European University Institute

ROBERT SCHUMAN CENTRE FOR ADVANCED STUDIES

RSCAS POLICY PAPERS

Special Edition for the EP Elections 2019

RSCAS PP 2019/08
Robert Schuman Centre for Advanced Studies

Making Social Investment Happen for the Eurozone

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RSCAS Policy Paper 2019/08

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ISSN 1830-1541

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Printed in Italy, February 2019
European University Institute
Badia Fiesolana
I – 50014 San Domenico di Fiesole (FI)
Italy
www.eui.eu/RSCAS/Publications/
www.eui.eu
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European Parliament elections in May 2019 come at a critical time in the evolution of the EU as these will be the first elections after the expected departure of the UK (March 2019) and at a time when divergence on many issues characterises member state relations. Wider global developments weigh heavily on Europe with the return of hard geopolitics and efforts to undermine the global multilateral order. The European University Institute (EUI) wants to highlight the major issues that are at the heart of the political agenda at this juncture as a contribution to the debate. The papers are part of a wider programme on the elections including the development of a Voting Advice Application (VAA), euandi2019, and an online tool specifically tailored for mobile EU citizens voting either in their country of citizenship or residence, spaceu2019.

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Abstract

The most competitive economies in the European Union (EU) spend more on social policy and public services than the less successful ones. 21st century knowledge economies and ageing societies require European welfare states to focus as much – if not more – on ex-ante social investment capacitation than on ex-post social security compensation. While poverty mitigation through inclusive minimum income protection 'buffers' remains a prerequisite for any effective social investment strategy, by exempting human capital 'stock' investments from the Stability Pact, for the eurozone, the E(M)U can deliver on the promise of the 2017 European Pillar of Social Rights (2017) and recoup its existentially important future-oriented upward convergence momentum.

Keywords

Welfare state, social Investment, employment, poverty, eurozone, and Stability Pact

1. Re-engaging Europe's double commitment

A decade after the first crisis of 21st century capitalism, Europe has passed the nadir of the aftershocks unleashed by the 2008 global downturn. It is time to count blessings: a rerun of the Great Depression has been avoided and growth returned to the besieged continent. Whether the upswing will continue in 2019 is doubtful as dark clouds hover on the horizon. The spectre of deglobalization looming over trade tensions between the United States (US) and China, the uncertain fallout from Brexit, Hungarian, Polish and Romanian backsliding on the rule of law, and the rise of populism across the continent confront the European Union (EU) with an existential crisis. Across the eurozone, (youth) unemployment remains very high, especially in the economies most adversely affected by the Great Recession. The recent standoff between the European Commission and Italy's Eurosceptic government of Cinque Stelle and the Lega over its fiscal stimulus commitment, together with the *gilets jaunes* backlash against President Macron's reform momentum in France, also demonstrate that the eurozone predicament is far from over.

The EU's post-crisis fall from grace as an even-keeled project of regional economic cooperation committed, in the words of the Lisbon Treaty, to a 'social market economy' fostering economic prosperity and social solidarity in tandem within and between member states has deepened Eurosceptic discontent and welfare chauvinism and increased support for xenophobic and right-wing populism across the continent. Can Europe's unique 'double commitment' to inclusive social citizenship at the level of the nation state and progressive economic integration on the European plane be rescued in the years ahead? Is there political room for a more assertive social reform agenda bolstered by eurozone policy instruments to countenance the 'efficient market hypothesis,' which was falsified by the 2008 financial crash, and the equally threadbare protectionist populist backlash?

The good news, based on the eurocrisis management experience of the past decade, is that when the going gets really tough, as it did in the aftermath of the Greek near-default in 2010, eurozone member states, including Hanseatic ones, agree to intrusive measures by the European Financial Stability Facility to keep the single currency afloat, with conditional fiscal support for Ireland, Portugal and Greece, backed up, with some delay, by unorthodox ECB monetary policy interventions with Mario Draghi at the helm. Other good news is that, despite ongoing duress, three quarters of the citizens inhabiting the eurozone continue to favour the twenty-year-old single currency.

