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How to deal with inequality: Welfare system challenges and European responses

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Kiel Policy Brief

How to Deal with Inequality
Welfare System Challenges and European Responses

Andreas Friedl, Dennis Görlich, Sebastian Horn,
Christiane Krieger-Boden, Matthias Lücke

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How to Deal with Inequality

Welfare System Challenges and European Responses

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1 Introduction

In many countries across the world, there is concern about persistent poverty, an increasingly unequal income distribution, and an eroding commitment to equity and fairness among citizens. Against this background, Dadush and Dervis (2013) call the maintenance of social cohesion a key policy challenge of the 21st century. Absolute poverty, although it still affects approximately one out of seven world citizens, has declined during the last three decades. Income inequality, however, is on the rise in many countries, fuelling social and political instability. The financial and economic crisis in Europe and North America during the late 2000s has profoundly changed the context in which inequality occurs: median incomes are stagnating, the share of income earned by the richest 1 % is increasing, unemployment rates are at record highs, and government resources are severely strained by austerity measures. Under these circumstances, limiting the increase in inequality becomes even more important.

Welfare systems in Europe are now facing several simultaneous, though not necessarily related challenges. First, growing inequality in market incomes, such as through technological progress and globalization, puts upward pressure on inequality in household disposable incomes. Second, because of the Great Recession since 2008, welfare systems in Europe have to provide for a growing number of unemployed individuals while facing funding constraints due to tight fiscal policies. Third, there are concerns that demographic change may increase the dependency ratio (the ratio of transfer recipients to contributors) to unsustainable levels and that the design of some national welfare systems may inappropriately reduce incentives to work.

In this paper, we seek to identify innovative ways to limit inequality in households' disposable incomes and living standards while keeping welfare systems fiscally sustainable. We focus on the welfare systems of EU countries in comparison, to better understand their key features. To set the scene, we review trends in income inequality in Europe in relation to other major world regions. We compare inequality before and after taxes and transfers across European countries to gain insights into the extent of redistribution and, hence, the impact of the national welfare systems (Section 2).

Next we review the experience of five European countries that have been identified as examples of distinct welfare system models. We characterize national welfare systems in terms of the extent to which they decommodify labour, emphasize or relax stratification, and engage in social investment rather than income replacement during spells of unemployment (Section 3). We go on to assess the performance of our selected countries in terms of income redistribution, economic growth, polarization between rich and poor, and labour market developments (Section 4). We complement the picture by looking closely at evidence from surveys and economic experiments to assess inequality aversion in our selected countries and relate our findings to the extent of redistribution and other features of the national welfare systems (Section 5). We look for recent challenges for and responses by the welfare systems and reflect on adjustment requirements that lie ahead (Section 6). The final section concludes (Section 7).

Our findings may be summarized briefly:

