

# Economic Governance in the Eurozone and the EU: Drawing lessons from the crisis

Cape Sounio, Athens, Greece, 10-13 June 2010<sup>1</sup>

## Session 4: Political and social consequences of the crisis

### “The End of an Era: economic crisis and welfare state transformation”

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*Rough draft*

#### 1. Crisis aftershock alert

Deep economic crises are moments of political truth, so the history of the 20<sup>th</sup> century teaches us. In the wake of both the Great Depression in the 1930s and the Great Inflation of the 1970s, the socioeconomic order of advanced economies, triggered by exceptional economic hardship, recast in fundamental ways, far beyond partisan political policy redirection. The experience of the 1930s, its financial chaos, depression, political instability, mass unemployment and poverty, together with the atrocities and the immense human suffering of the World War II, inspired the establishment the mixed economy in the late 1940s. The state took responsibility for taming financial markets and mitigating the social risks of modern industrial economies in the post-war welfare state. Keynesian economic theory, advocating both constraints on financial markets and the expansion of modern social policy, was very much the intellectual brainchild of the post-war era. The prime objective of economic became of full employment, with demand stabilization as the key instrument.

Under the aegis of Keynesian macro-economic management, the post-war welfare state was extremely successful in achieving political stability, economic efficiency and social fairness. Expanding world markets, high growth rates, and increased productivity went hand in hand with full employment, substantial wage increases, higher standards of living, a significant reduction of inequality, and stable industrial and political relations. A positive theory of the state, together with moderation on the part of the social partners supported the welfare state and the Keynesian mixed economy, which, in turn, offered citizens the prospect of a positive spiral of full

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<sup>1</sup> With the support of the Lifelong Learning Programme, Jean Monnet Actions of the European Union Education, Audiovisual & Culture Executive Agency. This project has been funded with support from the European Commission. This publication reflects the views only of the author, and the Commission cannot be held responsible for any use which may be made of the information contained therein.

employment, high wages, rising demand, and increased productivity, which produced a higher standard of living for everyone (Hall 2001). The architects of the post-war social and economic order, such as John Maynard Keynes and William Beveridge, believed that society, the economy and politics after 1945 were primarily in need of stability, and therefore sought to provide organized protection from the disruptive and destructive effects of unmediated market forces.

This happy marriage between social policy and economic performance was brought to an abrupt end with the oil shocks of the 1970s. Suddenly it became clear that the post-war welfare state was based on assumptions about the economy, the world of work and family life that were no longer valid. The recessions in the 1970s and 1980s revealed that the welfare state, sheltered by Keynesian macro-economic management, had become disengaged from the realities of economic production and competition. Economic progress and efficiency had been taken for granted. High rates of inflation and mass unemployment were associated politically with an overall failure of the welfare state, and welfare advocates increasingly came to be seen as conservative defenders of the status quo ex ante. The 1970s real economy crisis of stagflation (low growth and high inflation), in turn, revealed the practical limitations of Keynesian macroeconomic management in fighting stagflation after the two oil shocks of 1973 and 1979. A neo-liberal economic policy consensus took shape, favouring disinflation, budgetary discipline, and currency stability, for Europe culminating in Single Market program in 1986 and, eventually, EMU in 1999. In its wake, the requirements of labour market flexibility and welfare retrenchment were rediscovered as important objectives of economic policy.

The neo-liberal policy shift to hard currency and balanced budgets did manage to contain wage-price inflation. Trade flows and international market expansion have indeed grown, and European economic integration has intensified following the policy logic of market deregulation and monetary integration. On the other hand, European governments were much less successful in sobering up public finances.

The current economic crisis is, once again, fundamentally redrawing the boundaries between states and markets, calling into question many issues of economic governance that were taken for granted over the previous three decades, ranging from central banking, monetary and fiscal policy, financial regulation, macroeconomic management, labour market policy, welfare provision, European integration, and global trade. Thus far, policy attention has mainly focused on immediate crisis management, especially with respect to financial sector risk management, fiscal consolidation and monetary stability. The crisis reveals how hard times can exacerbate existing tensions, resulting in the overthrow of ruling parties. The United States, Iceland, the Czech Republic, Japan, Greece, Germany and Britain have all experienced government turnover after recent elections held in the wake of the 2008 financial crash. Important political institutional questions of social and economic governance have thus remain to be answered. Will the political rules of the economic game be rewritten? Does the Great Recession, like its Great Depression and Great Inflation predecessors, mark a new opportunity to reinvent 21<sup>st</sup> century European welfare capitalism once more?