Untried policy ideas are never expedient, but they become relevant when unanticipated political contingencies press status-quo-breaking politics. Any problem-solving search for a more balanced European socioeconomic governance regime should start with a proper diagnosis of the 2008 crash and its unexpected spillover into the eurozone crisis. My contention on this score is that Europe's most successful feat of mid-twentieth century social engineering – the national welfare state, a brainchild of the Great Depression – has been wrongly (but unsurprisingly) left in cognitive disregard in the prevailing diagnoses. The 'structural reform' mantra of labour market deregulation, social protection retrenchment, pension privatization and social service liberalization ruled the waves of eurozone financial crisis management, widening divergence rather than nurturing upward convergence across the besieged continent.

The overwhelming evidence that the more active – big spending – welfare states of north-western Europe were best able to absorb the economic and social aftershocks of the global credit crunch, and the eurozone conundrum that followed, should be the launching pad for exploring effective and legitimate post-crisis eurozone and domestic reform complementarities. Building on recent proposals to reinforce a joint-insurance capacity for the Eurozone (Section 2), together with an analysis of welfare state resilience in times of adverse demography and the knowledge economy (Section 3), this policy brief proposes to ratchet up domestic social investment reform through tangible eurozone fiscal support in order to re-engage Europe's double commitment to economic prosperity and social progress by

exempting human capital 'stock' investments from the Stability and Growth Pact for a decade or more (Section 4).

2. The half-return of the master

A decade ago when the first signs of the global financial crisis reached Europe they did not cause immediate anxiety. In the aggregate, the European economy was in relatively good shape, with overall sound public finances, low inflation and gradually rising levels of employment across the continent. However, soon Ireland, the Netherlands, the United Kingdom and Spain had to salvage a great many 'too big to fail' international banks and insurance companies which were heavily implicated in the US credit bubble that burst with the fall of Lehman Brothers. Overnight increases in public deficit and national debt could only be restored, European leaders agreed, by sobering up welfare provision. After the Greek fiscal crisis threatened to break up the euro, the mantra of fiscal irresponsibility and the imperative of welfare retrenchment from the 1980s was reinforced with a vengeance.

Despite critical differences between the *real* economy stagflation crises of the 1980s and the *financial* crisis of 2008, the austerity reflex irrespectively prevailed in the EU's crisis response. And this was not simply a matter of generals being biased towards fighting previous wars rather than the ones they are confronted with today. Tragically, the austerity reflex took quasi-permanent precedence in the EU Treaties. As the single market and the single currency were negotiated at a time when the 'supply side' revolution in economic theory was riding high, the architects of the Treaties naively believed that the Single European Act (SEA), Economic and Monetary Union (EMU) and the associated Stability and Growth Pact (SGP) would inescapably force member states to keep their 'wasteful' welfare states in check. It has been argued, among others by Fritz Scharpf (1999) and Maurizio Ferrera (2005), that the intricate connection between free movement in the internal market and, for the eurozone, budgetary rules setting limits to discretionary fiscal reflation in times of demand-deficient unemployment in effect undermines the counter-cyclical capacities of national welfare states to preserve inclusive social protection. In addition, the nominal 3 percent deficit rule and the 60 percent debt ceiling flatout prevent policy-makers from distinguishing between public consumption outlays and public investments in the long-term health of the economy. All public spending – which in rational-expectation macroeconomics drains the private sector – is equally bad.

That the Great Recession did not end in a real depression as in the 1930s is to be attributed to two factors. Most importantly, in the first place, is the fact that over the previous quarter century many European countries had ventured welfare reform strategies to accommodate their social programmes to the new economic and demographic realities of the 21st century, with a proactive and reconstructive intent to raise employment in a gender- and age-balanced fashion. Second, by stealthily breaching the doctrines enshrined in European treaties, when the time was nigh member state governments did ultimately together come to the rescue, backed by the heterodox quantitative easing effort of an assertive ECB.

For decades, government intervention in the economy had been considered detrimental to dynamism and growth, but since 2008 the post-war 'mixed economy' has come back as a real blessing (Rajan, 2010). State interference proved indispensable for financial and economic stability and maintaining employment. In the recent literature, the revival of the mixed economy has been referred to as the 'return of the master' – John Maynard Keynes – whose macroeconomic teachings were largely forgotten during the long era of market liberalization starting in the 1980s (Skidelsky, 2010). However, I view the recent rekindling of Keynesian monetary policy, together with prudent financial market re-regulation, as a mere 'half-return of the master.' Ten years after the crisis, it is about time to reinvigorate the deeper socioeconomic objectives of full employment and social protection at the heart of Keynesian macroeconomics.

