change or societal evolution. 'Active' labour market policies that enhance human capital, rather than the more traditional passive income support for the economically inactive, can equip an economy to meet challenges such as decarbonization or the growth of the knowledge economy, and help to provide the workforce with the new skills required.

Some critics of social investment point to its correlation with what has become known as the 'Matthew effect', deriving from verse 13.12 of the Gospel of Matthew in the Bible, which states: 'for whosoever hath, to him shall be given, and he shall have more abundance: but whosoever hath not, from him shall be taken away even that he hath' (see also Cantillon 2011). They argue that too many of its benefits accrue to middle-class citizens, examples being increases in childcare support or favourable treatment for private pensions. The wider concern expressed by bodies such as the European Anti-Poverty Network is that by putting work at the heart of social policy, the social investment approach discriminates against those in the most dire need and undermines the principles of protection and solidarity that are central to European welfare policies.

4. Drivers of change

While Europe's governments have developed an elaborate system of social protections and incentives for their citizens, its welfare states are now under threat from a number of directions. Principal among these are demographic change, the pressures at national level from economic globalization, the increasingly explicit EU-level requirements for national budget discipline, and the changing nature of work. Dealing with climate change is also widely recognized as a core challenge, likely to generate new social risks that welfare states are ill-equipped to manage. An obvious example is fuel poverty resulting from rising energy prices. But there are also opportunities; targeted energy efficiency measures (better insulation of the European housing stock, for example) would help to reduce carbon emissions and address fuel poverty. The many dimensions of 'sustainability' are, therefore, also germane to the future of the welfare state.

Demographic change

Population ageing will affect all European countries, albeit at different rates and times. The populations of Finland and Germany are already starting to decline and are projected to fall sharply up to 2050, with ramifications for the labour market and the financial sustainability of each country's welfare state. The German workforce, for example, is projected to shrink by between 11.1% and 18.7% (depending on the scenario) by 2030 compared to today (Dolls et al. 2014), while the country's old-age dependency ratio (the ratio of elderly dependents to the working population) is expected to rise to about 0.45, from 0.31 in 2010 (Paulus et al. 2014). Ireland is at the other end of the spectrum, but will still have to deal with ageing before long. Overall, the proportion of the population aged 65 or over in the EU28 is projected to rise steadily from 18.9% in 2015 to 23.9% in 2030 and 28.1% in 2050 (Eurostat 2013).

The challenge this presents for the welfare state has several dimensions. The first relates to the simple arithmetic of the 'piggy bank' function: more pensioners, living longer increases the financial burden unless countervailing action is taken. Provision of care, sheltered housing or other social services adds to the financial challenges, while also requiring suitably qualified labour. In appraising the costs, it is important to note that the distinction between fully capitalized funding (through which pension funds own the assets from which the income flows pay pensions) and pay-as-you-go systems (which rely on raising revenue from today's taxpayers and social charges) may affect the details, but does not fundamentally alter the arithmetic of a falling working population having to support a growing dependent population. However, it does raise governance questions around fairness, mechanisms, legitimation and transparency.

Immigration can mitigate the impact of the demographic shift, particularly if migrants are predominantly younger working-age people who are motivated to work. However, the difficulties European countries have had in coping with would-be migrants crossing the Mediterranean illustrate the political and social obstacles to higher immigration across the EU, even in Germany which has been more receptive to migrants than many other EU countries. Moreover, there have been instances of specific problems associated with integrating immigrants and resulting tensions. The evident problem here is that the blurred boundary between, on the one hand, those trying to come to Europe as economic migrants and, on the other, refugees fleeing oppressive regimes has inhibited rational debate about the potential role of immigrants in countering the ageing of populations.

Globalization

Globalization is reducing European governments' ability to sustain or reform welfare institutions and arrangements independently. For example, currently elaborate and often expensive welfare provision is frequently funded by requiring European employers to pay a labour tax or social charge for each worker employed. At a time of mobile capital and a global race to attract foreign investment, European countries with relatively high welfare charges find domestic companies moving increasing proportions of their operations to locations with lower labour costs, whether inside or outside Europe. Similarly, restrictions on firing workers as a means of minimizing the social exclusion caused by unemployment can lead to companies taking employment 'offshore'. Remedies include shifting the tax base, e.g. to environmental taxes (part of the attraction lies in taxing 'bads' rather than 'goods' such as labour), but care is needed not to create new problems as a result of unintended consequences. A poorly designed carbon tax, for instance, could aggravate fuel poverty for poor households and damage competitiveness by raising energy costs, particularly if European standards are out of step with those in other Western economies and emerging markets.

In several European countries high unemployment has been exacerbated by the tension between restrictive labour markets and the pressures on companies to earn high returns on capital. Restrictive labour regulations can undermine the demographic dividend for European countries that comes from taking in younger immigrants, by making it hard to integrate newcomers into the labour force. Instead of finding work quickly, thereby contributing to the funding of the welfare system, immigrants can end up placing additional burdens on it.

European integration

Public debt has risen significantly across the EU to a weighted average in a range around 90% of GDP. While some of the blame for this can be attributed to the need for certain governments to bail out parts of their financial sectors following imprudent lending in the lead-up to the 2008–09 financial crisis, sustaining welfare commitments at a time of declining economic competitiveness in an increasingly open world economy has also contributed to the rise. A further significant rise in debt levels would become unsustainable.

Given the integrated nature of European economies through the single market, reducing government deficits and debt has become a central priority for European governments and the EU as a whole. Although the mix of welfare expenditure in each EU member state is driven by national politics and policies, coordinating reform responses at the EU level has become, in many cases, the only way for national governments to overcome domestic vested interests that seek to protect specific aspects of welfare. Past examples of such coordination included the convergence criteria established in advance of the Maastricht Treaty to determine which countries would join the single currency, and the Stability and Growth Pact agreed at the launch of monetary union in 1999. More recently, the EU's economic governance has been deepened to embrace the 'semester' process through which the European Commission now scrutinizes member states' economic policies and, for the euro area members, annual budgets.

One consequence of the creation of a single market in the EU allowing free movement of goods, services and capital was the need for free movement of labour. In theory, this provides a means of absorbing economic shocks affecting only part of the EU, because workers will be attracted to the more dynamic countries and regions, rather than languishing

in unemployment. Free movement of labour then led to the concept of a European welfare model, enshrined in the EU's Social Chapter, which stipulated EU-wide rights for workers – ranging from rights to holidays to limits on the number of hours someone can be obliged to work. However, a frequently heard academic argument is that the market-making associated with European integration (referred to in the literature as 'negative integration') has long been politically easier to achieve than common social regulation aimed at curbing market excesses (known as 'positive integration'). In the European context, Fritz Scharpf (2010) has argued that member states converge towards an integrated liberal market economy model which at the same time substantively obstructs the embedding of a strong social dimension in EU policies.²

Changes in the family structure/societal change

EU welfare states are facing reform pressures from societal changes that create new demands for social provision while affecting the basis for welfare funding. In particular, the significant increase in the participation rate of women in the labour force in large parts of Europe over the past two to three decades (Figure 7 for the evolution in Germany) has raised demand for publicly funded childcare. It has also led to calls for a rethinking of entitlements. The shift away from the male-breadwinner model is still a work in progress, even though it is increasingly essential at a time when Europe's overall workforce is shrinking as the population ages. As this process unfolds, certain aspects of the welfare model, such as the provision of public support for childcare or child benefit, will increase in importance.

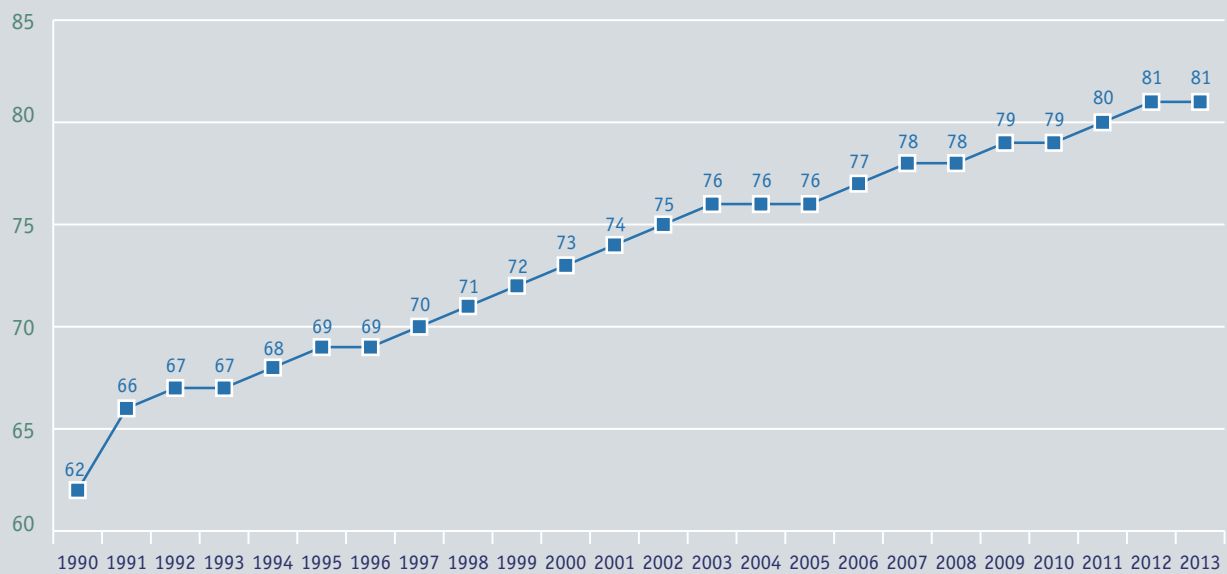
² Scharpf's characterization of the newly evolving European model draws on the work of Esping-Andersen (1990) as well as on Hall and Soskice (2001).

The general need for increased immigration to compensate for ageing populations and the reality of growing numbers of migrants coming from and through the Middle East and North Africa are posing additional challenges to European welfare states. Local services, from schools to hospitals, have to cope with more young people entering primary public education and more elderly people requiring public support. In some EU countries, there is evidence of immigrants' families suffering social exclusion. Nevertheless, EU agreements in areas such as pension portability can at least underpin intra-EU migration and allow EU residents to take advantage of opportunities to move freely, whether for work or retirement.

Technology, innovation and the changing mix of jobs

New technologies and structural changes in economies are bound to affect the welfare state and the nature of jobs. Productivity growth is at the heart of economic growth and generally to be welcomed, but in a period of slow growth there can be a tension between maintaining jobs and introducing labour-saving innovations. Fears that jobs will disappear, leading to pervasive unemployment, often prove to be misplaced. But periods of transformation undeniably create winners and losers. In all EU countries, the trend has been for the share of service activities in the economy to grow and that of industry to decline, with implications for the types of jobs that are created or lost. There is also some evidence that 'green' jobs are increasing, albeit from a low base, raising questions about the skills and associated training that such a shift may require. Both the European Centre for the Development of Vocational Training (CEDEFOP), which analyses skills needs for the EU, and the OECD stress the importance of 'transversal' green skills – i.e. skills

Figure 7 | Labour force participation rate (female–male ratio)*, Germany



* Ratio of female to male of proportion of a country's working-age population (aged 15 and older) that engages in the labour market, either by working or actively looking for work, expressed as a percentage of the working-age population.

Sources: UN Development Programme; Key Indicators on the Labour Market (7th edition, Geneva: International Labour Organization, 2013).

applicable to a broad range of environmental tasks – rather than occupation-specific ones (OECD and CEDEFOP 2014).

For European countries, one of the issues that surfaced during the crisis years was how to maintain employment levels. The very different rates of unemployment among them testify to the divergence in their ability to achieve this objective. In Germany and the United Kingdom, low unemployment rates are at least in part attributable to the way job preservation was stressed (belying the 'hire and fire' image of the latter), although critics argue that this was only possible because of resort to precarious forms of employment, such as 'Kurzarbeit' in Germany or 'zero hours' contracts in the United Kingdom.

In other countries, such as Spain, job losses were substantial. These differences also reflected the incidence of the recession. Ireland and Spain suffered big downturns in construction, a sector less likely to retain employees when demand falls.

The European Commission, just prior to the crisis, had espoused 'flexicurity' – an approach combining flexible labour markets, fairly generous social protection, and activation policies – as its favoured model. In a number of countries this was criticized as an anti-worker policy. Germany, however, offers an example of the successful application of this approach, having undergone significant deregulation of its labour market following reunification. This is in contrast to what happened

in France, where the scope for creating ‘non-standard’ jobs as a means of averting higher unemployment proved more limited (Dustman et al. 2014; Carlin et al. 2014).

The European welfare model is also challenged by polarization in the labour market. Europe continues to generate a healthy number of high-skilled jobs. It also has steady demand for lower-skilled jobs in areas such as care and other personal services. However, there is evidence of a hollowing-out of jobs in the middle of the range of skills distribution. This is largely as a result of technological change, although the pattern varies among member states (Eurofound 2015). An increase in high-skilled jobs has most recently given way to renewed growth at the lower end of the skills distribution. An associated trend is an upsurge in part-time jobs, which raises challenges for states that base entitlements to various forms of welfare provision on full-time work.

5. Dilemmas for the welfare state

Economic concerns

Given the drivers of change examined above, a frequently expressed view is that Europe can no longer afford the welfare state that was one of the mainstays of its social models during the postwar period. The 'Merkel formula' that 7% of the world's population producing 25% of global output cannot sustain 50% of global social protection spending implies that European welfare states have become unaffordable. The message is that by continuing to accept such a burden, European economies are rendering themselves uncompetitive in global markets and that welfare states have to change (and would have needed to do so even without the squeeze on public finances of recent years).

The other side to the story is that well-designed welfare states can promote sustainable growth, potentially increasing the size of the overall welfare 'pie' in addition to determining how it is sliced. This prompts the question of whether current provisions in Europe, most of which are mediated through the public sector, are appropriate. Some welfare arrangements in Europe manifestly need recalibration or even wide-ranging reform, but others can be shown to be necessary and efficient.

In his work on the economics of the welfare state, Barr (2012) is critical of the woolly thinking that fails to distinguish between the objectives and the means of delivery of different welfare state provisions. In many European systems, the right to healthcare, social provision and so on is often conjoined with the idea that it must be produced by the state. There are certainly sound arguments that public risk-pooling can be better and more efficient than private provision, as noted by the prime example of the vastly expensive US healthcare system. However, care is needed to identify why market failures arise and when government failures might be just as bad, if not worse.

Moreover, the social risks against which welfare states provide insurance or support arise everywhere; if they were not dealt with by the welfare state, they would have to be resolved by other means. For example, the growing difficulties in financing pay-as-you-go pension systems have led many policy-makers to advocate a transition to funded pension schemes, not least to benefit from the high returns on investments that capital markets yield. But as noted above, both systems are equally sensitive to demographic change. In a funded scheme individuals acquire claims on future consumption over their working lives, accumulated in pension funds. Upon retiring, those claims will be realized, and the nominally accumulated assets or monetary funds used for consumption. Since overall output, however, does not increase, the burden shouldered by the economically active population is the same as in a pay-as-you-go system.

There are potentially even more intractable challenges associated with the increasing demands that ageing populations, who are also living longer, are imposing on stretched public healthcare and long-term care systems. New medical breakthroughs, which are obviously good news for individual health and welfare, often result in substantial additional costs, while expectations of care provision can rise. The conjunction of an ageing society and the higher probability that older people will vote, and campaign for higher public spending that favours them, raises difficult questions around democratic decision-making in relation to the welfare state.

Although a long-term solution to ageing costs could involve policies to increase fertility, it cannot improve matters before the next cohort enters the labour market. Moreover, more children may create an additional burden of dependency. Unless the systems change, the decline in the number of people paying into the pension system and the increase in those drawing on it could lead to growing pressures on public budgets. There are, nevertheless, approaches to stabilizing outlays on pensions,

for example by linking them to GDP growth, such that the cost of pensions is prevented from rising excessively. Over a 10- to 20-year horizon, therefore, there are four possible solutions for easing the cost of ageing. These are:

- Increasing the effective age at which 'piggy bank' benefits become payable by altering the balance between the working lifetime and the projected period of inactivity (noting that, as in the recent German pension reform, fairness dictates that years worked, as well as the official retirement age, have to be taken into account). Early-retirement schemes favoured for reasons of providing jobs for young entrants into the labour market have proved in the past to be a mistaken policy response.
- Reducing the generosity of payments and services offered to the elderly.
- Raising additional revenue from the working population, including by boosting the latter's size by attracting immigrant workers.
- Investing abroad to generate a future flow of income, emulating the example of Norway's massive sovereign wealth fund.

Social concerns

An underlying dilemma is that many of the core assumptions on which welfare states were constructed are no longer tenable. Longer life expectancy, much improved health, the emancipation of women and the virtual elimination of absolute poverty are rightly celebrated as achievements. Although the 2008–09 financial crisis has resulted in the return of poverty and mass unemployment in the worst-affected countries, and

increased use of food-banks in others, three of the five 'giant evils' listed by William Beveridge in his 1942 report that laid the basis for the postwar UK welfare state – disease, squalor and ignorance (the others were want and idleness) – are no longer endemic in European societies as they were in the early postwar years. Instead, the new social risks have to be summed up with a different array of watchwords, such as exclusion, inequality, lack of opportunity, frailty and transitions over the life-course. It can also be argued that while advances in healthcare have largely eradicated many of the diseases, such as tuberculosis and polio, that afflicted European societies in Beveridge's day, new healthcare challenges have to be confronted. Obesity, lifestyle-related cancers, mental health problems and the growth of age-related dementia are among the contemporary health concerns reshaping demands on welfare systems, often for chronic rather than acute care.

To the extent that welfare states with a mix of family, retirement and survivor benefits were designed for a typical working-life pattern, it was that of the full-time male manual worker as the principal breadwinner. In many welfare states, especially in Southern Europe, the family remained a key part of the model, providing care and shelter for younger, older or incapacitated members. Greater social mobility, changing gender roles and rising expectations of public services have all contributed to an evolving societal model which is reshaping social policy demands.

As a result, new risks have to be confronted and new expectations of welfare states recognized. The new issues include various forms of social exclusion, dealing with single parents where family structures fail to cope, new vectors of poverty and various dimensions of equality. In some cases, increasing segmentation of the labour market is leading to concerns about how to ensure that 'outsiders' are fairly treated, but also about whether supposedly standard models of employment fit the new context. A link with environmental

sustainability has been posited by a number of authors, but the consequences for policy choices remain to be clarified.

Governance concerns

In all these areas, there are governance issues to resolve. A first is the balance between public and private provision in some of the most costly components of social policy. Even though the economic crisis of the past few years has been profound and has lasted longer than previous cyclical downturns, European societies (with obvious exceptions, such as Greece) are richer than they have ever been.

None the less, a narrative of the unaffordability of the welfare state has taken hold. In this regard, a distinction has to be made between the short-term imperative of restoring the sustainability of public finances and the much more contentious question of limits to the size of the state. Equally, the public/private dichotomy concerns the choices for individuals about how much they have to save, when they spend it and how their welfare entitlements are determined.

An associated question is how to organize welfare provision. In some EU countries, the state is the prime actor, while others delegate to specialist executive agencies or assign responsibility to social partners, such as employers' organizations and trade unions. National tradition is, plainly, central to what is done, but there may also be reasons to break with established norms: does the 'long goodbye to Bismarck' (borrowing the phrase from Palier 2010) signal that the time is ripe to rethink the fundamentals of welfare states based on the contributory principle? Yet as Esping-Andersen (2010) observes, there is no clear direction for where Bismarckian welfare states go next, although he notes the general trend towards the introduction of a basic safety net through some variant on minimum income.

A related issue is whether, despite the continuing resistance of many member states, closer economic integration may warrant an EU-wide (or at least eurozone-wide) unemployment insurance scheme of the sort mooted by the former European commissioner, László Andor (2014).

In a relatively closed economy with stable employment, funding the welfare state through social charges shared between employers and employees is viable, but with intensifying global competition, what labour economists describe as the 'wedge' between labour costs and wages becomes a difficulty. Where, as in certain EU countries, the wedge is half or more on top of wages, it can have a debilitating effect on competitiveness, over and above the cost in terms of the share of GDP. Ageing compounds the problem, if it means a rising welfare burden alongside a shrinking contributory base, even if more welfare spending comes out of general taxation rather than from a tax on labour.

More efficient delivery of welfare state provisions ought to be uncontroversial, and there is undoubtedly scope, in particular, for more and (crucially) better use of information technology in this regard.

Resistance is often substantial, partly for the familiar reason that disruptive technological change will mean that some jobs will be lost and that established models of managing activities have to be reformed. Equally, there is a growing body of evidence on new and experimental approaches that can be transformative. For example, the Finnish Innovation Fund Sitra (one of the partners in this project) has examined a range of innovations and suggested how they could be implemented in improving approaches to government functions (Doz and Kosonen 2014). In a world of increased short- and long-term pressures on public finances, it will be incumbent on decision-makers to accelerate the adoption of such innovations.

6. Visions for the welfare state and strategies for achieving them

The welfare state is a defining feature of European societies, and the values which underpin it are deeply embedded in them. Differences between European countries are small compared with the gulf between Europe and many other parts of the world, and what Europe has is widely envied. Those contemplating reforms of social models and policies should not overlook the abiding strengths of European welfare states, even if it is accepted that major challenges arising from the drivers of change discussed above have to be confronted.

Moreover, as John Hills (2014) explains, the welfare state's influence is pervasive and affects opportunities for all strata of society, not just those currently claiming particular benefits. Hills finds that for most income groups, what they receive over their lifetimes from the welfare state broadly matches what they contribute. Only the top decile of the income distribution makes relatively lower (though still sizeable) demands on welfare systems, while the bottom decile receives relatively more (Hills 2014). In this sense the welfare state in all EU countries has to be seen as part of the fabric of society and not as an overblown and costly liability.

Transformation of the welfare state cannot, however, be avoided, so it is pertinent to ask towards what, for whom and how? It is worth stressing, first, that austerity and the aftermath of the financial crisis are largely short-term considerations. Certainly, welfare states need to be fiscally sustainable. Countries that have allowed social spending to race ahead of fiscal capacity will have to rein in the excesses. Equally, however, the proposition that welfare spending needs to decline sharply as a proportion of GDP is a false one.

The welfare state offers a comprehensive response to social risks which, if not covered by the state, would still arise (Begg 2005). Critics often overlook the fact that the welfare state deals with these risks efficiently (Laurent 2014). Instead, the question Europeans need to answer, not least in pondering the 'Merkel formula', is whether the costs of 'non-social' responses would be lower.

New employment patterns are an acknowledged, if often insufficiently understood, part of the picture. As noted above, the median worker today is no longer a man employed in a factory, but is as likely to be a woman as a man, working in an office, hospital or care service. Careers evolve and may be subject to sharp changes of direction. Work-life balance is an objective that can have pronounced effects on welfare arrangements. In the light of these transformations, the answer may be to reinforce moves already apparent in some EU countries towards a system in which entitlement is based on citizenship rather than employment history.

A more pessimistic scenario of the future of European welfare states follows the argument of Fritz Scharpf mentioned above that, due to the inherent bias towards negative integration, the formation of a European social market economy with a strong social dimension is impossible. Instead, EU member states will converge towards a liberal welfare model, entailing retrenchment of the welfare state, especially in the social-democratic countries (following the Esping-Andersen conceptualization).

Choices have to be made, and the means by which decisions are taken invites examination, particularly where new demands (e.g. for enhanced childcare provision) can only be met if other spending is reduced. It is well known that welfare states are 'sticky', in the sense of being politically resistant to change – if only because losers from reform are bound to shout louder than new winners. Politicians apprehensive about losing elections find it easy to shy away from necessary reforms.

Nevertheless, as Anton Hemerijck (2012), taking issue with some of the more negative assessments, asserts: 'both the welfare state and EU, two major feats of mid-twentieth century institutional engineering, have at critical times been able to reinvent themselves'.

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Social inequalities in Europe – The challenge of convergence and cohesion

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Executive summary

Europe is becoming more unequal, both between and within countries, but there is no one-size-fits-all explanation for this. The EU has stopped being a 'convergence machine'. Overall, new member states recorded impressive economic growth after their accession to the EU, but the eurozone crisis triggered a process of divergence between the eurozone members. Within the member states, the overall position of pensioners has improved, but, among the non-elderly population, two mutually reinforcing processes of polarisation are leading to more inequality at the bottom end of the income distribution. First, more people are living in work-poor households, i.e. households with a weak attachment to the labour market; second, these households are experiencing higher poverty risks. The latter trend already started before the crisis.

There is no silver bullet to tackle increasing inequalities; we need a set of complementary strategies and instruments that can improve both the social protection and the employment perspectives of households with a weak attachment to the labour market. The role and quality of traditional instruments of social policy, such as unemployment insurance, activation and minimum wages, have to be reconsidered, both within the member states and at the level of the EU. Simultaneously, innovative approaches with regard to social services and benefits are necessary to overcome policy stalemates in certain areas, such as the social situation of lone parents.

The founding fathers of the European project who prepared the Treaty of Rome optimistically assumed that growing cohesion both between and within countries could be reached by supranational economic cooperation; domestic social policies were to redistribute the fruits of economic progress, while remaining a national prerogative. This traditional division of labour is not fit for the current challenges. As a matter of fact, the EU has already had a considerable impact on the member states' social policies. Hence, we must now define what we expect from the EU in the domain of social policy.

European social policy responses need national and regional contextualisation. Simultaneously, the European Union needs a sense of common purpose and a common policy framework in support of national and regional social policies. Its aim should be to *create a virtuous circle whereby both pan-European cohesion and national cohesion are enhanced*. Cohesion is about income and employment, but also about other dimensions of well-being. The European Union deserves a *Social Triple A*, if it actively supports both convergence towards higher aggregate levels of well-being across the member states and convergence towards more equality of individual well-being within the member states.

The EU should stimulate and support the member states to develop policy packages that pursue both aims simultaneously.

Such 'dual-use' policy packages do exist: education offers a telling example. Upward convergence in the quality of our human capital is a key condition for long-term upward convergence in prosperity and well-being across the EU. Currently, the European Union is deeply affected by a human capital divide, both between and within the member states. The European Commission has developed a comprehensive agenda on education, training and skills. However, this educational agenda does not carry sufficient weight in the setting of budget priorities. Real public expenditure on education was lower in 2013 than before the crisis in ten member states, including those that badly need to improve their education system.

Reducing background inequalities between families with children and investing in childcare and education contribute both to national cohesion and to long-term EU-wide convergence. Obviously, creating greater access to success in education for all children is not just a question of money; it also requires reforms in the education system in many member states. In other words, a child-centred social investment strategy that addresses inequalities in opportunities serves a dual purpose. Governments pursuing such a strategy deserve encouragement and opportunities to learn from other EU governments, but also tangible support from the EU, notably when they are in budgetary dire straits. We need more 'solidarity in reform'.

There is a growing awareness that we need to promote solidarity within the European Union; witness the recent Five Presidents' Report on the future of the eurozone and the refugee crisis. The promotion of solidarity requires mutual trust. Mutual trust is needed with regard to the quality of the social fabric in the member states. Mutual trust is also at stake in the social dumping debate. A crucial condition for European public opinion to accept labour mobility and migration is that they should fit into a regulated social order; they must not undermine that social order. Reconciling mobility and the four freedoms, on the one hand, with the internal cohesion of national welfare states and industrial relations, on the other hand, is a complex challenge, but it is not an insurmountable one. This 'balancing act' should figure high on the European agenda.

In short, the EU's role in social policy can be summarised as follows. The EU should provide a framework that reconciles openness and mobility with domestic social cohesion; it should support national welfare states on a systemic level in some of their key functions; it should guide the substantive development of national welfare states by indicating general social standards and objectives, leaving ways and means to the member states.

1. Introduction

This paper focuses on inequality within and between EU member states. It does not recapitulate all the functions of the welfare state. Welfare states not only organise redistribution from the better-off to the worse-off. They are also ‘piggy banks’, enabling citizens to insure themselves against social hardship and to spread their income more securely over their lifetime. And they have a social investment function, with the state investing in the nation’s human and social capital.¹ However, as we argue in this paper, tackling inequalities requires an adequate combination of the redistributive, the ‘piggy bank’ and the social investment function.

We will not repeat existing analyses on the extent and the causes of inequality, for which we refer the reader to an impressive set of publications by the OECD, the European Commission and academics. The yearly *Social Justice in the EU – Index Report*,² which quantifies a multidimensional approach to social justice and underscores the diversity of national contexts, should also be seen as an important complement to this paper. We focus, selectively, on observations and arguments which we consider particularly relevant for a true *European* perspective on social inequalities. For instance, the analytical part of the paper emphasises the need to *integrate* two perspectives: a perspective on inequalities within member states, and a perspective on inequalities between member states. There is no one-size-fits-all explanation for increasing inequalities across the EU. This has two implications. First, there is no silver bullet to tackle increasing inequalities; we need a set of complementary strategies and instruments.

Second, member states share challenges and risks, but European policy responses need national and regional contextualisation. Simultaneously, the EU needs a sense of common purpose and a common policy framework in support of national and regional social policies.³ The policy question that informs this paper can be summarised as follows: **How can we create a virtuous circle whereby both pan-European cohesion and national cohesion are enhanced?**

The structure of the paper is as follows. In the next section, we argue that we need two perspectives on solidarity: a pan-European and a domestic perspective. In the third section, we sketch a framework that allows a definition of the *Social Triple A* notion launched by the President of the European Commission, and we briefly add some normative considerations. In the fourth section, we illustrate this framework with summary data on median incomes and income poverty. In sections five and six, we dig a little deeper into the data on income poverty and relate them to the pension challenge⁴ and to employment. In section seven, we add education and skills to our framework. In section eight, we signal data on other dimensions of well-being (health and the environment), without elaborating upon them. In section nine, we argue that policy packages should and can contribute both to positive convergence and stability across the EU and to increasing cohesion within the member states. In section ten, we elaborate upon solidarity, trust and the need to reconcile openness and domestic cohesion. In the final section, we provide a conclusion.

1 This is explained in Begg et al. (2015).

2 See Schraad-Tischler (2015).

3 The need for a common framework and a sense of common purpose is developed in Vandenbroucke and Vanhercke (2014) and Friends of Europe (2015).

4 The pension challenge is also discussed in Hüttel et al. (2015).

2. A European approach to social inequalities: Two perspectives on solidarity

Over the last few years, inequality has become a hot topic in public debates. Impressive analyses have been published by international organisations such as the OECD, by the European Commission and by academics.⁵ Our aim is not to repeat the existing analyses. Rather than simply recapitulating what has already been said elsewhere, we want to develop a truly *European* approach to the problem of social inequality.

A European approach implies that we go beyond a purely national perspective on inequality, in which only inequalities among people living in the same country are deemed relevant. Given the increasing role of migration and mobility, entertaining a purely 'domestic' view on social justice is increasingly anachronistic in today's Europe. A purely national perspective also ignores the fundamental goals that have been part and parcel of the European project since the Treaty of Rome of 1957: the simultaneous pursuit of *economic progress*, on the one hand, and of *social progress and cohesion*, on the other hand, both *within* countries (through the gradual development of welfare states) and *between* countries (through upward convergence across the Union). We believe that it is necessary not only to reconnect with this old ambition, but also to reconsider the role national welfare states and the EU have to play in realising this ambition.

The founding fathers of the European project who prepared the Treaty of Rome optimistically assumed that growing cohesion both between and within countries could be reached by supranational economic cooperation, together with some specific instruments for raising the standard of living across the member states (which were later brought together in the EU's 'economic, social and territorial' cohesion policy).

Economic integration was to be organised at the EU level, and would boost economic growth and create upward convergence; domestic social policies were to redistribute the fruits of economic progress, while remaining a national prerogative. The specific social dimension of the EU would, in essence, be confined to the coordination of social security rights for mobile citizens and to the gradual development of an (impressive) body of anti-discrimination legislation. Admittedly, after 60 years of piecemeal developments, the European *social acquis* encompasses other important policy areas that were shifted from the national to the EU level, such as health and safety standards at work. But redistributive policies, education policies and the development of social security remained – at least in theory – firmly anchored at the national level.

With hindsight (and in a slightly benign interpretation), one may say that the founding fathers of the European project created two perspectives on *solidarity*: a pan-European perspective and a national perspective. How would we understand this dual perspective?

The founding fathers wanted upward economic convergence and cohesion on a European scale. They also wanted to give individual Europeans the right to improve their own lives by working in a member state other than the one of which they are nationals, with no discrimination on the basis of nationality. Gradually, patients acquired the right to benefit, under certain conditions, from medical care in other member states than their state of residence. Is the word 'solidarity' an adequate description of the founders' purpose? Their approach was not 'redistributive', nor was it about the mutual insurance of risks; historically, it was mainly about *fair access to opportunities*: trade and investment opportunities for countries joining the EU and personal opportunities for all their citizens wanting or needing to be mobile. One might also say that, in pursuing cohesion, it was motivated by *inclusion* on a pan-European

⁵ See for instance OECD (2008); OECD (2011); OECD (2015); European Commission (2015) and the Commission's reports on Employment and Social Development ESDE (2012); ESDE (2014); ESDE (2015); Council of Europe (2013); Salverda et al. (2014); Oxfam (2015) and Atkinson (2015).

scale. However, recent developments – those associated with monetary unification (the need for stabilisation), on the one hand, and international migration (the refugee crisis), on the other hand – are forcing upon the Union a classic notion of solidarity in coping with *shared risks*. A polity that initially emerged as an ‘opportunity structure’, motivated by the aspiration of growing cohesion, is in need of mutual insurance and true solidarity.

Solidarity within national welfare states is well-known territory. It refers to social insurance, income redistribution and the balance of social rights and obligations. As already indicated, the founding fathers did not believe that integration would diminish the potential for national solidarity, so conceived. On the contrary, they were confident that welfare state actors and institutions would redistribute the produce of economic integration, i.e. more economic growth, fairly within the member states, in tune with social preferences in each state.

We propose considering this dual perspective on solidarity, national and pan-European, which is the logical consequence of developments that started more than 60 years ago, as a defining normative feature of ‘the European Social Model’. The European Social Model is not simply a summary description of a set of co-existing national social models; it also describes the way these national welfare states interact with each other – or are supposed to interact with each other – in Europe.

This dual perspective on solidarity is inherently complex and multifaceted. Consecutive enlargements as well as monetary unification made this notion of solidarity even more complex and demanding. Indeed, what is seen by some as ‘the dynamics of upward convergence’ associated with the enlargement of the EU is seen as social dumping by others. At the same time, monetary unification necessitates forms of solidarity which

have been, so far, a no-go area in European politics, such as a eurozone stabilisation capacity and fiscal transfers.