What makes the current predicament so uncomfortable is that today's policymakers are pressed to act almost instantly to a series of rapidly unfolding, inter-related

economic and political aftershocks unleashed by global financial crash of 2008. The magnitude of these aftershocks not only potentially jeopardise the recovery, they also constrain the range of policy choices available to governments and international institutions, both in the short-term and the long-term.

First, there is the aftershock of deglobalisation. The forces of financial deglobalisation we are currently experiencing are not dangerous per se, as unfettered financial globalisation through unbridled capital market deregulation is in part at the root cause of the global downturn. What is dangerous, however, is the risk of financial deregulation cascading into real economy protectionism.

The second aftershock concerns the looming crisis of unemployment. Unemployment usually lags behind general economic activity by roughly a two- to three-quarter delay, so labour market conditions in the advanced industrial world are still likely to worsen in the coming years. Most worrisome is the surge in youth employment: in Latvia, Italy, Greece, Sweden, Estonia, Hungary, Lithuania, France, Ireland, and Belgium, youth unemployment has crossed the 20% threshold, and in Spain it is over 30%.

Third, there is the aftershock of the pension crisis – the sharp fall in equity markets has severely affected the value of pension fund assets, jeopardising pensioners' incomes in countries with large private pension provision. Declining population levels have already resulted in a shrinking work force, which significantly reduces tax revenues, even independently of the crisis. According to Eurostat estimates, by 2050 almost one third of Europeans will be over 65 years old – compared one-tenth in 1960s. In order to achieve fiscal sustainability, new ways to finance health and pensions must be found as costs rise. Yet reforms are constrained by the popularity of existing pension programmes and the steadfastness of vested organized interests defending them.

The fourth aftershock unfolding is a fiscal crisis of the state. Costly bank bailouts, stimulus packages, and ageing populations, are draining the public purse, resulting in a 'double bind' of rising social benefit expenditures combined with declining government revenues. By 2010, the financial crisis turned a sovereign debt crisis for Greece. What if pension-heavy Greece is ultimately not able to pay down its debt? Will Spain and Portugal follow suit? And to what extent, now that Greece, Spain, Portugal, and also Ireland have introduced tough measures of fiscal tightening and retrenchment, is there a real danger of fiscal consolidation reinforcing deflation which would make fiscal austerity self-defeating in terms of recovery?

Over the past three months, the spectre of the debt Greek crisis set the scene for the fifth aftershock of a currency crisis of the euro as financial markets begun to speculate against the euro, in the expectation that European governments would fail to live up to the deeply anchored political commitment to underwrite the stability of the euro, on the one hand. Betting against the euro became a new sport. Financial markets were doubtful about the EU's willingness to accept and ability to enact much tighter political economic coordination within the eurozone. To be sure, by early May eurozone leaders came to the rescue with a €750bn liquidity fund for the weaker members, while the ECB shifted gears to the unorthodox measure of buying government bonds, a path departure from its monetarist orthodoxy. Nonetheless, the

rescue of the euro was preceded by wavering and procrastination, especially on the part of the leadership of Europe's largest member state Germany. So as to ease contagion fears, meanwhile, Portugal, Spain, France, and Italy have stepped up and accelerated their fiscal consolidation strategies, aimed at bolstering the credibility of the €750bn stabilisation plan of the EU together with the IMF, so as to ease contagion fears.

The sixth aftershock is the realistic expectation of a protracted period of low growth. The magnitude of systemic debt, the sum of private and public, is very likely to delay recovery from the current crisis. The financial crisis severely curtails the most important growth driver of the recent decade: easy credit and private consumption. The key question is what growth driver can replace toxic easy credit and private consumption. There is a real danger of the crisis persisting for more than just a few bad years. Japan's 'lost decade' following the crisis in the early 1990s provides a realistic antecedent.

At some point, no doubt, the recession is likely to recede. Before that happens, we may experience a seventh aftershock of rising prices in raw materials, especially oil, and energy.