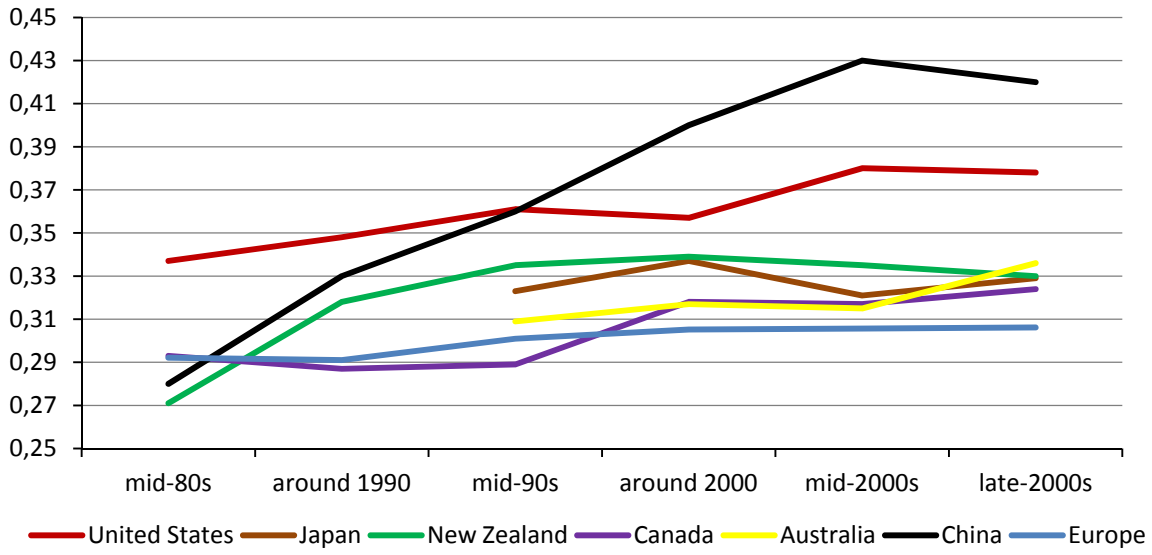
- Compared with other world regions, inequality in disposable income in Europe is relatively low and has not increased sharply during the last two decades.
- Welfare systems in Europe may be distinguished based on (1) the extent to which they decommodify labour; (2) whether they emphasize or relax stratification; and (3) the extent to which they emphasize social investment rather than income replacement during unemployment spells.
- When putting together the characteristics of welfare systems and the economic performance of each country during the last quarter century, Sweden with its Nordic-type welfare system has done particularly well. Economic growth was robust, polarization between the rich and the poor remained limited, and high employment rates - overall and for women in particular - sustained the tax base and ensured that government expenditures, including welfare payments and social investment, remained fiscally sustainable.
- The UK also experienced relatively rapid GDP growth, but suffered from growing polarization between the rich and the poor. At the same time, both survey and experimental evidence suggest that the UK citizen's aversion to inequality is lower than elsewhere in Europe.
- Germany, France, and Italy experienced only modest GDP growth. Italy's welfare system which privileges insiders over outsiders has resulted in polarization, low employment rates, and an unsustainable fiscal situation. France managed to avoid growing polarization, but suffers from high unemployment and growing doubts about the sustainability of the fiscal situation. Germany's labour market reforms during the early 2000s resulted in favourable labour market indicators with low unemployment and high total and female employment. However, incomes have become more polarized and total GDP as well as most workers' incomes have grown only slowly.
- We find little correlation between national attitudes towards inequality and the actual extent of redistribution through the national welfare system.
- Real challenges lie ahead of the welfare systems, and they require considerate public debates for efficient rather than sham solutions.

2 Inequality and Redistribution

Compared to other parts of the world, Europe stands out in that household income inequality *after* taxes and transfers (i) is lower than elsewhere and (ii) has not increased much during the last three decades (Figure 1). The population weighted average Gini coefficient for major European countries grew by less than two percentage points and remains below 0.31 during the late 2000s. In China, by contrast, the corresponding Gini coefficient grew from 0.28 in the

mid-1980s to 0.42 in the late 2000s reflecting systemic transformation, rapid economic growth and structural change. In the US, the Gini coefficient increased from 0.34 to 0.38.[1]