According to the World Economic Forum's (WEF) Global Competitiveness Index, the most competitive European economies are high-spending welfare states, including Finland, Germany, the Netherlands and Sweden, with levels of social spending hovering between 25 per cent and 30 per cent of GDP. At a minimum, the evidence that high social spending correlates with competitiveness, high employment and low (child) poverty presses us to consider the *quality* rather than the *quantity* of social spending when trying to better understand the relation between welfare provision and socioeconomic wellbeing in rich democracies. It is not at all surprising that the countries best able to absorb the economic and social aftershocks of the financial crisis were the more inclusive welfare states in northwest Europe. They allowed universal social security provision to 'buffer' the macro-economy at large and household incomes at the micro-level in hard times, exactly as Keynes and Beveridge foresaw in the 1930s and 1940s. But successful welfare states today do more than simply 'buffer' a recession following a deep financial crisis, as I will explicate below.

A second implication that would follow from a 'fully fledged return of the master' is that the greater cross-national heterogeneity of the enlarging eurozone, which bars the option of country-specific devaluation, is best supported by a joint-insurance capacity to reinforce the potential benefits of deeper European economic integration (Schelkle, 2018). Historically, this road was not taken for reasons of 1980s cognitive inertia. By constitutionally committing the union to the no-bailout principle in fiscal policy and the lowflation prerogative in monetary policy, the architects of post-1989 European economic integration deemed that convergence was best served by disciplining member states to individually self-contain the moral hazard predicaments produced by their hefty national welfare states. The eurozone crisis critically exposed the naïve policy belief in deepening European economic interdependence without providing for an effective safety net. Thus, while the new eurozone members in central and eastern Europe have been able catch up, since the onslaught of the financial crisis the northern core and the southern periphery have diverged dramatically in terms of socioeconomic fortunes and with respect to real wages, income per capita, employment, productivity, investment, relative poverty and redistribution.

Given that inclusive welfare states are far more robust at buffering asymmetric shocks than any banking resolution instrument discussed today under a Banking Union and the Capital Markets Union, many economists and policy makers, among whom ex-commissioner Laszlo Andor and former Belgian social affairs minister Frank Vandenbroucke, are proposing a kind of 're-insurance scheme' for national unemployment insurance systems to provide fiscal breathing space for countries asymmetrically affected by a possible downturn (Beblavy et al., 2015; Dullien, 2014; Andor, 2016; Vandenbroucke, 2017; Vandenbroucke et al., 2017). A eurozone common re-insurance facility acting as an automatic stabilizer is indeed fully consistent with a 'full return' of the master. I agree with Andor and Vandenbroucke's focus on the eurozone, as indeed the overriding – Keynesian – lesson from the European experience of the Great Recession was the non-availability of a policy instrument for eurozone shock absorption. An added cognitive advantage to this proposal, furthermore, is its intimate affinity with arguments about the Banking Union and the Capital Markets Union, which are also increasingly framed as eurozone re-insurance devices, not least by Mario Draghi (2018).

However, a eurozone facility to reinsure national social insurance systems is difficult to follow through. First of all, against the background of popular national welfare states, a pan-European or eurozone-wide insurance device tied to contributory obligations and other behavioural constraints is not readily politically legitimated. The myth of national welfare state sovereignty runs deep. A more practical second problem is that, as Vandenbroucke (2017) concedes, any effective eurozone social re-insurance facility impinges on the variegated design of national unemployment insurance systems, especially with regard to the extent to which the prevailing social security systems are able to buffer large cohorts in the working-age population. There is a need for some minimal institutional convergence in the scope and operational routines of national social insurance systems for a smooth Keynesian operation of the envisaged eurozone unemployment re-insurance, touching on social security coverage,

activation, minimum wages and income protection for households with weak attachments to the labour market.

A more fundamental problem, third, is that social insurance typically protects insiders rather than outsiders. From the perspective of contemporary politics, the EMU social re-insurance top-up may prove to be an effective device in the event of future asymmetric shocks. As such, however, it does not address the problematic socioeconomic divergence that has been unleashed by the eurocrisis and its neoliberal (mis-)management. From the perspective of current social imbalances, arguably, outsiders, ranging from youngsters, women and the long-term unemployed, rather than labour market insiders, have disproportionately borne the brunt of the social aftershocks of the crisis. Mario Monti is purported to have labelled the EU the "trade union of the next generation." Today, the EU – and especially the eurozone – is not doing a very good job for the next generation.

