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Towards a European Union of Social Investment Welfare States

Looking back on the long decade of the Great Recession and the COVID-19 health shock, it is undeniable that far from crowding out scarce resources, well-funded and active welfare states are a *sine qua non* to the resilience of liberal democracies, knowledge economies and ageing societies. Since the Russian invasion of Ukraine, the EU is confronted with a cost-of-living crisis that places a heavy burden on low-income households. There is much uncertainty, about the pace of climate change, breakthroughs in artificial intelligence and their impact on jobs, and geopolitical strife between the US and China. Yet throughout, it is imperative not to forget about the “known knowns” of adverse demography and increasingly tight labour markets. These predicaments call for generous welfare provisions that both protect income and foster employment. Drawing on four chronologically ordered lessons from the recent past, I warn against juxtaposing here-and-now social protection versus future-oriented social investment. The former reinforces the latter, and vice versa. I conclude by making a modest proposal for the EU polity to upgrade the carrying capacity of an effective welfare state in turbulent times.

Lessons from the recent past

Lesson one: Inclusive buffers are indispensable

In times of turbulence and transformation, policymakers and academics are often confronted with the uncomfortable truth that past theories no longer pertain. This is not to be taken lightly, because the hardest part of any learning process is the unlearning of old beliefs. In her address to the World Economic Forum in Davos on 24 January

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2013, then German Chancellor Angela Merkel dramatised Europe’s predicament vis-à-vis the Great Recession by reminding everyone that the continent “represents 7% of the world’s population, 25% of the world’s GDP and 50% of the world’s social spending”, implying that in an era of intensified global competition such largesse was unsustainable. As costly bank bailouts drained the public purse, she inferred that fiscal consolidation had to gain primacy in tackling the aftershocks of the global financial crisis, requiring across-the-board cuts in welfare benefits and social services.

Merkel’s critique was nothing new. The economic and monetary union (EMU) fiscal rules restricting public deficit below 3%, and debt below 60% of GDP, were enshrined in the Stability and Growth Pact and underwritten in the no-bailout clause (European Union, 1992). The thinking behind the fiscal limits on public spending was premised on the idea that they were key to keeping “wasteful” welfare states in check. Since the stagflation crisis of the 1970s and 1980s, generous welfare provision was believed to crowd out private initiative and to set the scene for stagnant growth, high levels of unemployment and permanent wage inflation (Blanchard and Summers, 1987).

Looking back on the long decade since the global financial crisis, it is undeniable that many of Europe’s most generous and inclusive welfare states are also among the most competitive economies in the world, including Germany, which under Merkel, preserved social spending while ratcheting up social services for working families with children (Hemerijck and Huguenot-Noel, 2022). What made the Great Recession a “recession”, and not a “depression” as in the 1930s, was that it was not allowed to persist. Policymakers swiftly launched counter-cyclical monetary and fiscal policies. Compared to the United States, European policymakers were slow to recognise the severity of the credit crunch (Tooze, 2018). On the other hand, many EU member states presided over far more generous automatic stabilisers in the form of unemployment insurance and minimum income protection transfers, absorbing close to 50% of the unemployment shock, compared to the United States, where figure was just over 30% (Hemerijck and Matsaganis, 2023). In hindsight, Europe’s comprehensive and expensive welfare states, including Finland, France, the Netherlands and Sweden, buffered the Great Recession (and the eurozone crisis) the best. For these countries, income-support mechanisms

Figure 1
Social protection spending vs poverty and competitiveness



Source: Own calculations based on Eurostat and World Bank.

created for demand-deficient recessions with high unemployment really did kick in: as earnings fell, social benefits were there to mitigate poverty and cushion the macroeconomy. On the other hand, the countries hardest hit by the Great Recession (Greece, Ireland, Italy, Portugal and Spain) retrenched social spending pro-cyclically – more in health and education than in pensions – as the economy contracted and unemployment grew (Plavgo and Hemerijck, 2021). These member states were also more constrained by the fiscal rulebook of the “incomplete” single market and currency union, to which I return below.

Overall, my first lesson is that comprehensive and inclusive social safety nets proved their worth, precisely as John Maynard Keynes (1936) and William Beveridge (1944) had anticipated in the 1930s and 1940s. As Figure 1 indicates, high spending on unemployment insurance and social assistance in 2007–2012 was strongly correlated not only with lower levels of poverty (which is unsurprising), but also with higher levels of competitiveness (which to some might seem counterintuitive).