Factual developments and distrust now threaten to erode the basis of solidarity itself, both national and pan-European. Within many of our countries, we are witnessing increasing social inequalities and concomitant social distrust. Between countries, the eurozone has displayed the exact opposite of convergence: increasing divergence, which saps the legitimacy of the European project. We risk being caught in a trap: we badly need more European solidarity at a time when it is becoming more difficult to achieve. We are at risk of experiencing a vicious rather than a virtuous cycle. **How can we create a virtuous circle whereby both pan-European cohesion and national cohesion are enhanced?** That is the main focus of this contribution to the *Vision Europe Summit*.

3. Convergence, well-being and equality: How to define a 'Social Triple A' Europe?

Suppose, for the sake of simplicity, that we focus only on incomes when assessing social inequalities in Europe. The inspiration of the European project's founding fathers, as described in Section 1, could then be summarised as follows: our aim is the *simultaneous pursuit of convergence towards higher levels of national median income across the member states and convergence towards less relative income poverty within the member states*.⁶

Admittedly, prosperity and well-being are about much more than income; and relative income poverty is only one indicator in a diverse set of well-known inequality indicators. Broadening the scope of our assessment beyond income indicators (let alone, GDP) is an important challenge, if we want to revamp the notion of a European Social Model. In Sections 4 to 6, we will start with an analysis of income data, but in the following sections we will move on to other parameters, such as education, skills, health and the environment in which people live. The benchmark for assessing the success of the European Social Model should be framed in terms of the aggregate levels of well-being member states can achieve (measured at the member state level) and inequalities in well-being within the member states.⁷

6 Space forbids elaborating on this 'dual' normative benchmark and relating it to a broader philosophical debate on international distributive justice. An alternative normative approach would be to start from pan-European indicators that directly (and only) apply to individual European citizens; from a philosophical perspective, a case can be made for a single pan-European income poverty objective based on a single, pan-European poverty threshold. The dual benchmark which we formulate here could then be interpreted as a pragmatic approach to a more fundamental pan-European objective of this nature.

7 This formulation is a starting point and would need further elaboration. It leaves open how one should aggregate well-being at the member state level, and whether or not cross-country differences in preferences are taken into account. One should note that it is possible to take into account the distribution of well-being in the aggregation, for instance, by giving more weight to those who are worst off. The second prong of the benchmark also presupposes a consensus on how one should weight individuals (in the assessment of internal inequality) and on the treatment of differences in individual preferences. Whether or not the two dimensions of the benchmark can be reduced to one dimension is a question which we will not develop here.

The President of the European Commission launched the idea that the EU should be characterised by a *Social Triple A*.⁸ So far, this notion has not been defined.

We propose the following framework: the Union deserves a *Social Triple A* if it actively supports upward convergence in relevant dimensions of well-being across the member states, and convergence towards less inequalities in those same dimensions of well-being within the member states.

Obviously, this is a framework to conceptualise a *Social Triple A* Europe, rather than a precise definition. It raises questions which we cannot discuss in this paper for reasons of space, but which need careful thought. We briefly indicate them in the remainder of this section.

As much as there is an important debate taking place today on the way in which one should move 'beyond GDP' and measure well-being,⁹ there is also a long-standing debate on the notion of equality which asks the question: are we in favour of 'equality of opportunity' or 'equality of outcome'? Philosophical proponents of equality of opportunity argue that one should make a distinction between circumstances for which we cannot hold people responsible (e.g. their family background, innate talents) and choices for which we can hold them responsible (e.g. the effort with which they valorise their talents). The philosophical case for equality of opportunity, as understood by authors such as Roemer and Trannoy (2013), is robust; it is not a superficial meritocratic approach, which is not to say that it is uncontroversial.

8 Speech by President Jean-Claude Juncker to the European Parliament upon his election: "I want Europe to be dedicated to being triple A on social issues, as much as it is to being triple A in the financial and economic sense". Strasbourg, 22 October 2014.

9 See Stiglitz et al. (2009); Fleurbaey and Blanchet (2013); the OECD Better Life Initiative; Hellström et al. (2015); Hämäläinen (2014).

Roemer and Trannoy (2013) also argue that there is an important and relevant divide between European countries with regard to equality of opportunity, which is not captured well by the usual statistics on outcome inequalities. For instance, there is stark contrast between equality of opportunity in Denmark and in Hungary; the impact of the family's educational background on an individual's later earnings is much larger in Hungary than in Denmark.¹⁰ Moreover, it seems easier to build a broad consensus on equality of opportunities – understood as meaning that all should have the same life chances, regardless of their initial conditions – than on equality of outcomes. Also, the turn to activation and activating social investment in social policy over the last 20 years is linked to a normative recalibration, in which the emphasis is on life chances rather than outcomes 'here and now' (Hemerijck 2014). Finally, as argued in Section 2, historically the pan-European 'social space' was conceived of as an opportunity structure for mobile people; it was not about the redistribution of outcomes. All this means that real equality of opportunity has a lot of traction, if we set out normative benchmarks for the European Social Model: equality of opportunity cannot easily be dismissed as a notion that is 'in retreat' vis-à-vis a traditional European understanding of social equality. However, both the OECD (2015) and Atkinson (2015) argue that the distinction between opportunities and outcomes is not straightforward. *"Higher inequality of incomes of parents tends to imply higher inequality of life chances of their children. To achieve greater equality of opportunities without tackling increasing inequalities in outcomes will be very difficult."*¹¹ With a simple algebraic decomposition, Lefranc et al. (2007) show that changes in 'inequality of income opportunity' can be understood as the product of changes in the intergenerational elasticity of income (which capture the transmission of inequalities from parents to children), on the one hand, and changes in parental income inequality, on the

other hand. This raises important normative questions which we cannot settle here, but the practical conclusion, so it seems, is that the European Social Model should be *both about real equality of opportunity and equality of outcomes*.

A next question relates to the potential tension between the legitimate diversity of welfare states across the EU – legitimate, as it corresponds to different national histories and different national preferences – and the aspiration of convergence which we see as part and parcel of the European project. The convergence we argue for is about outcomes and opportunities. It is – in principle – not about the ways and means to achieve those outcomes and opportunities: subsidiarity remains an important principle. However, there is a limit to the institutional diversity that can be accommodated in the EU if convergence is our aim (Vandenbroucke 2015a, b). A further difficult question concerns democratic accountability. Traditionally, national governments in nation states could be seen as accountable for the performance of their welfare states and the well-being of their citizens. Today, the location of democratic accountability is less straightforward: in many European countries, regions (or local municipalities) have taken over important responsibilities, with a huge impact on the well-being of individuals and the performance of the welfare state at large. In a country like Belgium, for instance, accountability for the performance of the welfare state cannot be attributed in a one-sided way to either the federal government or the regional governments: all of them share in that responsibility. The 'active support' role which we propose for the EU adds to that complexity: on the one hand, one cannot hold the Union responsible for everything that goes wrong in member states in social terms; on the other hand, if a *Social Triple A* is a stated ambition of the Union, it cannot hide from its responsibility for the eventual outcomes. Shared responsibilities make democratic accountability complex. But there is no return to the 'good old days' of national sovereignty and the concomitant, simple understanding of democratic accountability.

¹⁰ See Roemer and Trannoy (2013) for details.

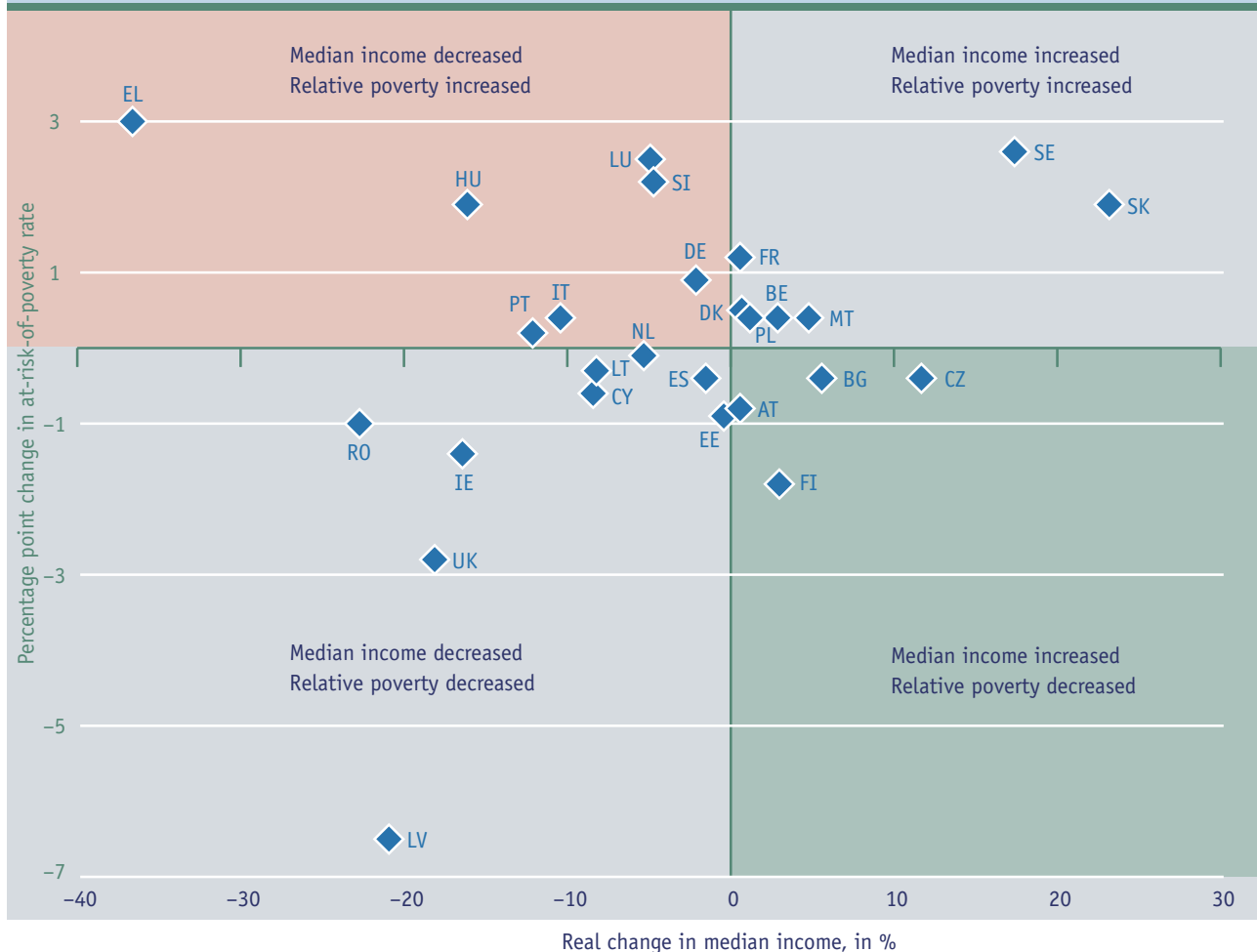
¹¹ OECD 2015: 27.

4. Median incomes and relative income poverty

Would we award today's EU a *Social Triple A*? In answering that question, we first focus on the most traditional 'outcome' yardstick: monetary incomes. In Figure 1, we combine changes

in the member states' median income with changes in the income distribution within the member states.

Figure 1 | Change in real median income and percentage point change in poverty (with floating threshold), SILC 2008–SILC 2013



Source: EUROSTAT, EU-SILC [ilc_di03] and [ilc_li02], authors' calculations.

On the horizontal axis of Figure 1, we show the growth rate (or reduction) of real median income between 2007 and 2012;¹² on the vertical axis, one finds the percentage point change in the conventional at-risk-of-poverty rate between 2007 and 2012. The poverty rate measures the share of people living below the national poverty threshold; we apply a floating poverty threshold (60% of the 2007 median incomes to measure poverty in 2007; 60% of median incomes in 2012 to measure poverty in 2012). Hence, the north-eastern quadrant of the graph shows countries in which median incomes increased in real terms, but the income distribution deteriorated at the bottom end, e.g. Sweden and Slovakia. The south-western quadrant shows countries in which median incomes decreased in real terms, but the relative income distribution improved at the bottom end, as is the case with the UK, Ireland and Romania. Greece, in the north-western quadrant, experienced both a drastic reduction in median incomes and a worsening income distribution. Very few countries are in the south-eastern quadrant where median incomes increased in real terms and relative poverty decreased. Obviously, the pattern shown in Figure 1 reflects the crisis, notably within the eurozone; if we were to look at a longer time span, for instance starting in 2004, the picture with regard to the growth of median incomes would be more favourable for a number of countries. However, since the outbreak of the crisis, we have been far removed from a *Social Triple A* scenario.

We now zoom in on a single indicator which captures the growth in incomes and the distribution of incomes; that is, we examine, both for 2007 and 2012, the share of individuals

living in a household in which household income is lower than 60% of the median household income in 2007.¹³ For 2007, this is simply the conventional at-risk-of-poverty rate. Applied to 2012, this indicator is called the ‘at-risk-of-poverty rate anchored in time’, because the poverty threshold is kept constant at its 2007 level, adjusted for inflation. The at-risk-of-poverty rate anchored in time reflects the combined impact of income growth and changes in the distribution of incomes. If all incomes decrease (increase) at the same rate, and the relative distribution of income remains unchanged, the at-risk-of-poverty rate anchored in time increases (decreases): in 2012, more (less) people will have an income below (above) the poverty threshold of 2007. If median incomes remain unchanged, but the income distribution worsens (improves) at the bottom end, the at-risk-of-poverty rate anchored in time increases (decreases). In practice we see a mixture of these scenarios. Figure 2 compares the conventional at-risk-of-poverty rates in 2007 with the anchored poverty rates for 2012. Countries are ranked from left to right by their 2007 poverty rates.

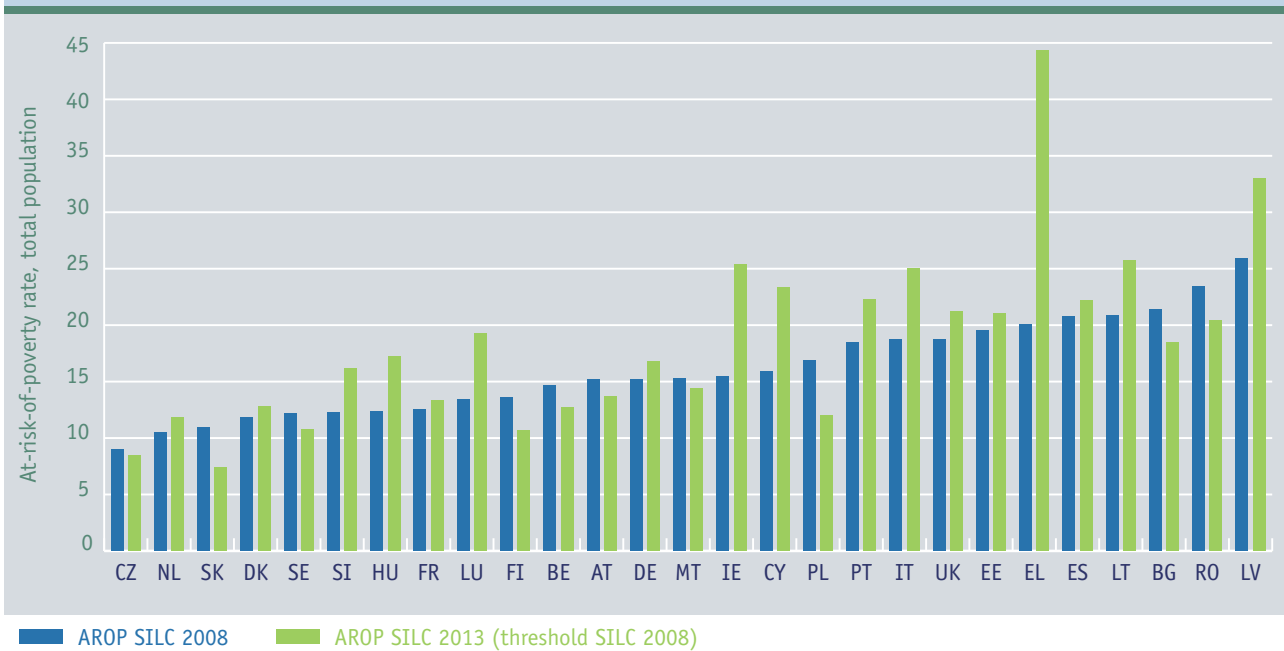
The at-risk-of-poverty rate anchored in time increased in the majority of EU countries between 2007 and 2012¹⁴, with dramatic increases in Greece (from a poverty rate of 20.1% in 2007 to a poverty rate, anchored in 2007, of 44.3% in 2012), Ireland (an increase of 9.9 percentage points), Cyprus, Latvia and Italy. It also increased in countries which we consider successful such as Germany (an increase of 1.6%). It decreased significantly in Poland and more moderately in Slovakia, Romania, Bulgaria, Sweden, Finland, Belgium and Austria.

¹² We use ‘median income’ as a short cut for ‘net disposable equivalised household income’, as registered in EU-SILC. This indicator pertains to individuals and takes into account taxes and transfers and the size and composition of the household in which the individual lives. Incomes received in 2007 are registered in EU-SILC 2008 and incomes received in 2012 are registered in EU-SILC 2013 (except for the UK and Ireland: for these countries we compare incomes perceived in 2008 and incomes perceived in 2013). Increases in nominal incomes are corrected for inflation.

¹³ The median income is adjusted for inflation between 2007 and 2012. We use EU-SILC 2008 and 2013 for this comparison; for the UK and Ireland we compare 2008 and 2013, for the other countries 2007 and 2012.

¹⁴ As mentioned, with the exception of the UK and Ireland, EU-SILC 2008 and 2013 refer to incomes in 2007 and 2012.

Figure 2 | At-risk-of-poverty rate in % (anchored in time), SILC 2008–SILC 2013



Source: EUROSTAT, EU-SILC [ilc_li22b] and [ilc_li02].

Note: At-risk-of-poverty rate (AROP) is the share of individuals living in households in which net disposable equivalised household income is lower than 60% of the median net disposable equivalised household income. AROP SILC 2013 (threshold SILC 2008) are the poverty rates ‘anchored in time’. Data refer to total population.

The pattern shown in Figure 2 is one of dramatic divergence, driven mainly by what happened in the eurozone.¹⁵ Notwithstanding some important exceptions (notably Poland, but also Slovakia), the much heralded European ‘convergence machine’ of the past stopped working.

A corollary of the observations shown in Figure 2 is that severe material deprivation,¹⁶ a standard ‘absolute’ measure of poverty, decreased in Poland, Slovakia and Sweden (it was already very low in the latter country), whilst it increased significantly in Ireland and the UK and dramatically in Greece. In the EU15 taken as a whole, severe material deprivation was larger in 2012 than in 2007, a regressive development probably

15 If we were to analyse the non-eurozone countries alone, we might discern a minor tendency towards convergence in that small subset of countries.

16 Severe material deprivation refers to a state of economic strain defined as the enforced inability to pay for at least four of the following nine items: i) rent, mortgage or utility bills; ii) adequate home heating; iii) unexpected expenses; iv) meat or proteins or regular meals; v) a holiday; vi) a television; vii) a washing machine; viii) a car; ix) a telephone.

never seen in the history of the European project;¹⁷ in the new member states, severe material deprivation decreased from its initially high level, as the impact of economic growth (notably in Poland) dominated adverse evolutions in the relative income distribution in some new member states. On balance, in the EU27 taken as a whole, severe material deprivation was marginally higher in 2012 than in 2007. Hüttl et al. (2015) provide data on the intergenerational divide with regard the evolution of material deprivation.

Severe material deprivation, poverty rates anchored in time and poverty rates with floating thresholds give conflicting signals about what happens in our societies. Therefore, we should take them all into consideration. The time perspective is important here. In the short and medium term, material deprivation and anchored poverty provide the best indication of the social stress societies experience. In the longer term, anchored poverty becomes an anachronistic indicator in growing economies, as more and more people will acquire incomes above the anchored poverty threshold. In the very long term, material deprivation, as we measure it, becomes a yardstick of the economic and technological development of societies, rather than a yardstick of social justice in societies.¹⁸

Therefore, relative inequality indicators, such as poverty rates with floating thresholds, GINI-coefficients or quintile shares are indispensable for assessing the evolution of social justice in our societies, notably in the medium and longer term. In the next section, we focus on the development of poverty using a floating poverty threshold, i.e. we focus on the relative position of people at the bottom end of the income distribution.

17 This statement can only be intuitive, since we do not have comparable statistics for the past; moreover, the EU of the 1980s was not the EU of the 2000s. However, it seems implausible that such large scale, simultaneous increases in material deprivation happened before in countries constituting the European Communities or, later, the EU.

18 This sentence should be understood with respect to indicators of material deprivation that remain unchanged.

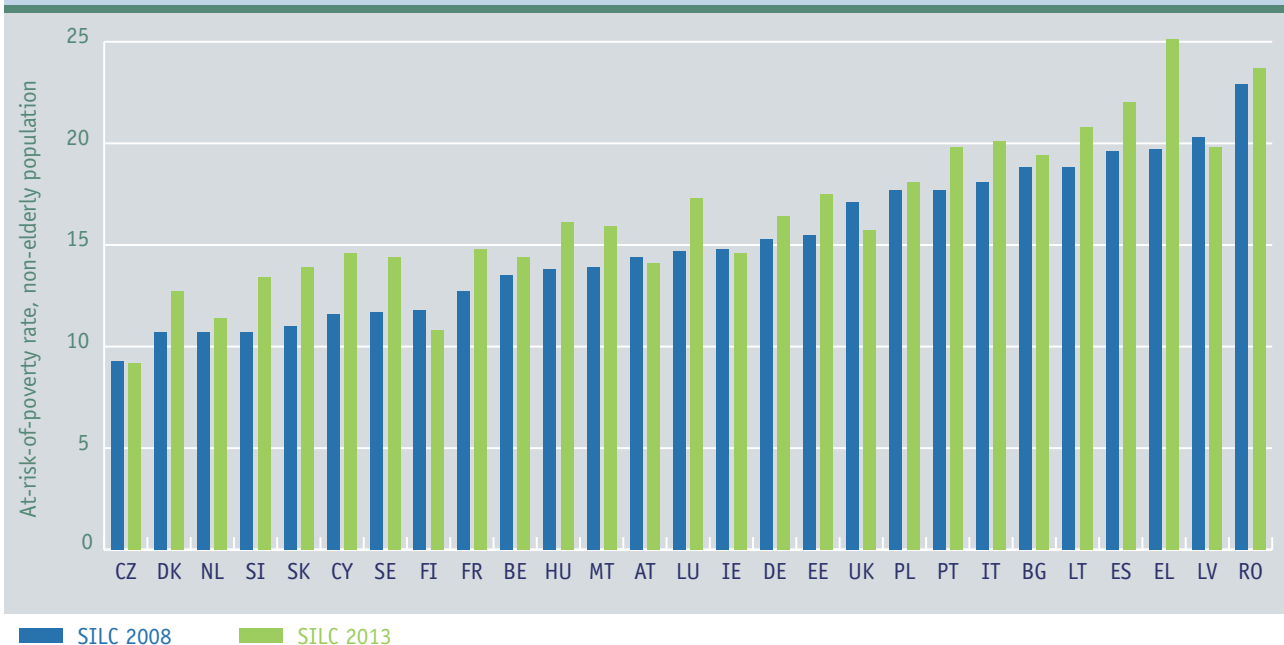
5. Income poverty, pensions and non-pension transfers

The poverty rates in Figures 1 and 2 concern the whole population. In Figure 3 instead, we show conventional at-risk-of-poverty rates for the non-elderly, i.e. people younger than 65 in 2007 and 2012, using a floating poverty threshold.

Figure 3 reveals that most countries experienced an increase in poverty in the non-elderly population (on average, we see an upward shift), whilst the picture for poverty in the total population is more mixed. For the non-elderly, at-risk-of-poverty increased in as much as 18 member states, it remained relatively steady in seven member states, whilst

it only decreased significantly in Finland and the UK. The picture for poverty in the total population is more mixed because elderly poverty diminished significantly in a number of countries. Over the years 2004–2006, on average, elderly poverty in the EU15 was about four percentage points higher than non-elderly poverty; by 2012, the situation had changed completely: non-elderly poverty was 3.3 percentage points higher than elderly poverty. In the new member states, the initial situation was different: elderly poverty was lower than non-elderly poverty in 2004–2006; the gap between poverty rates of the non-elderly population and the elderly population

Figure 3 | At-risk-of-poverty rate in % (with floating threshold), SILC 2008–SILC 2013, non-elderly population



Source: EUROSTAT, EU-SILC [ilc_li02].

Note: At-risk-of-poverty rate with floating threshold set at 60% of median net disposable equivalised household income. Data for population below 65 years old.

narrowed, but then increased again after the crisis so that, today, it is even higher than in 2004–2006.¹⁹

The explanation of this remarkable reversal in the relative poverty risks of the elderly and the non-elderly include both long-term sociological trends (such as the rise in dual earnership and the increasing numbers of female pensioners with a substantial employment record, which steadily reduced poverty in the elderly population) and the short-term impact of the economic crisis. From the point of view of individuals, pensions provide a much more robust ‘automatic stabiliser’ in times of economic crisis than unemployment insurance. Pension incomes were relatively well protected during the crisis; unemployment insurance, in contrast, is patchy in a number of countries, notably in countries that were hard hit by the crisis, like Italy and Spain. Moreover, in the context of austerity policies, some countries had to switch off their automatic stabilisers (too) rapidly, and were forced to take measures that may have affected pension incomes less than other incomes.²⁰ As a matter of fact, from a short-term Keynesian point of view, the relative stability of pension incomes was not necessarily bad; the problem was, rather, the limited stabilisation impact of working-age benefits in a number of countries (Dolls et al. 2012). Economically, pension spending acted as a short-term buffer, albeit not a very efficient one. But also from a social point of view, there is a tension between the long-term need to reduce the structural ‘pension heaviness’ of some welfare states (such as Greece), on the one hand, and the short-term observation that children are to a significant degree protected against poverty by pension incomes in those welfare states,

19 In this paragraph, ‘elderly’ refers to individuals aged 65 or more; the ‘non-elderly’ are individuals below the age of 65. The average over the years 2004–2006 is a weighted average of the data registered in EU-SILC 2005–2007.

20 Our reading of what happened is also influenced by the statistics we use to measure poverty. These indicators only take income into account; they are not affected by increases in indirect taxes, increases in tariffs for services, etc.

due to the extended family model (Diris et al. 2014). Hence, the transition from a pension-heavy welfare state to a welfare state that provides adequate protection for working-age families and children needs careful consideration: in countries like Greece, governments have to build a new welfare state, with new and adequate transfer systems for working-age families and children, whilst reducing the pension overload of the old welfare state.

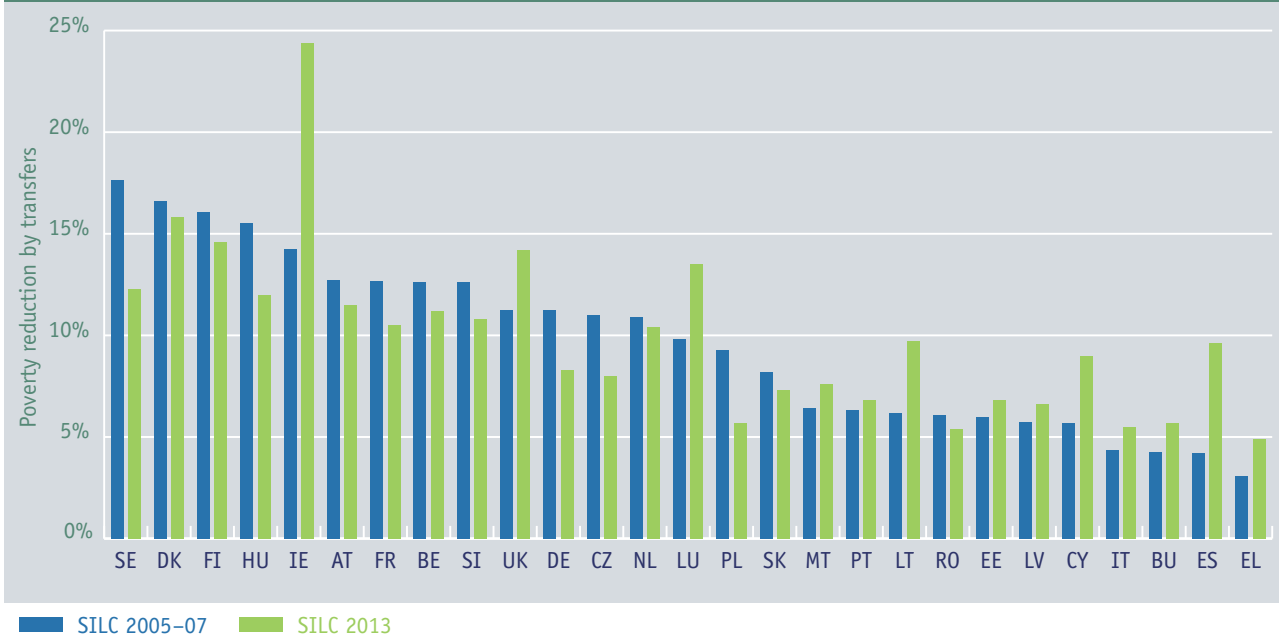
In the long term, pension reform should be based on a notion of intergenerational fairness, as embodied in the so-called Musgrave rule. Simplified,²¹ this means that the pension benefit ratio (the ratio of average pension incomes on average incomes in the active population) should be stabilised on a target value.

In other words, it means that pension systems should be guided by²² a principle of ‘defined ambition’ with regard to the income distribution between pensioners and non-pensioners (in contrast to principles of ‘defined contribution’ or ‘defined benefit’, which put the burden of adjustment in periods of demographic change unilaterally on future pensioners or the future active population). Such a principle of ‘defined ambition’ is absent from pension reform in most of the EU member states.

21 The translation of the Musgrave rule into a stable pension benefit ratio is a simplification for different reasons. It does not take into account structural (sociodemographic) changes in the population of pensioners, which may justify changes in the pension benefit ratio. Also, the Musgrave rule does not, in itself, determine the selection of a pension policy; normative judgements on the optimal ‘leisure-consumption trade-off’ and the desirable degree of consumption smoothing also inform the selection of a pension policy. The Belgian Commission on Pension Reform 2020–2040 has proposed a thorough pension reform for Belgium, based on the Musgrave rule. The Annex 1.4 of the Commission’s report presents a formal algebraic presentation and a translation of such a principle into a ‘point system’; see www.pensioen2040.belgie.be (Dutch) or www.pension2040.belgique.be (French).

22 The expression ‘guided by’ is deliberately vague. A case can be made for adjustment mechanisms that are built into pension systems to keep them ‘on course’ (towards the defined ambition), whatever the structural demographic and economic changes societies experience.

Figure 4 | Poverty reduction by non-pension transfers (percentage points): SILC 2013 compared to average of SILC 2005–2007



Source: EUROSTAT, EU-SILC [ilc_li02] and [ilc_li10], authors' calculations.

Note: Poverty reduction is the difference between the at-risk-of-poverty rate and the at-risk-of-poverty rate before transfers (pensions excluded from transfers). For the start of the period (left bars), we provide the average value of the data registered in SILC 2005, SILC 2006 and SILC 2007.

In some countries, pension benefit ratios are set to decline considerably in the long term, which means that today's young people will enjoy pension systems of lesser quality than today's pensioners; this is documented in Hüttl et al. (2015). On the basis of realistic hypotheses about future developments, 'defined ambition', so conceived, is only attainable if working careers become longer.²³ We briefly return to this challenge in the next section.

23 This condition is necessary, but maybe not sufficient. Additional financing which does not rely on earned income may be necessary; cf. Annex 1.4. to the Belgian Commission on Pension Reform.

We now turn our attention to the evolution of non-pension transfers (or 'transfers', as a short cut). Figure 4 shows the evolution of an indicator which is commonly called 'poverty reduction by transfers': it is equal to the difference between a 'post-transfer poverty rate' and a 'pre-transfer poverty rate'. The post-transfer poverty rate is simply the at-risk-of-poverty rate one can observe in reality; the pre-transfer poverty rate is a theoretical counterfactual, based on a manipulation of the data in which non-pension transfers are eliminated from the household incomes registered in the survey. This theoretical counterfactual should be interpreted cautiously (Vandenbroucke

et al. 2013); rather than showing the level of poverty that would obtain if there were no transfers, it indicates in a mechanical way the ‘amount of work done’ by non-pension transfers to reduce poverty. However, bringing together levels and changes over time in this indicator, as we do in Figure 4, illustrates much of the predicament of European welfare states.

We compare the value of ‘poverty reduction by transfers’ over the years 2004–2006 with the value of ‘poverty reduction by transfers’ in 2012.²⁴ Over this period, the *average* value of poverty reduction by transfers across the EU member states was stable; the pattern shown in Figure 4 is one of convergence, which is neither upward nor downward. Where poverty reduction by transfers was higher than average, it diminished (except for Ireland, the UK and Luxemburg); where it was lower than average, it increased (except for Poland, Slovakia and Romania).

One should note that a high level of poverty reduction by transfers is not *per se* ‘good’: a high level of employment with fair access to decent jobs and a low level of poverty reduction by transfers may be preferable and generate *less* post-transfer poverty than the opposite situation of high unemployment, leading to a high level of pre-transfer poverty and large-scale transfers. If pre-transfer poverty diminishes because employment increases, a decreasing ‘poverty reduction by transfers’ is not necessarily an indication of a reduced capacity to fight poverty (Vandenbroucke and Diris 2014). When both post-transfer poverty and poverty reduction by transfers decrease simultaneously, we may be witnessing a normal, ‘endogenous’

²⁴ We take the average value EU-SILC 2005–2007 (which correspond to 2004–2006), rather than 2007 as in the previous graphs, because we want to show a somewhat longer period. Given the fact that for some countries the EU-SILC results for those years yield changes in indicators that are hard to explain (next to instability in the survey itself) and that for some countries EU-SILC only starts in 2006 or 2007, we use average values for the beginning of the period. As mentioned earlier, for the UK and Ireland, the EU-SILC years correspond to the years in which the incomes were perceived.

adjustment mechanism of a well-functioning welfare state where employment is increasing and/or pre-transfer (market) income inequality diminishes. However, that benign scenario is not what happened in a number of countries. In Belgium, France, Austria, Germany, Sweden, Slovakia, Denmark and Slovenia post-transfer poverty increased among the non-elderly population whilst poverty reduction by non-pension transfers diminished. This parallel development signals a worrying reduction in the redistributive capacity of those welfare states. In Section 6 we elaborate upon this observation, but first we return to the general pattern shown in Figure 4.

Before the crisis, poverty reduction by transfers was, on average, relatively high in Western and Northern European countries (Sweden, Denmark, Finland, Austria, Belgium, for instance), as well as in Anglo-Saxon Europe (Ireland and the UK); it was very low in the Southern eurozone countries (Greece, Italy, Spain, Cyprus, Portugal), which are pension-heavy and have patchy benefit systems for working-age families and children. With regard to poverty reduction by non-pension transfers, the new member states were and remain very heterogeneous; on average, their position is between the EU West and North cluster and the Southern eurozone countries. During the crisis, poverty reduction increased in the Southern eurozone countries, but not very much (except for Spain, where the increase was considerable); the ‘automatic stabilisation’ effect one should expect from transfers in such a deep crisis remained limited. In Poland, poverty reduction by transfers was less at the end of the period, but so was post-transfer poverty among the non-elderly; this particular trajectory is explained by a considerable increase in employment.

