The welfare state in Europe: still worth having?

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Have the negative economic consequences brought about by the financial crisis made European welfare states unaffordable? **Iain Begg** *writes that while there is some validity to criticisms of welfare spending, the welfare state performs a number of core functions that ensure it will continue to be around for the foreseeable future. He also notes that European welfare states have shown a greater capacity for change than is often recognised, with the shift toward a system that gives priority to social investment making a real difference in several countries.*

Many Europeans regard the establishment of the welfare state as one of the major achievements of the 20th Century. Yet, in a time of stagnating economies and increasing strain on public finances, difficult questions are now being asked about whether welfare states have become too big, too resistant to change and, as a result, too much of a drag on the economy. A phrase often repeated by Angela Merkel, the German Chancellor, sums up the difficulty: Europe, she claims, has seven percent of the world's population, twenty-five percent of its GDP yet accounts for as much as fifty percent of the world's social protection spending.

Her message is that this is unsustainable. Welfare states have to be funded by imposing taxes on workers and companies, so that they make production more expensive in countries with generous welfare states. But this financing burden makes those workers more expensive to hire than their counterparts in emerging markets, while the tax on companies can induce them to relocate to jurisdictions with more favourable tax regimes.

Some critics go further by arguing that the underlying reason for the crises affecting so many European countries is that public debt had been pushed upwards by the inexorable demands of the welfare state. The reasoning is that, because politicians fear a backlash from voters if they try to cut welfare provisions, they are reluctant to impose cuts on welfare budgets, and are also scared of raising taxes. Instead, they prefer to borrow ever increasing amounts, leading to a steady increase in debt levels. When an economy is growing, this does not matter because a strong economy means there is less demand for a number of welfare payments (such as unemployment benefit) and tax revenues are buoyant. Moreover, as long as GDP increases, the economy can 'carry' a higher debt level.

However, when there is a downturn, especially one as severe as that which hit several European countries in recent years, governments have to meet existing obligations and face new demands on the welfare system arising directly from the crisis. Certainly, in countries like Greece and Portugal, the increase in social distress is highly visible, but even in countries facing less severe problems – Germany and the UK included – there has been a worsening of social conditions. This leads directly to a budgetary crisis. The dilemma that governments then face is how to achieve significant reform of the welfare state at precisely the time when more people need its help.

Is the welfare state still worth having?

While there is some validity to these criticisms of European welfare states, they are also simply too crude to tell the whole story. Welfare states in Europe fulfil three distinct functions and it is crucial to understand the balance between these functions in assessing their sustainability and effectiveness in dealing with social risks. The first function is to offer an institutionalised means of savings for the population as a whole. Europeans have become accustomed to the idea that they should be net contributors to the welfare system during their working lifetimes, but then draw from the system in old-age through public pensions.

Second, the welfare system redistributes economic resources in various ways. An example would be tax systems which take less (and sometimes even give money back – an issue that has been central to the UK renegotiation with the EU) from poorer people and more from richer people. This redistributive function has been described as 'Robin

Hood' after the famous historical character who took from the rich and gave to the poor. A related effect is achieved by public services which facilitate the sharing of risk between vulnerable people and secure people, a good example being universal health care. If you are sick, no matter what your income is, you may face risks that you could not afford to cover on your own.

These first two functions have in common that the welfare state is only one of several ways of dealing with the same challenges. The risk may fall purely on the individual or, in some countries, the risk sharing and the savings may be internalised within families. This can work effectively if families remain physically close to each other and can spare resources to look after older or infirm family members. But in today's world in which labour mobility is increasingly important, it is common for families to be much more dispersed. They may still be able to share incomes, but directly offering care is much less practical.

Homeless in London. Credits: Victoria Johnson / Flickr (CC BY 2.0)

It is the third function which is often least appreciated by critics of European welfare states, namely investing in the capacities of both individual people and society as a whole. Basic education is a long-standing role of the state, but in many European countries, welfare states are now allocating a growing share of their budgets to various forms of social investment that go well beyond educating children. An important motivation behind policies such as enhanced child-care or increased opportunities for retraining or further education for adults is to ensure that the supply of labour is increased.

The social investment function of the welfare state helps to explain the apparent paradox that some of the countries in Europe which spend the most (as a proportion of gross domestic product) on welfare are also frequently placed highest in international league tables of competitiveness, such as those produced by the World Economic Forum. By investing in the workforce, countries like Sweden and Denmark are able to boost the human capital of their populations. As a result, the cost of welfare policies does not undermine competitiveness as much as might be expected, because it is offset by higher productivity and employability of workers. In this sense, the welfare state is a productive factor rather than something which damages the economy.

Nevertheless, the balance matters. Some countries, especially in southern Europe, created generous pension systems and then found that they were becoming unaffordable. As the number of pensioners rose relative to the size of the working age population, it became increasingly difficult to fund the agreed payments. It is a problem that will strike all countries subject to rapid ageing, including China where the long-term consequences of the one-child policy will have a dramatic effect on the balance between young and old.

The solutions to this problem are analytically quite straightforward: raise the pension age, reduce the generosity of payments or find alternative sources of revenue, for example by raising taxes or using the returns from a sovereign wealth fund invested abroad. However, the experience of many European countries has also shown that making change is politically very tricky. Pensioners are more likely to vote in elections and, not surprisingly, they will tend to support political parties that offer them better terms. As the proportion of pensioners in the population grows, so too does their political influence and this is where the reluctance of governments to make unpopular decisions can have damaging effects on public finances. Many European governments have reason to fear the power of the 'grey' voter.

On an optimistic note, European welfare states have shown a greater capacity for change than is sometimes realised. The debt problem is real, but across the continent, the shift towards a system that gives priority to social investment is making a real difference. In spite of everything, and Chancellor Merkel's concerns, they will be around for the foreseeable future.

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Note: This article originally appeared at the People's Daily. It gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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