## **2. Conjecturing transformative institutional change**

Designing effective and legitimate policy responses is a complex craft, especially in the uncertain aftermath of the 2008 credit crunch. On the one hand, we should count our blessings; a complete collapse of the world economy has been prevented and a nascent, but fragile, recovery may be underway. On the other hand, policymakers, while anxiously awaiting signals of whether or not we are emerging from the global downturn, have entered uncharted waters. Our understanding of the current crisis remains limited and fundamentally ambiguous. Also given the unpredictability of the cumulative impact of the aftershocks, and their positive or negative interactive feedback effects, it is really too early to draw definite conclusions about the institutional, social and political, consequences of this momentous economic shock. To clamour "reform is the answer!" is easy, but to answer the question "what kind of reform?" is effective and legitimate is a tall order under so much uncertainty. To put together a domestic and international reform package that is effective in stabilizing public finance without hurting sustained recovery, and one that is sufficiently equitable, in the sense that it is seen as fair by larger democratic publics, is extremely difficult. Amidst this intellectual void, there are forces pulling governments in opposite directions. Some advocate an immediate swift return to the neo-liberal settlement prior to the crisis; others vouch to prolong the Keynesian stimulus policy response, while at the same time seeking to recalibrate and update their social and (international) economic policy commitments in response to, not only the global economic crisis, but also to the predicaments of ageing populations and climate change. The current precarious economic juncture is riddled with temptations for wrong-headed policy decisions. There is the obvious temptation to completely abandon fiscal discipline to save jobs and maintain, as much as possible, the welfare status quo. Then there is the opposing – but similarly short-sighted – temptation to retrench current welfare commitments in order to quickly regain financial and budgetary stability. However, this would destroy a critically important social infrastructure that has proven its worth in cushioning the 2009 downturn, especially

across Europe. An equally ineffective policy solution is the alluring strategy of fighting unemployment by reducing labor supply through early retirement schemes – a policy trap that many European governments fell victim to in the 1980s and 1990s. Worse still are the nationalist and protectionist temptations that were disastrous in the 1930s, and which could easily be revived today if governments begin paying direct subsidies to failing domestic industries. Finally, pandering to domestic discontent with Eurosceptical rhetoric will do nothing to solve the current problems. To be sure, the European Union as an economic and political institution has been deeply affected by the current economic crisis, and at the 2010 deadline of the Lisbon Agenda, it has become all too apparent that the Lisbon goals have proven to be overambitious. This makes it politically opportune for political leaders to turn their backs on the EU and let Euroscepticism triumph over integration and supranational problem solving. However, this would play straight into the hands of xenophobia and populism. These political traps are all very real and threaten to deepen the economic downturn, worsen job losses, reduce state revenue, erode pensions, widen the gap between rich and poor, and undermine democratic trust. In addition, the murky nature of (international) politics, power asymmetries, short time horizons, outstanding social commitment, vested interest reform opposition, make the world of politics and policy of today fairly implausible spheres for self-corrective policy learning. Yet, such open minded, and politically sensitive, social learning is imperative today! It takes quiet some intellectual courage to give up old ways of looking at the world and thinking what is best for economy and society, especially in the heart of the policy making citadels of power. Learning in times of crisis always involves dimension of unlearning, of giving up old habits and accepted routines. Are political leaders and policy experts, at the level of the EU, who have committed themselves so wholeheartedly to the intellectual incoherence of the Lisbon Agenda, truly willing to explore and ponder alternative cognitive and normative orientations? Keynes was very outspoken about politicians as usually the “slaves of some defunct economist”.

The good news is that the fundamental insight that emerged from the crisis is that economic markets are not self-creating, self-regulating, self-stabilising, and self-legitimising. While this important lesson is certainly not new, in the past decades of neo-liberalism policymakers did seem to forget the fundamental truth that the benefits of global economic interdependence rely heavily on robust social and political institutions. In mid-2007, the state (re-)emerged as a key strategic economic actor. Faced with an exceptionally deep crisis, most advanced economy governments showed little inhibition in pursuing bold strategies of crisis management, on a scale truly unthinkable only a few years ago. Public institutions in economic affairs have proven to be indispensable. Re-establishing the rules of the game and the relationship between the market and the public authorities has returned to the top of the political agenda. Today, most observers agree that the public authorities’ activist crisis management strategies have succeeded in forestalling the darkest scenario -- a rerun of the Great Depression.

What the crisis brought out is the deep complementarity between states and markets. Nobody expects the demise of the free market system. However, the free market is now more pragmatically seen as a means rather than an end. However, it is naive to claim that public authority contributes to economic performance *tout court*. There are no quick fixes and there is no perfect marriage of states and markets. The relationship between economic efficiency and public accountability is necessarily conditional. The

analysis of public authority as a productive factor relies heavily on empirical data and case-by-case comparisons.