Prima facie, the converging pattern shown in Figure 4 is congenial to an observation by Bénassy-Quéré et al. (2014) over a much longer time span (1985–2010), encompassing both taxes and transfers, but focusing on a more limited

number of countries. They conclude that the tax and transfer system has not become less redistributive, but that there seems to be “a convergence amongst EU member states on the extent of redistribution” during this long period.²⁵ This prompts a discomfiting question: are we witnessing the irresistible impact of globalisation and/or European integration, which forces mature welfare states to cut back on transfer systems? Atkinson (2015) convincingly argues, on the basis of much academic research, that globalisation does not force nations to cut back their welfare states. As a matter of fact, a number of mature welfare states with a high level of social spending rank high in the World Competitiveness Index. The welfare state is not *per se* the problem, when it comes to economic competitiveness; on the contrary: if it is well-organised it can be a competitive asset (Vandenbroucke and Vanhercke 2014).

With relatively high levels of social spending, countries like Sweden, the Netherlands and Denmark achieve high employment rates, a good score in the competitiveness index and relatively low levels of poverty (although poverty is now increasing in the Nordic countries); in contrast, a country like Italy, which has more or less the same level of social spending, performs worse on all these counts. In order to understand these cross-country differences, we should broaden our examination of welfare states beyond transfer systems. The strong historic record of Northern welfare states with regard to employment, poverty and competitiveness has been linked to their long-term orientation towards *social investment*, i.e. activation, investment in human capital, and capacitating social services such as childcare (Hemerijck 2014). Obviously, investment in education and childcare are no panacea; welfare states also differ with

regard to the effectiveness of their social protection systems, as already indicated on the basis of Figure 4; moreover, the impact of social protection seems to change over time. Welfare state performance depends on the complementarity of effective investment in human capital – by means of education, training and childcare – and effective protection of human capital – by means of adequate transfer systems and healthcare. The redistributive role of social protection remains important *per se* (Cantillon and Vandenbroucke 2014). We dig a little deeper into recent evolutions in the redistributive role of social protection in Section 6, and focus on human capital in Section 7.

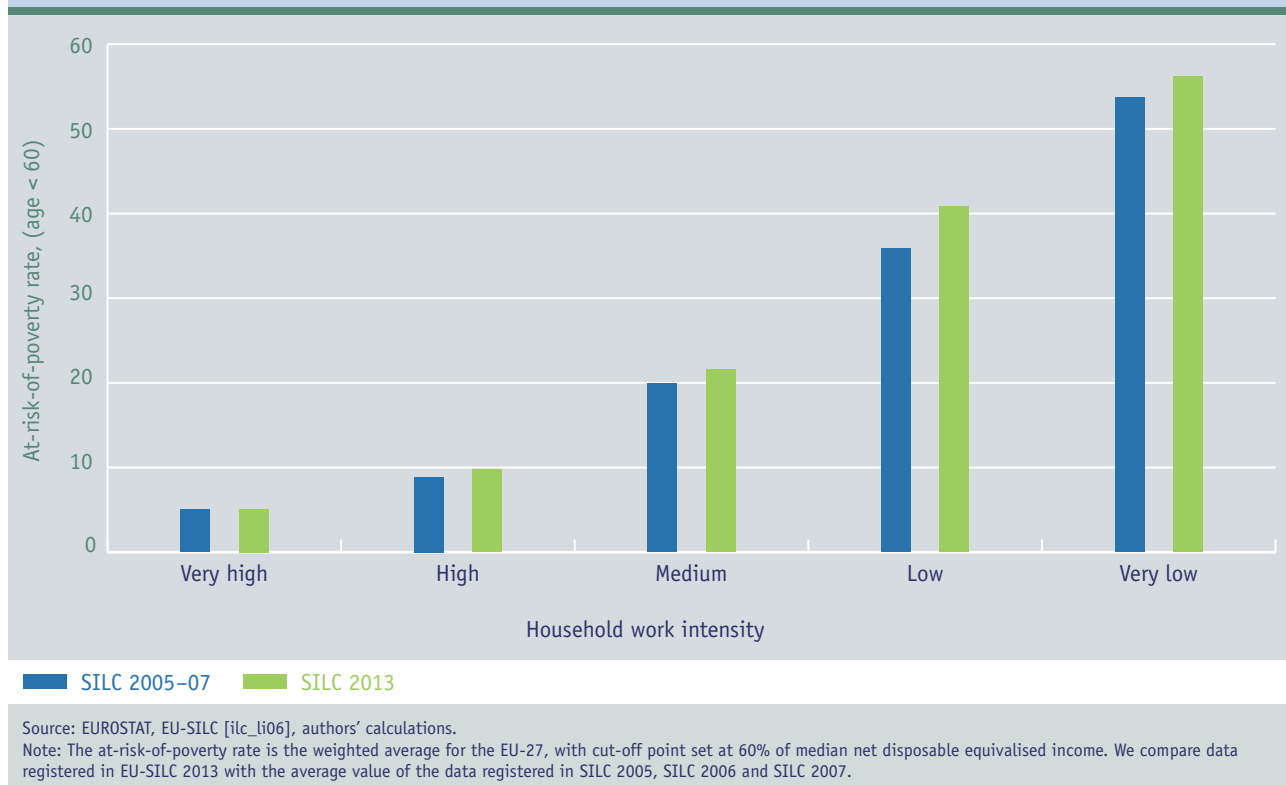
25 Bénassy-Quéré et al. (2014: 8) state that “the system has become less redistributive in Nordic countries but more so in Italy. In France and Germany, the tax-and transfer system seems to have delivered similar amount of redistribution along the period”. In contrast, the OECD finds that tax and benefit systems have become less redistributive in the countries they examine.

6. Work-poor and work-rich households in the EU and the changing nature of employment

We measure individual incomes and poverty on a household basis. A crucial determinant of the poverty risk of individuals is the labour market participation of the members of the household in which the individual lives. We measure this by an indicator called ‘household work intensity’. On this basis

we can distinguish five subgroups of households: households with a very high, high, medium, low, and very low work intensity.²⁶ The lower the work intensity, the higher the poverty risk for the individuals in the household. Figure 5 illustrates this, with average observations for the EU27.

Figure 5 | Poverty risks by work intensity of households for EU-27 (%), SILC 2013 compared to average of SILC 2005–2007



²⁶ Eurostat defines work intensity of a household as the ratio of the total number of months that all working-age household members have worked during the income reference year and the total number of months the same household members theoretically could have worked in the same period (the indicator also takes into account the number of hours worked per month).

Table 1 | Structure of population below 60 years on the basis of household work-intensity (%)

	2007	2008	2009	2010	2011	2012	2013
Very high work intensity	42.2	44.1	43.9	42.9	42.5	43.5	43.1
High work intensity	22.3	22.5	22.7	22.1	22.3	21.5	20.9
Medium work intensity	18.2	17.4	17.0	17.4	17.3	17.0	17.2
Low work intensity	6.9	6.3	6.7	7.0	7.1	7.1	7.6
Very low work intensity	9.7	9.1	9.1	10.0	10.3	10.4	10.7

Source: Eurostat.

Note: Years refer to EU-SILC years.

In Figure 5, we show the poverty risk by work intensity of the household, comparing the average values in 2004–2006 with data for 2012. Around the middle of last decade, people living in households with a very low work intensity were confronted with a poverty risk of 53.7%, whereas people living in households with a very high work intensity were confronted with a poverty risk of only 5.1%. This sizable divide has further heightened. By 2012, the poverty risk of individuals living in households with low and very low work intensity had increased considerably; conversely, the poverty risk of individuals living in households with very high work intensity remained the same. What we see in Figure 5 is a polarisation in poverty risks. Using the terminology we applied earlier, one could also say that it instantiates divergence, not between countries but between different groups of people across Europe – differentiated on the basis of the labour market attachment of their household.

Simultaneously, we witnessed a polarisation of employment across households in Europe: the share of individuals living in households with very high work intensity was reduced by the crisis, but it is today again higher than in 2007.²⁷ The share of people living in ‘work-poor’ households (by which we mean households with low and very low work intensity)²⁸

²⁷ EU-SILC years correspond to observation years for work intensity.

²⁸ ‘Work poor’ is about work intensity, not about incomes earned; hence, it is not to be confused with ‘in-work poverty’.

increased and is – as yet – not returning to its pre-crisis level. Simultaneously, there was a hollowing out of the middle: the share of people living in households with medium and high (but not very high) work intensity is lower than before the crisis. Compared to 2007, more people live in a household that is ‘very rich’ in terms of work intensity, and more people live in households that are ‘very poor’ in terms of work intensity. This is shown in Table 1.

The combination of Figure 5 and Table 1 goes a long way in explaining why non-elderly poverty increased in Europe. Two mutually reinforcing factors are at play: more people are living in work-poor households; these households experience higher poverty risks than before the crisis. The latter trend started before the crisis: in a number of countries, the poverty risk of work-poor households has been increasing since EU-SILC began. Even before 2008, it increased considerably in mature welfare states such as Germany, Sweden, Austria and Finland. This explains why ‘employment successes’ before the crisis were, in a number of countries, not converted into ‘inclusion successes’ (Cantillon and Vandenbroucke 2014). In fact, the pattern of change was far from homogeneous across Europe. Since 2004, some countries have combined increasing employment with decreasing non-elderly poverty, notably Poland. In other countries, poverty increased despite increasing employment. These diverse trajectories cannot be explained by one single

driver; rather, a set of drivers is at play and the role and impact of the drivers differs from country to country.

An economic crisis reduces employment, but the long-term trend towards polarisation of jobs across households is a phenomenon that is not well understood (Corluy and Vandebroucke 2015). We have more indications with regard to the reasons for the increasing poverty risk of work-poor households. In principle, three sets of factors can have an influence:

1. tax-and-transfer systems may have become less generous for people without work, compared to people in employment;
2. changes in household structures can also play a role: a lone-parent household with a medium or low work intensity (say, a lone mother who holds a part-time job), is confronted with a higher financial poverty risk than a couple with children with the same medium or low work intensity (say, a couple where both partners work part-time or where one partner works full-time and the other is not employed);
3. if households with lower work intensity (but not zero work intensity) are dependent on a segment of the job market where the quality of jobs is lower, both in terms of contractual security and earnings, they lose out in terms of earned income compared to other households.

The first factor, tax-and-transfer systems, may be associated with the activation turn, which emphasised that financial incentives to take up employment had to be increased: if enhanced financial incentives are not accompanied by success in activation in the segment of work-poor households, relative poverty can increase because the income gap between employed and unemployed people grows.

However, apart from deliberate changes in policy, there may also be an increasingly difficult structural constraint on the social adequacy of benefit systems. In societies where the standard of living of work-rich *dual-earner* households determines what is necessary for a decent standard of living for *any* household, social policy is confronted with a dilemma. It is not just the case that most work-poor households cannot reach this standard, whatever the number of working-age adults in the household; differences in the constellation of households create a dilemma that is structural. On the one hand, individual income replacement benefits are constrained, since they must not create employment disincentives, notably in comparison with the level of minimum wages; and the level of minimum wages is in turn constrained by considerations of cost competitiveness. On the other hand, income replacement benefits are insufficient to protect single-adult households against poverty (and even a comparatively decent minimum wage, as the Belgian one, is insufficient to protect single-adult households against poverty risks if the parent cannot work full-time, or if there are more than two children). Hence, the challenge is to improve social protection *at the household level*, whilst avoiding 'work poverty traps' at the household level, both for lone parents and for other households with children.

Therefore, we should reconsider the need for schemes designed to alleviate 'household costs' facing singles and single-income households as well as dual earners, including the cost of child-rearing, healthcare or housing. This would imply that, within the social security toolset, greater weight is assigned to so-called 'cost-compensation' benefits as supplements to individual replacement incomes, and intelligent and nuanced principles of household income selectivity are applied to those supplements. Simultaneously, the development and design of social services in support of families is of utmost importance.

These observations underscore the role of minimum wages, which we should understand correctly. To a certain extent (and with considerable heterogeneity across countries) minimum wages function as a 'glass ceiling' for the generosity of transfer systems. In countries where minimum wages are under pressure, the generosity of benefit systems will in the end also be under pressure.²⁹ Apart from their role as a (potential) glass ceiling for systems of minimum income protection, the direct impact of minimum wages on poverty is rather limited (OECD 2015; Eurofound 2015). Fundamentally, minimum wages underpin a notion of 'fairness' with regard to the compensation for work: their prime objective is not poverty alleviation. However, the OECD (2015) notes that minimum wage settings can help supporting low-wage workers and low-income families while avoiding significant job losses, if they are well designed and embedded in appropriate tax-and-transfer settings. Minimum wages are increasingly seen as under pressure because of cross-border mobility: part of the fears of social dumping may be unwarranted, but in specific sectors competitive pressure from 'low-wage' employers within the EU cannot be denied. In addition, there are problems with enforcement of minimum wage standards, in the context of posting of workers.

All these considerations support the idea that the EU would be well advised to develop a framework on minimum wages. A European framework could put pressure on all member states to have a system of minimum wages with universal coverage of the workforce, whatever the nature of the system (statutory, or based on collective bargaining).

29 The idea of a 'glass ceiling on poverty reduction', linked among other factors to the development of the wage floor, is explored in Cantillon et al. (2015).

The direct impact on poverty of the third factor in our list, the changing nature of employment, is difficult to assess empirically. However, the OECD (2015) notes that since the mid-1990s more than half of all job creation was in the form of non-standard work and discerns important links with the trend toward income inequality in a number of countries. Non-standard work can be a 'stepping stone' to more stable employment – but it depends on the type of work and the characteristics of workers and labour market institutions. In many countries, younger workers, especially those with only temporary work contracts, have a lower chance of moving on to a more stable career job. Many non-standard workers are worse off in many aspects of job quality, such as earnings, job security or access to training. In particular, low-skilled temporary workers face substantial wage penalties, earnings instability and slower wage growth. Households that are heavily dependent on earnings from non-standard work have much higher income poverty rates, and the increase in the number of such households has contributed to higher overall inequality, according to the OECD.³⁰

With regard to job quality, we are confronted with contradictory demands. Voluntary part-time work can match preferences of individuals; part-time jobs can improve the distribution of work over households. Part-time jobs can allow older workers to remain active. So conceived, the development of a part-time labour market is positive. Simultaneously, many individuals need full-time employment to earn a decent living and to secure an adequate pension, i.e. a sufficient supply of full-time jobs remains necessary. The development of zero-hour contracts, which undermine the very notion of the employers' responsibility to secure an income (and concomitant entitlements in the social security system), raises even more difficult questions: for some individuals, zero-hour contracts

30 This paragraph is based on the OECD's own executive summary of OECD 2015: 15–16.

may be an attractive option; but for many others it may be a cul-de-sac. The rise of 'marginal employment' in the form of mini-jobs, as in Germany, also implies fundamental long-term problems with regard to the social security coverage of those individuals who would only rely on such mini-jobs.

The European Commission's *Employment and Social Developments in Europe* report for 2014 contains an informative chapter on job quality and work organisation in Europe, to which we refer the reader. Their analysis signals the increasing prevalence of temporary short-term contracts and other forms of precarious work; it also emphasises that job quality can enhance labour productivity. In other words, there need not be a contradiction between a choice for job quality and economic progress (ESDE 2015).

Job quality is not only about contractual arrangements; it is also about 'job control' and autonomy, as also highlighted in the *Employment and Social Developments in Europe* report. 'Job control' and autonomy are key to sustaining the drive for longer working lives. Nordic countries, in which people work longer than elsewhere in Europe, have more jobs that are characterised by job control and autonomy: that correlation is not happenstance.

The key message that emerges from these analyses is the following:

1. The need for activation and for financial incentives to take up jobs should not be questioned. First, however, activation must be based on a 'high road' to quality jobs and real investment in human capital. In other words, both the quantity and the quality of jobs count; the quality of employment should actually be seen as a condition for a full valorisation of human capital.
2. Europe needs a combination of adequate social investment and adequate social protection; they cannot be substitutes for each other. For instance, adequate unemployment benefit systems serve a dual purpose, apart from protecting individuals: they are a corollary to flexible labour markets and they act as macro-economic stabilisers. The emphasis on 'investment' in human capital should not ignore the need for protection of human capital, i.e. the traditional 'protective' functions of welfare states. Traditional instruments of social policy, such as activation, training, social benefits and minimum wages, remain important; but there is no denying that social protection systems are confronted with new challenges for which new and innovative solutions are to be found.
3. The changing nature of employment raises issues with regard to the architecture of our social protection systems, issues which need to be addressed. These are difficult questions, but the EU could provide a unique learning environment for policy-makers on how to tackle them (Hellström and Kosonen 2015).

7. The human capital divide

If we restrict our attention to formal education, there is evidence of upward convergence across Europe. The heterogeneity in the share of formally high-skilled individuals is still wide, with less than 25% of the 25- to 34-year-olds in Italy, Romania and Austria having earned a university degree. In contrast, in Ireland, Cyprus and Lithuania one out of two young adults attains tertiary education. Nevertheless, upward convergence in formal education is taking place, and the divide, compared with that of the year 2000, is shrinking. In Figure 6A we can observe that the share of formally low-skilled individuals, i.e. those with less than upper secondary education, has diminished over time in the vast majority of EU member states, with Romania being the only notable exception to the trend. Likewise, Figure 6B shows an encouraging convergence coupled with an upward shift in the number of young adults with tertiary education.

Unfortunately, formal education is only a piece of the story. Two issues are a cause of concern: first, upward convergence is less strong in formal education for children, where it would instead be mostly needed to ensure the eradication of poverty and social-exclusion transmission mechanisms; second, the divide in actual skills is growing.

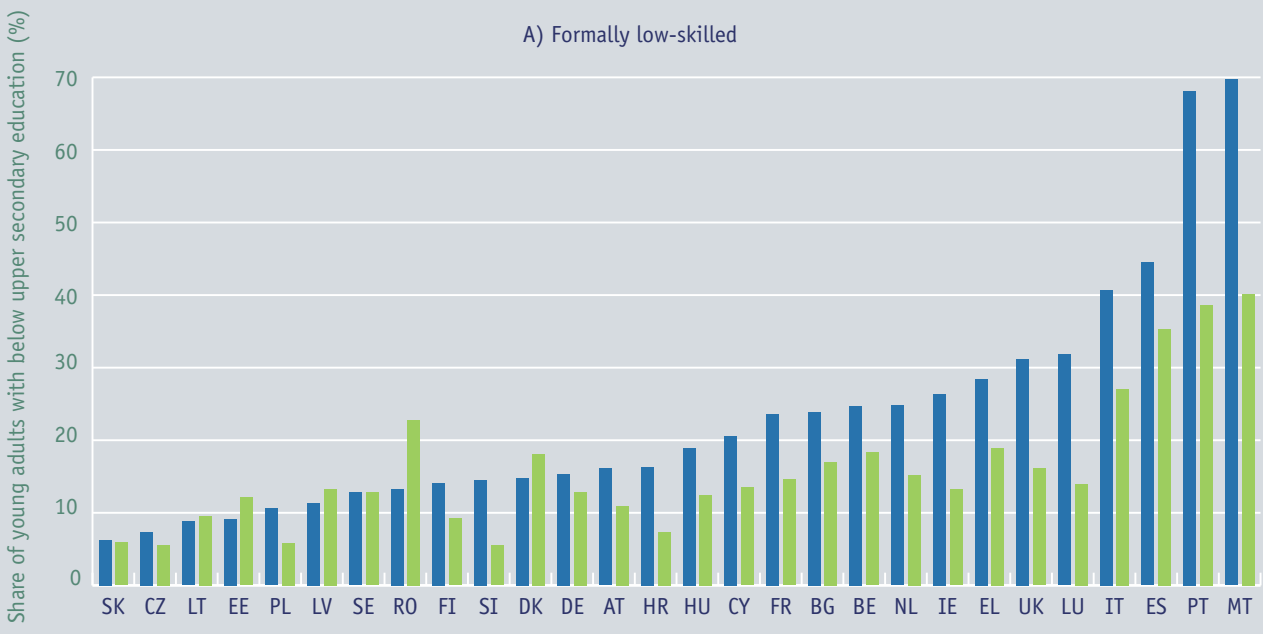
In Figure 7 we can observe the development of formal childcare for children below the age of three. There is upward convergence, to some extent, but there are signs of downward shifts in Denmark, Spain, Lithuania, the UK, and Italy. In the latter country, for instance, fiscal consolidation has considerably reduced funds for regional and local welfare systems which are responsible, among other things, for primary and preschool services. Funds for Early Childhood Education and Care (ECEC) in 2015 are 3% lower than those available in 2010 and 54% lower than those available in 2008. It is therefore not surprising to see that enrolment decreases: the highest percentage of children below three years who are enrolled in ECEC services was registered in 2008 (28%); it decreased to 21% in 2013 and it is likely to contract

further. Lack of investment in early childhood services is not a problem affecting Italy alone. The ESPN (2015) finds that, notwithstanding the message of the Social Investment Package (SIP) and the Commission Recommendation on Investing in Children, several countries (namely Bulgaria, Cyprus, Czech Republic, Greece, Spain, Croatia, Italy, Lithuania, Latvia, Malta, Portugal, Romania, Serbia, Slovakia and Turkey) still have very low investment in childcare and weak policies for supporting early childhood development. Moreover, as reported in Rinaldi (2015), the uptake of early childhood care in the EU is higher among wealthier and more educated parents, whereas the role of ECEC in the framework of a social investment strategy should consist in empowering disadvantaged households.

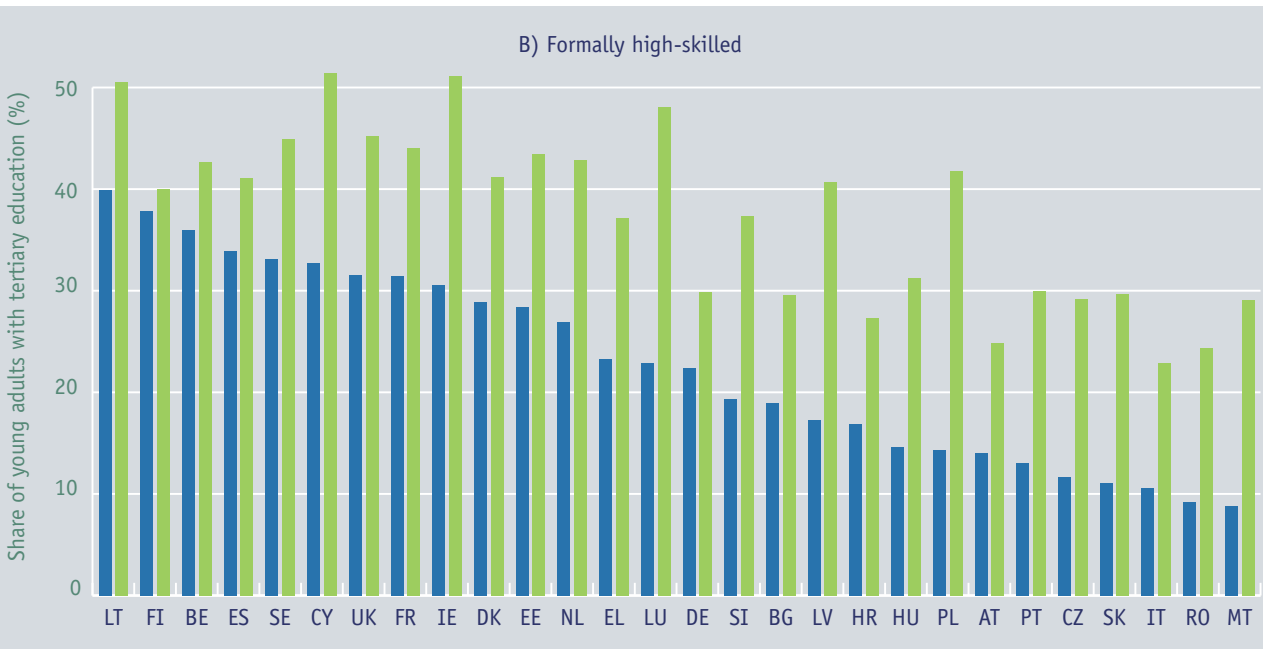
Actual skill levels are what matter, rather than formal educational attainment. To analyse the development of skills over time, we focus on the PISA scores for reading skills and compare the performance of 15-year-old pupils in 2000 and 2012, i.e. we use reading proficiency as an overall proxy for skills.³¹ The contrast between Figure 6 on formal education and Figure 8 on actual skill levels is striking. On the one hand, in terms of educational attainment almost all countries have improved, but, on the other hand, in Figure 8A, we observe that the share of low-skilled individuals increased in nine member states, including Austria for which the increase is marginal. Furthermore, in 14 countries the share of top performing pupils decreased or showed no sizable increase. In Poland, the reduction of the share of students who are not able to meet the baseline level of reading proficiency paired with an increase in the share of top-performing students; in Sweden, Finland and Slovakia instead, the share of the high-skilled decreased and the share

³¹ European Commission (2013), by comparing PISA 2009 and 2012 results, confirms that the trend we described for reading performance is consistent with those in mathematics and science. The share of low achieving students in EU member states has remained unchanged for both maths (from 22.3% in 2009 to 22.1% in 2012) and science (from 17.8% in 2009 to 16.6% in 2012).

Figure 6 | Development of formal education attainments



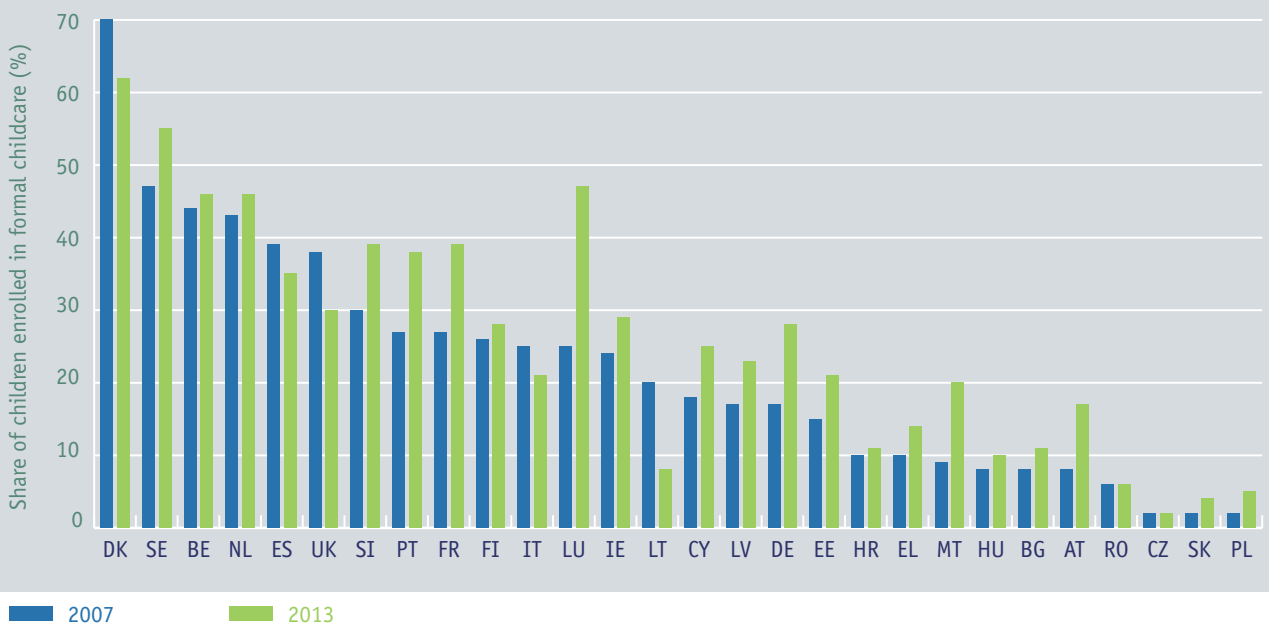
■ 2000 ■ 2013



■ 2000 ■ 2013

Source: EUROSTAT UOE [edat_lfse_05] and [edat_lfse_07] authors' calculations.
 Note: Data refer to age group 25–34 year-old. Formally low skilled refers to population with less than primary, primary and lower secondary education (levels 0–2).
 Formally high skilled refers to population with tertiary education (levels 5–8). Data for Croatia are for 2002 instead of 2000.

Figure 7 | Developments in early childhood care



Source: Eurostat EU-SILC [ilc_caindformal], authors' calculations.

Note: Participation rate accounts for formal childcare for children below 3 years of age and refers to both part- and full-time participation. Data for Lithuania refer to 2012 and not to 2013, data for Croatia refer to 2010 instead of 2007.

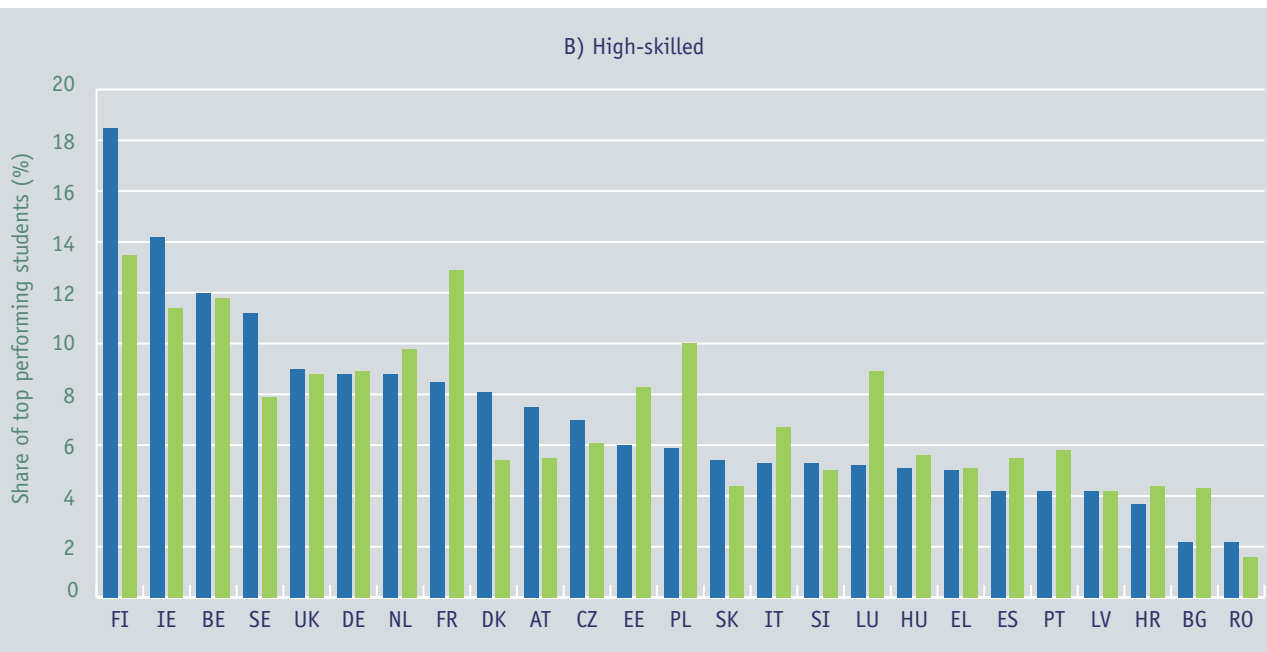
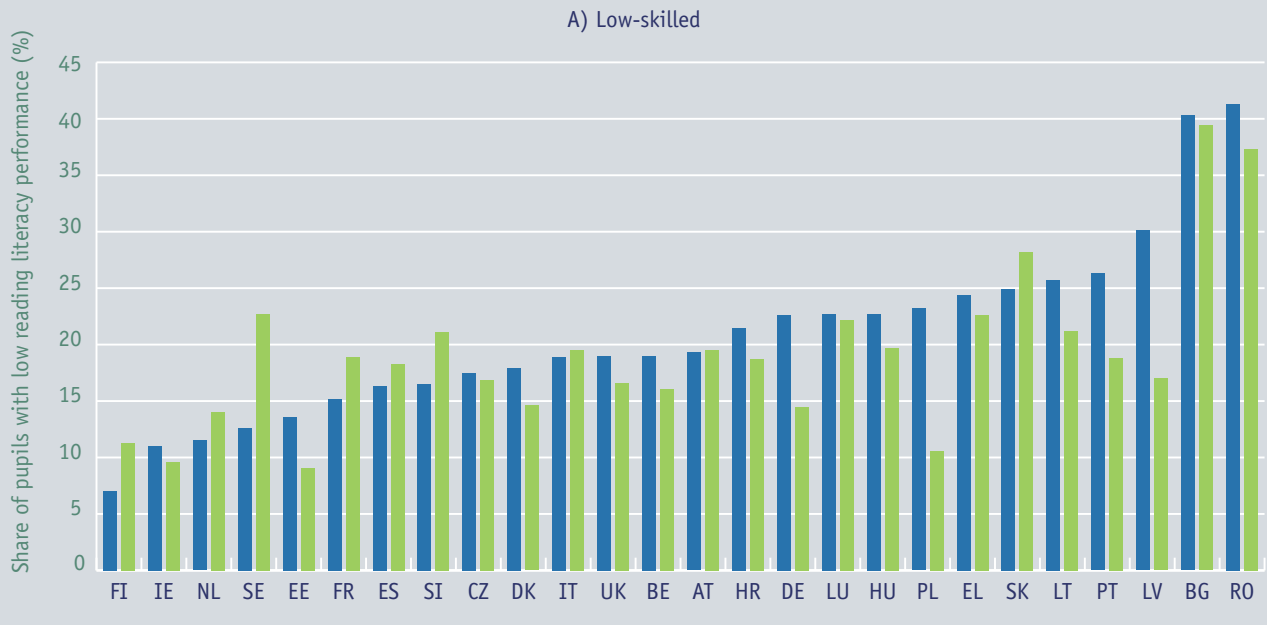
of the low-skilled increased. A certain degree of convergence is present but it is not due to a catching up towards higher levels of competences, it is rather due to deterioration of skills levels in those countries that were doing relatively well. Figure 8 also highlights that this mixed convergence has not been able to lessen the skills divide affecting Europe. Romania and Bulgaria with over 35% of low-skilled pupils and only less than 5% of high-skilled still lag considerably behind other EU member states in terms of skills.

Figure 9 provides additional insights into the dispersion of reading skills *within* member states. We report both the P75/P25 score percentile ratio (Figure 9A) and the cut-off score for

the 25th percentile³² (Figure 9B). The two indicators tell two different stories, neither of which is really positive. The P75/P25 ratio shows that in ten member states internal inequality in skills distribution worsened (France, Sweden, Bulgaria and Slovakia are examples) from 2000 to 2012. The P25 level shows that the absolute performance level at the bottom end of the skills distribution increased in some countries (such as Poland, Portugal and Germany, countries in which major efforts have been undertaken to improve performance) but decreased in a number of other countries, among others in Sweden, Finland, Slovakia, and Slovenia.