Figure 1:
Gini Coefficients after taxes and transfers since mid-1980s

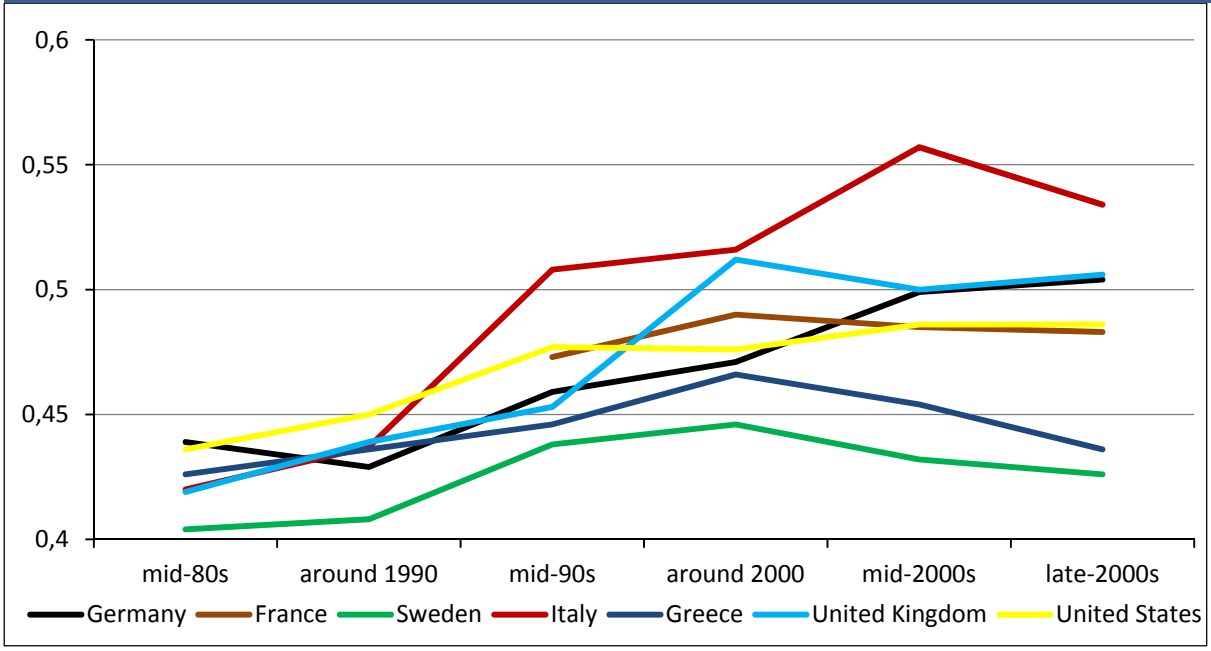


Source: OECD Statistical Database (2013), Worldbank World Development Indicators (2013).

Probably, European welfare systems were responsible in large measure for this favourable performance. In fact, income inequality *before* taxes and transfers in selected European countries increased sharply in Italy, the UK, and Germany, and more modestly in Sweden (Figure 2). "Pre-government" inequality, i.e. the unequal distribution of market incomes before households pay taxes and receive transfers from the government, is mainly the result of households' initial "factor endowments" – the education and skill levels of their working members, their productive and financial wealth, etc. Over time, wages, employment opportunities, and household income from other sources are affected by changes in the global supply and demand for capital and labour as well as a wide range of government policies that affect product or factor markets. Specifically, the observed increase in pre-government inequality in many high-income countries since the 1970s has probably been driven by a combination of two global trends: first, technological progress biased against low-skilled workers and benefitting high-skilled workers along with the owners of capital, and second, the globalization of markets for goods, services, capital, and labour. At the same time, of course, technological progress and globalization have generated large economy-wide benefits through higher output and better living standards.

[1] While several statistical measures of income inequality exist, we rely on the Gini coefficient because it is the most widely used by far.

Figure 2:
Gini Coefficients before taxes and transfers since mid-1980s

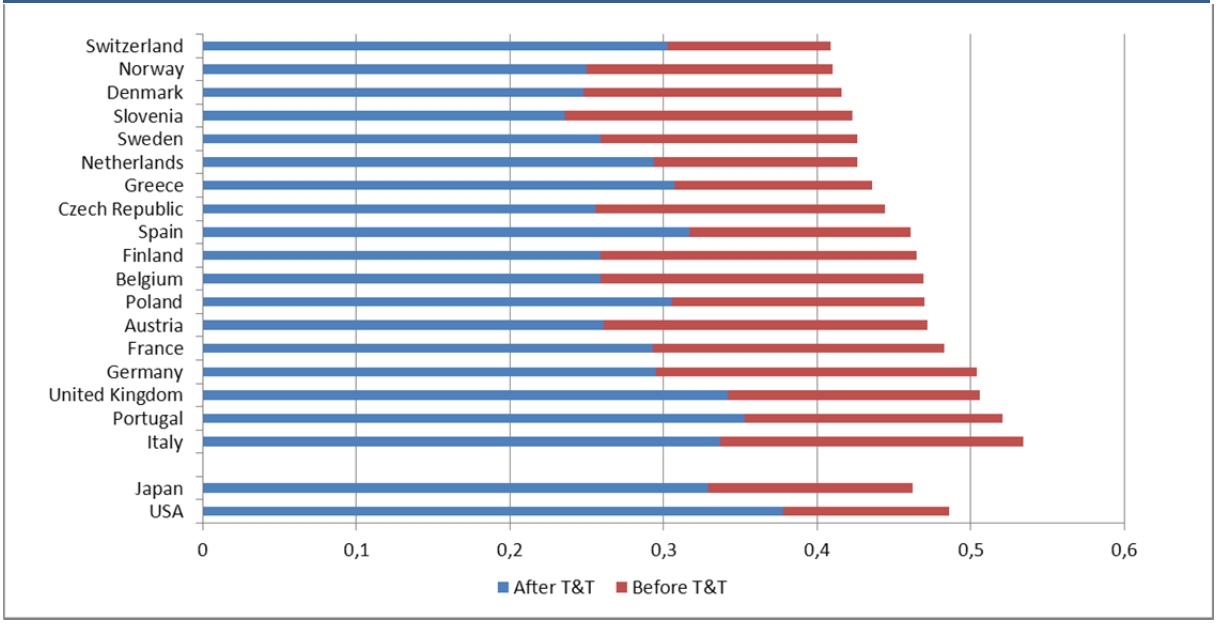


Source: OECD Statistical Database (2013).