### **3. Restorative forces**

In the years ahead, a fundamental re-thinking of the institutional embedding of the market economy in all spheres of (international) economic policy making, is imperative! Any success of extraordinary politics of institutional transformation is conditional on the extent to which policy makers and key economic and political actors are able to overcome vested interests and political sentiments defending the policy status quo ex ante. Today two obvious restorative forces capture the policy debate. First there is the eagerness to restore immediate status quo ex ante of neo-liberal financial success miracles. In this scenario stock market recovery is likely to be followed by elevated consumer spending in the United States, which in turn will serve to revitalise the export oriented economies of Germany, Japan and China. The return to the heyday of neoliberal success is not only pushed by Wall Street and the City of London. Also pension fund managers and especially finance ministers, who have vested large sums of tax payer money into bailing out banks and stabilising the financial industries, have a clear interest in the stock market success and the resurgence of high rates of growth, reminiscent of the previous decade unfettered financial markets. Given the likely aftershocks still to be anticipated this scenario is not very plausible. Moreover, we now know that the more recent neoliberal growth experience, based financial innovation, was largely fictitious. At the beginning of the era of neo-liberalism, governments adopted the imperatives of balanced budgets, inflation targeting, deregulation, and privatisation, thus constraining the money supply. However, over the 1990s, the private financial sector was allowed to use financial innovation to create as much money as it saw fit. This led to massive – though wasteful – wealth creation. In the process, structural inequalities were allowed to persist and widen further, both within and between countries. While many developed countries saw their GDP increase by up to 25% over the past fifteen years, median incomes barely rose at all (and in some countries even declined), revealing a highly skewed distribution of growth. In macroeconomic parlance, increased inequality implies weak domestic demand: the skewed wealth distribution and high unemployment rates were bad for consumer demand and therefore for the economy as a whole.

The second restorative force finds its roots in the nostalgia of the golden age of welfare capitalism: the thirty post-war years in which war-battered economies were reconstructed, males worked hard in the industrial sectors and social and political stability was secured by the welfare state. The narrative of the lost ‘golden age’ of European welfare capitalism is closely associated with a sense of powerlessness and social anxiety about large scale immigration. Most opinion polls indicate that between 20-25% of the European electorate is, broadly speaking, resentful of immigrants. Immigrants are perceived as welfare profiteers that receive favourable treatment by ruling political elites. It is to be expected that the current economic crisis to further increase feelings of discontent and thus strengthen radical right-wing anti-immigration and populist parties as well as radical left-wing anti-capitalist and socialist groups. The current crisis has reinforced the strength of welfare state nationalism. In contrast to traditional right-wing politics, the newly emerging right-wing populism is pro-welfare state, but vehemently anti-immigrant. Already in the

2005 referenda on the ratification of the European constitution, the rising strength of nationalism was clearly demonstrated. Citizens held their national governments accountable for their security and wellbeing, not the EU. The growing support for anti-globalization and anti-immigrant parties seems to be more difficult for traditional social democratic parties than for right-of-centre conservative parties, as the 2009 elections for the European parliament have demonstrated. European citizens may have benefited greatly from economic integration – and from globalisation for that matter – but today European integration and economic internationalization are primarily seen as threats. While those in the upper strata of society continue to welcome European economic integration as a positive-sum project, large sections of the middle class feel more and more uncomfortable about the prospects of worldwide competition, outsourcing, labour market flexibility, financial deregulation and the rise of the knowledge-based economy. It comes as little surprise that EU political legitimacy suffered tremendously in the wake of the crisis, and it may even come to be considered a political casualty of the crisis. Feelings of vulnerability have also inspired widespread unease over the process of European integration. European citizens feel betrayed by the liberalising and globalising ambitions of the EU, and the economic crisis heightened such sentiments. ‘Brussels’ is viewed as the driving force behind free market capitalism, rather than as an institutional shield against international competition. In the past, national political leaders had often misrepresented EU regulations, framing them as a scapegoat for unpopular reforms. Popular support for the European project suffered as a result, and so did the credibility of political elites. The growing numbers of disenchanted citizens puts pressure on existing governments and parties to proclaim support for nationalist policies and downplay their commitments to European integration. It is much easier for national leaders to bank on the anti-Europe segments of the electorate than to attempt to develop a unifying platform, for example, one that could muster support for a significant deepening of the European political project combined with a more pronounced EU social policy repertoire.

Of course, just like the party of neoliberal financial excess, the image of the cosy post-war welfare state is a myth. It wrongly idealizes a framework of familiarity and happiness that does not do justice to the economic burdens and political conflicts of the post-war era. In addition, economic life may not be any more uncertain now than it was in the past – in fact, the reverse may be true. Yet, the image of a welfare paradise lost is very powerful, especially when it is positioned rhetorically in contrast to the perceived present-day heartless global competition and insecurity. Citizens of mature welfare states hold high expectations of government protection from economic uncertainty. While surveys repeatedly show high levels of self-reported individual life satisfaction and happiness across the EU, the middle class is no longer convinced that their offspring will have a better life than they do. As such, it heavily influences how people relate to politics. The longer the crisis, the more it will intensify political disenchantment. Moreover, tight fiscal control and painful cuts in Europe’s cherished welfare programs will certainly be met with strong public opposition. Austerity measures planned to curb eurozone spending have already met with a wave of strikes, walkouts, and violent demonstrations in Greece, France, Italy, Latvia, Germany, Portugal and Spain.