32 The cut-off score for the 25th percentile identifies a score such that 25% of the student sample perform worse.

Figure 8 | Developments in skills



Source: OECD PISA 2012 Database and Eurostat [tsdsc450]. Authors' calculations.
 Note: Low reading literacy performance of pupils is defined as the share of 15-year-old pupils who are at level 1 or below of the PISA combined reading literacy scale. Top performance is defined as Level 5 and above in reading proficiency. Reading literacy focuses on the ability of students to use written information in situations which they encounter in their life. When data for PISA 2000 are not available, the graph refers to PISA 2003 (Luxembourg, Slovakia and the Netherlands) or to 2006 (Croatia and Estonia).

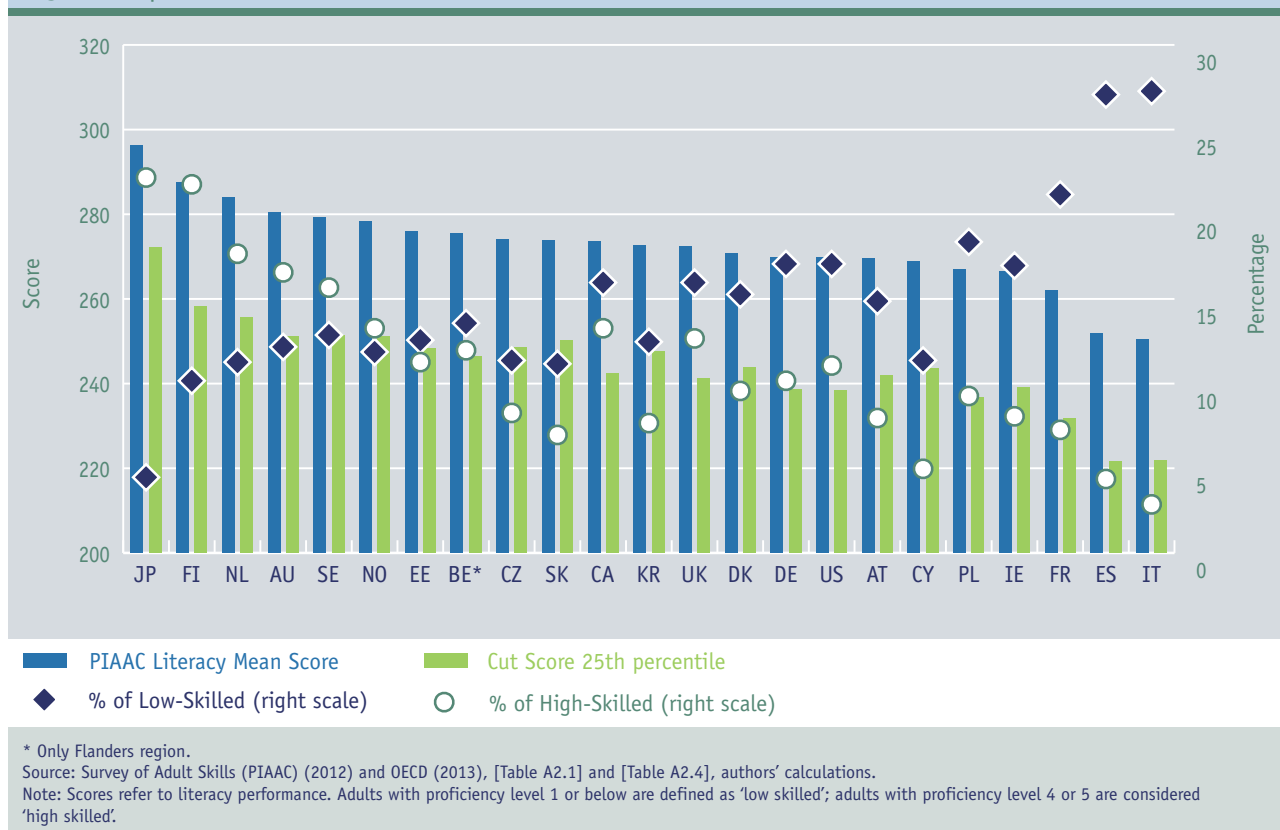
Figure 9 | Skills dispersion



Source: OECD PISA 2012 Database and OECD (2014), authors' calculations.

Note: Cut scores of 15-year-old students on PISA reading literacy scale at 25th percentile. When data for PISA 2000 are not available, the graph refers to PISA 2003 (Luxembourg, Slovakia and the Netherlands) or to 2006 (Estonia, Croatia, Lithuania, Slovenia and the United Kingdom).

Figure 10 | Distribution of adult skills across countries



To have a better understanding of the 'stock' of skills, we also look at the skills distribution among adults. PIAAC³³ results, released in 2013, give insights into inequality in skills across countries and within countries among the working-age

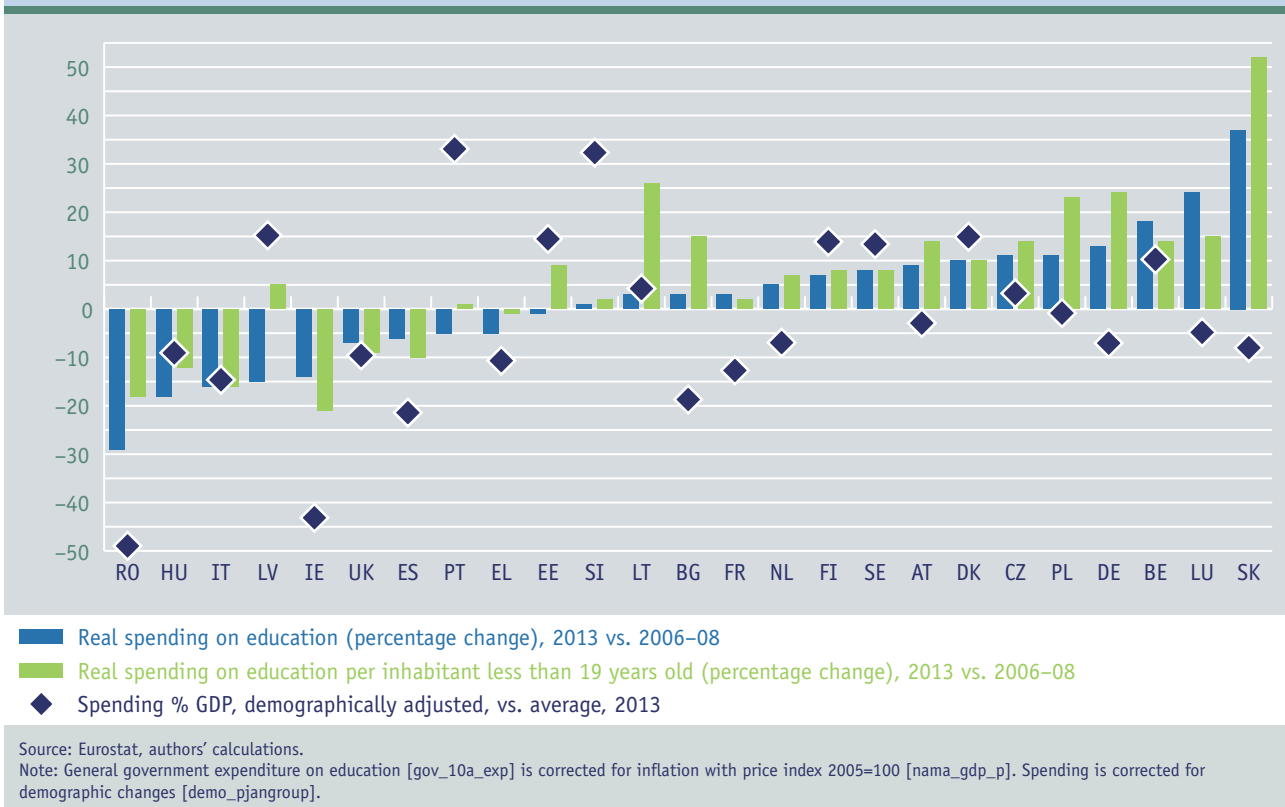
population. We condense the information in Figure 10, which reports scores at the mean and at the 25th percentile as well as the percentage of low- and high-skilled adults³⁴ for 23 countries.³⁵ The divide between Finland, the best-performing

33 The Programme for the International Assessment of Adult Competencies (PIAAC) is an international survey carried out by the OECD. It assesses literacy, numeracy and problem-solving performance of people between 16 and 65 years old and thus evaluates cognitive and workplace skills. As PIAAC data are cross-sectional, it is impossible to study the evolution of adult skills over time.

34 PIAAC identifies five levels of proficiency. We define as low-skilled those who achieve proficiency level 1 or below, whereas we consider high-skilled those who achieve proficiency level 4 or 5.

35 The PIAAC sample is relatively limited for the EU, covering 16 EU countries plus Flanders, as shown in Figure 15 together with other participating countries.

Figure 11 | A worrying divergence in public spending on education



EU country, and Italy is alarming. With regard to literacy, more than 22% of Finnish adults are highly skilled, compared to a mere 3.3% in Italy. The mean score in the Scandinavian country is 287.5, whilst the mean in Italy (250.5) is even lower than the Finnish cut-off score for the 25th percentile (258.3). The percentage of low-skilled adults is below 10% in Japan, whilst it is above 20% in France, Spain and Italy. The worst results in terms of adult skills can be seen in those countries where social investment strategies are either non-existent or at a very

embryonic stage. A weak culture of lifelong learning and training on the job is likely one of the main causes of poor skills among adults. The need for a serious investment in new skills in young people is evident in several European countries in this sample, notably France, Spain and Italy.

To sum up, the EU is deeply affected by a human capital divide, both between and within the member states. With regard to formal educational attainment, there are positive developments; but with regard to skills, insofar as there

is convergence across the Union, there is a mixture of positive and negative developments. With regard to early childhood education and care, there are signs of upward convergence but, simultaneously, austerity policies have negatively affected ECEC efforts in many countries. The discrepancy between upward convergence in formal education and persistent inequalities in the actual distribution of competences both among and within member states is alarming. The European Commission (2015), which stresses similar results, sees this as a key threat to the achievement of a real European labour market and concludes that educational inequalities have often increased, since “*educational equality has never been a policy priority in many EU countries*”.³⁶

European countries are therefore faced with a double challenge: they should consider how to boost skills and competence levels whilst also addressing the issue of how to bring high levels of competences to a broader share of the population.

The EU certainly recognises the huge education challenge with which it is confronted and the European Commission has developed a comprehensive agenda on education, training and skills, and issued excellent recommendations on the modernisation of education systems. However, this educational agenda does not carry sufficient weight at the highest levels of European political decision-making and in the setting of budget priorities. Real public expenditure on education was lower in 2013 than before the crisis in ten member states, including those that badly need to improve their education system.

Figure 11 displays data on the evolution of public spending on education in real terms. The blue bars compare public education spending in 2013 for each country with the country’s

average spending over the years 2006-2008 (deflated with the GDP deflator). In ten of the 25 countries under review, real spending is now lower than it was, on average, in the years before the crisis. In Romania the decline is 29%, in Hungary it is 18%, in Italy 16%, in Latvia 15% and in Ireland 14%. Meanwhile, there was a significant increase in real spending, with an increase in education spending of 10% or more in Denmark, the Czech Republic, Germany, Poland, Belgium, Luxembourg and Slovakia (always comparing 2013 with the average over 2006-2008). Obviously, demography plays a role; in Figure 11 we can see that when demographic change is taken into account, by calculating real public spending on education per inhabitant younger than 19 years of age, real spending per young inhabitant decreased with 18% in Romania and 12% in Hungary; in contrast, in Ireland real spending per young inhabitant diminished with 21%. The effort in public education spending is spectacular in Germany and Poland, when taking demography in account.

The divergence in education spending across the EU may lead to more long-term divergence in productivity, instead of the convergence that is so badly needed. That is not to say that the quality of education systems can be measured in a simplistic way by the level of public spending on education; but it seems very hard to improve education systems significantly while disinvesting. EU budgetary governance must be made coherent with a social investment strategy that promotes investment in lifelong education.

³⁶ European Commission 2015: 21.

8. Health, healthcare and the environment

With regard to life expectancy, there is a large divide across European regions. Mediterranean and Western countries have higher life expectancies, with Spain leading among EU member states with 82.4 years. Eastern and Baltic countries, in contrast, have shorter life expectancy, with Romania, Bulgaria, Latvia and Lithuania bringing up the rear with less than 75 years. Since 2000, there has been a remarkable upward shift: for all member states, life expectancy increased. Nevertheless, a clear distinction remains between two groups of countries: Western countries, with a life expectancy of more than 75 years in 2000 and about 80 years or above now; and Eastern countries, with life expectancy below 78 years, not all of which have achieved the levels that Western countries enjoyed 15 years ago. The nine years' difference between Spain and Lithuania (73.4 years in 2013) is a considerable gap.

Universal access to quality healthcare has to be regarded as one of the core aims of European welfare states. We can assess how the availability and affordability of healthcare services have improved over time in European countries on the basis of the EU-SILC database, which registers the self-reported assessment of unmet needs for medical examinations. Medical examinations and treatment are crucial aspects of healthcare; high costs, long waiting lists and the distance to the service provider can be very relevant barriers to access for individuals who need healthcare. If we look at the year 2013 for the entire EU28, the percentage of people reporting unmet needs for medical examinations – due to services that were too expensive, distances that were too far or waiting lists that were too long – was 1.5% for the top income quintile; in contrast, it was 11% for the bottom 40% of income earners.

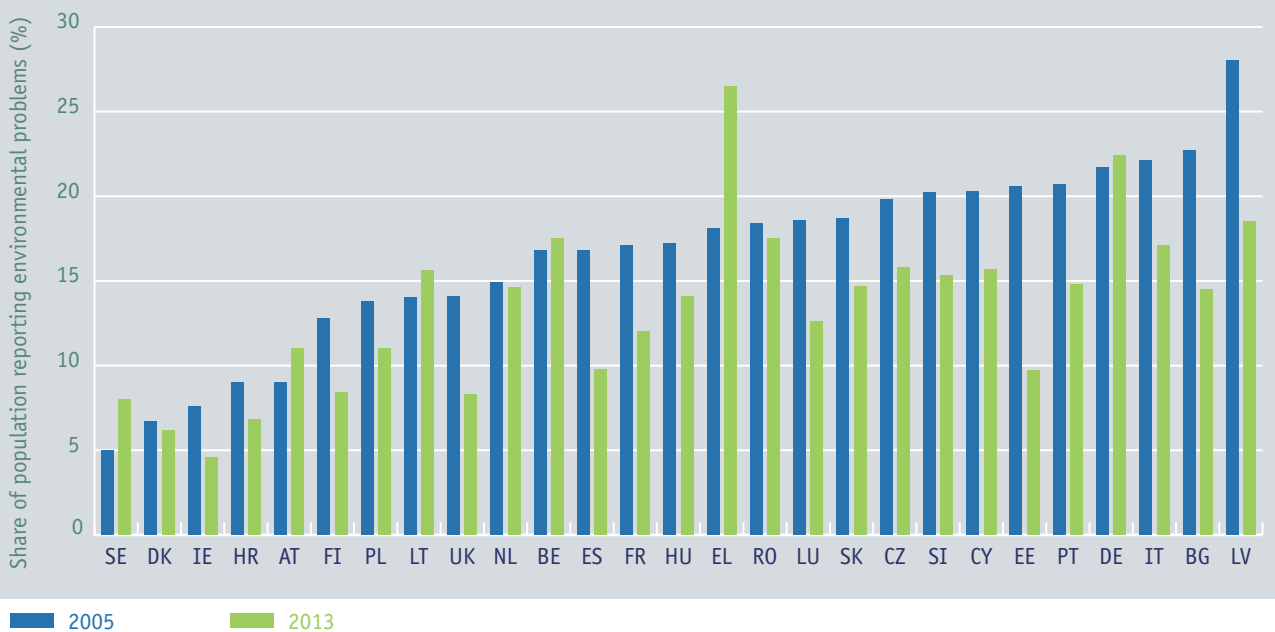
Inequalities in access to healthcare which penalise low-income households are unfortunately not a novelty. What emerges as a more striking pattern is that, with the exception of Portugal, Bulgaria, Germany and Lithuania, there is no evidence of a

downward trend in the share of people with unmet medical needs. Actually, Finland, Poland, France and some countries deeply affected by austerity measures, such as Greece, Latvia and Italy, have experienced a noticeable rise in unmet medical care for lower incomes. Some of the top-performing countries regressed and now have a higher share of poor individuals with unmet medical needs in 2013 than they had in 2007 (Finland +8.9%, Belgium +6.2%, France +4.3%).

Concerns over environmental justice are growing in Europe and it is now relatively clear that the environment and related policies have a strong impact on social conditions and well-being, notably via health, access to amenities, and consumption patterns. Despite that, a more general debate on the crossing of social and environmental perspectives has not yet emerged in all member states³⁷ and it is at an embryonic stage at the European level. Council of Europe (2013) develops an analysis that links aspects of poverty and inequality to waste and access to resources; in a study for the European Commission, Pye et al. (2008) review the numerous interlinkages between environmental and social policy and attempt to define patterns promoting synergies for mutually reinforcing policies. In this context, Laurent (2010) identifies four types of environmental inequalities: i) *inequalities in policymaking*: as certain socially disadvantaged groups have less or no impact on decision-making affecting their environment; ii) *inequalities in environmental impact*: as different social groups with different lifestyles impact the environment differently; iii) *inequalities in environmental regulation*: as individuals from different social groups or with different incomes are affected diversely by environmental policy, regulation and taxes; iv) *inequalities in exposure and access*: as environmental quality is distributed unequally

³⁷ The UK leads the way with its national sustainable development strategy developed in 2005 and with the broad mandate of the UK Environmental Agency.

Figure 12 | Developments in environmental quality



Source: EUROSTAT, EU-SILC [ilc_mddw02].
 Note: Percentage of total population reporting exposure to pollution, crime or other environmental problems.
 Data are not available for 2005 for Romania and Croatia, 2007 and 2010, respectively, are reported.

across individuals and groups according to their incomes, ethnicity or social status.

The distribution of environmental quality remains unequal, because the exposure to environmental risk and hazard is higher among vulnerable groups and because access to environmental amenities is at times limited for disadvantaged groups. Being exposed to pollution and crime and living in environmentally risky or excessively noisy areas represents a serious threat to health and well-being and can constitute a barrier to the empowerment of certain strata of society. To address social inequalities, social policy must embrace the issue of environmental justice.

To check whether Europe has made progress with regard to environmental inequalities, Figure 12 shows the share of population that reports problems linked to the presence of pollution, crime or other environment-related problems such as smoke, dust, unpleasant smells or polluted water, in the proximity of their dwelling. Over the 2005–2013 period, the only sizable increases in reported environmental discomfort happened in Greece and Sweden; some countries remained relatively steady (Denmark, Lithuania, Belgium, Germany and the Netherlands). Nevertheless, there is evidence of downward convergence in the rate of exposure to environmental problems, i.e. an upward convergence in environmental quality.

Upward convergence in environmental quality has impacted both top and bottom incomes, with marginally higher gains for the former. If we look at the euro area for instance, the share of reported environmental distress decreased 3.2 percentage points for those above 60% of median equivalised income and 1.5 percentage points for those below. Marked differences between income groups are present in Bulgaria, Hungary, France, Belgium and Germany, whilst for countries such as Greece and Romania the EU-SILC survey reports that environmental problems are more of a concern for the richer.

As stressed by Laurent (2010), European social policies should deal with the impact, in terms of health and socio-economic conditions, of environmental conditions and policies. A reduction of environmental inequalities by means of social-ecological policies should be among the objectives of modern welfare states.

9. 'Dual-use' policy packages for convergence and cohesion and the role of the EU

In its report *In It Together. Why Less Inequality Benefits All*, the OECD (2015) emphasises that reducing the growing divide between rich and poor requires policy packages, mobilising a whole range of instruments, in four main areas:

1. women's participation in economic life,
2. employment promotion and good-quality jobs,
3. skills and education,
4. tax-and-transfer systems for efficient redistribution.

Simultaneously, the OECD emphasises that there is no single best model or policy mix to adopt. "Each country will have to design its own package, depending on the key factors at the origins of inequality in the national context."³⁸ The OECD adds a particular dimension to discussions on policy choices by demonstrating how inequality can reduce growth. The main transmission mechanism between inequality and growth, according to the OECD, is human capital investment. While there is always a gap in education outcomes across individuals with different socio-economic backgrounds, the gap widens in high-inequality countries as people in disadvantaged households struggle to access quality education. The report suggests that it is the position of the bottom 40% that matters in particular for economic growth. It is not only the situation of the very poorest section of the population that inhibits growth, but that of a much broader group of working and lower middle class people. Policy thus needs to be directed towards the bottom 40%.

The data in Section 7 show that upward convergence in the quality of our human capital is a key condition for long-term upward convergence across the EU. Hence, *reducing background inequalities between families with children and investing in childcare and education support both national cohesion and long-term EU-wide convergence*. Obviously, creating greater

access to success in education for all children is not just a question of money; it also requires reforms in the education system in many member states.

In other words, a child-centred social investment strategy that addresses inequalities in opportunities serves a dual purpose. Borrowing from military terminology, one may say that it is a dual-use policy package in the current European context. Governments pursuing such a strategy deserve encouragement and opportunities to learn from other EU governments, but also tangible support from the EU, notably when they are in budgetary dire straits.

Other policy orientations, put forward by the OECD, have a similar *dual-use* character in the context of the eurozone. Adequate unemployment insurance and coordinated wage bargaining are two examples.

The OECD notes that increasing coverage of unemployment insurance is a promising avenue for promoting worker security, provided systems are designed to preserve incentives to work and meet other conditions which the OECD sets out. Inadequate coverage of unemployment insurance is an endemic problem in some European countries, notably in the Southern eurozone. Apart from their negative social consequences, patchy unemployment benefit systems undermine the automatic stabilisation capacity of those welfare states. They also make it difficult to opt for a more flexible labour market with more balanced employment protection. Addressing labour market segmentation, promoting flexibility and improving unemployment insurance coverage should go hand in hand. Flexible labour markets are also a condition for a monetary union to function smoothly. In other words, a policy package that combines improved unemployment insurance and flexibility will serve both internal social inclusion and the future stability of the eurozone. This is one of the reasons why some argue

³⁸ OECD 2015: 36.

in favour of a European support for national unemployment insurance systems, notably in the eurozone.

The coordination of wage bargaining has the same dual-use potential. This may be a surprising and more controversial statement, but it merits serious consideration. The OECD mentions the improvement of social dialogue and industrial relations as important elements of a more equitable and inclusive growth: high union density and bargaining coverage, and the centralisation/coordination of wage bargaining tend to go hand in hand with lower overall wage inequality, although there is some disagreement about the size of these effects and whether they hold for women (OECD 2015). Atkinson (2015) stresses the same insight, integrating it into a broader discussion of the link between equality and empowerment, and of the need to have 'national conversations' on pay and income inequality. From a totally different vantage point, wage coordination is also important in a monetary union – for reasons of symmetry in wage developments. What we have learned since 2008 is that exposure to market forces has not in itself produced wage discipline in the monetary union. On the contrary, monetary integration, as it has been implemented, invited 'lack of discipline' rather than discipline. This is one of the reasons why divergence obtained, rather than convergence.

Elsewhere we argue that, therefore, the eurozone needs a visible hand that pursues symmetry, notably with regard to wage increases (Vandenbroucke 2015a, b). Moreover, member states need labour market institutions that can coordinate wage increases: the visible hand must be effective.

Hence, the EU should acknowledge the positive results that come from coordinated wage bargaining within member states. Instead of encouraging the decentralisation of collective bargaining, the EU should take steps to encourage and

facilitate bargaining coordination. The Five Presidents' Report (2015) on the future of the Monetary Union now presents a proposal which can be linked to the need to revamp systems of collective bargaining: it proposes a euro-area system of national 'competitiveness authorities', thereby referring to Belgium as an example of good practice. It so happens that the Belgian competitiveness watchdog is embedded in national collective bargaining institutions, and derives its authority precisely from being part and parcel of the collective bargaining system. Hence, the 'good practice', which the Five Presidents' Report refers to, may be broadened to embedding such competitiveness authorities in collective bargaining systems.

Finally, EU initiatives may also be necessary to allow member states to implement certain OECD recommendations successfully. The OECD emphasises that adequately designed redistribution via taxes and transfers is a powerful instrument to contribute to more equality and more growth. According to its analysis, the effectiveness of redistribution weakened in recent decades in many countries due to working-age benefits not keeping pace with real wages and taxes becoming less progressive. The OECD leaves no doubt that policies need to ensure that wealthier individuals, but also multinational firms, pay their share of the tax burden. Without a European framework on corporate taxation, tax competition between EU countries seems to make that very difficult, if not impossible (Bénassy-Quéré et al. 2014). In the 1980s, creating a level playing field with regard to health and safety at work was seen as a natural corollary to the deepening of market integration; in the same vein, consolidating the Union today may necessitate the creation of a level playing field in new domains, such as corporate taxation.

10. Solidarity and mutual trust

In the previous section, we highlighted the link between specific challenges for the EU and certain OECD recommendations with respect to inequality. These observations touch upon more fundamental issues of solidarity, mutual trust and the role of the EU. We briefly elaborate upon this in this section.

Since 2008, we have learned that design failures of the European Monetary Union made it unstable and fragile: it lacked both a banking union and a central bank that was ready to be lender of last resort, if necessary. The Five President's Report now adds to this that the euro area also needs a fiscal stabilisation function. Indeed, both a lender of last resort and a fiscal capacity are indispensable to support eurozone welfare states in one of their key systemic functions: stabilisation in times of economic crisis. The idea of a fiscal stabilisation function, which implies fiscal transfers in one way or another, remains at a very generic level in the Five Presidents' Report. Admittedly, it raises complex political and technical questions, and different options can be pursued; the idea of a European support for national unemployment insurance systems, referred to in the previous section, could be one option.³⁹ It is therefore important to clarify these ideas, which constitute a research agenda rather than a policy programme. Fundamentally, both with regard to the completion of banking union (which raises issues of mutual insurance) and fiscal stabilisation (which can also be understood as the organisation of a kind of mutual insurance against adverse economic circumstances), the Five President's Report signals an acute awareness that we need to organise more solidarity in the eurozone.

The organization of solidarity requires mutual trust. Solidarity on the basis of mutual insurance is a rational option, but even the most rational individuals will not engage in mutual insurance, if they do not trust each other sufficiently. European solidarity requires mutual trust with regard to the quality of the social fabric in the member states, notably with regard to their capacity to deliver on competitiveness and sound public finances.

Mutual trust is also at stake in the social dumping debate. In the past, the spectre of large-scale social dumping has never materialised, but in today's enlarged EU, blatant cases of illegal working conditions and exploitation do occur, resulting from the interplay of gaps in the domestic implementation of social and employment protection in member states, their reduced legal sovereignty and the absence of common social standards in a very heterogeneous group of countries. A crucial condition for European public opinion to accept labour mobility and migration is that they should fit into a regulated social order; they must not undermine that social order. Whether or not minimum wage standards can be protected in a context of free movement of workers and services is a salient example. Reconciling mobility and the four freedoms, on the one hand, with the internal cohesion of national welfare states and industrial relations, on the other hand, is a complex challenge, but it is not an insurmountable one. It requires a 'balancing act', which is feasible. This balancing act is not just between economic principles and social principles. Both international openness (under certain conditions) and domestic social cohesion can be understood in terms of solidarity; we touched upon this in Section 2, when we explained that the European project implies a complex notion of solidarity. Hence, the balancing act is also between different types of solidarity.

³⁹ See Beblavý and Maselli (2014) for a simulation exercise that compares a harmonised European unemployment benefit scheme with a reinsurance scheme and Enderlein et al. (2013) for the alternative proposal of a cyclical shock insurance based on output gap measures.

11. Envoi

The EU deserves a *Social Triple A* if it actively supports both convergence towards higher aggregate levels of well-being across the member states and convergence towards more equality of individual well-being within the member states. In a sense, this twin ambition is not new; it means that we have to revisit what originally inspired the European project's founding fathers. The problem is less with the original inspiration than with our current capacity to deliver on it. The founding fathers optimistically assumed that growing cohesion both between and within countries could be reached by supranational economic cooperation; domestic social policies were to redistribute the fruits of economic progress, while remaining a national prerogative.

This traditional division of labour is not fit for the current challenges. As a matter of fact, the EU has already had a considerable impact on the member states' social policies. Hence, we now have to define what we expect from the EU in the domain of social policy.⁴⁰

The EU should stimulate and support the member states to develop policy packages that contribute to growing cohesion both within and between countries. Such 'dual-use' policy packages do exist: education offers a telling example. Upward convergence in the quality of our human capital is a key condition for long-term upward convergence in prosperity and well-being across the EU. Currently, the EU is deeply affected by a human capital divide, both between and within the member states. Hence, reducing background inequalities between families with children and investing in childcare and education contribute both to national cohesion and to long-term EU-wide convergence. Obviously, creating greater access to success in education for all children is not just a question

of money; it also requires reforms in the education system in many member states.

Governments pursuing such a strategy deserve encouragement and opportunities to learn from other EU governments, but also tangible support from the EU, notably when they are in budgetary dire straits. We need more 'solidarity in reform'.

There is a growing awareness that we need to organize more solidarity in the EU, as witnessed by the recent Five President's Report on the future of the eurozone and the refugee crisis. The organization of solidarity requires mutual trust. Mutual trust is also at stake in the social dumping debate.

A crucial condition for European public opinion to accept labour mobility and migration is that they should fit into a regulated social order. Such a 'balancing act' should figure high on the European agenda.

The EU's role in social policy can be summarised as follows.

The EU should provide a framework that reconciles openness and mobility with domestic social cohesion; it should support national welfare states on a systemic level in some of their key functions; it should guide the substantive development of national welfare states by indicating general social standards and objectives and organise mutual learning processes, but leave ways and means to the member states.

⁴⁰ See Fernandes and Maslauskaitė (2013), who provide three scenarios for deepening the European Monetary Union and Vandenbroucke (2015a, b), who makes the case for a European Social Union.

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The growing intergenerational divide in Europe – What role for the welfare state?

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Executive summary

During the crisis years, an increased divergence was observable between the younger and older populations in Europe. Poverty indicators have shown the emergence of an intergenerational divide, especially in the crisis-hit South, and unemployment has become a major concern, with young people hit hardest. The surges in youth unemployment and youth poverty are particularly worrying since they have long-lasting effects on productivity and potential growth, marking young people for their lifetime, lowering their productivity and often excluding them from the labour market for an extended period of time.

In the paper, we identify three types of policy actions which have significantly contributed to the growth of the intergenerational divide in recent years. First, macroeconomic management. Before the European Central Bank's decision to start an Outright Monetary Transactions programme (OMT) in July 2012, financial conditions diverged substantially in the euro area, pricing some countries and their businesses out of markets. Fiscal policy was overly restrictive in the euro area as a whole. This aggravated the recession and increased poverty indicators and (youth) unemployment.

Second, the composition of government spending changed during the crisis. Spending on family and children as well as on education decreased and put youth at a greater disadvantage. Only pensioners seem to have been spared from cuts and, in

some cases, benefited from increasing government spending. As the composition of public expenditure shifted from families and children and education towards pensioners, it contributed to a further deterioration of the intergenerational divide.

Third, intergenerational equity in pension schemes. Our analysis suggests that overall entitlements have been curtailed in many countries to address sustainability questions, but the burden seems not to have been shared equally, favouring current over future pensioners, especially in the crisis-hit South (Italy being an exception).

We recommend to forcefully address this intergenerational divide. Europe needs macroeconomic policy tools that allow a better management of the euro area-wide fiscal stance. In the short term, we are sceptical about creating major European stabilisation functions such as a European unemployment insurance scheme (Claeys et al. 2014). Such measures could prove effective, but they would require an extraordinary effort to create harmonised European labour market legislation. Instead, we would focus on an enhanced, symmetric and binding policy coordination framework for fiscal policy, as outlined in Sapir and Wolff (2015). To address youth unemployment, we suggest labour market reforms that allow for graded job security as workers acquire tenure. However, such measures will only help once economic growth picks up. Furthermore, if budget cuts

become necessary, it would be advisable to cut unproductive government spending while preserving spending on the younger generation and investment in the future. Governments should reconsider the composition of government spending as this would not only increase intergenerational equity, but also provide an investment in the long-term growth potential of our economies. Lastly, we recommend better intergenerational burden-sharing in pension schemes, safeguarding a constant benefit ratio over generations by adjusting contribution rates for the working population and benefit levels for retirees (Musgrave rule).

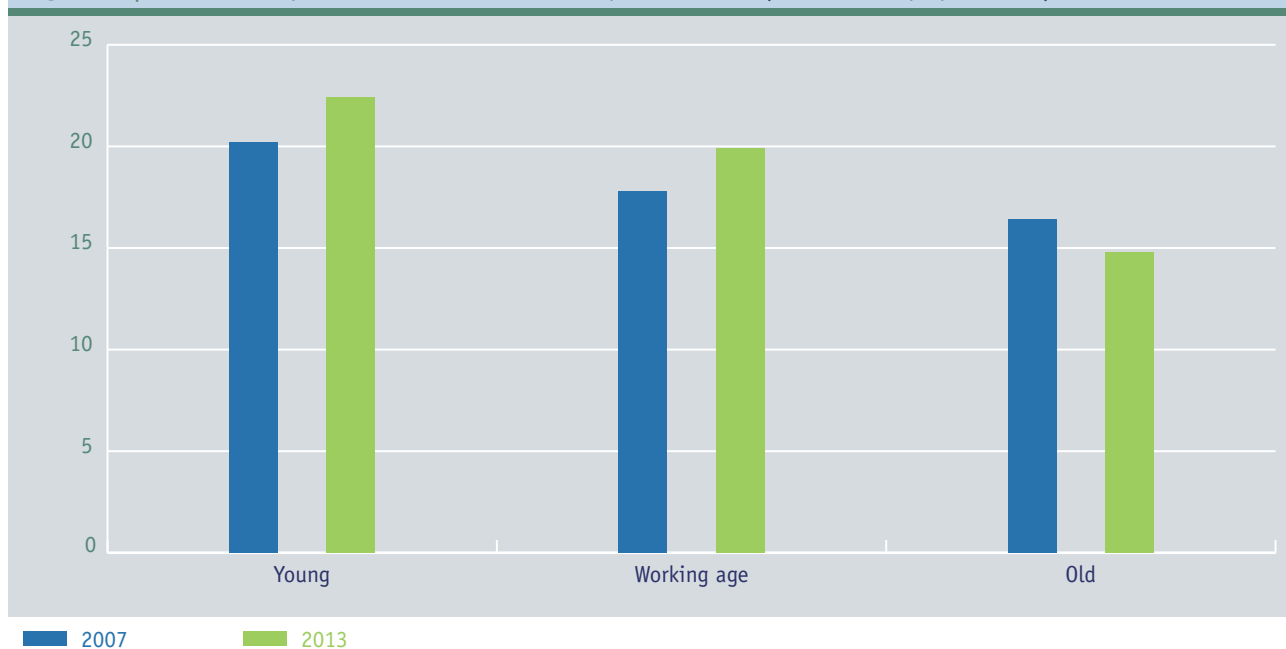
Overall, we are concerned that the crisis has left a dangerous intergenerational legacy. Addressing this legacy by making the government spending mix more favourable for the younger generation while establishing intergenerational equity in pension schemes should be a key concern for policy makers throughout large parts of the European Union.