But welfare systems in most European countries have apparently dampened the upward pressure from market incomes on inequality in disposable incomes, re-distributing market incomes across households through a combination of progressive taxation, transfers to various categories of individuals, and the provision of free public services. By contrast, the Gini coefficient for US income inequality increased by similar amounts for both, inequality before (Figure 2) and after taxes and transfers (Figure 1). The US welfare system apparently did little to absorb market pressures leading to greater income inequality.

The important role of European welfare systems in limiting income inequality is confirmed by a country-by-country analysis (Figure 3). Gini coefficients before taxes and transfers varied from 0.53 in Italy to 0.41 in Switzerland during the late 2000s, largely reflecting diverse labour market outcomes that in turn are shaped by labour market institutions, working hours and unemployment rates (OECD 2012b). Gini coefficients after taxes and transfers are typically 15 to 20 percentage points lower, reflecting a wide variety of redistributive institutions. Remarkably, the relatively high Gini coefficients *after* taxes and transfers in the US and Japan can largely be attributed to a small impact of the welfare system, rather than to high income inequality *before* taxes and transfers. Figure 3 also demonstrates that, although the Europe experience is distinct from the US overall, there is also considerable heterogeneity across European countries in terms of pre-government inequality as well as the reach of the welfare system as measured by the difference between the Gini coefficients before and after taxes and transfers.

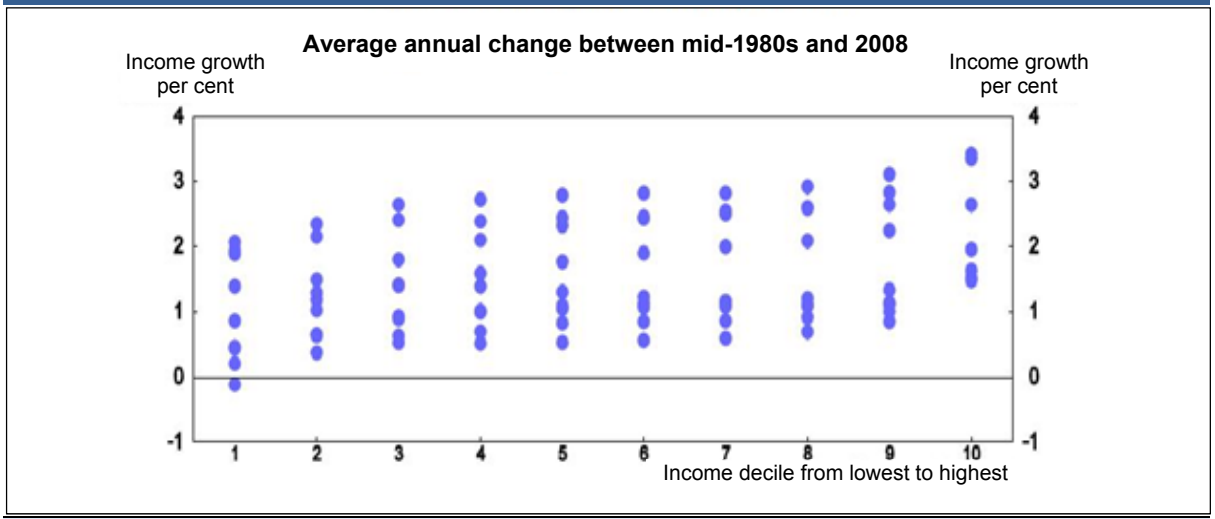
Figure 3:
Gini reduction through taxes and transfers during the late 2000s



Source: OECD Statistical Database.

While the Gini coefficient is a useful comprehensive measure of income inequality, it is not very sensitive to changes in the income shares of small subgroups of the population that may nevertheless be important from a normative point of view (such as the richest 1 % or poorest 10 %). To complement our analysis based on Gini coefficients, we review the evolution of the average income of each income decile in selected European countries (Figure 4).

Figure 4:
Disposable Income Growth by decile



Note: Dots correspond to observations for Denmark, Finland, France, Germany, Italy, Luxembourg, the Netherlands, Sweden and the United Kingdom.

Source: Bonesmo Fredriksen (2012).