#### **4. The contours of the new European embeddedness**

Periods of unsettled beliefs do inspire social and economic policy innovation. This we have learnt this from the experience of the Great Depression in the 1930s, as well as the crisis of stagflation in the 1970s and 1980s. Will the gravity of the first economic crisis of 21<sup>st</sup> century global capitalism trigger another moment of extraordinary policy change?

In a period when neo-liberal solutions seem to have run their course, policymakers must find new strategies should be implemented to achieve stronger growth, more and better jobs and more equality, social cohesion and environmental sustainability. If we still to believe in the ends of the 2000 Lisbon agenda, we have to explore new means, based on an alternative understanding of the economy, the polity and society. At first sight, a new era of strategic state intervention will not necessarily follow the initial instance of fire brigade Keynesianism. Today, citizens seem to have as little faith in the state as they have in the market.

It is important to highlight that neo-liberalism did not attain institutional hegemony overnight. While the elections of Margaret Thatcher and Ronald Reagan may retrospectively have marked the beginning of the neo-liberal era, it was only with the fall of the Berlin Wall that the neoliberal doctrine achieved global hegemony. The neo-liberal rise to dominance was largely evolutionary; it emerged gradually through a series of institutional transformations and policy changes over a longer period of time. It is to be expected that a more fundamental recasting of our socioeconomic order is likely to follow a similar evolutionary logic of incremental transformative change, as part of a long trial and error learning process. I believe that, after three decades of neo-liberalism, a critical re-imagining of social and economic policy repertoires is underway in two core policy areas of social and economic governance: macroeconomic coordination and welfare provision. Because, in these uncertain times, it is easy to lose sight of the overall aim of creating employment-friendly, fair and efficient welfare systems, which have an almost ontological quality in self-perception of the citizens of the EU, I concentrate on the latter in the remainder of this essay. To be sure, short- to medium-term macroeconomic measures will be necessary to respond to the ongoing aftershocks, but such measures should be consistent with the ongoing recalibration efforts to prepare domestic welfare states and EU social policy for the 21<sup>st</sup> century challenges that lie ahead, such as ageing, family, change and labour market transformation. In China, where American economic demise has brought the perils of excessive domestic saving to the fore, the government announced a Keynesian stimulus program to deepen and strengthen social safety nets in the areas of pensions, healthcare, active labour market policy, vocational training, unemployment insurance, and close supervision of finance. In the United States, where the stock market collapse has wiped out retirement savings and rising unemployment is leaving ever more people without health insurance, officials in President Barack Obama's administration are looking towards recent pension and healthcare reforms in the Netherlands, Sweden, and Switzerland for inspiration.

In Europe, the crisis has been, in many ways, a stress test for the welfare state. A recent study by the OECD testifies to the staying power of the welfare state, corroborating the fact that OECD governments now 'spent more on social protection than any time in history' (OECD, 2008). Even in countries where neo-liberalism

gained the strongest political support, such as in Britain, welfare retrenchment has remained limited. On the other hand, since the second half of the 1980s, many European welfare states evolved in the direction of greater inequality and more income poverty, including in the more egalitarian and stronger welfare states in Scandinavia and continental Europe. The OECD report, *Growing Unequal? Income Distribution and Poverty in OECD Countries* (2008), cited above, says that, ‘...there has been an increase in income inequality that has gone on since at least the mid-1980s and probably since the mid-1970s. The widening has affected most (but not all) countries...’ (OECD, 17). The report concludes, ‘Over the entire period from the mid-1980s to the mid-2000s, the poverty headcount increased in two-thirds of the OECD countries’ (2008: 129). The rise in the Gini-coefficient has been substantial almost everywhere, but most dramatically in the UK, and one can also note a surprising increase in Sweden. Rising inequalities are very much driven by the top pulling ahead of the rest, which, of course, contributes to widening earnings differentials. But the bottom is also losing ground in Finland, Germany, and Italy. Perhaps the most troubling trend lies in the substantial rise in child poverty across Europe, in Italy, Germany, and the Netherlands, especially in the 1990s.