1. The emergence of an intergenerational divide

Seven years of economic crisis have increased the intergenerational divide in many countries of the EU. Poverty among the young has increased considerably, whereas poverty among pensioners has gone down (Figure 1). Youth unemployment has increased significantly while older workers have been less affected (Figure 2). While this pattern has been particularly pronounced in Southern Europe, it is a Europe-wide problem. In this paper, we document the issue in detail and focus on three policy developments that are responsible for the increasing intergenerational divide: macroeconomic management, changes in the composition of government expenditures, and pension reforms.

EU unemployment peaked at 10.9% of the labour force in 2013, before recovering somewhat in 2014. But it is the young that have been most hit by the unemployment increase. Youth unemployment measured by the NEET rate, i.e. the rate of young people not in employment, education or training, has increased from 15.2% in 2007 to 18.6% in 2013 in the EU, with huge country differences: In the countries most hit by the crisis (Greece, Cyprus, Spain, Italy and Ireland), the NEET rate increased by more than 15 percentage points from 2007 to 2013, peaking at over 30% in Greece and Italy. By contrast, the NEET rate declined in Germany over the same period, from 13.9% to 9.5% (Figure 3).

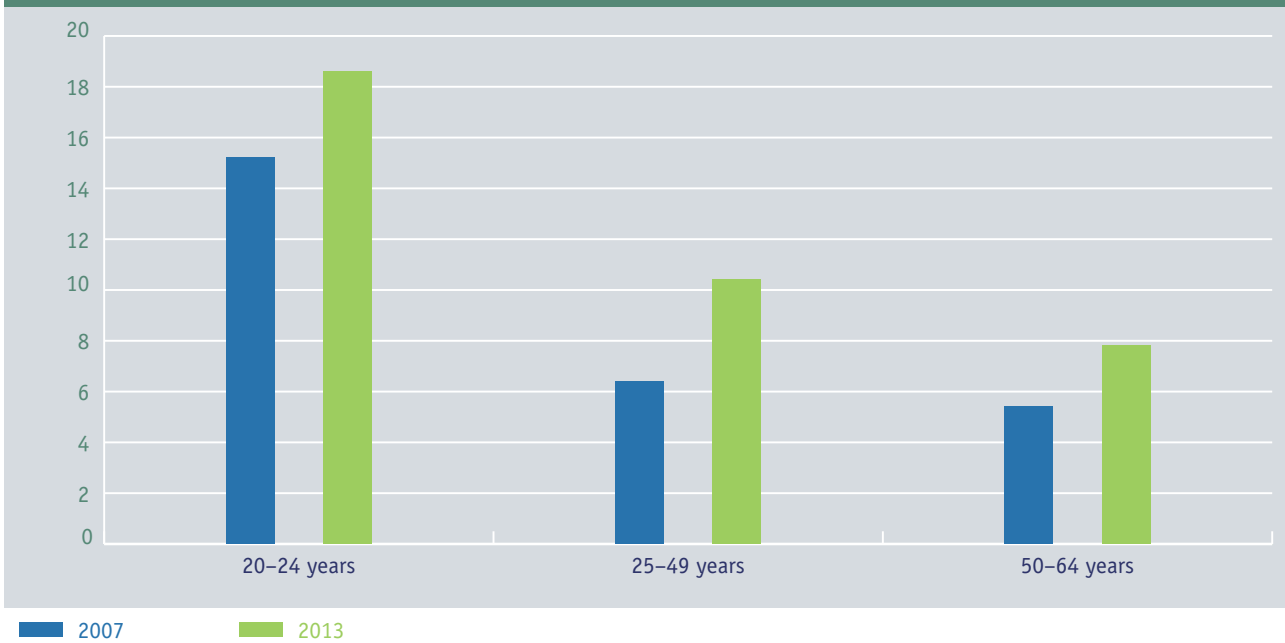
Figure 1 | Material deprivation rate in the European Union (% of total population)



Source: Eurostat.

Note: Young = under 18 years; Old = over 65 years. European Union = EU27. The material deprivation rate refers to a state of economic hardship, defined as the enforced inability (rather than the choice not to do so) to pay unexpected expenses or afford a one-week annual holiday away from home, a meal involving meat, chicken or fish every second day, the adequate heating of a dwelling, durable goods like a washing machine, colour television, telephone or car, or being confronted with payment arrears (mortgage or rent, utility bills, hire purchase instalments or other loan payments). The material deprivation rate is defined as the enforced inability to pay for at least three of the above-mentioned items; other measures such as the at-risk-of-poverty rate show a similar pattern.

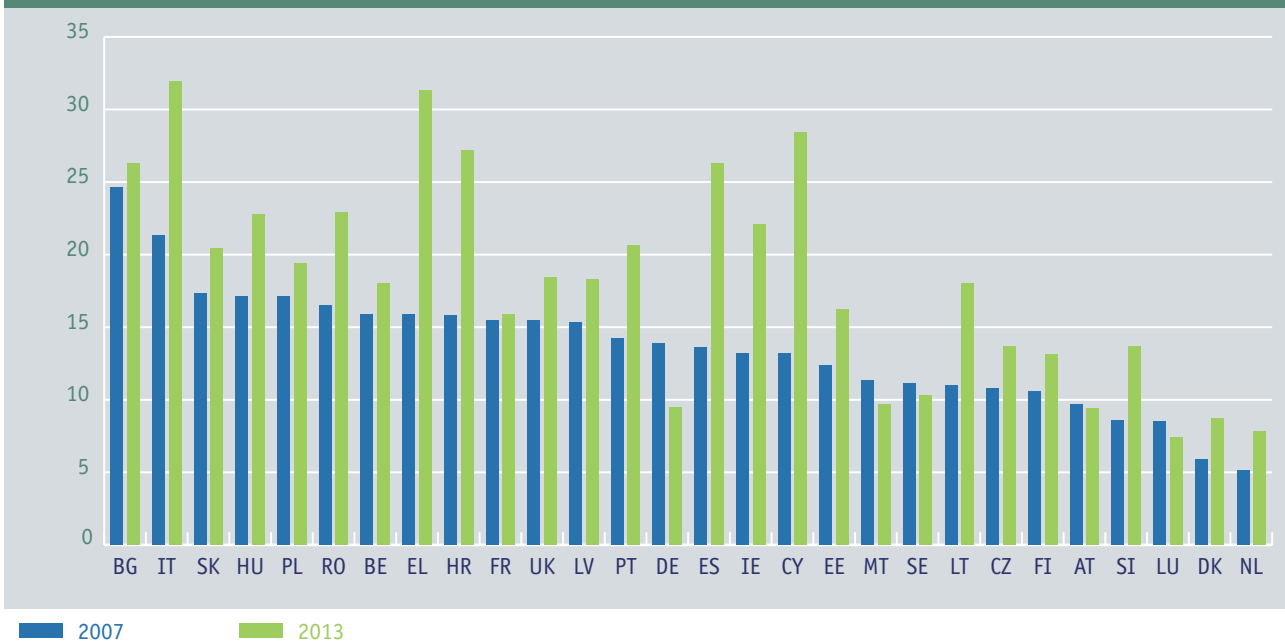
Figure 2 | Unemployment rate in the European Union by age group (% of active population in the respective cohort)



Source: Eurostat.

Note: The unemployment rate of the age group 20-24 refers to 'young people not in employment, education or training' (NEET rate), which is a more accurate measure than the youth unemployment rate.

Figure 3 | Young people not in employment, education or training aged 20-24 (% of cohort population)



Source: Eurostat.

The material deprivation rates are higher for young people than for other groups (working age and old), as reported in Figure 1. In 2007, 20% of young people were materially deprived, compared to 16% of old people. As with the NEET rates, there are major differences in material deprivation between countries (Table 1). While less than 10% of young people faced poverty in the Nordics (Denmark, Sweden, Finland) in 2007, more than 20% of young people were materially deprived in the Southern countries (Greece, Portugal, Cyprus). In Latvia, Hungary and Poland about 40% of young people are poor. Bulgaria reports the highest numbers for both young and old people (70% and 83% respectively), but the trend has been declining.

Figure 4 shows the percentage changes of the material deprivation rate over the crisis (2007–2013). The material deprivation rate increased substantially more for the young compared to the old, especially in countries hit most by the crisis (except in Ireland), meaning that the already high levels observed before the crisis in those countries deteriorated even further. Only Italy and to a lesser extent the United Kingdom experienced deteriorating ratios for both the young and the old. By contrast, the Nordics (Sweden, Finland), with low levels to start with, saw their respective material deprivation rates decline for both young and old people over the same period. The same is valid for Poland.¹

Table 1 | Material deprivation rate, young and old (% of cohort population)

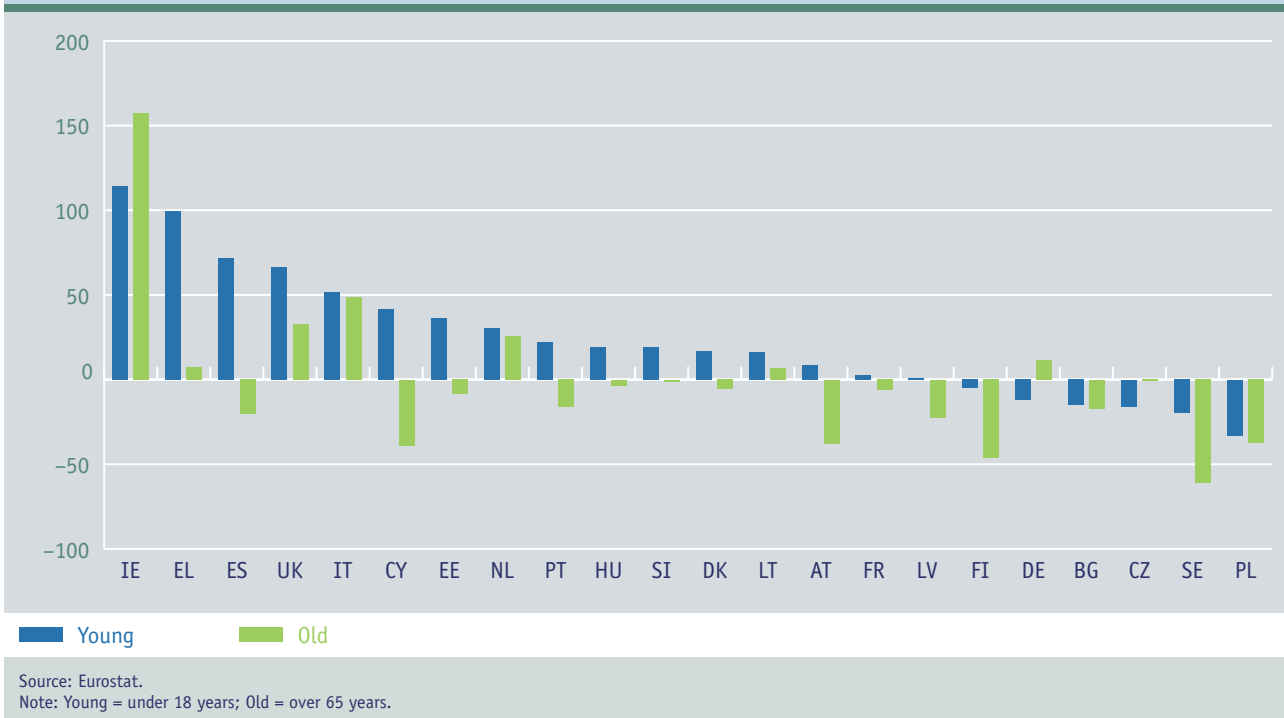
	Young			Old		
	2007	2013	% change	2007	2013	% change
LU	4.0	7.6	90.0	1.0	2.8	180.0
NL	6.3	8.2	30.2	3.1	3.9	25.8
SE	7.6	6.1	-19.7	3.1	1.2	-61.3
DK	8.3	9.7	16.9	3.6	3.4	-5.6
FI	9.8	9.3	-5.1	8.0	4.3	-46.3
AT	12.0	13.0	8.3	9.8	6.1	-37.8
ES	12.7	21.8	71.7	10.8	8.6	-20.4
SI	12.7	15.1	18.9	18.4	18.2	-1.1
IE	13.9	29.8	114.4	4.2	10.8	157.1
DE	14.0	12.3	-12.1	6.8	7.6	11.8
EE	14.3	19.5	36.4	20.3	18.6	-8.4
FR	15.1	15.5	2.6	8.0	7.5	-6.3
UK	15.4	25.6	66.2	4.9	6.5	32.7
IT	17.9	27.1	51.4	14.0	20.8	48.6
CZ	19.5	16.4	-15.9	16.7	16.6	-0.6
EL	20.0	39.9	99.5	28.9	31.1	7.6
PT	23.9	29.2	22.2	27.5	23.1	-16.0
CY	28.1	39.8	41.6	44.2	27.0	-38.9
LT	28.6	33.2	16.1	38.6	41.2	6.7
PL	38.8	26.0	-33.0	40.6	25.3	-37.7
LV	40.8	41.1	0.7	59.1	45.9	-22.3
HU	43.5	51.8	19.1	37.0	35.7	-3.5
BG	70.4	59.9	-14.9	83.0	68.8	-17.1

Source: Eurostat.

Note: Young = under 18 years; Old = over 65 years. The indicator is defined as the percentage of population with an enforced lack of at least three out of nine material deprivation items in the 'economic strain' and 'durables' dimensions.

1 Poland did not experience a significant slowdown in its economic growth during the crisis years, which might explain for this development.

Figure 4 | Percentage changes of the material deprivation rate (2007–2013, % of cohort population)



Overall, a worrisome picture emerges. First, poverty indicators have shown the emergence of an intergenerational divide, especially in the crisis-hit South. Second, unemployment has become a major concern, with young people hit hardest during the crisis. Arguably, the surges in youth unemployment and youth poverty are particularly worrying since they have long-lasting effects on productivity and potential growth, marking young people for their lifetime, lowering their productivity and often excluding them from the labour market for an extended period of time (Bell and Blanchflower 2010; Arulampalam 2001; Gregg and Tominey 2005). They also have negative effects on fertility rates and demographics, possibly due to increased income uncertainty related to unemployment and resulting

choices to delay founding a family (Kreyenfeld and Andersson 2014; Currie and Schwandt 2014). The cost of Europe’s youth not in employment, education or training is therefore much greater than the immediate short-term loss of foregone economic activity. The next section explores to what extent government action has addressed or worsened these problems.

2. Key drivers of the intergenerational divide

The intergenerational divide which has emerged during the crisis is driven by three important policy developments. The first is macroeconomic management. Unemployment responds to the business cycle, but youth unemployment reacts much more strongly to recessions than total unemployment. This is in part due to the disproportionate use of temporary contracts among young workers (Boeri 2011) but also to information asymmetries and other problems. The intergenerational divide therefore typically grows in times of recession. Second, structural changes to government spending are important. Darvas and Tshekassin (2015) show that fiscal consolidation measures during the crisis led to an increase of poverty rates. This leads us to the question: Has government spending become less favourable for the young, increasing the share of materially deprived young people? Third, reforms of the pension system are hugely important for intergenerational equity. We discuss each of these central factors determining the intergenerational divide in turn.

Macroeconomic management

A lot of ink has been spilled over macroeconomic management in the EU during the crisis. Generally speaking, the public sector steps in to smooth the impact of adverse developments, through the workings of automatic stabilisers and discretionary policy choices such as investment programmes. Regarding the latter, Darvas and Barbiero (2014) find that gross public investment declined in the European Union during the sovereign debt crisis, and even collapsed in the most vulnerable countries, thereby exaggerating the output fall. Regarding the former, automatic stabilisers were broadly at work in the EU during the financial crisis in 2008 and 2009. However, in the course of the sovereign debt crisis, some countries' budget space was constrained and they arguably cut government spending more quickly than would have been advisable from a stabilisation

point of view. The fiscal stance within the euro area was clearly too restrictive from 2011 to 2013. In terms of monetary policy in the euro area, moreover, a number of mistakes were made; in particular, raising rates in April and July 2011 was premature, at least in hindsight. Finally, before the European Central Bank's decision to start an Outright Monetary Transactions programme (OMT) in July 2012, financial conditions diverged considerably in the euro area, pricing some countries and their businesses out of markets. This substantially aggravated the recessions in the concerned countries and increased unemployment and youth unemployment (Darvas and Wolff 2014).

The orientation and composition of government spending

In 2008, governments across the EU spent around 7.8% of GDP on pensions, followed by health (6.2%) and education (4.3%). Family and children as well as unemployment benefits played a marginal role (2). On a country level, major differences emerge: Italy spent 12% of its GDP on pensions, well above the EU average, followed by the core countries with 10% and the programme countries with 9% of GDP. Moreover, expenditure on education and family and children was below the EU average in the programme countries, Italy and Central Eastern Europe, and above average in the Nordics and the United Kingdom.

To grasp how the composition of government spending changed during the crisis and its impact on the intergenerational divide, Table 3 shows the percentage point change in the composition of government spending from 2008 to 2013. Unsurprisingly, countries that experienced the sharpest fiscal consolidation in the euro area (Greece, Ireland and Portugal) as well as Italy saw unemployment expenditure increase substantially more as a share of total expenditure as their unemployment rates soared. Spending on health grew in importance in the core

Table 2 | Government expenditure in % of (group) GDP, 2008

	EU27*	Programme countries	Italy	Core countries	United Kingdom	CEE	Nordics
Total	44.3	45.6	47.8	47.9	46.6	42.1	49.7
Health	6.2	6.5	7.0	7.1	7.2	5.7	7.2
Education	4.3	4.0	3.9	4.2	5.5	3.8	4.8
Old age	7.8	9.2	12.3	10.1**	7.4	7.2	8.5
Family and children	1.9	0.9	0.9	2.0	2.3	1.6	3.4
Unemployment	1.0	1.2	0.5	1.7	0.3	0.4	1.8

Source: Bruegel calculations based on Eurostat gov_10a_exp database.

Note: Expenditure on family and children is defined as provision of social protection in the form of cash or in-kind benefits to households with dependent children, cash benefits such as maternity allowances, parental leave, benefits geared towards childcare. Education excludes spending on tertiary education. *Excluding RO (due to data limitations). **Excluding NL. The country groups are defined as follows: programme countries = EL, ES, PT; core countries = BE, DE, FR, NL, AT; CEE = BG, CZ, HU, PL, SI, SK; Nordics = DK, SE, FI.

Table 3 | General government expenditures by function, percentage point changes in composition, from 2008 to 2013

	EU27*	Programme countries	Italy	Core countries	United Kingdom	CEE	Nordics
Health	-0.2	-2.5	-0.5	0.7	1.3	-0.4	-0.1
Education	-0.4	-0.3	-1.1	-0.1	-1.0	-0.3	-0.6
Old age	2.1	2.9	1.8	1.1	3.0	2.3	2.2
Family and children	-0.2	-0.5	0.1	-0.2	-1.2	0.3	-0.4
Unemployment	0.6	1.1	1.3	0.2	0.0	0.0	0.6

Source: Bruegel calculations based on Eurostat gov_10a_exp database.

Note: See footnote in Table 2.

countries and the United Kingdom, while it fell substantially in the programme countries, on the back of fiscal consolidation measures. The importance of spending on education decreased slightly in the EU27 and its share fell substantially in the United Kingdom and Italy. Regarding family and children, the United Kingdom and the programme countries decreased

their respective shares. By contrast, pensioners were the main beneficiaries of fiscal adjustments, as spending on this category increased across all countries and exceeded the EU27 average, especially in the United Kingdom, the programme countries and, to a lesser extent, the CEE.²

² As also highlighted by Begg et al. (2015).

Pension reforms

Government expenditure for pensions can increase, as pensions are politically considered to be more difficult to change than other benefits. However, several member states have introduced pension reforms. Such reforms can benefit current pensioners at the expense of future generations or vice versa. The most important pension reforms³ were implemented in the stressed countries, especially in Greece, Spain, Portugal and Italy, as the crisis made the lacking sustainability of their respective pension systems apparent and more doubtful. In 2010 and 2012, the Greek parliament adopted an unprecedented overhaul of the old pension system, with cutbacks in entitlements and increases in the retirement age. Similar pension reforms were introduced in Spain in 2011 and 2013 and in Portugal in 2013. However, the Greek pension system is still not sustainable due to the extensive use of early retirement schemes during the crisis in particular in the public sector. The introduction of a 'sustainability factor' in Spain and Portugal changed the size of the pension benefit depending on the expected demographic changes (such as life expectancy at the time of retirement).⁴ On top of this, Spain passed a pension reform in 2013, which promotes policies to keep people in the workforce longer and restricts access to early retirement. Italy introduced a significant pension reform under Prime Minister Mario Monti (Box 1). The introduction of pension reforms to make pension systems sustainable was a major factor in restoring confidence in the countries affected by the crisis. These reforms typically aim at increasing the sustainability of pension systems by reducing implicit debt obligations, and should therefore favour the young and future generations. In general, a successful reform should increase sustainability while not compromising adequacy for future generations.

3 For a full list of pension reforms enacted in the European Union, see box I.2.1 in European Commission (2015a).

4 Such measures were already introduced in Sweden and Germany over a decade ago, in Denmark in 2006, and in the Netherlands in 2011.

Box 1 | An overview of Italy's 2011 pension reform

A contribution by Elsa Fornero

In November 2011, Italian public finances were near collapse and the country's political system was at a stalemate. Financial operators were turning their backs on Italian sovereign debt auctions and the few who took part were demanding exaggerated interest rates, so that the interest paid by Italy on its new 10-year bonds exceeded the interest paid by Germany on similar-type bonds by a spread of 500 basis points (more than three times the spread as of July 2015). Italy had (and still has) to refinance on average over €1 billion per day of its huge public debt and its well-tested system for doing so was under massive attack. It is not just rhetoric to say that financial breakdown was around the corner. The possibility that interest might not be paid and that expiring bonds might not be reimbursed was very real; pensions and civil service salaries were at risk, while central and local administrations were already unable to pay suppliers.

The financial crisis, however, was only one side of the coin. The other was a slow industrial decline that had been afflicting the country for about 20 years, reducing Europe's once most buoyant economy to a shadow of its former self. Italy had cut its research and development expenditures, got out of high-productivity sectors such as electronics, chemicals and drugs and concentrated on labour-intensive fashion-oriented 'made in Italy' products, encountering increasingly stiff competition from developing countries.

When the technocratic government took office (16 November 2011), pension reform was a key priority. The reform had to be harsh enough to convince both European partners and financial markets that Italy deserved to be trusted as a debtor, but still sensible enough to obtain (albeit reluctant) approval from the majority of Members of Parliament and the public. It had to realise immediate savings in pension expenditure as well as future savings in the coming decades, thus reducing the burden on the young and on subsequent generations. It had to eliminate or

drastically reduce the distortions still embedded in the system after 20 years of reasonable but too gradual reforms.

The reform (law 214/2011) is the latest stage of a very long and slow restructuring of the Italian pension system that started in 1992 (also in response to a fiscal emergency). It speeded up the transition to the Notional Defined Contribution (NDC) system by extending as of 1 January 2012 to all workers (including Members of Parliament) the DC method of benefit calculation. This was very important to restore credibility to the formula, still largely unfamiliar to the people and considered 'too severe' by politicians. In terms of parametric changes, the reform significantly raised statutory retirement ages and largely eliminated the so-called seniority pensions, which were based on the number of years worked, mostly irrespective of age; it aligned, as of 2018, the retirement ages of women to those of men; and it indexed all retirement requisites to changes in life expectancy. To make things fair once again with respect to past 'generous' DB (Defined Benefit) pensions, the reform established a 'solidarity contribution' for people receiving very large pensions. On the other end, given the country's critical situation, it also froze for two years the indexing of pensions to prices, excluding only pensions under €1,400 per month. These last two measures were later nullified by the Constitutional Court, but substantially re-established by the subsequent governments.

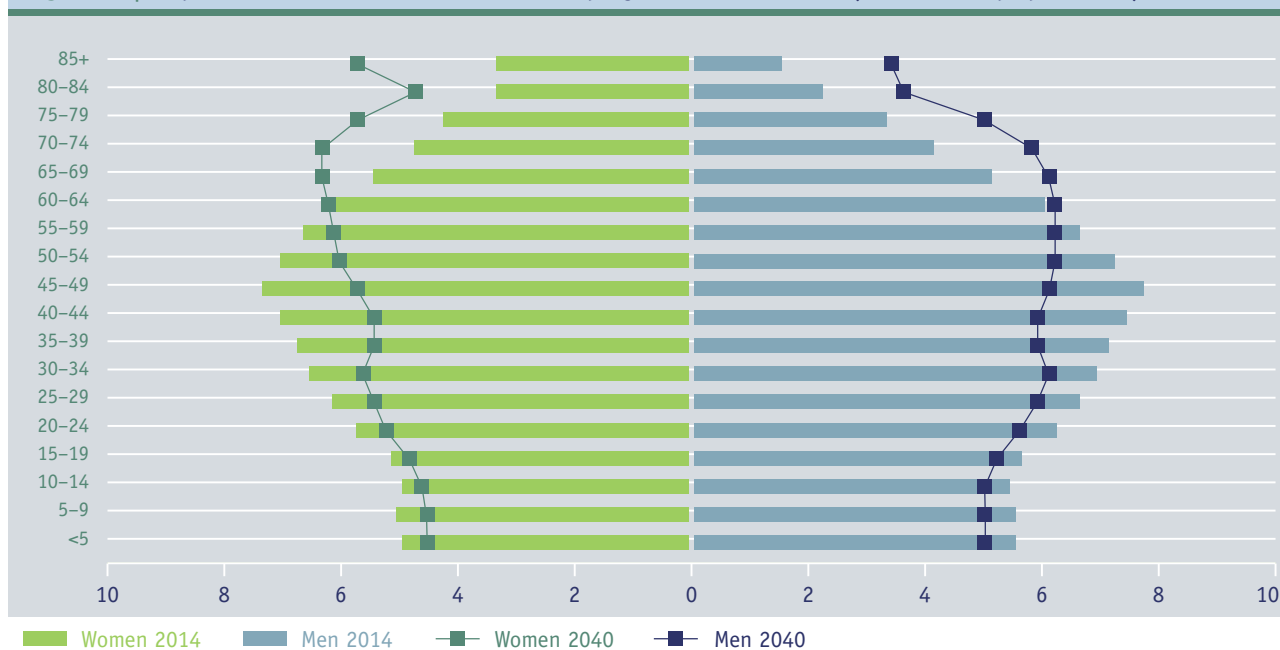
As a result, according to international evaluations, the Italian pension system is now financially sustainable. Most families had to revise lifetime financial strategies downward to take into account the new situation. Due to the financial emergency, there was little time for social dialogue, parliamentary debate (the reform was presented to Parliament as a government decree and approved in just a few weeks through a vote of confidence) or the transition period that is customary in pension reforms. The absence of a transition period caused problems for workers who were already displaced from their job, in a mobility scheme, expecting to retire within a few years or who had, at some point in their working life, voluntarily left their job, trusting that pension laws would remain unchanged. The reform established a safeguard clause for 65,000 workers, according to an estimate by the Istituto Nazionale della Previdenza Sociale (INPS), the national pension office.

It turned out later that the number was much too small, since many individual and some collective agreements between workers and employers had been concluded without any formal registration. The press and public opinion lumped all cases together, calling this group 'Esodati', referring to a forced exodus from the labour market, and considered all of them as equally deserving of being safeguarded, irrespective of the heterogeneity of their situations and, in particular, because many of them had voluntarily left their job, often in exchange for a lump sum to be added to their severance pay. In subsequent provisions, the government added another 65,000 workers to the safeguard clause, for a total of 130,000 safeguarded workers. The subsequent government further increased the number to almost 160,000.

Despite widespread protests, the trade unions did not call for a general strike. The reform not only reduced the implicit pension debt, it also challenged the 'lump of labour fallacy', a basic premise of past pension legislation and a frequent assertion in public debate that such a reform would reduce the number of jobs available to the young by keeping older workers at work longer. Obviously, the extension of working life requires additional measures to stimulate the demand for older workers, something that is more difficult in a period of recession.

Political debate concentrated on the short-term effects of the reform and generally disregarded the long-term goal of generational rebalancing in favour of the young, which is indeed the true value added of the pension reform (and of the subsequent labour market reform). The failure to clearly convey the message of a structural change in the pension and labour markets remains, for me, a cause of regret and was certainly one of the shortcomings of government action. Short-term effects were certainly not absent: The approval of the 'Rescue Italy' decree, of which the pension reform was a fundamental part, resulted in a marked reduction in the interest rate spread and was a fundamental factor behind the European Commission terminating in May 2012 the infraction procedure for excessive deficit, initiated in 2009.

Figure 5 | Population in the EU28, 2014 and projections for 2040 (% of total population)



Source: Eurostat.

These changes of entitlements have to be put into a more general view of rising life expectancy and declining fertility across the EU (Figure 5), which represent a major challenge to future pension (and health) systems. The Ageing Report from the European Commission (2015a) states that the EU will move from having four working-age people for every person aged over 65 today to about two working-age persons in 2040. This will affect both revenue and spending: There will be less revenue due to the shrinking working-age population and more spending due to higher costs for pensions, health and long-

term care.⁵ To address these challenges, several EU member states have enlarged the role of pre-funded, privately managed schemes as opposed to the prevailing statutory, public, pay-as-you-go schemes (OECD 2014).⁶ There are, however, clear limits to what such schemes can achieve.

- 5 The Ageing Report (European Commission 2015a) highlights that increased longevity can contribute to an increase in future long-term care and health spending.
- 6 From an intergenerational perspective, the public-private mix in pension schemes is not an issue per sé, if appropriate regulation obliges the collectively privately funded schemes to integrate an intergeneration risk-sharing element in their set-up (Schokkaert and Van Parijs 2003).

To see to what extent the intergenerational divide has been affected by reforms in the crisis years, we use an analysis based on the Musgrave rule (see Box 2 for a more detailed discussion). In short, pension reforms that do not affect intergenerational equity keep the ratio of the income of the retirees to the income of the active working population invariant in the future compared to the current ratio. We therefore study a) how the current benefit ratio has changed, b) how the 2060 benefit ratio has changed, and c) how the relationship between the two ratios has changed. It is the latter concept that best captures the ongoing intergenerational changes in the pension system.

Figure 6 compares the benefit ratios in 2007 and forecasts for 2060 to their current counterparts, the 2013 benefit ratios and their respective 2060 forecasts.⁷ 2060 is a useful year for comparison as the current generation of 20-year-olds will then be approaching or already be in retirement. It thus helps to discern the effect of the reforms on today's young. The position of a country changes when the current benefit ratio changes (keeping constant the future benefit ratio), or vice-versa. A perfectly equitable pension scheme should safeguard the benefit ratio of the future generation in 2060, keeping it the same as that of today's generation. Therefore, the more equitable the intergenerational distribution is, the closer the countries are to the 45° line.

In 2013, Denmark, most continental welfare states and the United Kingdom were close to the 45° line and can therefore be considered to have relatively equitable pension systems. All other countries were below the 45° line, indicating a bias towards today's generation, resulting from a smaller future benefit ratio compared to today's ratio.

⁷ These numbers are taken from the European Commission Ageing Reports (2009 and 2015).

Box 2 | The Musgrave rule and the benefit ratio

To address the generational divide, we need to identify a stable and equitable intergenerational contract that assures the well-being of the elderly, without crowding out resources for the young. The Musgrave rule helps in that respect, stating that efficient risk-sharing between different generations means keeping invariant the ratio of the income of the retirees to the net income of the working population (the so-called 'benefit-ratio'). The example below illustrates this.*

Let us assume a country has a pay-as-you-go system designed either with defined benefits or a fixed contribution rate. Imagine now an unpredictable shock on the younger generation. In a defined benefit set-up, the cost will fall on the younger generation itself, as contribution rates increase to keep the defined benefit level. In a fixed contribution set-up, the cost will fall entirely on the older generation, as less contributions are paid in, reducing the benefits paid out to pensioners. In a system that reflects the Musgrave rule, both contributions and benefits are set so they maintain a constant benefit ratio. Therefore, when a negative shock hits the younger generation, the contribution rates for the younger generation rise, but benefits for the older generation must decrease too, to keep the benefit ratio constant. Both parties 'lose' at the same rate, allocating the burden in an equitable way between generations.

The **benefit ratio** as provided by the European Commission is defined as the average pension benefit divided by an economy-wide average wage. It is crucial for the pension expenditure projection exercise as outlined in the Ageing Report (European Commission 2015a), which captures three important aspects of pension schemes: (a) the assumed increases in average pensions due to indexation rules and longer contribution periods, (b) changes in the average wage driven by assumptions of labour productivity growth rates and (c) changes in the structure of the respective population groups. Both the 2007–2060 benefit ratio and the 2013–2060 benefit ratio are based on European Commission estimates.

* The information in this box draws on Schokkaert and Van Parijs (2003) as well as Myles (2002). Vandenbrouke and Rinaldi (2015) discuss shortly the limits of the Musgrave rule.

Analysing how the ratio of the two has changed during the crisis allows us to track the impact of the pension reforms and other factors on the intergenerational justice of the pension systems (Table 4, Figure 6).⁸ Compared to 2007–2060, the countries most under stress reduced their 2013–2060 benefit ratio. Greece moved from a benefit ratio biased towards future generations in 2007 towards a benefit ratio which favours current pensioners. Spain and Cyprus moved from a more-or-less balanced position in 2007 to a system biased in favour of current pensioners, while Portugal increased its benefit ratio for both current and future pensioners, not changing the burden-sharing between generations in a significant way. Further north, Belgium did not change its position, while Austria curtailed entitlements for current pensioners, moving closer to the 45° line. Germany decreased its 2013–2060 benefit ratio compared to 2007–2060 for both current and future pensioners, not changing the bias towards current pensioners significantly. Denmark moved toward a more just intergenerational burden-sharing, by decreasing the benefit ratio of future pensioners in 2013 compared to 2007, while Sweden decreased both entitlements for current and future pensioners, without improving its position. Romania and Hungary moved from a balanced burden-sharing to significantly favouring current pensioners, while both Bulgaria and Poland curtailed entitlements for both current and future pensioners, not affecting their intergenerational burden-sharing. A notable and important exception is Italy: Compared to 2007–2060, the benefit ratio for 2013–2060 exhibited the greatest shift towards a more just intergenerational position. Italy achieved sustainability in its pension system not by cutting the future benefit ratio, but by reducing the current benefit ratio, thus improving its intergenerational burden.