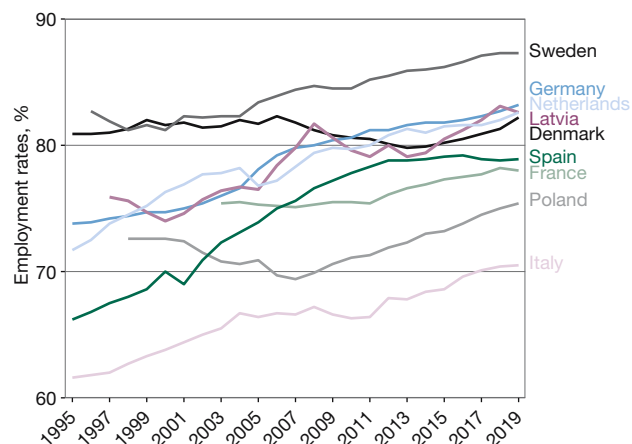
These observations beg the question why Merkel, like the original architects of the EMU, failed to see the relevance of income buffers and automatic stabilisation. My hunch is that, since the 1980s, policymakers, but also many academics, had bought into the narrative of fail-safe economic internationalisation and European integration, at the expense of seriously examining looming policy vulnerabilities and institutional weaknesses in EU market making. With the passing of time, the important lessons of the 1930s

Great Depression were unlearned and/or forgotten, and the welfare state came to be narrowly defined in terms of redistributive economics and politics. This intellectual turnaround began in 1975 with Arthur Okun’s idea of a “big trade-off” between equity and efficiency, arguing that the pursuit of lower inequality could only be achieved at the expense of lower economic performance. Political scientists, on the whole agnostic on the equity-efficiency trade-off, have, since the 1990s, come to rely on assumptions of zero-sum welfare politics under fiscal conditions of “permanent austerity” (Pierson, 2001). Strikingly, this emphasis on distributive economics and politics differs significantly from the productive and problem-solving understanding of welfare provision held by the post-war social engineers and political thinkers. For Beveridge and Keynes, the modern welfare state held out a promise of full employment (admittedly only for men), comprehensive social safety nets, and universal access to good quality health care and educational opportunities. Over the past decade, in a return to that older way of thinking about the welfare state, the latter function of “capacitation” through social investment, promising advances in both social cohesion and economic dynamism, has gained greater prominence in Europe’s knowledge economies and ageing societies.

Lesson two: Social investment is key

The evidence shows that what really matters is not the *level* of social spending but its *composition* and *efficacy*. This is where I would like to raise a second cheer in support of social investment. Beyond shock absorption in a

Figure 2
Full-time equivalent employment rates, 1995-2019



Source: OECD.

crisis, when it comes to bouncing back, the active welfare states of northern Europe did much better in terms of lower unemployment and higher employment than their more passive and fragmented southern counterparts. Not suffering from an austerity panic attack, it was the countries like Denmark and the Netherlands, with their strong dual-earner family services, that were able to reinforce high levels of employment in hard times, as shown in Figure 2.

In the new millennium, the notion of “social investment” gained purchase as a policy compass for welfare state recalibration. Today, international organisations, from the European Union and the Organisation for Economic Co-operation and Development (OECD) to the World Bank, associate social investment reform with strategies of “inclusive and sustainable growth” (European Commission, 2013; OECD, 2015, 2018). The objective of social investment-oriented policies is to enhance individuals’ opportunities and capabilities to address *ex ante* social risks typical of post-industrial economies, while ensuring the high levels of (quality) employment necessary to sustain the “carrying capacity” of the welfare state. Early childhood education and care, vocational training over the life course, active labour market policies, work-life balance policies such as (paid) parental leave and long-term care – all these policies embrace and transcend the compensatory logic of post-war social security. For a better understanding of the social investment logic, we need to adopt a life-course perspective. Across the life course, there are moments of transition that can potentially cause (cumulative) disadvantage. In an attempt to overcome the