Although the crisis will definitely put a strain on many redistributive institutions, this can also have positive consequences. The crisis has reminded many Europeans of the importance of social programs to support the unemployed, the disabled, and the others most negatively affected by the crisis, and also Keynesian automatic stabilisation has contributed positively to responding the first aftershocks. In the years ahead, most likely, social policy will resurface in the centre of political debates.

The economic crisis has brought the welfare state to a new political crossroads. Deciding which direction to take from here entails hard policy choices. Nowhere is this challenge more apparent than in Europe. Can we seize the opportunity for change, presented by the global economic crisis, and rethink 21<sup>st</sup> century welfare provision? The critical challenge lies in redirecting the broad public support for traditional welfare protection, which is strong in most EU member states, towards designing a new model of welfare state that is capable of providing solutions to modern, post-industrial problems. The resilience of EU economies and welfare states requires both growth-oriented macroeconomic policies and accelerated social investment. There is abundant potential for social policy to expand and enhance human capacities if it includes concepts such as the life course and labour market transitions and thus opt for a policy agenda that prioritizes high levels of employment for both men and women, while combining elements of flexibility and security. New forms of governance, based on subtle combinations of public, private, and individual efforts and resources, should focus on removing social barriers for labour market entry, discouraging early exit, making labour market transitions less precarious, and providing equality of opportunity throughout the life cycle.

## **5. The social investment turn**

With respect to welfare provision, already since the mid-1990s, I believe that we have entered a new era, best characterized as the social investment turn. The initial drive towards social investment policy innovation was not a rapid reaction to a deep economic recession, but instead emerged gradually through a protracted series of partial policy changes, whose intellectual coherence can only be appreciated retrospectively. Its rise to prominence was largely political, and was triggered by

growing disenchantment with neo-liberal policy prescriptions and outcomes in the areas wage bargaining, social insurance, pensions, family services, and labour market regulation. However, this is not to say that the social investment edifice lacks an economic policy framework. In fact, it rests on coherent economic ideas that differ markedly from the neo-liberal dogma of a crude trade off between economic efficiency and redistributive justice. Most importantly, in contrast to the neo-liberal critique that generous social policy necessarily sacrifices efficiency to achieve equity, the social investment policy paradigm rests on the idea that social policy can in fact be a productive factor, producing win-win outcomes in which increased social equity goes hand in hand with increased economic efficiency. New pieces of intelligence, expert reports, academic books and policy papers have emerged on a number of salient topics: unemployment hysteresis, moral hazard and adverse selection in comprehensive social insurance, rising old age dependency, labour supply reduction policy failures, falling fertility, rising rates of early school drop out, and unsatisfactory work-life balance for many working mothers. Because social protection is strongly redistributive over the life cycle, the agenda-setting volume, *Why We Need a New Welfare State* by Gosta Esping-Andersen and his colleagues (2002), commissioned by the Belgian presidency of the EU in 2001, pushes for a focus on how welfare provision interacts with fertility, education, and labour supply, the future productive tax base, so as to maintain a sustainable and fair welfare state. The aging of populations, rising life expectancy and declining fertility, increases pressures on public spending and threatens inter- and intra-generational solidarity. In this book, we argued that the more incomplete the transition to a new social investment welfare repertoire, the higher the probability that large shares of the population will face sub-optimal life chances, and the more likely it is that we shall see polarizing inequalities in labour market opportunities, income, educational attainment, and intra- and intergenerational fairness. To the extent that welfare regimes across Europe continue to be based on the demographic, family, and labour market patterns of the post-war and neo-liberal eras, they will become increasingly unstable. Demographic ageing puts a growing premium on maximizing fertility. However, parenthood has become more difficult to reconcile with other objectives. If, as in most countries, citizens cannot form the families to which they aspire, this is a truly problematic welfare deficit. Today, the lack of affordable childcare and rigidities in labour markets that are still based on a traditional male breadwinner paradigm, are the major obstacles to fertility. Policy provisions count as social investments to the extent that they help responsible adults to lead longer, freer, more fruitful and more productive working and family lives. At the heart of the new paradigm, lies a normative reorientation away from freedom from want towards freedom to act. Achieving high levels of employment for both men and women is the key policy objective, yet this is understood to require a combination of flexibility and security, the accommodation of both work and family life and a guaranteed social minimum. Social policy contributes to the creation of a more dynamic and heterogeneous society by focusing on endowing citizens with capabilities early in their life course through active policies, rather than relying on expansive reactive policies later in life.