⁸ The benefit ratio not only varies because of pension reform impacts, but also due to demographics and labour market movements. Comparing the two projection exercises, one can find that the old-age dependency ratio in 2013 for 2060 is lower than assumed in 2007 for 2060, suggesting better-than-expected demographics. On the contrary, labour market developments worsened, especially in the case of Greece.

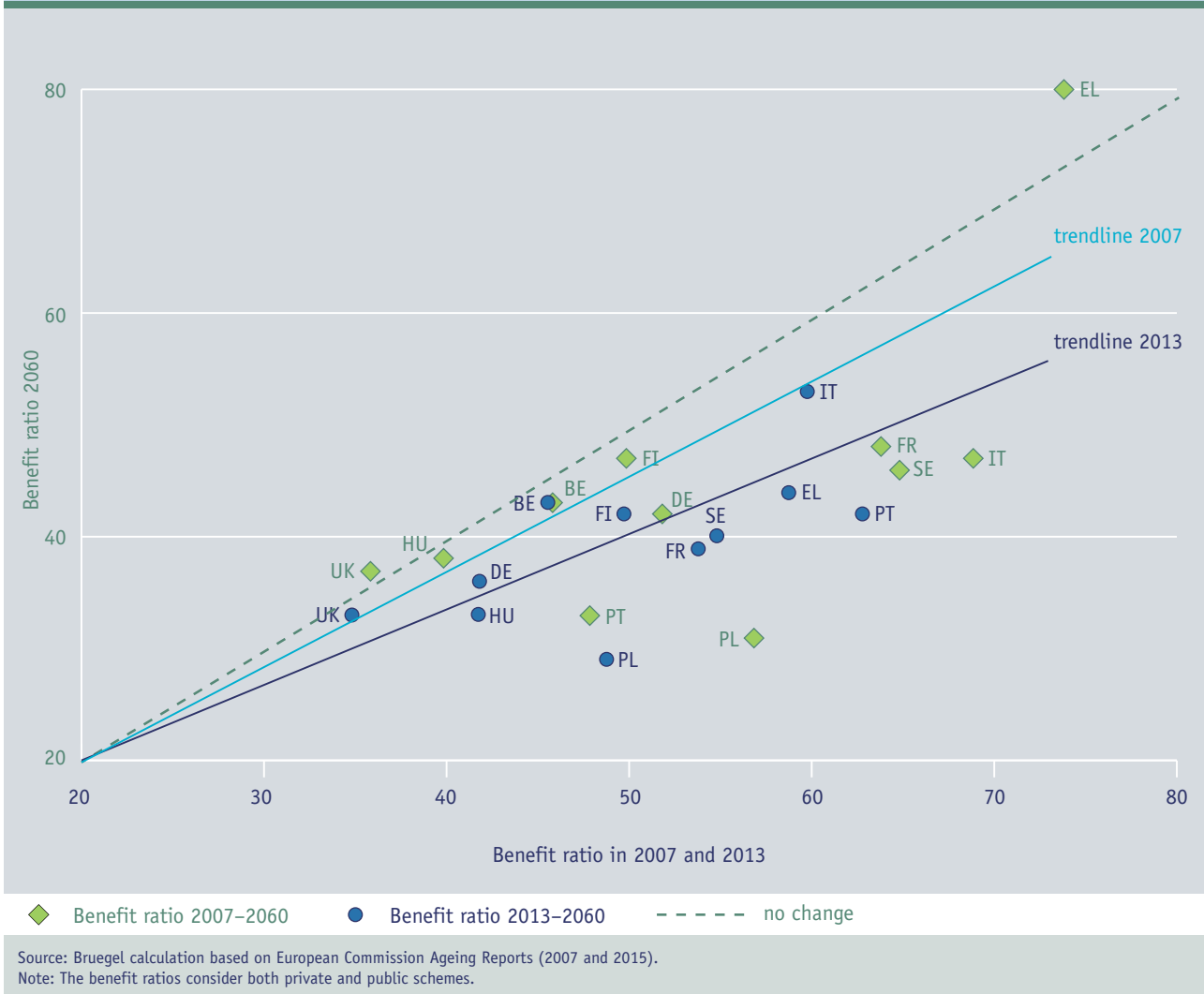
Table 4 | Projected benefit ratios, 2007–2060 and 2013–2060

	2007	2060		2013	2060
BE	45	43	BE	45	43
BG	44	41	BG	37	32
CZ	45	38	CZ	43	41
DK	64	75	DK	62	64
DE	51	42	DE	41	36
EE	26	22	EE	31	25
IE	27	32	IE	30	27
EL	73	80	EL	58	44
ES	62	57	ES	65	40
FR	63	48	FR	53	39
IT	68	47	IT	59	53
CY	54	57	CY	75	42
LV	24	25	LV	28	20
LT	33	23	LT	35	38
LU	46	44	LU	57	58
HU	39	38	HU	41	33
MT	42	40	MT	47	46
NL	74	81	NL	63	63
AT	55	39	AT	41	37
PL	56	31	PL	48	29
PT	47	33	PT	62	42
RO	29	43	RO	37	26
SI	41	40	SI	38	33
SK	45	40	SK	46	30
FI	49	47	FI	49	42
SE	64	46	SE	54	40
UK	35	37	UK	34	33

Source: European Commission Ageing Reports (2009 and 2015).

This analysis suggests that overall entitlements have been curtailed in many countries to address sustainability questions, but the burden seems not to have been shared equally, favouring current over future pensioners, especially in the crisis-hit South (Italy being an exception).

Figure 6 | All pensions benefit ratio, 2007–2060 and 2013–2060 (%)



3. Ways forward: Policy measures to address the intergenerational divide

The increase in the intergenerational divide over the course of the financial crisis is not only worrying per se and for its political and social consequences. It also constitutes a serious economic cost to the European economies. In fact, youth unemployment has long-lasting negative effects on productivity and potential growth, as unemployment marks young people for their entire lives. It also has implications for the sustainability of the European welfare state, inter alia, as youth unemployment has effects on fertility. In this section, we recommend possibilities for addressing the intergenerational divide by discussing policies against youth unemployment, by rebalancing spending, and looking ahead by strengthening the intergenerational equity in pension scheme designs.

One of the biggest legacies of the crisis is high youth unemployment. Bentolila et al. (2010) and Boeri (2011) argue that the two-tier system with ultra-secure permanent workers and vulnerable temporary workers (which are often the young entering the labour market) is a major factor behind the increasing burden younger workers face during recessions. It also suggests a possible solution: labour market reforms that allow for graded job security as workers acquire tenure. In our analysis, however, such reforms are unlikely to yield significant job benefits in a situation of depressed demand. Other measures to counteract youth unemployment, such as the European Youth Employment Package,⁹ are a step in the right direction but are hardly adequate as a counterweight to national policies; in addition, the European Court of Auditors

has questioned the adequacy of such policies.¹⁰ Private investors have also become interested in addressing the growing issue of youth unemployment (OECD 2015b) but such initiatives are hardly relevant from a macroeconomic point of view.¹¹ We therefore doubt that labour market reforms are, overall, the key to addressing the intergenerational divide in the short term. In the medium term, such measures can reduce the impact of a future recession on youth unemployment.

Recommendation:

Address dualism in labour markets: Once economies have picked up growth, European governments must address the two-tier systems with secure permanent workers and the vulnerable (young) temporary workers. Graded job security as workers accumulate experience would be an option.

Beyond such structural measures, adequate macroeconomic policies are important to prevent a large increase in unemployment. Except for monetary policy, the tools for macroeconomic management are in the hands of euro area countries. Some have therefore argued that instruments need to be created at the euro area level. Former EU Commissioner Lazlo Andor, for example, proposed creating a European unemployment insurance scheme.¹² In the short term, we are

9 In 2013, the European Commission called for giving all young people up to age 25 continuing education, an apprenticeship or a traineeship within four months of leaving formal education. This could foster the establishment of vocational training programmes and policies that support finding jobs, especially in countries which have not had such provisions before. See the Council recommendation establishing the youth guarantee: [http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013H0426\(01\)&from=EN](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013H0426(01)&from=EN).

10 A recently published report from the European Court of Auditors questions the adequacy of the total funding (€12.7 billion from 2014 to 2020), how its target is defined and the way monitoring and implementation are proceeding. See www.eca.europa.eu/Lists/ECADocuments/INSR15_03/INSR15_03_EN.pdf.

11 In the United Kingdom, a new Youth Engagement Fund (YEF) aims to support up to 8,000 disadvantaged young people, aged 14 to 17, by improving educational qualifications and securing employment. The YEF is a £16-million payment-by-results fund. Funding will be provided through four new social impact bonds (SIBs), with investors funding innovative initiatives to prevent young people from becoming NEET. Government will only pay if the initiatives are successful and lead to positive outcomes.

12 See Hellström and Kosonen (2015) for a more detailed discussion.

sceptical about creating major European stabilisation functions such as a European unemployment insurance scheme (Claeys et al. 2014). Such measures could prove effective, but they would require an extraordinary effort to create harmonised European labour market legislation. Such measures could also result in significantly blurred policy responsibilities (Thimann 2015).

Instead, we would focus on an enhanced, symmetric and binding policy coordination framework for fiscal policy, as outlined in Sapir and Wolff (2015). The main reason why we advocate this step is that 98% of EU government spending is national. Macroeconomic stabilisation therefore works through national budgets. It is of central importance that national public finance is cautiously managed in good times, so as to have enough fiscal leeway in bad times. However, a system relying exclusively on national policies would be inadequate for the monetary union for two reasons: Irresponsible fiscal policy can have substantial cross-border spill-over effects; and the sum of national fiscal deficits does not add up to an adequate fiscal stance for the euro area as a whole. A deeper coordination framework that is binding in exceptional times should therefore be created, to prevent unsustainable fiscal policies, while it should ensure that countries provide adequate stabilisation for the area as a whole.

Recommendation:

Create a fiscal stabilization mechanism: Some type of fiscal stabilization mechanism is needed for the euro area. Such a tool should safeguard the sustainability of public finances to give room for stabilization in recessions. Moreover, the sum of national fiscal deficits needs to add up to sufficient euro area-wide stabilization.

Second, we have shown that public expenditure has shifted away from spending on the young, families, education and investment, towards spending on the old. Concentrating budget cuts on such items is a mistake and also not in line with initial policy announcements at the beginning of the crisis. In fact, if budget cuts become necessary, it would be advisable to cut unproductive government spending while preserving spending on the younger generation and investment. This would not only increase intergenerational equity that suffers badly in recession times. It is also an investment in the long-term growth potential of our economies.

As noted by Myles (2002), the aggregate well-being of future generations depends primarily on the quality and quantity of the stock of productive assets (including human and environmental capital) they inherit or create, and not so much on the design of pension systems. We have shown that during the crisis, social spending on families and children, as well as on education, was preserved less in the United Kingdom and in Italy, and held constant in the countries which faced the highest youth unemployment rates. By contrast, especially those policies aimed at education and childcare, as proposed in the context of the social investment dimension,¹³ could be a game-changer for addressing the intergenerational divide. Children are the future workforce, and investing in better education and affordable childcare will achieve higher levels of productivity and employment (Hemerijck 2013). Education is also important as a policy measure to reduce income inequalities. By increasing access to high-quality education, greater equality of opportunities is fostered, which in turn contributes positively to economic growth (OECD 2015a). Also, as pointed out by Vandenbroucke and Rinaldi (2015), investing in education and childcare can reduce intergenerational gaps.

13 As an example, see the social investment package promoted by the European Commission, accessible at <http://ec.europa.eu/social/main.jsp?langId=en&catId=1044&newsId=1807&furtherNews=yes>.

Recommendation:

Prioritise social investment in government spending

composition: Cuts in government spending should not fall primarily on investment, research, education and family and children. Instead, these policies, which are the backbone of the social investment debate, could be a game changer for addressing the intergenerational divide. Children are the future workforce, and investing in better education and affordable childcare will achieve higher levels of productivity and employment.

Third, in terms of burden-sharing among generations, we have found that current pensioners have been protected compared to future pensioners (Italy being an exception). Safeguarding a constant benefit ratio over generations by adjusting contribution rates for the working population and benefit levels for retirees would allow for better intergenerational burden-sharing.¹⁴

Recommendation:

Strengthen intergenerational equity in pension

schemes: Pension schemes, regardless of their public-private mix, should incorporate some sort of Musgrave rule, where the contribution rates of the younger generation rise but benefits for the older generation have to decrease, too. In this way, the burden will be allocated in an equitable way between generations.

Overall, we are worried that the crisis has left a dangerous intergenerational legacy. Addressing this legacy by making the government spending mix more friendly for the younger generation while re-establishing intergenerational equity in pension schemes should be a key concern for policy makers throughout large parts of the European Union.

¹⁴ As pointed out by Vandenbrouke and Rinaldi (2015), Belgium is proposing a Pension Reform 2020-2040 along the lines of the Musgrave rule.

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Governing the welfare state and beyond – Solutions for a complex world and uncertain future

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Executive summary

The European welfare state is confronted by many acute social and economic problems (e.g. increasing inequalities and poverty, rapid growth of refugee flows, slow growth and increasing public debt). However, when designing the future of the welfare state, we need to also look beyond these immediate concerns. This paper focuses on the long-term renewal needs of the welfare state and on the governance practices that enable such renewal.

In order to respond to future social, economic and ecological challenges, Europe needs to increasingly a) aim at sustainable well-being (in addition to responding to traditional deprivation problems) and b) invest in sustainable well-being (in addition to compensating citizens).

Governance is an essential instrument for both identifying the need for and actualising societal renewal. In the increasingly independent and complex world we live in, any significant long-term socio-economic reforms cannot be made without profoundly developing the governance of our societies towards more integrated approaches. Therefore, when reforming the welfare states, **governance reform must be set as a priority area of equal importance to socio-economic reform.**

The core question of this paper is: **How can we develop the governance approaches of our welfare states to better foster and invest in sustainable well-being and, thus, be more competitive, without compromising basic European values?** As a response to this question, the paper presents five ambitions for future governance, and makes recommendations resulting from them. These ambitions are:

Ambition #1 Create governance capacity-building processes at EU and national levels to ensure that politicians, civil servants and other societal actors relevant to the welfare state have adequate understanding of the complexity and interdependency of social problems, and of the governance approaches and tools needed for addressing them in strategic and agile ways.

Ambition #2 Develop phenomena-based welfare policies to ensure long-term impacts and customer satisfaction when addressing strategic cross-sectoral challenges.

Ambition #3 Strengthen the democratic base of the welfare state by exploring democratic innovations that go beyond representative democracy and the interests of present generations.

Ambition #4 Support the transition of the welfare state towards a welfare society, with more shared responsibilities and coordinated activities by public, private and civil society actors for the best solutions as a whole.

Ambition #5 Strengthen social adjustment functions in those policy mechanisms and policy areas where the EU already has legitimacy of action, while simultaneously preparing definitions of sustainable and legitimate long-term directions for social policy in the EU.

By following these ambitions and adopting the recommendations resulting from them, the EU and its member states have the potential for becoming forerunners in modern governance, enabling investments in sustainable well-being, and thus, enhancing our competitiveness!

By embracing Europe's core values (e.g. democracy, welfare and equality, as well as a market-based economy and sustainable development), the governance approaches presented in this paper should also strengthen the foundation of our societies.

The suggested changes in governance approaches require new mindsets and the adoption of new everyday practices. Naturally, they also include both winners and losers. Therefore, some tips for implementing change and overcoming adjustment rigidities are given in the Appendix.

1. Introduction

Perceptions of the welfare state vary from basic ideas on how to finance and organise for the provision of basic security needs in a country to more comprehensive ideas of societal models. Within Europe, there is significant variation in the welfare state models¹ in different regions, in regard to how welfare provisions are organised and financed, and who is entitled to them. Many of these models are presently under reform². Yet there are similarities in the underlying basic values, ideologies and even philosophical notions, which can be seen as forming the social contract of the welfare state.

The European post-war welfare states have traditionally been characterised by a distinctive combination of democracy, welfare and equality³, and a market-based economy. More recently, the idea of sustainable development has also gained importance as a leading European policy principle. Each of these is under serious pressure:

- There are cracks in our *democratic system*. Voting rates are decreasing, people are searching for other channels of influence and the policy arena is increasingly occupied by populist movements. Contrary to democratic values, even the limiting of freedom of speech has become a concern in part of Europe.

1 A classical distinction is made by Esping-Andersen (1990) between the social-democratic (Scandinavian) model, the corporatist (Continental) model and the liberal (Anglo-Saxon) model, which can nowadays be complemented by a Mediterranean model and an East European model (Begg et al. 2015). Yet in relation to differences in governance approaches, such classifications are not very relevant. Countries that have many similarities in relation to how welfare provisions are organised and financed, and who is entitled to them, may apply very different types of governance approaches to design and implement welfare policies. Moreover, owing to different traditions and contexts, two countries with similar governance approaches may produce very different policy decisions. Even within an individual nation state, governance traditions and solutions may vary significantly between different fields of welfare policy.

2 In many Bismarckian countries, for example, there is movement towards both a more liberal and social democratic regime (Palier 2010).

3 Diverging political opinions exist as to whether equality should be viewed from the perspective of equality of opportunities or equality of outcome (Vandenbroucke and Rinaldi 2015).

- Europe faces increasing difficulties in fulfilling its promises of *equality and welfare* (often understood as basic socio-economic security). There has been a worrying trend of increasing social and economic polarisation, and even poverty⁴ in Europe. In addition to monetary inequalities, social cohesion is being impaired in Europe by diverging opportunities (e.g. in education) and health and environmental issues (Vandenbroucke and Rinaldi 2015).
- The present form of *market economy* is vulnerable to economic crisis, and the economies needed to finance the welfare state are sluggish and burdened by high public debt and unemployment. A heated political debate is taking place on whether or not Europe can afford to sustain the kind of welfare state that was built during the post-war period, and on what the social and economic costs would be of not responding to the social risks presently addressed by the welfare state (Begg et al. 2015).
- Although the pursuit of *sustainable development* has entered the European policy sphere as one important guiding policy principle of the region, most welfare state problems are viewed separately from environmental challenges. The welfare state and the green economy, for example, are rarely discussed together.

Accordingly, the challenges of the welfare state are striking at the very roots of our societies: our social contract. Therefore, if we wish to conform to – and even strengthen – the basic European values described above, it is time to ask the following question:

4 The share of the population at risk of poverty increased substantially between 2008 and 2013. The gap between younger and older generations has widened, as young people have been hit hard, particularly in the South (Hüttel et al. 2015).

Can the burning societal problems of today be fixed within the prevailing frames of the welfare state, or are we facing a need to consider deeper renewal of our current societal model?

A crucial question for the future of European welfare states is whether they are able to transform into ‘sustainable well-being societies’ aiming at well-being within the ecological boundaries of the planet⁵. In the following, two important directions for such renewal are presented: a) aiming at and b) investing in sustainable well-being. These ambitions form an important thread for this paper.

Aiming at sustainable well-being

Western welfare states have been built on a long anthropocentric tradition, during which the concept of well-being has largely been understood in terms of monetary or social resources and seen as identical with prosperity. Welfare policies have had the inbuilt objective of solidarity, protecting people against social risks and raising their standard of living (Hirvilammi and Helne 2014; Vandembroucke and Rinaldi 2015).

Welfare states have focused mainly on eliminating traditional deprivation problems related to basic physiological, health and safety needs. These traditional risks are now being spread in new ways. For example, single-parent households have a higher risk of poverty, and those having incoherent working careers often face old-age poverty. At the same time, new types of social risks are emerging, related to frailty, long-term dependency and labour market exclusion (Palier 2010). New risks also derive from the increasing importance, relatively speaking, of social and psychological needs. Life management problems, stress, hurriedness, depression, loneliness, and substance

abuse are becoming more prevalent and are not necessarily covered by traditional welfare state arrangements, although they have severe consequences for the future (Hämäläinen and Michaelson 2014).

The foundation of the socio-economic welfare state was laid in an era when human activities mostly had a local and reversible impact on the environment. Today, if global ecological problems are not solved, the whole foundation of the economy, well-being and security will break down. Welfare problems can no longer be addressed by the resource-intensive production and consumption patterns that have prevailed since the establishment of the welfare state. Future welfare policies need to enable and promote sustainable lifestyles. In enabling sustainable lifestyles⁶, new social risks such as fuel poverty, caused by the costs of vigorous climate and natural resource policies, must also be dealt with. We should begin to think about governing socio-economic-ecological systems as a whole (Dryzeck 2014).

Although human well-being is the ultimate goal of social policy and although the environment sets absolute boundaries for human activities, welfare state leaders rarely feel the need to discuss and define what sustainable well-being⁷ might be. Without a more profound interest in renewing our understanding of what constitutes well-being, and the interconnection between well-being and the environment, a transition of welfare states towards sustainable well-being societies (Hellström et al. 2015, see also EU 2013a) is unlikely.

6 In order to be sustainable, well-being should be generated in a way that satisfies well-being needs with a minimal impact on the environment. Accordingly, in a sustainable well-being society, the sustainable standard of living should provide all people with the necessary resources in a way that does not exceed nature’s capacities (Hirvilammi and Helne 2014).

7 From an individual’s perspective, sustainable well-being is defined as, collectively, a sufficient and sustainable standard of living, purposeful and responsible behaviour, significant relations and an alert presence (Hirvilammi and Helne 2014).

5 See EU 2013a; Hellström et al. 2015.

Investing in sustainable well-being

Risk-sharing has been an important motivation for welfare states, as they provide insurance (e.g. unemployment or disability benefits) against unfortunate changes in individuals' life circumstances (Begg et al. 2015). However, in addition to risk-sharing, the welfare state should increasingly focus on risk avoidance.

Over the last two decades, a trend has emerged in European welfare states towards social investment as opposed to more traditional forms of social protection (Hemerijck 2013; Begg et al. 2015; Vandenbroucke and Rinaldi 2015). The essence of the social investment approach is that timely policy interventions prevent future problems, reducing the need for subsequent interventions to compensate citizens (Morel et al. 2012). Early childhood education, for example, may avoid exclusion of young people and save later costs related to unemployment, criminal activity, etc. Social investment is most often discussed in relation to education or childcare, out-of-work training and various types of work-related tax benefits. Social investment policies may either 'enable', e.g. through childcare, which allows parents to work, and adequate transport, or 'activate' by helping to match available workers with jobs, or to upgrade their skills (Begg et al. 2015).

Social investment does not necessarily mean favouring one welfare policy area over another. It can also be adopted within a single policy area. Social and healthcare systems, for example, have been better calibrated to respond to problems that have already emerged, rather than preventing them. In public budgets, social and health expenses are more often viewed as costs than investments. This reactive approach has proven to be very costly in the long run. Social and healthcare services need to be seen as long-term investments in the sustainable well-being society, taking into account genetics, lifestyle choices,

physical and mental well-being and interaction between people and their living environments (Hellström et al. 2015).

Social investment provides an active approach to the challenges posed by many long-term socio-ecological transitions, e.g. responses to ageing and climate change. Active labour market policies which enhance human capital can equip the economy to meet challenges such as decarbonisation or the growth of the knowledge economy and the new skills both will require (Begg et al. 2015). Active social investment policies especially aimed at education and childcare may also help to reduce the generational gap that has widened in Europe in recent years (Hüttel et al. 2015).

The scope of this paper:

The European welfare state is confronted by many acute social and economic problems (e.g. increasing inequalities and poverty, rapid growth of refugee flows, slow economic growth and even stagnation, and increasing public debt). However, when designing the future of the welfare state, we also need to look beyond these immediate concerns. This paper concentrates on the long-term renewal needs of the welfare state and on the governance practices that enable such renewal. In order to address the challenges described above, the paper adopts a mid- to long-term perspective, with the focus on the welfare state and beyond.

2. Purpose of the paper: From reactive to proactive governance

In recent decades, Western Europe and the United States have typically led the way when it comes to economic efficiency and the ability of societies to provide well-being for their citizens. This is no longer something that can be taken for granted. For many developing countries, the European model is no longer the 'leading' societal model to be followed. The rapid development of East Asian societies, for example, challenges Europe in fundamental ways when it comes to the traditional European strengths in global competition: the economy, access to global resources, top-level expertise, innovativeness, entrepreneurship and diligence. Europe is at risk of being left behind unless it can become more competitive in these respects (Turkki 2015; Micklethwait and Wooldridge 2014).

A key problem is that Europe has not been able to renew itself. Particularly the welfare state, which has been an important competitive advantage for Europe, threatens to become a burden, if it is not reformed to become more just, more efficient, more responsive to well-being needs, more future-looking, more resilient and more sustainable – not only economically but also ecologically. These challenges are increasingly difficult to respond to using the outdated and reactive governance approach developed in the industrial era.

Our current welfare state model was created to cope with a more orderly, predictable and less interconnected world than the one we now live in. It capitalised on reconstruction and steady growth and on a young and growing population of hungry consumers moving up the economic ladder. When providing welfare benefits and services, public institutions could operate in relative autonomy, with stable budgets and clearly defined mandates and bureaucratic turf.

In the welfare states of the industrial era, governance has been typically viewed as a way to find solutions that address, effectively and efficiently, existing problems within

well-defined policy sectors. For example, how should the distribution of unemployment benefits be organised? Do we need a new division of responsibilities in the pension system? Which structural reforms are needed in the health services sector? Such problems are expected to be solved, or at least eased, if only the right institutional structures, division of responsibilities, financing mechanisms and supply of benefits and services are introduced.

In a case where the social problem is clearly defined, and where it can be solved effectively within the context of a specific policy sector or jurisdiction, such governance approaches can still work well. However, many of today's burning welfare problems (e.g. ageing, youth unemployment and social inequality) can no longer be treated as such. When addressing many of the complex social problems of today, silo-based governance approaches combined with a strong pursuit of efficiency may even aggravate or give rise to new societal problems and make societies more fragile and prone to unexpected shocks and crises.

In a world of growing uncertainty, interdependence and complexity of societal systems, fewer and fewer welfare problems can be addressed effectively by the **reactive** and hierarchical governance models of the industrial era, which address problems in sub-optimised policy silos only when problems have already occurred.

Addressing complex societal challenges successfully requires governance approaches that enable strategic insight and action across policy sectors, as well as collaboration between different societal actors and the timely reframing of problems prior to their aggravation. Rather than aiming at final solutions for individual welfare problems, such **proactive** approaches to governance increase the likelihood of timely and strategic policy decisions, making societies more resilient.

Box 1 | What is governance?

There is no universal definition for governance. As an abstract theoretical concept, it refers to all **processes of social organisation and social coordination** (Bevir 2013). It includes the various interaction and decision-making processes among the actors involved in solving a collective problem (Hufty 2011). These processes include the way (e.g. mechanisms, processes and relations) by which stable practices and organisations arise and persist.

Good governance is not about making the 'correct' decisions but about the quality of the coordination and decision-making processes related to the problem. Good governance is typically achieved through proven quality attributes, i.e. if it is transparent, participatory, inclusive, effective, legitimate, accountable, etc. Accordingly, even good governance cannot provide fixes to problems. It only increases the likelihood of taking action or making decisions that effectively address the problems at hand.

Many of the decisions on governance mechanisms (e.g. how to finance, organise and divide responsibilities) for welfare provision are affected by political ideology. It is important to note that this paper will not suggest individual governance mechanisms for any individual subsector of social policy. Instead, this paper will focus on ways to improve the governance capacities and processes of welfare states in a comprehensive way, so that the recommendations are applicable to a variety of complex social challenges which cross-cut different policy areas and, potentially, even different political interests. Many of the challenges presented and recommendations made are not restricted to the welfare state, but represent more general directions of change within our modern societies.

The core question for this paper is:

How can we develop the governance approaches of our welfare states to better foster and invest in sustainable well-being and, thus, be more competitive, without compromising basic European values?

In the following five sections, five fundamental governance challenges common to most European welfare states are discussed. In each section, the approaches needed to deal with these challenges are also described and illustrated with practical examples, and recommendations for national as well as EU leaders are given.

Leading questions for this paper include:

- What governance capacities do welfare states need for dealing with the increasingly complex and interdependent problems that they are facing? How can we develop the leadership capabilities required for strategic and agile policy-making? (Section 3)
- How can we develop policy processes that make better use of existing resources, allocate responsibilities more effectively and enable human-centric approaches in welfare provision? (Section 4)
- How can we strengthen the democratic base of the welfare state for increased innovativeness and legitimisation of future policies? (Section 5)
- What is the future role of the state and other societal actors in governing the welfare state? (Section 6)
- What is the role of the EU in future social policy? How can the EU be made more responsive to the complex social challenges that will continue to affect its member states in an interdependent way? (Section 7)

3. Developing governance capacities for strategic and agile states

Political debate on the needs to reform the welfare state has concentrated on social and economic reform of individual policy sectors (e.g. pension reform, unemployment benefit reform, health sector reform, education reform). Governance change has usually been viewed as a second-order reform need, which is typically identified only as a means to implement the sector-specific policy reforms.

European welfare states, however, face problems that cross individual welfare policy sectors. The burning challenges related to ageing societies, youth inclusion, youth unemployment, sustainable lifestyles, refugees, etc. create pressure for reforming the governance of the welfare state beyond any individual sector of welfare policy. European welfare states also face serious governance problems which are independent of the policy sector involved.

Major systemic changes in the ways that our welfare states operate as a whole are needed. Therefore, governance has to be understood as a first-priority reform need of equal importance to socio-economic policy reform.

Governance challenges to be addressed

Instead of long-term, cross-societal reforms, welfare states are focusing on short-term, sector-specific issues. They are experiencing difficulty in implementing structural reforms, their decision-making processes are slow and the tackling of major societal problems is dispersed among government departments with no one in charge (Doz and Kosonen 2014).

In the specialised policy sectors, a long-standing focus on one's own familiar sectoral policies easily results in a lack of holistic understanding and strategic insight, which easily turns into tunnel vision, meaning policies are made on the basis of narrow

disciplinary perspectives (Hämäläinen 2013). This is the case, for example, when welfare policies are guided by experts in traditional deprivation problems, who fail to see the growing importance of mental problems as a rapidly increasing cause of public health costs, absence from work and early retirements, or who fail to see the connection between well-being and the environment.

In order to respond to emerging new opportunities in an efficient way, scarce resources must be allocated in a flexible manner⁸. Unfortunately, in many countries the mobility of resources for new or alternative uses remains thwarted by sectoral policy silos⁹, and resources can be reallocated with only great difficulty. Management systems within welfare states are usually designed for subunit optimisation rather than sharing of available resources for common purposes. Often, the division of labour is also planned in line with isolated bureaucratic silos (Doz and Kosonen 2014).

The isolated silos within the welfare state bureaucracy have usually been structured on the basis of previous problems. Without a collective commitment to a shared vision, strategy and rules, welfare state bureaucracies tend to focus on increasingly limited and parochial goals, and there may be a strong interest in preserving the status quo and settling for only very modest action (Doz and Kosonen 2014). For example, many in the health-service sector would agree that healthcare

⁸ This has recently been highlighted by the rapid increase in refugee flows to Europe. Countries with better resource fluidity may respond to the increasing refugee flows more effectively and with less political turmoil. The need to address new social risks and new well-being needs and to develop more sustainable lifestyles also require reallocation of resources both within different areas of welfare policies and between welfare policies and other policy areas.

⁹ Resource silos may be upheld by laws and regulations, by conventional legacy planning or by individual units and leaders vigorously guarding their resources. Annual budgeting processes offer few incentives for longer-term performance and often end up in a game of zero-sum budgeting (Doz and Kosonen 2014).

should be made more widely available, more just and more preventive. Such statements can also be found in many policy papers. However, if they are not clearly declared as priority goals at high policy levels and if the collective commitment for actually implementing reform is not created, everyday practices will tend to prevent things from moving in the commonly desired direction.

Furthermore, traditional public sector hierarchies have serious problems coordinating dynamic cross-sector and cross-level interdependencies. The information and knowledge requirements of today's complex and adaptive social systems simply overwhelm their governance capacities. Many governments have tried to circumvent this challenge by decentralising decision-making into specialised agencies that are meant to be closer to citizens and thus more flexible and accountable. Such 'agencification' trends have often led to further fragmentation and even bigger strategic coordination problems in the public sector (OECD 2005).

A good example of coordination problems is the fragmented ICT structure of many welfare states. Decentralising health services has in many countries led to the development of scattered ICT systems that are no longer compatible or able to communicate with each other. The solution may not be in increased centralisation of the systems, but in providing common standards and architecture – for different subsystems and applications to communicate with each other – as has been done in the X-Road in e-Estonia.

Box 2 | Governance capacities for strategic and agile states in a nutshell

A new, more strategic and more agile approach to the governance of welfare states needs to emerge, including the following six mutually reinforcing governance capacities:^{*}

Strategic sensitivity = Early awareness and acute perception of incipient trends, converging forces, risks of discontinuities, and the real-time sense-making of strategic situations as they develop and emerge.

Collective learning = Learning through interacting and collaborating with other people who have different but complementary knowledge.

Resource fluidity = Fluidity in fast mobilisation and (re)deployment of strategic resources or funds, people and competencies, providing the operational underpinning for strategic agility.

Shared direction and commitment = Ability to make and implement decisions that mobilise multiple subunits to sustain and integrate interdependent activities.

Mutual adjustment = Effective utilisation of dispersed knowledge and strengths of decentralised actors, while at that same time facilitating the efficient coordination of interdependent activities.

Evolutionary development = Policy development based on the evolutionary process of niche creation, variation, experimentation, selection and growth (Rammel and van den Bergh 2003).

For more information on the approaches and for practical advice for decision-makers, see the Appendix.

^{*} See Doz and Kosonen 2014; Hämäläinen 2013.

Developing new competencies

Basic income is an example of a policy approach that has reappeared every now and then in the social policy debate in many European countries, without any country having yet adopted the approach on a wide scale. The example is interesting from the point of view of several aspects presented in Box 2 .

Basic income may seem barely lucrative from the point of view of any individual welfare policy sector. For example, employment officials may easily consider it a non-activating policy tool, whereas social security officials may regard it as very expensive because it does not address social security needs in a targeted way. Nevertheless, when creating collective understanding and long-term cross-sectoral strategic insight of the potential impacts of basic income on welfare costs as a whole (e.g. through reduced bureaucracy and the empowerment of people by freeing them to expend their energy on more productive activities than securing basic needs) the approach seems increasingly lucrative.

Basic income also represents a radical policy reform with a wide variety of potential benefits and consequences that are difficult to predict, due to the complexity of interrelated impacts. Subsequently, although the model has appeared to be lucrative, it has been too risky to implement in a once-and-for-all manner (Forss and Kanninen 2014). In such cases, carefully planned social experimentation in line with the evolutionary development principle may offer the way forward, as is being done in Finland¹⁰ and the Netherlands¹¹.