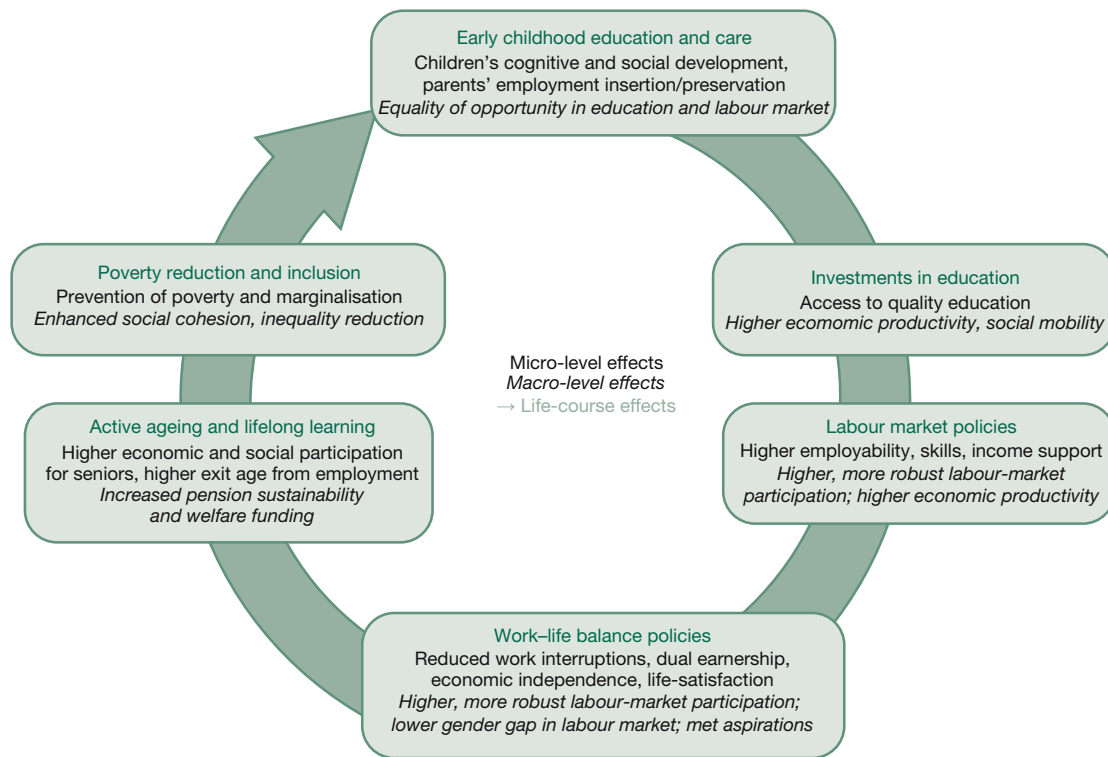
unwarranted opposition between passive, *ex post* compensatory social policies and active, *ex ante* capacitating social policies, I have developed a conception of the welfare state comprising three key functions: first, fostering lifelong development of human capital “stock”; second, easing the “flow” of family life course and labour market transitions; and third, sustaining inclusive social protection “buffers”. Based on the available evidence, it is possible to postulate a life-course multiplier mechanism, whereby social investment returns reaped over the life course generate a positive cycle of well-being returns, in terms of employment opportunities and gender equality, with positive results for intra- and intergenerational poverty mitigation (see Figure 3) (Hemerijck et al., 2023).

The social investment multiplier features prominently in the recent report by the High-Level Group on the future of social protection and the welfare state, of which I was a member (European Commission, 2023). At the micro level of individuals and households, this multiplier suggests how social investments, from early childhood on, improve material household well-being (employment and income) and help mitigate social risks later in life through opportunities for skills acquisition and the easing of (gendered) labour-market transitions. At the macro level, the multiplier suggests cumulative societal benefits, ranging from improved productivity, higher employment and reduced gender gaps to lower poverty, longer careers and later retirement, all of which are crucial to economic growth and the fiscal sustainability of the welfare state in knowledge economies and ageing societies. The fundamental lesson is that social investment welfare provision potentially contributes to achieving a “double dividend” of greater and more gender-balanced employment and productivity gains, able to sustain fair and adequate social protection. This indeed is worthy of a second cheer for the active welfare state. Good quality and affordable childcare make it attractive for young couples to have children, while active labour market policies, lifelong learning and public health policies enable workers to pursue longer careers.