Politically, the social investment turn was strongly supported by European social democrats like Tony Blair, Gerhard Schröder, Wim Kok, and Poul Nyrup Rasmussen, who strongly believed that most European welfare states had to be transformed from passive benefits systems into activating, capacity building, social investment states. These ideas were later popularized by the “Third Way” social theorist Anthony

Giddens (1998). Through the articulation of ‘social policy as a productive factor’, the EU has become a prominent social policy agenda-setter, catalyst and facilitator. In addition, in recent decades the EU has become a valuable ‘selective amplifier’ (to use Jelle Visser’s term) of domestic welfare reform, positively contributing to a more future-oriented discussion of how to coordinate social and employment policies across the EU. The notion of social policy as a productive factor has gradually been incorporated into a broader economic and social strategy – the Lisbon Agenda of 2000 – which can be seen as a social investment strategy that promotes competitiveness and growth alongside employment rates and quality of jobs. Through the Lisbon Agenda, and particularly the European Employment Strategy, Europe has indirectly become a very effective agent of reform.

## **6. The economics of social investment**

The new social investment paradigm is not founded on a unified body of economic thought in the same way that the post-war era was built on Keynesianism, or neoclassical economic theory was at the heart of neo-liberal retrenchment. There is an inherent ambiguity in the economics of social investment, despite the overall consistency in public policy analysis and practice.

However, there are some unifying concepts. There is a clear orientation towards the future, with investments today generating common dividends in the mid- to long-term. Central to the notion of social investment is that the economic sustainability of the welfare state hinges on the number and productivity of future taxpayers. Yet the economics underlying the social investment paradigm continues to share a focus on the supply-side of the economy with the doctrines of neo-liberalism, albeit on the basis of a more positive theory of the state. In contrast to neo-liberal theory, government is perceived as playing an important role in ensuring adequate social services (for example, child care, family services and education) and income transfers to make up for the fact that not all labour market incomes are sufficient to meet family needs. The fact that many basic needs remain unmet is understood to be the result of market failure, as citizens often lack the requisite information and capabilities to make enlightened choices (Barr, 1998). This is especially true in the area of family services and education, which, from a social investment perspective, will be chronically underprovided by the market. To the extent that low levels of education in less well-off groups depress productivity, underinvestment in education will lead to stunted economic growth and decreased tax revenues.

Recent history reveals how EMU can act as a ‘productive constraint’. Fiscal strain brought on by the Maastricht criteria, and the promise to meet standing social policy commitments, in retrospect seems to have encouraged a political search for new, economically viable, politically feasible, and socially acceptable social and labour market policy reform options. While accepting sound macro policies of low inflation and balanced budgets as the new orthodoxy, many social democratic parties (which returned to power in most European countries from the mid-1990s) have been able to underpin the new growth-oriented macroeconomic policy with a new redistributive bargain, without the fear that an uncontrollable wage and price spiral will undermine the project. From this perspective, EMU pressures seem to have mobilized, on the one hand, a convergent labour market policy response, marked by a shift toward activating social insurance and active labour market policies. On the other hand, in terms process, there has been a return to corporatism in the form of social pacts

between government, employers and trade union organisations regarding social and labour market reform.

Under the slogan 'make work pay', specific attention was given to the removal of obstacles that hinder labour market participation, especially for the low skilled, women, and the elderly. Towards the end of the decade, the experiences of the more successful European countries, like Denmark and the Netherlands, seemed to suggest that there need not be a trade-off between equity and jobs. In terms of the politics of the reform process, to everybody's surprise, the 1980s and 1990s saw a remarkable resurgence of 'social pacts'. As deregulation and radical retrenchment were likely to be met by strong opposition from the political left and the trade union movement, centre-left governments increasingly opted for novel social pacts between the social partners and the state. This began in the Netherlands with the 1982 'Wassenaar' accord. Subsequently, Denmark established more informal norms of wage moderation in 1987. Ireland also embarked on a series of tripartite accords from 1987 onwards. Governments rewarded the willingness of unions to pursue wage restraint by delivering various kinds of side payments ranging from work-time reduction, tax cuts, increased spending for active labour market policy and vocational training. Later, social pacts were reached in Finland (1996), Greece (1997), Italy (1993), Norway (1992), Portugal (1997), and Spain (1996) under the shadow of EMU. In contrast, attempts to negotiate national social pacts failed in Belgium (1993; 1996), France (1996-97) and Germany (1996). Retrospectively, we can see that as the EMU established limiting conditions for monetary and budgetary policy, the hard currency regime encouraged national policy-makers to concentrate on reforming and modernising industrial relations, labour market regulations and social security on the supply side of the labour market. Governments took the lead in persuading unions and employers to engage in social pacts. It would therefore be a mistake to assume that the state withdrew from the management of advanced market economies during the neo-liberal globalisation period and also that the macroeconomic architecture of EMU and the Single Market is hostile to comprehensive welfare states.