10 In its recent government programme, the Government of Finland (2015) has decided to conduct an experiment on basic income.

11 After the city of Utrecht announced that it would provide a regular and unconditional stipend to cover living costs to some of its residents, other Dutch cities are also considering similar experiments.

Worldwide governance indicators (Kaufman et al. 2010) suggest that the quality of governance¹² is best in high-income OECD countries, including Europe. Yet these governance indicators often emphasise stability, without paying sufficient attention to resilience and the ability of societies to reform themselves, which is a precondition for success in the rapidly changing, increasingly complex and interdependent world.

Addressing complex social challenges in a rapidly changing and interdependent world requires the development of new governance approaches that increase the strategic insight and agility of welfare states (see Box 2). Particularly the OECD has recently been active in developing and encouraging the adoption of new governance approaches that enable the increased agility and renewal of societies (e.g. OECD 2015).

Developing strategic and agile welfare states requires conscious development of the governance capacities of societies and the governance capabilities of their leaders. The business of government and the role of public servants are changing, and the educational pathways for bureaucrats need to change with it (Gallop 2014).

Governance capacities can be developed consciously through long-term societal training activities (see example in Box 3). Societal training differs from typical leadership and management training in that it does not primarily aim at competence-building at the level of individuals or organisations, based on demand from these clients. Instead, working on a non-profit basis and through careful selection of invited participants to take part in collective learning processes, it aims to build competencies at the level of whole societies.

12 Measured by voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption.

Box 3 | Leadership training of sustainable economic policy in Finland

The Finnish Innovation Fund Sitra offers regular training courses for top-level Finnish decision-makers and opinion formers in 'Leadership of sustainable economic policy'. The goal is to boost Finland's ability to make sense of and deal jointly with the key social challenges and opportunities of the future.

When focusing on economic policy, the main emphasis is on renewal of the welfare state to incorporate evolving social goals, including social investing, and to integrate ecological aspects into society's core decision-making. In addition to learning about economic policy (understood in a broad manner), the courses aim to build an understanding of how a more comprehensive and long-term approach can be incorporated into the governance practices of economic policy, as well as the whole society.

Participation in the training is by invitation only. Participants are selected to represent various sectors of society (public, private and civil society) in a balanced way so that the training not only builds individual competencies but also adds to competencies at the societal level.

The training courses are built on the governance principles of strategic and agile states. For example, they utilise collective learning processes and eye-opening field visits to increase strategic sensitivity. This means that knowledge, understanding and reality are built together with the participants, making the training model more representative of a joint development approach than traditional education models. Moreover, each training course creates shared visions and policy recommendations for new governance approaches for the future.

Instead of attempting to solve individual societal problems, the training courses have aimed to build capabilities to do so. According to feedback from the participants of the first two years (2014–2015), the courses have created new networks, improved understanding and respect for other perspectives, increased the participants' awareness of the

complexity of most challenges related to sustainable well-being, and created collective commitment to the need to develop and adopt new governance approaches to address those challenges.

Finland is not alone in its efforts. For example, the development of Singapore into one of the most prosperous and efficient states in the world has also been based on the work of highly professional, diligent and innovative civil servants. The Civil Service College of Singapore offers a wide range of activities which build strategic capacity in governance, leadership, public administration and management for a networked government. The work of the public service is also assisted by the views and values of the country's citizens.

Ambition #1

Create governance capacity-building processes at EU and national levels to ensure that politicians, civil servants and other societal actors relevant to the welfare state have adequate understanding of the complexity and interdependency of social problems, and of the governance approaches and tools needed for addressing them in strategic and agile ways.

Recommendations:

- 1) Set governance reforms as a top priority area on the reform agendas of welfare states.
- 2) Invest in research on next-generation governance practices, and establish international networks for collaboration and an exchange of views. Encourage welfare state leaders and experts to actively engage in dialogue with such networks.
- 3) Strengthen the role of strategic and agile governance in international governance indicators.
- 4) Initiate governance-related cross-sectoral societal training activities, in which welfare state leaders and actors can exchange knowledge and experiences with and learn from representatives of other sectors of society dealing with complex societal problems (see example in Box 3).

- 5) Create incentives, mechanisms and processes within individual welfare state organisations for developing governance capabilities needed for understanding and dealing with complex societal problems (e.g. job rotation, professional leadership careers, personal goal-setting).

For more practical advice for decision-makers, see the Appendix.

Following the recommendations beside has long-term implications for the welfare state. It may not provide immediate solutions to problems, but it is an important enabler for future-oriented and successful reforms. Accordingly, building governance capacities and capabilities alone will, of course, not suffice. In the end, the new governance approaches to concrete problem-solving must also be adopted. The phenomena-based welfare policies described in the following chapter offer a potential way of doing this.

4. Adopting phenomena-based and human-centric welfare policies

Many of today's burning social problems cross policy silos. Solutions to youth unemployment and the social exclusion of youth, for example, cannot be found within any single policy area or public agency, but require integration and coordination of activities in employment creation, income security, education, childcare and social services, to mention just a few. Turning ageing to an advantage (rather than a cost) is also a mounting challenge for most European countries. Addressing it requires integrated social and healthcare policies, pension policies, employment policies, urban planning policies, etc.

Although a key challenge facing today's welfare states is the complexity of the problems they must address, a key issue in our current policy-making process is fragmentation. Instead of addressing problems as cross-cutting phenomena, social and healthcare services have been traditionally developed as separate systems. Income support and employment services also operate in their own silos.

From policy silos to phenomena-based governance

The current welfare system is characterised by sub-optimisation, as each party aims to achieve operating conditions that are optimal from their perspective, and no one bears overall responsibility for funding, the quality of service or effectiveness. Resources are easily duplicated, and zero-sum annual budgeting practices as well as laws and regulations tend to tie resources to specific line items (Doz and Kosonen 2014). Moreover, silo-based policies often result in only incremental improvements to existing policies rather than new strategic and innovative responses to real social challenges.

When confronting new cross-cutting social problems, societies do establish cross-sectoral task forces or programmes. Yet

they are usually temporary solutions that tend to leave the administrative structures intact, and result in only very moderate redistribution of resources. Accordingly, they may not address the complex problems strategically, flexibly and effectively enough. The deeper problem behind this is that strategic thinking is neither natural nor easy¹³ for governments (Mulgan 2009), foresight processes are not sufficiently integrated into decision-making, long-term goal-setting is hindered by political opportunism related to short-term electoral periods, and the strategic goals of governments and their budgets are often disconnected (OECD 2015).

The fact that most countries lack proper infrastructure and processes (e.g. shared databases) for collaboration and resource-sharing between the administrative silos does not make the situation any easier. For example, risks of social exclusion of young people are often not recognised early enough, because official information resources on young people at risk of social exclusion are scattered and, for example, safeguarded for data protection purposes by a range of professionals. Often, professionals have to make decisions on support measures without sharing knowledge with each other. The lack of proper practices and indicators for measuring policy outcomes across policy fields is also a major obstacle for cross-cutting policy reforms.

Fragmented policies conducted in independent silos are a challenge for social investments, too. Policies may not be transferable across jurisdictions, since the investor and the future beneficiary may be in different jurisdictions (Begg 2015). For example, increased investments in professional training may be a cost for education policy, although they produce a later benefit for employment policy.

¹³ Public organisations do not seek competitive advantage. They face public opinion and high levels of scrutiny. Their goals are complex, ambiguous and often contradictory, and they cannot adopt a strategy of survival by adapting to their environment as their task is to shape the environment (Mulgan 2009).

Box 4 | The main phases and components of phenomena-based policy-making

1. Adopting a visionary whole-of-government approach to policy-making.

Governments at all levels (local, national*, EU) should first define a vision for 10 to 20 years ahead, and then identify the most important cross-societal challenges (or wicked problems) for reaching the shared vision. As the long-term visions, interests and perspectives of multiple stakeholders have to be integrated into a cohesive policy package, the societal challenges to be addressed should be identified through wide-spread collaboration across society.

2. Setting long-term phenomena-based welfare policy goals.

Strategic long-term goals (10 to 20 years) need to be set for each of the prioritised challenges/ phenomena. An example of a phenomenon turned into a goal is 'turning ageing to an advantage – in well-being and business'. Or in healthcare: 'from curing sicknesses to preventive well-being for all – in an equalitarian manner'. These strategic goals should then be broken down to concrete targets covering the upcoming electoral period. This has been done, for example, in Finland's new government programme (Government of Finland 2015).

3. Organising around phenomena-based policies.

Resources (money and people) need to be allocated to each phenomena-based target for the electoral period (derived from the strategic goal) instead of to line items in ministries. This allows resources to be redeployed in a flexible manner as the world around policy-makers changes. Monetary allocations should include both investments with proper return on investment (ROI) calculations as well as annual budget allocations and cuts to ministries and agencies.

Assigning key responsibilities for each phenomena-based strategic goal is the next phase of the organising process. It is important to assign key responsibilities (including minister posts) only after main monetary allocations (see previous phase) have been completed – in order to secure collective commitment to shared strategic goals and to avoid destructive turf battles.

More detailed action-planning for implementing the phenomena-based policies should then take place under the leadership of the assigned political leaders and their staff. It is important for there to be clear agreement between the key stakeholders (particularly ministries and agencies) about whose capacity is needed, and when and to what extent, for implementing the planned cross-societal policies in a coordinated manner.

4. Improving continuous sense-making and adaptation capacity.

The strategic goals that are broken down into concrete implementation targets need to be followed up and evaluated regularly in an open manner. The key government officials (political and civil service) need to follow up on the progress made in order to learn and adjust their course (through resource reallocation) in a continuously changing world, and people need to know how well the government is faring in terms of keeping its promises (accountability and credibility).

Setting up professional foresight, impact-measurement and outcome-evaluation processes and practices may require new institutional arrangements – for instance, in the prime minister's office. This is, however, extremely important from the sense-making, accountability and credibility point of view.

* Sweden adopted a whole-of-government approach in 1997, ending the autonomy of ministries as a way to provide a comprehensive, flexible and efficient operating model, which would enable the government to completely realise its political agenda. In the new system, in addition to the ministries, each central agency reports to the government as a whole, rather than operating under the jurisdiction of one particular ministry as was the case in the past (Doz and Kosonen 2014).

5. Break down phenomena-based policies into the delivery of human-centric local services.

People need individualised services tailored to their specific needs rather than universal services mass-produced by administrative silos. Advanced service design methods combined with modern ICT may provide major opportunities for developing services based on more individual needs.

In other words, the phenomena-based policies of the government need to be broken down into human-centric services for citizens, although it is not necessary for the individual to be aware of the administrative silos behind each specific service.

In order to address burning cross-societal problems, governments and public sector organisations need to adopt a new phenomena-based governance model, which addresses the most important social challenges in a strategic, collaborative and human-centric manner, by integrating different policy areas into large meaningful cross-sectoral entities (see Box 4).

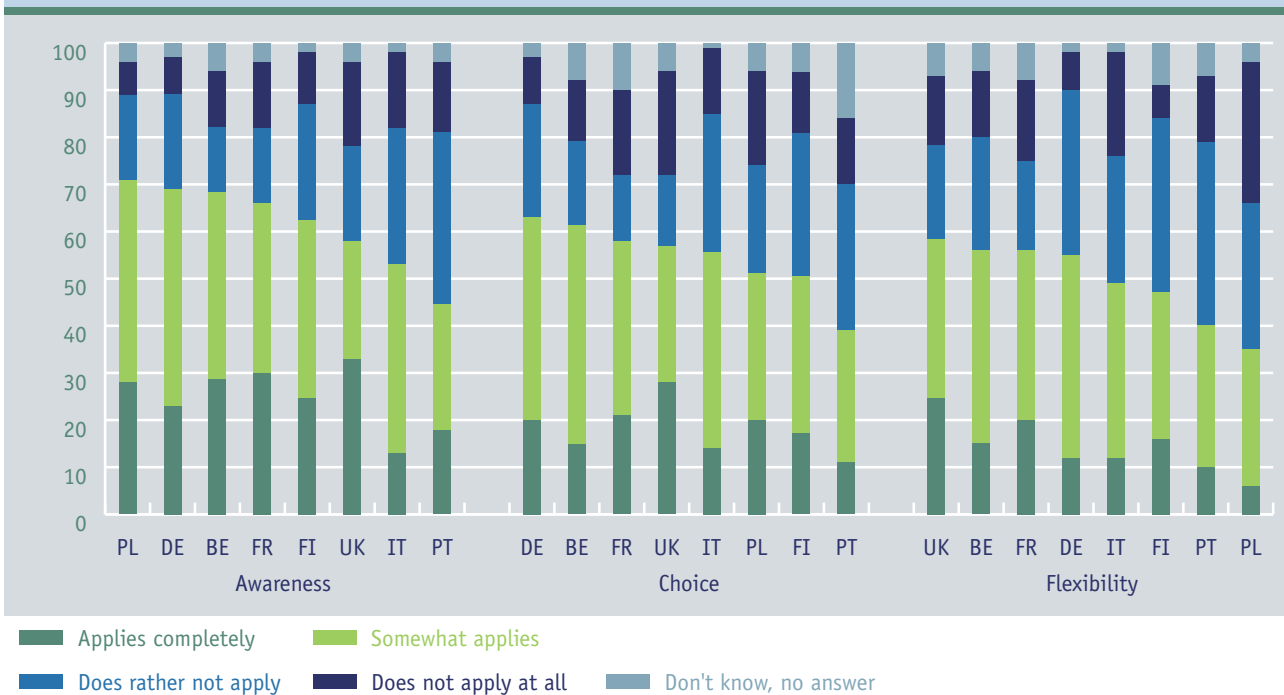
Towards customised and equitable services

Fragmented and sub-optimised policy-making not only leads to high costs and slow response times, but also to poor quality of service for citizens. For example, fragmented welfare policies may lead to individuals not knowing which welfare services and benefits are available to them and their family (Figure 1, Awareness). Additional worrisome features of present fragmented welfare policies are that the system seems to lack flexibility in providing services when life circumstances change (Figure 1, Flexibility), and opportunities to influence the form of the services that can legitimately be provided (Figure 1, Choice).

Customers have been traditionally seen as subjects of welfare services who must be satisfied with the information and services that they are given. Efforts to ensure equal access to services have been based on mass-produced solutions for rigidly defined demographic groups.

In the future, well-being services need to look at individuals more holistically. They must also be more customer-orientated and more personalised, and people must be given more choice. This may require multidisciplinary development work, co-operation across administrative boundaries and information systems, as well as systemic reforms. For example, although customers prefer personally adaptive and high-quality social and health services, and service providers are willing to offer them by adopting rapidly developing technology solutions, tight

Figure 1 | Quality of public welfare services and benefits according to a poll conducted in eight European countries (share of responses in %)



Source: Vision Europe Summit Consortium 2015.
 Note: In the survey, the following statements were tested:
 Awareness: "I know which public welfare services and benefits are available in my country for me and my family."
 Choice: "I can choose the way in which public welfare benefits and services, for example childcare services and healthcare services, are provided to me and my family."
 Flexibility: "The public welfare benefits and services in my country are flexible regarding changing needs in different life circumstances."

regulations that favour one-size-fits-all solutions for reasons of equality create barriers to more personalised services.

One way to make services more personalised and more equitable is to tie funding to the customer instead of the service provider. This forces service providers to take more of an interest in their customers' needs and gives citizens a wider choice of service providers. Another way is to give people ownership of their own customer data, as is already done in the state information

system e-Estonia¹⁴. It is also important to engage customers in the co-creation of services. The customisation of services will help prevent problems and will target services expediently, ensuring benefits outweigh costs in the long term.

14 The Estonian Electronic Health Registry (2008) has dramatically improved how patient information is handled. It combines data from different sources, making test results rapidly available online, giving doctors quick access to critical information and providing patients with timely and useful health advice. The Patient Portal protects the privacy of patients by giving them an element of control over the treatment of their own data (see www.e-estonia.com).

Ambition #2

Develop phenomena-based welfare policies to ensure long-term impacts and customer satisfaction when addressing strategic cross-sectoral challenges.

Recommendations:

- 1) Design and structure long-term welfare state policies (e.g. policy programmes, budgetary allocations, research programmes) across jurisdictions and according to real-life phenomena (e.g. ageing, youth unemployment, youth exclusion*).
- 2) Design local service provision in a human-centric manner by addressing people's real-life needs over their life cycle (e.g. services for people as they age and reflecting their various activities).
- 3) Co-create public welfare services together with customers to increase engagement and empowerment.

* The process of creating and implementing phenomena-based policies is presented above in Box 4.

5. Strengthening the democratic base of the welfare state

Empowering everyone and enabling everyone to contribute to the best of their abilities are the strongholds of democracy in the global competition of political systems. Innovation and renewal, for example, are built into representative democratic systems, providing diversity (both demographic and cognitive) in terms of decision-making, adequate foresight and sense-making capacity. Regular elections ideally provide sufficient rotation in the system and thus enhance resource fluidity. A well-performing democracy is also important for legitimising the role of the welfare state in redistributing between rich and poor and redistributing over the course of the individual's life (e.g. pensions).

Although promising in theory, representative democracy has not been able to solve many of the problems of the welfare state. In Europe, political participation is declining¹⁵. The trend does not only manifest itself during elections, but also in the membership of political parties¹⁶.

Welfare benefits for the elderly are often seen as protected and skewed in their favour because of their voting power, which has increased as societies have aged, and because of older citizens' willingness to join in the political process. The probability they will go to the polls is also much higher for older people with high educational attainment than for young people with low educational attainment (Thies 2015). Such factors may make it difficult to implement various changes such as pension

reforms that reduce the risk-of-poverty gap between younger and older populations¹⁷. Recent research from Germany also shows that those who are on the receiving end of welfare state policies – e.g. those who live in disadvantaged areas, have less than average income or receive unemployment benefits – are participating less and less in the formulation of these policies (Tillmann and Gagné 2013). It can be presumed that the social stratification of political participation can be found in other European countries as well.

Moreover, in times of serious economic constraints, investing in future benefits means disruption of existing arrangements and taking resources away from current beneficiaries. Therefore, a critical question for social investment is how the adoption of social investment principles can be legitimised (Begg 2015).

As representative democracy becomes less inclusive, welfare policies rest on an ever smaller base of public legitimacy. Moreover, present forms of representative democracy do not give voice to future generations.

Democracy can take many forms

In order to understand how the democratic base of the welfare state can be strengthened, we must turn to the essence of the concept 'democracy'. Democracy refers to the power or 'rule' of the people. It is the opposite of systems in which power is either held by an individual, as in an absolute monarchy, or in which power is held by a small number of individuals, as in an oligarchy.

¹⁵ Voter turnout in parliamentary elections in Germany in the 1970s was around 90%. In the last general election, voter turnout was a little more than 70%. In the UK, voter turnout fell from almost 80% in the 1960s to 66% in 2015; in Finland it fell from well above 80% to 67% in the same time period. The same is true for many other countries, although there are also exceptions to the trend such as in Sweden, where voter turnout has remained more or less stable over the last 30 years (Thies 2015; Van Biezen et al. 2012).

¹⁶ The absolute membership of political parties as well as membership relative to the size of the electorate has declined over the last 25 years in most European states except for Italy, France, Spain and Estonia (Van Biezen et al. 2012).

¹⁷ For example, the Musgrave rule states that efficient risk-sharing between different generations means keeping invariant the ratio of the income of the retirees to the net income of the working population (the so-called 'benefit-ratio') (Hüttel et al. 2015).

In the context of the welfare state, the concept ‘democracy’ is typically used in relation to how powers are distributed in decision-making. One form of such democracy is *direct democracy*, in which all eligible citizens participate directly in political decision-making, through referendums, for example. Another form of democracy typical to policy-making in welfare states is *representative democracy*, in which people elect representatives to make policy decisions on their behalf, for example in a parliament or municipal councils.

To address the challenges described above, states should make efforts to re-engage their citizens, especially the ones most removed from the political process, through methods that go beyond the traditional mechanisms of direct or representative democracy. These methods can range from established tools like citizens’ initiatives and public participation to so-called democratic innovations (Smith 2009).

In *participatory democracy*, people do not have direct access to decision-making, but they are heard during the process, for example, in on-line consultations. New technologies are increasingly enabling governments to receive feedback from citizens on policies and to gather ideas for new initiatives. Participatory democracy has been utilised successfully in city planning projects all over the world. Yet the lack of participatory processes is still common in many other areas of the public sector, where many reforms have been poorly implemented, or have even failed, because they did not involve important stakeholders in their development (Hämäläinen 2007).

Participatory democracy strengthens cognitive diversity as the opinions and contributions of more people can be taken into account online when new policies and laws are being prepared. It can also strengthen the adaptive capacity of states through increased alertness of decision-makers, as the opinions of people are continuously heard. Gathering valuable feedback on

policies from the people who are most affected by them may be instrumental in reducing tensions. It is also important for people to know – beyond the regular elections – when their voice is being heard and how it is going to be treated as part of the decision-making process.

In addition to offering channels for expressing opinions, participatory democracy can be used to design policies. Citizens can be systematically involved in processes that *develop concrete policy proposals*, such as in mini-publics¹⁸, citizens’ conferences or assemblies¹⁹, and crowdsourcing legislation (see example in Box 5).

In most welfare policies, participation and decision-making are kept strictly separate, with decision-making taking place only after the participatory process is complete, and carried out by different people than those engaged in the participatory process. Participatory budgeting (see example in Box 5) is an approach that *gives decision-making power to those who participate in the process*.

Today’s rapid digitisation also offers significant opportunities for democratic innovations. Through a range of new technologies, governments can receive feedback from citizens on policies or gather ideas for new initiatives. *Open data*, for example, offers new potentials for both open governance and innovation (see example in Box 5).

18 The work of expert commissions could be complemented by a mini-public working on recommendations that apply to the same issue the commission is addressing. In this case, a small group of randomly selected citizens that is representative of the overall population works on answers to important political or ethical questions (Thies 2015).

19 In an event typically lasting a day or two, citizens debate and develop proposals on a specific policy initiative or government programme (Thies 2015).

Box 5 | Examples of democratic innovations

Crowdsourcing legislation

In 2012, a modification of the Finnish constitution went into effect, allowing any citizen to propose a new law. The Citizens' Initiative Act requires 50,000 citizens of voting age to show support for the new idea by signing a petition so it can be submitted to the country's parliament. Open Ministry is an online platform developed by a non-profit organisation that facilitates such initiatives. Anyone can propose legislation and gather support for it using the platform. Before supporters begin campaigning, legal specialists help frame the language in a way that makes it acceptable to the parliament.

So far, two proposals have been submitted to Finland's parliament, one of which (the Equal Marriage Law, which allows all people to marry regardless of their gender) has been approved by the parliament.

Participatory budgeting

In participatory budgeting, the citizens involved in the participatory process decide on the spending priorities for a designated share of the public budget. Public libraries, for example, may open decisions on the acquisition of new items to citizen-based processes. In such processes, residents and community groups representative of all parts of the community a) discuss spending priorities, b) make spending proposals and c) vote on them. Local people can also be given a role in the scrutiny and monitoring of the process (Sillanpää 2013).

Participatory budgeting provides local residents with an opportunity to become an essential part of decision-making processes. It can also contribute to the residents' improved understanding of public decision-making and encourage them to participate in other areas of democratic life. The approach brings together people from different sectors who would not necessarily interact with each other. Moreover, involving residents, also from marginalised groups, in making decisions on how public funds are spent helps to allocate the funds appropriately (Sillanpää 2013).

Participatory budgeting was introduced in Europe in the early 2000s and is now one of the most widely used approaches to participatory democracy (Sillanpää 2013). It is common in Britain, and is also being experimented with in Finland.

From open data to open government

True openness provides accountability and transparency of governance. Open data is a means for increasing the openness of government. The term 'open data' refers to data that is accessible to all and can be freely used, re-used and distributed by anyone (Halonen 2012).

By opening up their datasets to public scrutiny, organisations can increase accountability and become much more efficient in terms of savings. Transparency allows vigilant citizens to identify wasteful behaviour in public organisations. In addition, more open expenditure information gives employees a better understanding of the organisation's financial situation so they can act accordingly. Open data can also enable the creative re-use of information by innovative citizens, which can enhance public services and opportunities for meaningful public participation (Halonen 2012).

US President Barack Obama, for example, signed an executive order that made open and machine-readable data the new default for government information in the US in 2013. Making information about government operations more readily available and useful is also crucial for more efficient and transparent government. In Estonia, the state information system e-Estonia is a European forerunner in open data and open governance based upon it.

Technology development, and particularly social media, also enables action-based democracy to bypass the public sector, thus stretching the notion of 'democracy' even further. As frustration has grown with the rigidity of traditional democratic approaches and with the channels of influence that are offered by the public sector, citizens are increasingly taking direct action to accomplish their goals. Time banks, for example, enable people to exchange welfare and well-being-related services amongst each other. Direct action based on the rule of the people initiated in small groups risks becoming an oligarchy, but in many cases it may also develop into widely spread and accepted citizen movements such as Restaurant Days²⁰.

Realising the potentials of democratic innovations

Democratic innovations have so many potential benefits that it would be unwise for the public sector not to get involved. Decision-makers should open-mindedly evaluate the advantages and disadvantages of different forms of democratic innovations. They should boldly clarify societal regulation and create favourable conditions for scaling up best practices and limiting potential negative impacts.

Citizen participation and democratic innovations are not without flaws, though. Including disadvantaged groups, such as migrants or people with low educational attainment, is a challenge, as it is with traditional modes of political participation. On the other hand, certain groups that are active

in adapting to democratic innovations and the potential they offer may have a disproportionate say on what happens to the welfare state (Thies 2015). Accordingly, the contributions of different stakeholders also need to be aligned and adjusted in addressing the common problem.

Citizen participation might also conflict with the agility of the welfare state to quickly respond to new problems and changing circumstances. Hence, the approach to be adopted needs to be carefully evaluated. Participatory citizen engagement may not be useful, for example, in crisis management. Involving citizens in political decision-making takes up resources needed elsewhere and slows down governance processes. On the other hand, it makes policy decisions more legitimate and less contested in the future.

Democratic innovations can be one of many tools that make the governance of welfare states more inclusive. Governments are still learning to open up to citizens' voices, and democratic innovations are currently being tried out in many states, regions and municipalities all over the world²¹. Yet they are often not yet institutionalised, but in an experimental stage, being carried out as one-time projects. People throughout society need to be made aware of new forms of democracy and invited to participate in reinventing democracy.

²⁰ Restaurant Day is a food carnival created by thousands of people organising and visiting one-day restaurants worldwide. During a Restaurant Day, anyone can set up a restaurant, café or a bar for a day. It can happen anywhere: at home, in the office, on a street corner, in a garden, in a park or on the beach. The event is facilitated by a team of volunteers. All restaurateurs are personally responsible for all actions related to running their restaurants. See www.restaurantday.org/en.

²¹ Many more examples can be found at www.participedia.net/en.

Ambition #3

Strengthen the democratic base of the welfare state by exploring democratic innovations that go beyond representative democracy and the interests of present generations.

Recommendations:

- 1) Broaden understanding of new and different forms of democracy, and how they could be applied in the context of the welfare state.
- 2) Increase co-operation with local communities by involving people from different walks of life in local development, by transferring more power to the local level and by motivating citizens to take action themselves.
- 3) Encourage and create incentives for public administrators to experiment with democratic innovations, including participatory and grass-root democracy, and to share, institutionalise and scale best practices.

6. Renewing the role of the state in welfare provision

The term ‘welfare state’ itself suggests the state’s dominant role in welfare provision. Indeed, in many countries the assumption is often that the right to social protection must be provided by the state.

However, in a period of a major socio-economic transformation²², the burning problems confronting modern welfare states cannot be assigned to any single stakeholder to be solved, and not to the public sector alone. The public sector is struggling with increasing resource constraints, and the knowledge needed for addressing new challenges may not always reside within the public sector.

The traditional role of the state in welfare provision is challenged. Some traditional tasks of national governments can now be more effectively undertaken by the private sector, social partners or civic society. Societal values are also changing in terms of what the role of the individual, family, employers, social partners and the state should be in welfare provision. We need a new perspective on the government’s role that takes into account other societal agents and sectors in a more collaborative and integrated way.

Changing roles of societal actors

In many countries *social partners*, including employers and trade unions, have an important role in the financing or provision of welfare, or as important lobbyists in welfare policy. As life-time employment in traditional economic

sectors is no longer guaranteed, an increasing number of people (particularly the unemployed) are left unrepresented, or fall through the welfare safety net if they lack the requisite number of years contributing to the system. This is particularly the case for many women, foreign labourers and workers in part-time jobs and new occupations. Social partners remain important actors and will continue to be so in the future, but their participation in welfare provision and policy needs to be re-examined from the points of view of equality, democracy and developments in the nature of work.

The Danish ‘flexicurity’ model is a good example of co-operation between the public sector and social partners. The model increases the level of mobility in the labour market by making hiring and firing easy for businesses, while individuals who are let go are offered generous unemployment benefits and a wide range of employment services. The model is made possible by efficient co-operation between social partners. Following the financial crisis, further improvements have been made to the model: The system now also addresses the relationship between mobility and education, which broadens the scope of actors involved. ‘Mobication’ is the new concept designed to provide security through the continuous retraining of the labour force and giving workers the motivation and ability to move where there is work available.

Public welfare systems in many countries complement public services by acquiring services from the *private sector*. In some cases, this leads to efficiency benefits, but equally often outsourcing services to private sector providers results in increasing costs. Nevertheless, health and well-being businesses are a major growth sector in Europe, and more and more large corporations have become interested in generating value not just for their shareholders but also for their

²² Instead of having clear roles and hierarchies, modern societies have developed into dynamic, multilevel systems-of-systems, or ‘panarchies,’ which involve differentiated institutions at all systemic levels (Gunderson and Holling 2002). Within such systems, organisational subunits, organizations, industrial sectors, regions, nations and communities all have their own cultural and behavioural norms and institutional rules. Yet they also tend to utilise some shared resources and require coordination of interdependent activities.

stakeholders²³ (see the example of social impact investing provided in Box 6). Moreover, the private sector has recently demonstrated increasing interest in addressing climate change as a business opportunity, not as a constraint. Accordingly, re-examining the relationship between the public and private sectors in creating sustainable well-being is one of the most important governance questions for the future of welfare states.

Families, local communities and peer-to-peer networks act as unofficial safety networks in many countries, particularly in times of limited availability of public provisions and services. A new age of communality is also dawning (see example of asset-based development provided in Box 6). People today are keener and more capable of engaging in meaningful co-operation with each other than ever before. Digitisation connects people in new ways and makes it possible for new joint activities to bypass traditional structures and processes. This is particularly visible in the recent development of collaborative consumption (see example in Box 6). Also, social entrepreneurship and other forms of the collaborative economy are turning citizens into active producers of social and ecological value.

In the present welfare states, *people* are often treated as passive consumers of public provisions and services. The welfare states do not always aim to truly empower and activate people to take responsibility and enhance their own well-being, which is also the perception of many Europeans (Figure 2). Future social services will need to focus more on encouraging people to be more independent and on empowering and activating

23 Promoting sustainable lifestyle choices is also a major opportunity for businesses. Examples of products and services that support sustainable lifestyles include electronic applications that allow people to monitor their own health and construction services aimed at improving the energy efficiency of homes. Intelligent energy and transport systems can also be built to support sustainable consumption habits and lifestyles. Taking consumers' different personal needs into account in the development of new products and services can increase both well-being and resource efficiency.

each individual to look after their own well-being. This requires that choices that increase well-being must also be attractive and readily available²⁴. Moreover, service providers need to empower people by engaging them in the active co-creation of services. Interestingly, as described in Section 5, some forms of collaborative consumption (e.g. time banks) even enable people to bypass the public sector by exchanging welfare and well-being related services amongst each other.

Strengthening collaborative governance

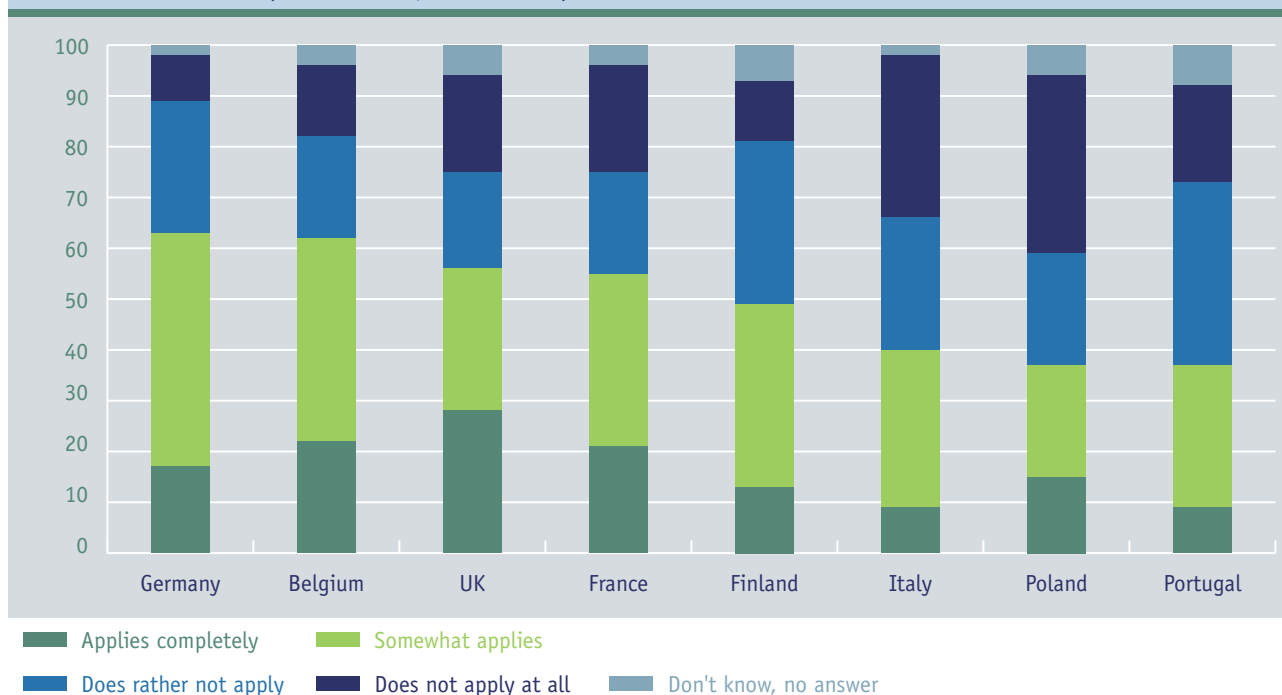
The governance environment of the welfare state requires mechanisms of collaborative governance that can support the co-evolution of multiple, mutually reinforcing activities in public, private and third sector organisations.

Collaborative government brings different stakeholders together to address a common problem in a dialogical process. It can thus help in overcoming defensive self-interests by giving responsibility to several actors for achieving collective improvement. Therefore, the key to collaborative governance is not transferring funding²⁵ or other responsibilities from the state to other societal actors, but sharing responsibilities and coordinating activities to achieve the best solutions as a whole.