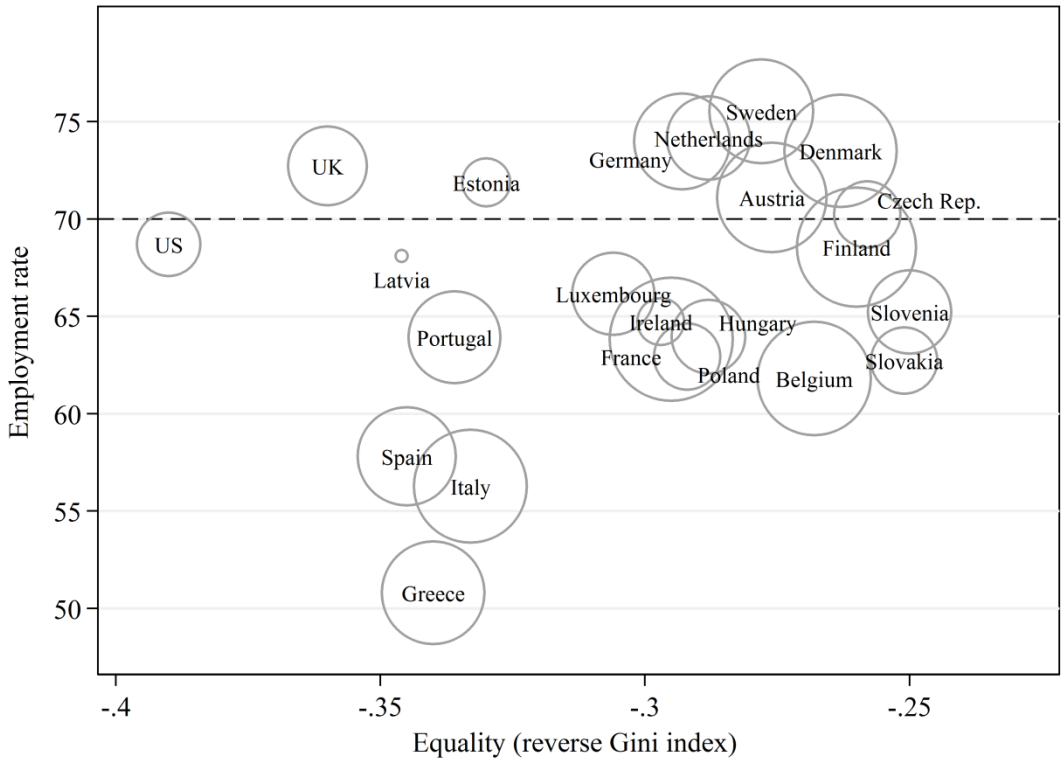
3. Taking social investment seriously

Central to the long-term financial sustainability of the welfare state are the number (quantity) and productivity (quality) of current and future employees and taxpayers. To the extent that welfare policy in a knowledge economy is geared towards maximizing employment, employability and productivity, this helps to sustain the so-called 'carrying capacity' of the modern welfare state. With the massive expansion in women's employment over the past quarter century, the work-income-family nexus is very much the 'lynchpin' of the social investment paradigm (Esping-Andersen et al., 2002). More flexible labour markets and skill-biased technological change, but also higher divorce rates and single-parenthood, make equal access to employment for women (economic independence) a prerequisite. In the absence of possibilities of externalizing child and elderly care, rising numbers of female workers face 'broken careers' and postponed motherhood, resulting in lower fertility and thereby intensifying the ageing burden on pensions and healthcare. Policies such as early child education and care (ECEC), education and training over the life-course, (capacitating) active labour market policies (ALMP) and work-life balance (WLB) policies like (paid) parental leave, flexible employment relations and work schedules, lifelong learning (LLL) and long-term care (LTC) all share objectives that transcend the compensatory logic of income-support, which was originally developed to protect (predominantly male) workers and their (stable) families against market exigencies. The social investment approach tilts the welfare balance to social risk *prevention* rather than *compensation* in times of economic or personal hardship. The core idea of social investment is that it is better to prepare than to repair, i.e. to assist individuals in adapting to the new risks associated with deindustrialisation, globalisation and the feminisation of employment. The objective is to increase human capital in quantity and quality in order to adapt the labour force to a period when demographic and technological changes accelerate.