This is not to say that a very critical constraint facing effective social investment strategies lies in accounting for practices in public finance, which to date have remained firmly anchored in the neo-liberal doctrine of balanced budgets. All the available evidence suggests that investments in childcare and education will, in the long-run, pay for themselves. Yet existing public finance practices consider any form of social policy spending only as consumption expenditures. This was a fair assumption for the post-war welfare state, as it was exceedingly income-transfer (and especially pension) biased. The need to distinguish social investments from consumption was also limited in the neo-liberal period. However, it becomes an urgent question when spending is directed at proactive policies, such as serving families, building life-long learning opportunities, or activation programs. A new system of public finance is urgently needed that would allow finance ministers to (a) identify real public investments, and (b) examine the joint expenditure trends in markets and governments alike. It is imperative to distinguish investment from consumption expenditures, and then to estimate the real returns. This would be akin to distinguishing between current and capital accounts in welfare state spending, just as private companies do. Besides education and training, there are a number of social policies that are easy to identify as investments in individual productivity and collective wealth creation, such as family services, building life-long learning

opportunities, and activation programs. In addition, all spending on child welfare has a high potential pay-off in terms of financial security and preventing child poverty.

Beyond the importance of adult numeracy and literacy, access to public services, labour market support, family services and minimum income protection, there is an argument to be made for using a different set of indicators of social and economic progress that go beyond the traditional measure of GDP growth. GDP growth may no longer be an adequate proxy for 'doing well'. To address this issue, in early 2008, Nicolas Sarkozy put together a committee of leading economists, chaired by Joseph Stiglitz, Amartya Sen and Jean Paul Fitoussi. Their report, which came out in September 2009, finds that the time is ripe for shifting to from indicators of gross economic production towards measures of people's income, consumption and wealth, with an emphasis on the household level. It also emphasizes the need for sustainability indicators (Stiglitz et al, 2009).

To a certain degree, the 2007-2010 economic crisis was the result of focusing exclusively on economic growth, as measured by average GDP growth and output. According to this yardstick, many western economies were indeed growing considerably over the past decade. European GDP, for example, has risen 20 to 25% since 1995. However, in many countries, median household incomes have risen more slowly during that same period, demonstrating the uneven distribution of growth. One of the lessons of the crisis is therefore to be very cautious in selecting and weighing indicators of the wellbeing of the economy. National income may be a useful indicator for steering economic policy, but when it is turned into a monolithic objective, other telling indicators tend to be overlooked. The OECD has also made considerable attempts to design such new measures by including more socially oriented indicators, such as the output of healthcare services. These efforts may indicate a move towards a more equitable post-crisis world. Neo-liberalism as a doctrine is conceptually unable to approach inequality from an efficiency point of view, despite mounting evidence that inequalities can create potentially large inefficiencies. But Adam Smith already made the economic case against too much inequality in 1776, by arguing that: '(...) what improves the circumstances of the greater part can never be regarded as an inconvenience to the whole. (...) No society can be flourishing and happy, of which the far greater part of the members are poor and miserable' (Smith, 1937: 78-79).

## **7. Conclusion**

The onslaught of the financial and economic crisis since 2007 forces us to rethink post-war welfare state development. The immense fiscal response to the crisis in 2008 and 2009 against deflationary dynamics saw the revival of the economic teachings of John Maynard Keynes. Will this lead to a re-appreciation of the demand stabilizing generous welfare states of the 1950s and 1960s? Or, by contrast, will massive government intervention, pushing fiscal deficits and debt to the highest levels since the Second World War, leave policymakers with little option but to restrict welfare commitments in order sustain economic recovery in the face of the crisis? The failure of the neo-liberal efficient market and rational expectations hypotheses to anticipate the crisis, and the ongoing roll-back of markets, are not necessarily guarantees of welfare state renewal. In the wake of the first crisis of 21<sup>st</sup> century capitalism, another key question will be whether the new social investment paradigm will carry the day,

or revert to marginality. Will the social investment perspective finally come to be supported by a new and distinctive new economic doctrine in the wake of the crisis, or will the new social risk management be sacrificed in the interest of macroeconomic stability? I contend that with a little more policy creativity, we should be able to turn the current tide of inward-looking pessimism about the sustainability of the welfare state into renewed political efforts at forward-looking 'social pragmatism'.