Lesson three: A mature currency union to break the spell of unemployment

Despite the growing evidence on the efficacy of social investment, up to the mid-2010s fiscal austerity carried the day. The eurozone debt and currency crisis laid bare the shortcomings of the architecture of the internal market and monetary union: without a lender of last resort and/or fiscal facility, it proved difficult to keep the eurozone together (De Grauwe, 2011). The Great Recession interrupted the convergence among eurozone countries – both nominal (interest, inflation and exchange rates) and real (per capita GDP growth and unemployment) – and

Figure 3

The social investment life-course multiplier at a micro and macro level

Source: Hemerijck et al., (2023).

hindered the steady catch-up in employment, wages and economic performance of the new member states in Central and Eastern Europe.

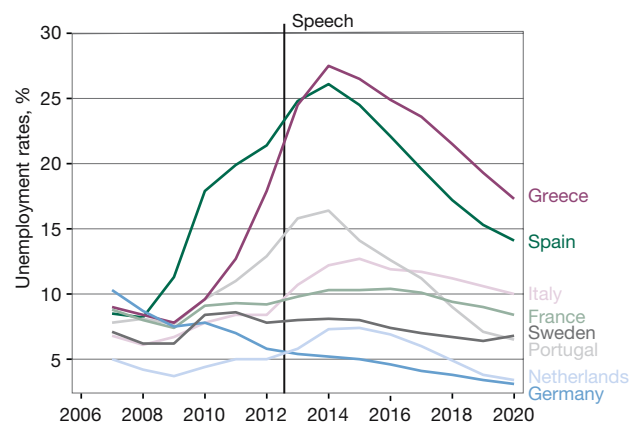
The original theory of the currency union assumed that the European Central Bank's mandate for price stability, together with fiscal discipline enforced by the Stability and Growth Pact, would raise pressures on the member states for structural reform. After the Mediterranean countries had secured entry into the EMU, however, the incentive to reform waned as public borrowing became excessively cheap. Paradoxically, the euro acted as a reform tranquiliser reducing, rather than reinforcing, pressures to balance the books and make welfare provision more inclusive and capacitating. Moreover, the Brussels-Frankfurt obsession with *public* budgetary discipline caused eurozone policymakers in Ireland and Spain (and the Netherlands) to ignore the destabilising effects of accumulating *private* sector debt (Hemerijck, 2013).

By the summer of 2012, as contagion spread from Greece to the already weakened southern periphery of the eurozone, Mario Draghi, then President of the ECB, broke the spell with his "whatever it takes" vow to fight rising spreads and deflation. Nevertheless, the introduction of

quantitative easing could not fully compensate for fiscal austerity. By the spring of 2018, Draghi admitted that the monetary union remained incomplete (Draghi, 2018). He felt that the eurozone needed an additional fiscal instrument to maintain macroeconomic stability during large shocks, without overburdening monetary policy. Draghi conceded that such a fiscal layer for macro-stabilisation would be difficult to design consistent with the Treaty, but eventually an instrument of budgetary solidarity would have to play its part in delivering financial stability and economic convergence across the eurozone.

Draghi's pledge to do whatever it takes to save the euro resulted in a more benign and stable macroeconomic environment, and a fall in unemployment, as observed in Figure 4. This allowed EMU member states to expand the policy space to more capacity-building and solidaristic reforms. In the troubled economies of Greece and Italy, national minimum income schemes were introduced for the first time ever. Germany, and to some extent France and the Netherlands as well, stepped up efforts to integrate hitherto excluded vulnerable groups within their social protection systems (Hemerijck and Plavgo, 2021). In addition, family services were extended in many more countries.

Figure 4
Unemployment in the wake of Mario Draghi's
“whatever it takes” speech



Source: Eurostat.

Lesson four: EU fiscal solidarity to broker social investment reform

By the second half of the 2010s, it became obvious that the original austerity reflex was both economically flawed and politically untenable. László Andor, the Social Affairs Commissioner in the second Barroso Commission, was the first to reopen the window for a European Union social investment strategy as a promising, evidence-based, corrective path (European Commission, 2023). However, mere lip service to social investment, in combination with fiscal rectitude, proved to be an incoherent mix. Social investment reform remained a privilege only for countries with deep fiscal pockets. Barring social investments where they were needed the most, moreover, did little to counter economic divergence within the eurozone.

There were silver linings too. The weakening of the expansionary austerity paradigm gave new impetus to “social Europe”. Raising the stakes for a triple-A-rated social Europe, the Juncker Commission launched the European Pillar of Social Rights in 2017, setting out 20 key principles that struck a fine balance of protective and social investment policies for well-functioning labour markets and welfare systems (European Commission, 2017).