Figure 1 surveys a selection of 22 EU countries and the US in terms of their employment rates and levels of equality after taxes and transfers (we use the reverse Gini index), while also giving an idea of the size of each country's welfare state in terms of public social spending (the larger the surface circle, the 'bigger' the welfare state). The long-cherished notion of a trade-off between economic efficiency and social equality does not seem to apply to many advanced 21st century economies. If anything, it appears to be the exception rather than the rule, with the US and, to a lesser extent, the United Kingdom (UK) – two compact 'liberal' welfare states – displaying relatively high (though not the highest) employment levels but performing poorly in terms of equality. By contrast, the countries showing record employment levels, which are among the bigger welfare spenders, successfully reconcile high levels of both equality *and* employment. The encompassing welfare states of northern Europe, with the partial exception of Finland, attain level employment well above the 70 per cent Lisbon target (dashed line). The same is true for the continental countries, Germany, Austria and the Czech Republic, which have caught up rapidly in the last decade. Certainly, employment-equity success does not hold for all the large European welfare states. Some big welfare spenders, such as France and Belgium, continue to be confronted with a 'welfare without work' trap: they do seemingly well in terms of redistribution but have failed to raise employment levels. More worryingly, southern European countries (especially Italy,

Greece and Spain, although the latter made progress before the crisis and today seems on the road to recovery) fall short of both objectives: they face low employment and high levels of inequality despite sizeable welfare spending (Hemerijck and Ronchi, forthcoming).

Figure 1. Employment rate, equality and the 'size' of the welfare state in the US and in selected European countries (year 2015).



Note: The size of the bubbles in the graph is proportional to welfare spending in each country, ranging from the 'smaller' welfare state in Latvia (14.4 per cent of the GDP) to the 'biggest' in France (31.7 per cent of the GDP). The dashed line indicates the Lisbon employment target (raising the employment to or above 70 percent).
Source: OECD.

Three complementary policy functions underpin the social investment edifice: (1) raising and maintaining the '*stock*' of human capital and capabilities; (2) easing the '*flow*' of contemporary labour market and life-course transitions; and (3) using '*buffers*' such as income protection and economic stabilization as inclusive safety nets. Aggregate evidence on welfare performance – before and after the crisis – corroborates the effectiveness of social investment: countries with strong and integrated portfolios of 'stock,' 'flow' and 'buffer' policies are best able to reconcile economic competitiveness and social inclusion (Hemerijck, 2017). Evidently, the human capital 'stock' function features most prominently in the social investment perspective. By comparison, the post-war Keynesian-Beveridgean welfare state prioritised social protection 'buffers' more, while the conservative-liberal critique of the interventionist welfare state of the 1980s gave primacy to 'flow,' understood as efficient labour market allocation, that is to say, undistorted by the 'moral hazard' predicament of welfare benefits and job protection regulation. In the social investment perspective, the relationship between the functions of 'stock,' 'flow' and 'buffer' is not only more intimate; each of the three functions individually take on a specific substantive disposition. In the social investment paradigm, 'buffers' are required to undergird far more volatile and precarious labour markets, and also to cover periods of training and more gendered childrearing and care obligations towards frail family members. As such, the substantive emphasis is on

'inclusive' income protection rather than employment-related social security for labour market insiders. Similarly, while 'flows' in the conservative-liberal critique are premised on lean social protection and indiscriminately deregulated labour markets, to ensure optimal market flexibility, satisfactory 'flows' in the social investment perspective are inherently related to 'work-life balance' and 'family reconciliation' requirements, which entails an element of (re-)regulation of (gendered) employment relations. Finally, human capital 'stock' exigencies in both the Keynesian-Beveridgean welfare state and the conservative-liberal welfare state have not reached much beyond compulsory primary and secondary education. In contrast, the 'stock' effort in the social investment paradigm embraces a 'lifelong' commitment to human capital acquisition from early childhood to old age. It follows that for social investment to work, effective policy coordination is essential. Inclusive 'buffers,' gender-balanced 'flows' and lifelong 'stocks' can produce mutually reinforcing synergetic effects over the life cycle in terms of aggregate economic performance and more individual social wellbeing.