24 Society's infrastructure and political decisions have a big impact on the choices that people make in their daily lives. Legislation is a powerful tool for influencing people's behaviour, as recycling obligations and smoking bans in public places have already shown. Shifting the priorities of taxation (e.g. ecological taxation) and financial incentives can also be used to promote the transition to more sustainable lifestyles. Examples of how society and its infrastructure can steer people's daily choices include good bicycle paths and efficient public transport, exercise vouchers provided by employers, prominent displays of healthy foods in stores and energy-efficient default settings in household appliances (Hirvilampi and Helne 2014; Hellström et al. 2015).

25 When designing collaborative governance, it is important to bear in mind that transferring funding and other responsibilities from the public to the private sector may involve both advantages and drawbacks.

Figure 2 | Activating role of social security systems according to a poll conducted in eight European countries (share of responses in %)



Source: Vision Europe Summit Consortium 2015.
 Note: In the survey, the following statement was tested: "The public welfare system in my country encourages me to actively enhance my personal well-being."

Public sector organisations are often best positioned to develop, produce, arrange and/or coordinate the production of public goods and institutions at higher systemic levels. They are usually the only actors with system-wide interests and responsibilities, and they are ultimately responsible for the consequences of bad policies no matter where they occur (Hämäläinen 2013). Accordingly, strengthening collaborative governance must be a priority in public sector governance.

The public sector needs to take an active role in enabling, facilitating and removing barriers to the extensive and deep collaboration between multiple stakeholders that is needed. Accordingly, 'orchestrating' system-wide co-operation is a new 'macro-organisational' role for the state in welfare policy (Hämäläinen 2013). This new 'system stewardship role' of the state (Hallsworth 2011) acts as a new public good for the participants of the co-operative network. It is not a substitution

Box 6 | Examples of collaborative governance

Communities as assets

Various methods have been introduced in Scotland to produce health and well-being by capitalising on the assets of communities. These asset-based approaches involve identifying and allocating local communities' shared resources, such as know-how, skills, experience and people's spare time, to protect the community's most vulnerable individuals and promote the health and well-being of the members of the community.

The focus is on enabling well-being and residents' empowerment, not on the provision of services. This makes residents feel like they are part of the solution rather than just a source of the problems.

A project called 'Older People for Older People' experimented with a concept in which communities in remote areas support the independent living of their older members as part of the community. The communities developed services that they themselves felt would best support older people in living independently.

Collaborative consumption

Instead of ownership, more and more people today want to have access to goods and services when they actually need them. Collaborative consumption refers to a sharing economy where people borrow, exchange, rent, recycle and produce goods, services, ideas and skills amongst themselves. In a sharing economy, resources are used in the most efficient way possible, and there is less and less need to produce new things. This allows society to reduce the consumption of natural resources and energy without forcing people to compromise their standard of living.

Collaborative consumption solutions are usually based on the Internet, which brings together voluntary networks or people who did not know each other before. It can therefore increase the level of trust in society, promote community spirit and increase the intangible well-being of individuals and their resilience in crisis situations.

In many countries, the spreading of collaborative consumption is effected by regulations on taxation, fundraising, employer rights, copyrights, transport, premises, construction and housing. Some of the regulations are rigid and outdated, whereas some protect citizens from the potential uncontrollable or negative impacts of the new practices.

Social impact investing*

Impact investment is a new, interesting and practical way of addressing the social and ecological problems of society as a joint effort between the public sector, private sector and civil society. In this new model, the public sector remains the 'owner' of the problem, but funding for the solution is provided by the private sector. In many cases, civil society may act as the practical operator, who is paid for the production of its services.

In order for the business case to materialise, concrete targets for the joint effort must first be established. The key principle of this arrangement is that the public sector pays only for the results and the private sector earns (i.e. the service provider receives profits and investors a positive return) only if targets are met or exceeded. If the business case does not materialise, the private sector bears the risk.

Impact investing is an interesting new vehicle for addressing increasing costs in the public sector by developing preventive solutions as investments for the future. At best, impact investment teaches the public sector to think in terms of investments instead annual budgets (zero-sum game). This is yet another means for adopting the social investment approach.

* It is important to note that 'social impact investing' is a particular approach to collaborative governance and, despite similarities in wording, it is not a synonym for the 'social investment' concept discussed in Section 1, which does not necessarily require collaboration between different societal actors.

for but complementary to the more traditional macroeconomic role²⁶ of government.

Instead of ‘welfare states’ we should begin to talk about ‘welfare societies’ in which – in addition to the role of provider – the government plays an active role as enabler of the activities of other societal actors.

Ambition #4

Support the transition of the welfare state towards a welfare society, with more shared responsibilities and coordinated activities by public, private and civil society actors for the best solutions as a whole.

Recommendations:

- 1) Strengthen collaborative network governance by strengthening the orchestration role of the public sector in facilitating co-operation, coordination and co-evolution of various mutually reinforcing development efforts.
- 2) Utilise community-based assets more efficiently by supporting initiatives that rely on learning from citizens’ experiences while empowering individuals, families and communities (see example in Box 6).
- 3) Evaluate the advantages and disadvantages of different forms of collaborative consumption (see example in Box 6) for increasing sustainable well-being, and clarify societal regulation and create favourable conditions to scale up best practices.
- 4) Explore potentials for social impact investing (see example in Box 6) to enhance public-private partnerships in welfare creation.

²⁶ In recent decades, the view of the rationale behind the role of the government has mostly been dominated by economic theory. Government interventions are justified as reactions to market failures. The main duties of government, and of the public sector more generally, have been seen as a) increasing the overall efficiency of the economy (e.g. competitiveness and growth) and b) reducing the social inequities among citizens (e.g. traditional welfare functions) (Hämäläinen 2013).

7. Governing the EU towards a legitimate social agenda

The simultaneous development of national welfare states in Europe and the deepening of European integration in the postwar period have laid an important foundation for the European social model. Both these pillars are now in a critical phase of reinventing themselves (Hemerijck 2013).

Social progress and solidarity have long been important elements of the European vision.²⁷ At present, the EU's social ambitions are reflected in the goals of the Lisbon Treaty (EU 2000): *to transform the EU by 2010 into the most competitive and knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion*. Despite the Lisbon promises, a great decline in social cohesion has been seen in Europe since the signing of the declaration. European unity is being challenged by an alarming increase in social inequalities both within and between countries (Vandenbroucke and Rinaldi 2015).

A core problem is that European social integration has not kept up with economic integration. Since 2008, European policy discourse and policy-making have been dominated by public debt, fiscal discipline, budget deficits and other economic issues, leaving little room for long-term strategic discussion of European values and directions and the role of the EU in providing for social well-being within ecological boundaries, as implied by the Lisbon Treaty (Soromenho-Marques 2015). The domination of economic integration is seen, for example, in the fact that labour mobility is encouraged in the EU, but no EU unemployment or health insurance exists to address its social consequences. In the long-term, greater divergence and a decrease in social cohesion in the EU may also ensue if some

of its member states increase their inputs in social investment (e.g. human capital) and others do not (Vandenbroucke and Rinaldi 2015).

Divided views on social policy

The increasing contradiction between the economic policies and their social impacts needs to be addressed, if the Union wishes to survive and flourish. In the long term, deepening social integration would be a logical next step in European integration. However, the economic problems faced by many EU countries, including those expected to become net contributors, and the strengthening of political movements critical of the EU appear to be sizeable obstacles to such development in the short term.

The subsidiarity principle has been an important cornerstone of EU policies. Due to a limited mandate in social policy, instead of invasive social policies the EU Social Protection Committee uses a voluntary process called the Open Method of Coordination for political co-operation in the areas of social inclusion, healthcare, long-term care and pensions. It rests on soft-law mechanisms such as guidelines and indicators, benchmarking and sharing of best practice. Accordingly, the method's effectiveness is dependent on a form of peer pressure. The process also involves close cooperation with stakeholders, including social partners and civil society. The social investment approach, already supported by the EU (EU 2013b)²⁸, also offers a way to use existing social budgets to achieve the best outcomes.

27 Social progress and solidarity have been promoted by Thomas Humphrey Marshall, Thomas Hobbes and Otto von Bismarck, among others (Soromenho-Marques 2015). At the European level, in 1961, the Council of Europe adopted the European Social Charter, which is a treaty on human rights and freedoms. In the EU, the social agenda was enshrined in the EU's Social Charter in 1997.

28 The European Commission has called on member states to prioritise social investment and to modernise their welfare states. The call features in a Communication on Social Investment for Growth and Cohesion (EU 2013b) adopted by the Commission. It gives guidance to member states on how best to use EU financial support, notably from the European Social Fund, to implement the outlined objectives.

The social problems that have culminated in recent years in the EU have increased debate on how far the subsidiarity principle should apply to social policies. On the one hand, pressure has increased to broaden the mandate and competencies of the EU so that more input and coordinated action is possible in the area of social welfare policies (e.g. New Pact for Europe, Emmanouilidis 2014). Shared competence (by nation states and the EU) on welfare policies may strengthen EU integration at a time when fragmentation threatens. It may also increase both economic performance and social cohesion, and help to narrow the distance between the EU and common citizens (Soromenho-Marques 2015). As part of the debate on how the EU could better balance its economic and social policies, initiatives have been launched to create economic and social adjustment funds, e.g. the EMU stabilisation fund (Delbecque 2013) and the EU unemployment fund (see example in Box 7).

Europe is divided in relation to such initiatives. Many member states resist giving the EU a broader mandate in social policy, particularly considering the EU's present weighty, rigid governance approach, and the fear they might become losers in terms of the financial transfers involved. Moreover, the rise of EU-critical populist parties in many European countries, and the strengthening of eurosceptic voices encouraging an exit from the EU or the eurozone, signal legitimacy problems in the EU and fuel reluctance to broaden EU mandates any further.

Substantial support exists among Europeans for increasing the mobility of students and workers, and for strengthening the role of the EU in social policy accordingly. However, opinions diverged as to whether this should only be done through more discreet or more invasive measures.

In a recent poll conducted in eight EU countries (Figure 3), two out of three respondents supported the introduction of more discreet measures of social policy such as minimum standards

Box 7 | Initiative for a European Unemployment Benefit Scheme

The European Unemployment Benefit Scheme is an example of an initiative for implementing social adjustment functions to compensate for the social consequences of economic policies.

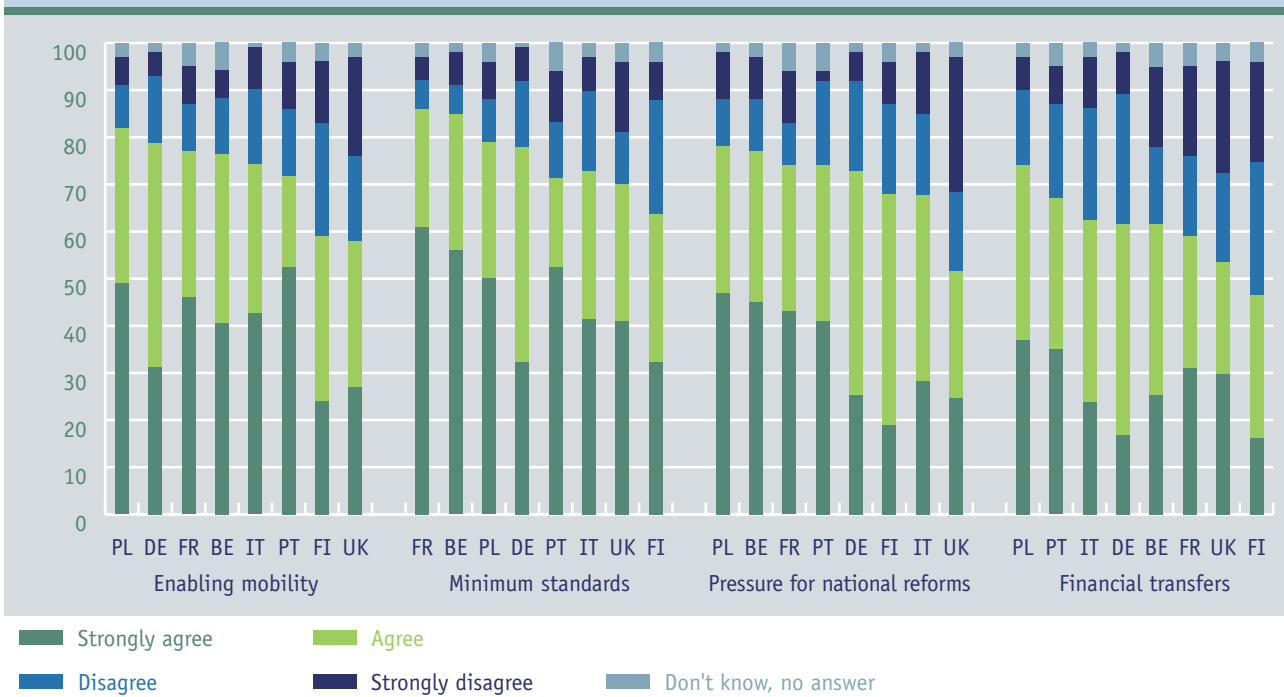
The recent European recessions have highlighted that EMU lacks the important instruments that countries have previously used to generate economic recovery and to develop macroeconomic stabilisation. The process of making EMU more resilient needs well-designed social adjustment functions. The European Unemployment Benefit Scheme is an initiative to tackle the declining social cohesion in Europe and to reorganise the architecture of EMU.

Through the scheme, member states would share a stake of the costs of short-term unemployment insurance. In practice each country would make an overall payment every month and receive an overall payment from the fund. The basic European unemployment benefit would be paid for the first six months at a 40% level of the person's previous reference wage. Each member state would have the option to pay higher or longer unemployment benefits. Also, short-term and part-time employees would qualify for support. People receiving the insurance money would be obliged to search for a job and participate in training courses. The interaction would be with national authorities.

Free-riding and situations where some countries would be the primary contributors could be avoided by adjustments based on constant monitoring of each country (experience ratings) and clawbacks that neutralise net transfers. This means that a member state could be a net beneficiary for several years, but its contribution and/or drawdown rates would be adjusted accordingly.

The idea for the fund comes from Sebastian Dullien who is affiliated with the European Council on Foreign Relations (ECFR) and the Berlin University of Applied Sciences. Since 2012, it has been analysed by the European Commission's DG Employment, Social Affairs and Inclusion (Dullien 2014).

Figure 3 | The future role of the EU in social welfare policy according to a poll conducted in eight European countries (share of responses in %)



Source: Vision Europe Summit Consortium 2015.
 Note: In the survey, the following statements were tested:
 Enabling mobility: "The EU shall enable and support more mobility of students and workers between the member states than existing today."
 Minimum standards: "The EU shall set minimum standards of social protection for all its member states."
 Pressure for national reforms: "The EU shall put pressure on national states including my country to implement reforms of the welfare system when they are necessary."
 Financial transfers: "The EU shall ensure financial transfers from the rich to the poor member states."

for social protection in the EU, as well as increased coordination among and pressure on member states when it comes to policy reform. Financial transfers from the richer to the poorer member states was – on average – supported by more than half of the respondents. Yet in all countries, significant divergence exists in the views expressed, as well as considerable opposition in some of the countries (e.g. UK and Finland).

In social policy, the EU faces a dilemma. On the one hand, the present more discreet social policy measures have not been effective enough to prevent the diminishing of social cohesion, which already now threatens European unity and which will undoubtedly decrease European competitiveness in the long run. On the other hand, the EU subsidiarity principle and existing EU competencies do not – in terms of social welfare policy – allow for great flexibility in the allocation of resources between countries or between different policy areas. Moreover,

the EU lacks sufficient legitimisation from its citizens for introducing such measures.

In the short term, in order to address the social consequences of integrated economic policies, social adjustment functions can and must be strengthened in those policy mechanisms and policy areas where the EU already has legitimacy of action.

In the long run, the EU needs to develop social policies that effectively address the increasingly complex social problems within and between the member countries in ways that are legitimate to both the member states and Europe's citizens.

Because many EU policies already have great impact on social welfare, it is essential to strengthen the reflective capacities of the EU in the sphere of social welfare issues. Foresight, global benchmarking, joint sense-making and experimentation in social issues, to name a few, need to be significantly strengthened to identify potential directions for the future.

The EU also needs a strong shared vision of the future role of social policy in the Union in order to guide the development efforts of individual member states in a mutually supportive manner. Subsidiarity should remain a guiding principle, but allowing flexibility and different forms of strategic planning at the decentralised level would contribute to creating wider European priorities (Stahl and Spinaci 2010). A shared vision provides the motivation for independent states and other actors to strive for coherent changes. It also allows the member states to make decisions using their own knowledge of local circumstances while, at the same time, recognising and supporting the direction the rest of the Union is taking. Collective commitment to a vision also enhances a feeling of solidarity between EU member states as a means of facilitating the needed national reforms.

In defining future directions for the EU, a broad partnership for progress²⁹ is needed, engaging stakeholders across society (Stahl and Spinaci 2010, see also Section 6). A vision of future social policy needs to be legitimate also from the European citizen's point of view. A poll indicating general acceptance (such as in Figure 3) does not suffice. Decisions on the future of Europe, including welfare policy, cannot be made only in the cabinets of Brussels³⁰, aided by a chorus of experts and lobbyists. Nor is it enough to rely on representative democracy (e.g. the European Parliament). In order for future social policies to be seen as legitimate by the European people, the Union needs to strengthen the role of participatory democracy and experiment with democratic innovations (see Section 5) so that it can adapt and adopt them to the European context.

There are no shortcuts to long-term solutions. Implementing governance changes that build both strategic insight and legitimacy along the lines discussed above may not solve the acute social problems of today, but they may help avoid the sudden escalation of social problems, and enable the design of sustainable solutions in the long term.

At the same time, acute problems, such as the dramatically expanding migrant and refugee flows to Europe, are challenging European welfare states, as well as any plans for future EU-level social policies, in unforeseeable ways. Therefore, what is said about welfare policy today may very soon become outdated.

29 The Covenant of Mayors has proved to be a successful pilot, engaging more than 1,000 mayors across Europe on the topic of reducing CO₂ emissions and the use of renewable energies. An adaptation of the same partnership format would be possible in other policy areas as well, including youth employment (Stahl & Spinaci 2010).

30 Owing to financial turmoil and debt crises, EU decision-making powers have recently shifted – at least temporarily – from democratic institutions to monetary treaties and institutions lacking electoral scrutiny, leading into a situation where economic actors, especially the Troika (International Monetary Fund, European Central Bank, European Commission), have the power to make decisions with extensive social impact (Soromenho-Marques 2015).

Ambition #5

Strengthen social adjustment functions in those policy mechanisms and policy areas where the EU already has legitimacy of action, while simultaneously preparing definitions of sustainable and legitimate long-term directions for social policy in the EU.

Recommendations:

- 1) Strengthen reflective capacities (e.g. foresight, sense-making and visioning) and processes to identify social impacts of other EU policies, and strengthen social adjustment functions within the present EU mandate in social policy.
- 2) Apply the principles of social investment to the EU funds already available for social purposes, and engage civil society and private investors in social investment projects, instead of relying only on additional funding from the member states.
- 3) Increase Europe-wide societal dialogue on the future role of the EU in social welfare policy. Encourage such dialogue and increase legitimation of future decisions by exploring democratic innovations (see also the recommendations related to Ambition #3 in Section 5).
- 4) Strengthen the EU's role and encourage the participation of its leaders in international research and benchmarking networks aimed at developing the governance approaches needed to deal with increasingly complex social problems (see also recommendations related to Ambition #1 in Section 3).

8. Synthesis and discussion

An important starting point for this paper was that in the increasingly independent and complex world we live in, any significant long-term socio-economic reforms cannot be made without profoundly reforming the governance approaches of our societies. In particular, a more proactive approach to governance, concentrating on the long-term and cross-sectoral renewal needs of the welfare state, is needed. Therefore, in reforming the European welfare state, governance reform must be set as a priority area of equal importance to socio-economic reform.

At the beginning of this paper, it was also asked whether the burning social problems of today can be fixed within the prevailing frames of the welfare state, or if we need to consider a deeper renewal of our societal model. This paper has argued that there is a need to reconsider the concept of the welfare state from two aspects of elementary nature – welfare and state. In the traditional concept of the welfare state, ‘welfare’ is the goal of the activity and the ‘state’ is the prime actor responsible for providing it.

Traditionally, ‘welfare’ refers to a reactive approach that provides a minimal level of well-being and social support only after problems have occurred. The European model needs to adopt instead a more proactive approach that invests in sustainable well-being – holistic well-being within the planet’s ecological limits. Moreover, as the state is not the sole actor providing well-being for its citizens, instead of the welfare ‘state’, we need our societal model to increasingly embrace also actors throughout ‘society’.

In the following, the five governance-related ambitions laid out for European welfare states in this paper (see Sections 3 to 7) are summarised and discussed in relation to two directions of reform: a) aiming at sustainable well-being (in addition to responding to traditional socio-economic deprivation problems)

and b) investing in sustainable well-being (in addition to compensating citizens).

Ambition #1 Developing governance capacities for strategic and agile states

Create governance capacity-building processes at EU and national levels to ensure that politicians, civil servants and other societal actors relevant to the welfare state have adequate understanding of the complexity and interdependency of social problems, and of the governance approaches and tools needed for addressing them in strategic and agile ways.

In an increasingly complex and uncertain world, developing welfare states towards sustainable well-being societies implies policy changes at the level of our current societal model. Designing such policies requires governance approaches that are strategic and agile at unprecedented levels. Adopting such governance approaches can be supported by vigorous foresight activities that shed light on what the next-generation governance approaches should be, and by cross-sectoral societal training activities that build and share understanding of the new approaches.

In particular, future governance needs to be strategically sensitive. This helps to create holistic understanding of the evolving content and goals of sustainable well-being (e.g. enabling better integration of social and ecological aspects in decision-making). Moreover, adopting and implementing new societal goals across old policy silos requires a new level of resource fluidity and collective commitment.

Developing governance capacities to strengthen strategic sensitivity and long-term insight is also necessary for successfully defining long-term social investment goals for complex issues. Increased resource fluidity and collective

commitment are needed to overcome the typical problem of different social-investment jurisdictions applying to investors and beneficiaries.

Ambition #2 Adopting phenomena-based and human-centric welfare policies

Develop phenomena-based welfare policies to ensure long-term impacts and customer satisfaction when addressing strategic cross-sectoral challenges.

Phenomena-based policies address strategic cross-sectoral policy challenges using a long-term perspective. Thus, they effectively enable the alignment of social and environmental policies towards a more holistic understanding of human needs and towards sustainable well-being. This is crucial, since environmental and social policies are typically pursued in detached policy silos, and even social policies typically consist of multiple hierarchical silos.

Phenomena-based policies help to avoid sectoral sub-optimisation and counteracting goals in different policy silos. This increases the effectiveness of policies and, particularly, of social investments. Phenomena-based policies may also motivate social investment in situations where the investors and future beneficiaries belong to different public jurisdictions. A shared outcome goal, which forms the basis of phenomena-based policies, also creates an enabling accounting basis for social investments.

Furthermore, phenomena-based policies address human needs through personalised services based on real-life phenomena. Accordingly, they enable more effective provision of welfare than is the case for traditional one-size-fits-all services.

Ambition #3 Strengthening the democratic base of the welfare state

Strengthen the democratic base of the welfare state by exploring democratic innovations that go beyond representative democracy and the interests of present generations.

Diversity of views combined with trust-based dialogue should provide optimal circumstances for innovations, as well as for mutually benefitting social compromises – the very foundations of Europe’s future competitiveness. Therefore, the strengthening of the welfare state’s democratic base is crucial for its future success.

Democratic innovations are needed to better enable representation of the long-term generational interests in decision-making, which is elementary for pursuing sustainable well-being. This is important, because representative democracy has not been able to safeguard the interests of future generations, or even ensure equal representation of the interests of present social groups.

Participatory democracy also offers innovative approaches which can be used to develop and experiment with different methods of social investment. Accordingly, democratic innovations can – at best – increase legitimisation of the reallocation of funds from present to future beneficiaries, which is characteristic of social investing. Democratic innovations at grass-root level are also important sources of initiatives for more sustainable lifestyles.

Ambition #4 Renewing the role of the state in welfare provision

Support the transition of the welfare state towards a welfare society, with more shared responsibilities and coordinated activities by public, private and civil society actors for the best solutions as a whole.

Individual states are powerless in the face of many social and environmental problems, nor do solutions to them exist within the public sector alone. In order to successfully address many of today's burning societal problems, the state needs to adopt a more proactive role in orchestrating society-wide co-operation towards future goals. The new orchestration role of government, and the collaborative governance approaches associated with it, strengthen the market-based economy, which is an important foundation for European welfare states. Collaborative governance approaches can also help in building joint commitment of different societal actors to the broader goals of society, which is essential for achieving sustainable well-being. As social investment typically involves multiple beneficiaries, it is more efficient if the inputs of key actors (e.g. client, operator, investor and evaluator) are well coordinated and the activities of key actors are aligned, as in collaborative governance approaches. The example of social impact investing (see Box 6) can also help to release business potentials for solving societal problems.

Ambition #5 Governing the EU towards a legitimate social agenda

Strengthen social adjustment functions in those policy mechanisms and policy areas where the EU already has legitimacy of action, while simultaneously preparing definitions of sustainable and legitimate long-term directions for social policy in the EU.

In the short term, any social policies that can be adopted within the present EU mandates will help to strengthen an important cornerstone of the European social model – welfare and equality – which is now being challenged by decreasing social cohesion both within and between countries. Increasingly addressing social issues at the EU level also enables social investment because, due to the mobility of people within the EU, investors and future beneficiaries of social investing may be in different countries.

However, transforming European welfare states into sustainable well-being societies can only take place through long-term reforms of the European model, legitimised by wide public debate and strengthened democracy. When initiating processes that aim to redefine the EU's future course in social policy, opportunities arise to better integrate environmental aspects into socio-economic decision-making (e.g. integrate social welfare and green economy aspects), as required by sustainable well-being goals.

By adopting the ambitions presented and recommendations made in this paper, the EU and its member states have the potential for becoming forerunners in modern governance and practices that invest in sustainable well-being. Investing in sustainable well-being is the next-generation societal goal that integrates economic, social and ecological sustainability in a future-oriented way.

The recommendations made in this paper embrace the shared European values of democracy, welfare and equality, and a market-based economy. Accordingly, when responding to global competition from countries with very different historical traditions and basic values (e.g. East Asia), European countries and the EU need not abandon their core values. Instead, the governance approaches presented in this paper should strengthen the foundations of our societies, while enhancing our competitiveness!

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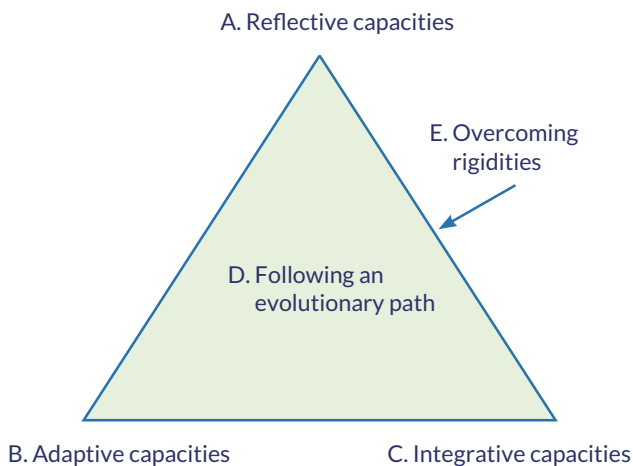
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Appendix: How to become more strategic and agile – Advice for decision-makers*



Strategic and agile decision-making requires the development of reflective (A), adaptive (B) and integrative (C) governance capacities, which can then be utilised in evolutionary development processes (D) in order to initiate and implement structural change. When developing new governance capacities, a number of rigidities (E) also need to be overcome.

A. Reflective capacities – Making sense of the world

Strategic sensitivity and strategy-level discussion on the long-term direction of societies is essential for the ability of societies to renew themselves. It originates in the combination or even collision of new and/or original sources of knowledge and the diversity of input in relation to the types of knowledge and forms of input utilised. Particularly when addressing cross-sectoral problems, strategic sensitivity demands the participation of and contributions by multiple stakeholders in a collective learning processes. Collective learning occurs when

people try to make sense of the world together by capitalising on one another's knowledge and skills so that the knowledge created then feeds back into the 'collective knowledge'. This builds trust, shared language and a more holistic understanding of the problem. Examples of practices for increasing reflective capacities of decision-makers include:

- Increase strategic intelligence capacity and activities, e.g. foresight, benchmarking, experimentation, sense-making and pattern recognition.
- Utilise new and original sources of information from experts and stakeholders from multiple fields, various backgrounds, traditions and specialisations, and use independent think-tanks to provide new perspectives.
- Create strategic options based on different cognitive frames.
- Develop and maintain high-quality dialogue among diverse societal actors. Refresh dialogue with new information and participants, and accept some tension as inevitable and as a source of creativity.
- Arrange opportunities for safe interaction and openness.
- Provide support for radical long-term research projects that challenge the established scientific and cultural paradigms.
- Support diversity and critical activities in the media, communication and culture, which highlight new contradictions in society, put new issues on the public agenda or take new perspectives on old issues.
- Utilise opportunities of digitisation and big data in knowledge creation, e.g. the 'wisdom of crowds', through modern communication technologies and the social media.
- Utilise methods of open innovation, co-design and co-production.

* Sources: Doz and Kosonen 2014; Hämmäläinen 2013 and 2015; Loorbach 2010.

B. Adaptive capacities – Enabling change

Resource fluidity is needed to respond to strategically important situations, e.g. suddenly emerging challenges and needs, as they develop, with a purposeful reallocation of resources. Resource fluidity goes hand in hand with strategic sensitivity. If key resources cannot be effectively and swiftly reallocated to new areas of strategic importance, the benefits of strategic sensitivity are lost. Examples of practices for increasing adaptive capacities of decision-makers include:

- Create multidisciplinary resource pools, build cross-functional teams and set up integrated support functions (shared information systems, etc.).
- Create multidimensional organisations, e.g. cross-ministerial programmes.
- Develop entirely new organisational and institutional capabilities, e.g. add new elements to governance such as Project Management Offices (PMO) to steer large structural reforms.
- Break traditional hierarchies by reallocating responsibilities to e.g. cross-ministerial programmes addressing cross-societal phenomena.
- Adopt a ‘whole of government’ approach with increased interaction between and integration of ministries and agencies.
- Apply flexible budgeting by reallocating resources (monetary and people) according to strategic cross-societal goals, not past performance.
- Enable multipurpose resourcing, e.g. designating a portion of public sector financial resources as belonging to a common pool, to be used when new needs arise.

C. Integrative capacities – Doing it together

The coordination of highly complex and uncertain phenomena requires mutual adjustment between decentralised but independent actors. In such circumstances, shared visions and strategy processes allow the various actors to make decentralised decisions with their best knowledge about local circumstances while, at the same time, supporting the direction in which the rest of the system is heading. The development of a widely shared vision and strategy must be an open process where the active contribution of all interested parties creates the necessary acceptance and collective commitment to the shared direction, as well as the behavioural, organisational and institutional changes required to implement them. Shared rules and incentives play an important role in directing the actions of various stakeholders towards common goals. Examples of practices for increasing integrative capacities of decision-makers include:

- Ensure the transparency and fairness of goals and targets.
- Reallocate roles and responsibilities for increased collaboration, e.g. increase the mobilisation of people by rotation between ministries and units, in order to increase appreciation for diverging perspectives.
- Recognise and reward collaboration instead of individual brilliance.
- Give strong policy and managerial support to overcome adjustment rigidities and bottlenecks.
- Invest in joint processes, creating shared mission, vision, strategies, rules, goals and values.
- Create incentives, e.g. professional leadership careers and personal goal-setting, that focus leadership attention on common challenges instead of subunit agendas and goals.
- Utilise participatory decision-making to strengthen commitment from all stakeholders.
- Create collaborative platforms to enhance networking.

D. Following an evolutionary path – Learning by doing

Evolutionary policy-making is a particularly appropriate approach for governing highly complex systems. It relies on several of the governance capacities discussed above. It utilises a combination of strategic intelligence activities, collective learning and envisioning processes, and practical experiments help to overcome the mental inertia of key stakeholders and to better consolidate their interests. The evolutionary approach requires that the state collaborates closely with other societal actors, adopting a ‘stewardship’ role in governance. Particularly when aiming at large structural reforms in complex social constructions, one-time radical changes in one policy sector may produce serious and unpredictable outcomes in others, and cause significant social unrest. When aiming at wide cross-sectoral transitions, a principle of change in incremental steps or learning by doing can be more successful than once-and-for-all radical change. The process includes the following phases:

1. Identify the systemic problem by strengthening strategic intelligence activities, e.g. foresight, benchmarking evaluations and strategic research.
2. Provide deeper insight into the system’s intricacies, e.g. integrated system analysis.
3. Select participants for a systemic change process, including frontrunners and visionaries who can look beyond their own area of expertise.
4. Create a safe place for interaction by participants, aimed at dialogue and collective learning about the challenge.
5. Develop a vision and alternate pathways for the transitions needed.
6. Choose practical experiments in which the alternate solutions can be tested. Enable funding and provide competencies, physical spaces, etc. for conducting them.

7. Evaluate the experiments to change the vision and the change agenda.
8. Scale up the successful experiments to change the mainstream activities.

E. Overcoming rigidities

Implementing new governance approaches is not easy. Changes tend to be prevented by various system failures and adjustment rigidities that may be emotional, cognitive, interactional or institutional. Examples of practices for overcoming rigidities include:

Create an emotional urge

- Give people the confidence to change, e.g. utilise symbolic action such as new mottos, logos and rebranding to symbolise change.
- Introduce new rules and rewards.
- Seed the ranks of the civil service with converts who genuinely convey positive emotions.
- Increase mutual understanding and high-quality dialogue between actors not only on factual issues but also on personal motives and values.

Create cognitive dissonance

- Use discomfort and create cognitive dissonance, e.g. highlight the tension between the shared goal and present state of affairs to create an ambition gap.
- Build a clear perception of failure.
- Listen to people’s experiences and help them to articulate the need for change in their own words.

Strengthen interaction and interdependencies

- Practice new skills and engage in playful collaboration.
- Recognise and reward collaboration to overcome the self-interest barrier.
- Reallocate roles and responsibilities.
- Engage ‘translational leaders’ who can skillfully tie together and mobilise complex networks of actors across system levels and organisational boundaries.

Navigate institutional barriers

- Implement organisational change last; consider what can be achieved first through other governance reforms.
- Change reporting relationships and the composition of activities of organisational subunits.
- Apply forms of multidimensional organisation that no longer strictly align hierarchy and reporting relationships within vertical silos.
- Extend multidimensional organisation to public-private partnerships and co-contracting.
- Prepare people by developing new integrative negotiation and collaboration skills so they can be effective in multidimensional organisations.

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