Then COVID-19 broke out. The early days of the pandemic brought back haunting memories from the eurozone crisis and the migration crisis of the early to mid-2010s, when solidarity among member states was in high demand but short supply. While in hindsight the welfare state was the unsung hero of the Great Recession, the pandemic ushered in the unthinkable: a truly assertive reappraisal of the European welfare state for the twenty-first century. My

first lesson resurfaced with zest. Inclusive welfare states providing broad and well-organised access to sickness and unemployment benefits and to short-time working arrangements for all their citizens – regardless of their employment contract or status, the type of job they do or the sector in which they work – swiftly bounced back into good health (Hemerijck and Matsaganis, 2023).

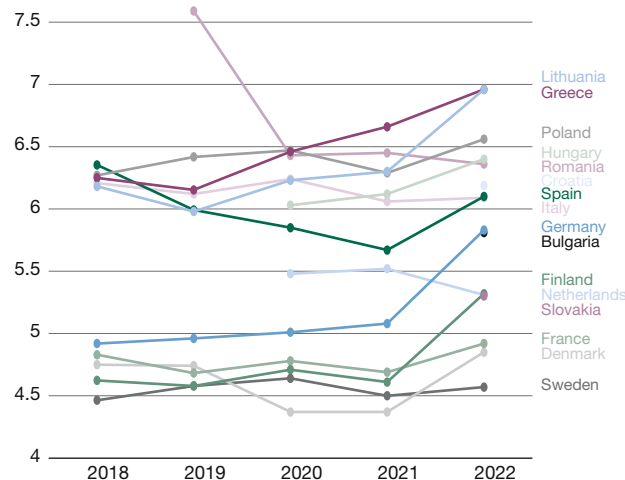
Also at the EU level, the COVID-19 policy response was truly assertive and well coordinated. In March 2020, the Commission activated the “general escape clause” of the Stability and Growth Pact to allow member states to depart from medium-term budgetary objectives. In April, a new quasi-automatic fiscal stabiliser (Support to mitigate Unemployment Risks in an Emergency – SURE) was created to support member states with short-term work schemes. Finally, in July 2020 the European Council reached agreement on the NextGenerationEU, including a Recovery and Resilience Facility, to mitigate the socio-economic consequences of the COVID-19 health shock. This €800 billion facility marked an unprecedented leap in EU fiscal solidarity, paving the way for a more inclusive, investment-led recovery from the pandemic. This paid off. Employment rose and unemployment quickly fell below pre-pandemic levels. In particular, Mediterranean eurozone economies grew admirably, with debt coming down much faster than across the Great Recession, precisely because of favourable growth dynamics.

Compared to the euro crisis, an important political difference was that the nature of the pandemic could not be framed in terms of sinful debtors and virtuous creditors. It is my contention, however, that the effectiveness of the policy response to the pandemic cannot be understood simply in terms of a symmetric health shock being unlike the asymmetric debt crisis. My argument is that, in effect, the hard lessons learned from the long decade of the Great Recession critically informed the rapid, assertive and progressive response to the COVID-19 crisis. From this perspective, while the pandemic was the existential tipping point, the experiential game changer was rooted in the macroeconomic, social and political aftershocks unleashed by the Great Recession.

Early childhood social investment now

Two cheers for the welfare state, praise for the ECB's courage to engage in heterodox monetary policy, and a final compliment for the European Commission and the member states for mustering EU fiscal solidarity at long last. Besieged by two major shocks – the Great Recession and the pandemic – it is safe to say that adversity has strengthened the policy salience of the European social investment welfare state. Ultimately, EU fiscal solidarity,

Figure 5
Average support for solidarity (0-10), 2018-2022



Source: Hemerijck et al., (2022).

leveraged by SURE and NextGenerationEU, underpinned by the normative principles of the European Pillar of Social Rights, brought into being a “holding environment” where active welfare states can flourish (Hemerijck, 2019). This is a far cry from the erstwhile “disciplining environment” to keep “wasteful” welfare states in check, anchored in the Maastricht Treaty of 1991 (Hemerijck, 2013).