4. Exempting social investment 'stock' spending from the SGP

My concrete proposal is to discount social investment policies from the fiscal criteria of the Stability and Growth Pact (SGP) and the Fiscal Compact in order to create the necessary fiscal space, within a band of 1 to 2 per cent of GDP, for the coming decade. Reasoning on the three policy functions of social investment in terms of a viable division of responsibilities between the EU and the member states, clearly the function of social security 'buffers,' the core prerogative of the national welfare state, jealously guarded by domestic political actors, should remain in the remit of national welfare provision. The 'flow' function, concerning labour market regulation and collective bargaining in synch with work-life balance, gender equality and family-friendly employment relations, is best served by mutual learning and monitoring processes of open coordination, engaging national administrations, relevant EU expert committees and social partners in sharing practices – good and bad – for reform inspiration. This leaves us with the overriding importance of the social investment 'stock' option. The eurozone austerity reflex resulted in a public investment strike, most unfortunately in the area of human capital stock capabilities, lifelong education, training and healthcare, with significant negative spillovers for future growth, employment and productivity in knowledge economies facing adverse demographics. It is here that the EU should press its formidable weight without trespassing on national welfare state jealousies.

Granting more fiscal room (within bounds) to countries that experience excessive social and macroeconomic imbalances would enable them to secure future-oriented financing of their lifelong education, skill upgrading and social care systems before the ageing predicament becomes truly overwhelming. Exempting such investments from SGP deficit requirements would provide member states that opt for social investment reform with an enlarged fiscal space, and without trampling on eurozone fiscal rules. For countries struggling to commit to a balanced budget without abandoning their 'buffering' social protection commitments, such exemptions could foster immediate gains in early childhood, female employment, improved work-life balance and reduced levels of early school leaving, with positive medium-term outcomes in employment growth, productivity through higher educational attainment and ultimately a lower pension burden resulting from higher levels of employment.

Because any human capital upgrading strategy often takes a generation to fully reap the anticipated returns, I propose making a decade-long commitment to this political strategy. I am therefore not talking about some under-specified discretionary fiscal wiggle-room for countries in budgetary difficulties on a year-to-year basis, in agreement with communications on flexibility in EU fiscal governance from the Commission (2017). Given its substantive ambivalence, politically, the current flexibility clause is already looked upon with suspicion by some of the more fiscally austere Hanseatic member states. Moreover, as my proposal concerns a concrete commitment to human capital 'stock' improvement, it is more easily monitored and, as a consequence, more likely to also engender stronger member-state legitimacy for EU action, also because it is specific focus on young generations and families. In times of resurgent national welfare chauvinism, domestic reform ownership is crucial. This is why the reform initiative lies with national political actors. Italy and Spain could, inter alia, opt for the immediate

creation of (primarily female) jobs by making major investments in high quality childcare centres, while France would be able to pursue a radical improvement of its system of vocational education and training based on the German example, and Belgium, the Netherlands and Slovenia could ramp up their rather regressive lifelong learning arrangements following the Finnish model.

For the Italian conundrum that I referred to in the introduction, it is tragic to concede in hindsight that if the social investment support facility had been available for the Letta, Renzi and Gentiloni administrations significant investment in social infrastructure would have been underway with considerable reform pride and ownership, leveraging (female) employment gains in particular with endogenous economic growth. Barring that option, Italy today is left with a populist government that ramps up passive consumption spending to restore growth, but we know that old-style Keynesian fiscal reflation no longer suffices in knowledge economies and ageing societies, where investment in younger generations sustains pensions in the long run and popular welfare states more generally. Admittedly, the Italian predicament of low (female) employment and high poverty has home-grown roots. However, protracted stagnation in the aftermath of the financial crash is intimately related to how the euro crisis which came to a head in 2012 panned out differently compared to other European welfare states. This being the case, a corrective effort is imperative.

It goes without saying that discounting human capital 'stock' investments will have to be closely monitored through the European Semester in terms of effective open coordination with regard to labour market regulation and employment relations that help ease labour market and life course 'flows' for individuals and families, together with progress towards making social security 'buffers' more 'inclusive' across the member states. As such, closely monitored eurozone social investment aid is likely to contribute to progressive institutional convergence across the 'stock' and 'flow' functions of the new welfare state. This could ultimately pave the way for layering a reinsurance of national social security systems, as advocated by Laszlo Andor and Frank Vandenbrouke, to further reinforce the overall resilience of the monetary union. Finally, to the extent that, over time, the eurozone would acquire a credible social dimension, this would surely be attractive to (young) voters in central and eastern Europe who now merely tolerate illiberal autocracy because of a lack of an inspiring alternative.

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