As always, in politics and public policy many issues remain unresolved. Faced with high deficits and debt levels, inflation and rising interest rates, governments will have to increase taxes to foot the bill for health care and social security expansion, against the background of Russia’s invasion of Ukraine, related inflationary pressures and higher defence spending. Most of the new EU instruments are temporary: the general escape clause of the Stability and Growth Pact will be in place until the end of this year, the SURE sunset clause has already been reached, while the Recovery and Resilience Facility experiment will run until 2026. But even as temporary instruments, I consider them part and parcel of the EU’s new policy toolbox, as they can easily be reactivated in future emergencies.

The most important lesson is that the cognitive mind-sets and political orientations have been transformed in a manner that makes it difficult to turn back the clock. In addition, this reorientation gathered momentum not only among policy elites but also across European publics, as evidenced by the EUI-YouGov survey that we have been running now for six years (Hemerijck et al., 2021). When my colleague Philipp Genschel and I started our survey with YouGov in 2018, there was a strong cleavage be-

tween northern and southern member states. In the wake of Brexit, the pandemic and the war in Ukraine, EU solidarity and trust in EU institutions has progressively grown stronger and the North-South divide has subsided. Figure 5 indicates that European citizens have over the years come to appreciate a more assertive and political crisis management style on the part of EU institutions.

Overall, there is room for optimism. There is a common understanding now that it is better to *improve* rather than *retrench* welfare systems and that durable economic growth is a crucial ingredient for debt sustainability. Twenty-first-century evidence shows that generous, inclusive and capacitating welfare policies are fully compatible with economic growth, high employment and fiscal balance over the economic cycle (Hemerijck and Matsaganis, 2023). This positive re-appreciation of social policy as a formidable “productive factor”, I believe, should take pride of place in the debate on the future of EU fiscal and monetary governance. In essence, there is a need to agree on a stable and equitable inter-generational welfare contract that assures the well-being of the elderly in ageing societies *without* crowding out productive resources for the young to prosper in the dynamic knowledge economy.

If the main success of mid-twentieth-century welfare provision was to guarantee economic security in old age, the overriding objective of twenty-first-century welfare provision is to foster strong life chances for the young. According to Eurostat, in 2021, 19.5% of children were at risk of poverty, compared with 19% of the working-age population, while 16.5% of 20- to 34-year-olds were not in employment, education or training. Former EU Commissioner and former Italy’s Prime Minister Mario Monti has allegedly called the European Union “the trade union of the next generation”, which he meant as a compliment. Well, on that score, the EU is not doing a great job.

The political conundrum is that discretionary spending on social investments is often sacrificed on the altar of popular transfers for adults and pensioners. Political cynics maintain that as the returns on social investment only materialise in the long run, they inevitably clash with short-sighted electoral competition. Nonetheless, unless we invest in high-quality and affordable education and care, governments will soon need to tax shrinking labour forces to fund ailing pension and health care systems. At some point, young dual-earner couples will, against their wishes, effectively give up starting a family – as is already happening in southern Europe and Poland.

Essentially, there is a need for a special EU financing vehicle for public investment with a triple-A rating, and

strong positive effects on long-term growth and debt sustainability. If there ever was merit in having a “golden rule” in EU fiscal governance, early childhood investment is a no-brainer: it is cheap, it immediately creates jobs, it directly reaches out to young families, and it is where the social investment multiplier is highest – 13% per year, on Nobel Prize winner James Heckman’s estimation (The Heckman Equation, 2016). It is crucial that early childhood investment should not compete with current expenditures, and this should be anchored in EU fiscal governance, on the logic of funding tied to fundamental reforms. An EU early childhood social investment facility should also not be seen as a pro-natalist proposition, but in terms of the normative objective for citizens to pursue fuller and more satisfying lives, which includes facilitating genuine fertility aspirations, in line with the European Pillar of Social Rights. European University Institute research reveals higher levels of subjective well-being in countries with good quality and affordable early childhood education and care (Lehmus-Sun, 2023).

In conclusion, the notion that the EU can advance as a project of market integration and fiscal austerity has now been abandoned. In his 1599 play *As You Like It*, William Shakespeare came up with the marvellous line “Sweet are the uses of adversity”. Over the past 15 years, European welfare states have had more than their fair share of adversity. As a result, we are wiser now. Hopefully, we will no longer hear the false claim that the welfare state is a luxury we cannot afford in hard times. Inclusive and active welfare states make European societies less unequal, their economies more dynamic, and their democracies stronger. This is no time for complacency: on early childhood social investment, European policymakers must act now!

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