Although the overall distribution of disposable income in Europe has only become a little more unequal over time (Figure 1), the disaggregated analysis shows a distinct polarization: The richest 10 % of income recipients (the 10th decile) have seen their average income increase much faster (at between 1.3 and 3.4 % per year) than the poorest 10 % (the first decile), whose income growth ranged from a small decline to just over 2 %. By contrast, income growth patterns were remarkably similar for deciles three to eight (Bonesmo Fredriksen 2012).

The polarization at the extremes of the income distribution entails an increased risk of social exclusion for the poor. Recent research has identified several drivers of growing polarization:

- The lowest decile has been affected particularly by unemployment, which is by far the single greatest risk factor for poverty and one of the main characteristics of the lowest decile (Eurostat 2010).
- But even in those European countries with low unemployment rates such as Germany and the Netherlands, wage moderation and labour market reforms aimed at increasing labour flexibility have led to beneath average income growth for the lowest decile (Bonesmo Fredriksen 2012)
- At the other extreme, above average income growth for the highest decile was mainly driven by the effects of globalization and technological progress that have caused a steady rise in the returns to skilled labour (Goos, Manning and Salomon 2009).
- On a policy level, this trend has been supported by declines in the progressivity of tax rates in some European countries, where reduced top marginal tax rates and the abolishment of wealth taxes have increased the disposable incomes of the rich.

In this section, we have used the difference in Gini coefficients for household income before and after taxes and transfers as a broad measure of the size of national welfare systems (Figure 3). However, real-life welfare systems have a far more complex set of tasks than simply redistributing income to reduce the Gini coefficient. Guaranteeing all citizens a minimum standard of living, preventing social exclusion of those whose incomes systematically lag behind the vast majority of the population (such as households in the first income decile – Figure 4), ensuring access to essential services like health care and basic education to all citizens irrespective of income, and providing insurance against major life risks such as unemployment and disability are all part of the widely recognized responsibilities of modern European welfare states. The extent to which individual countries take on these tasks as well as the broad strategies pursued and policy instruments employed vary widely. This is the context for our discussion, in Section 3 below, of the different types of European welfare systems and the challenges faced by the Continental approach in particular.

3 Types of European Welfare Systems

Although reference is often made to a "European social model", no such uniform European model exists. Even the term "model" is misleading as it suggests completeness of institutions, clear system boundaries between inside and outside, and no needs for adjustments (Hemerijck 2013: 153f). Rather, as has been established by the pioneer work of Esping-Andersen (1990) and resumed by others, there exist at least three to five different types of European welfare systems. A recent characterization by Hemerijck (2013: 155ff) distinguishes four different types, labelled Nordic, Continental, Anglophone and Southern type (Table 1). Cluster analyses by different authors, by and large, sustain this kind of characterization.[2]

The Nordic or social democratic type of welfare system, which is usually said to apply to all Scandinavian countries, is based on collective responsibility and universal social citizenship rights (Kangas and Kvist 2013), pursuing the idea of a citizens' "folkhem". The Continental, conservative or corporatist type, often attributed to Germany, the Benelux countries, Austria and perhaps France, is based - in a Bismarckian tradition - on the principles of status and income maintenance; traditionally, it has supported male-breadwinner nuclear family structures (Hemerijck 2013: 158). The Anglophone or liberal type, represented primarily by the UK and perhaps Ireland, is characterised mainly by its strong reliance on market mechanisms in welfare production and by the limited and residual role it assigns to the state (Hemerijck 2013: 159). The Southern type, usually attributed to Italy, Spain, Portugal and Greece, resembles the Continental type in the important role assigned to welfare production by the family; at the same time, it exhibits distinct institutional features such as strong insider outsider cleavages between regulated and peripheral markets (Ferrera 1996). To these four types one may add the Central and Eastern European transformation countries which display a rather heterogeneous mixture of elements also found in the four other types (Hemerijck 2013: 160). However, as the Central and Eastern European welfare systems are still undergoing far-reaching changes and do not yet represent a distinctive type, we do not consider them here.

In order to explore further the validity of the distinction between the four types of welfare systems and to understand better the specific challenges faced by the Continental European model, we now discuss key characteristics of the national welfare systems of Sweden, France, Germany, the United Kingdom, and Italy. These countries are not only the largest European economies in terms of GDP, but they also represent the four types of welfare states. We structure our discussion along three dimensions that existing research has identified as important:

[2] See, for instance, Kammer, Niehues, Peichl (2012), Obinger and Wagschal (1998). The latter also show all European systems to be closer to each other (and to Australia and New Zealand) than to the systems of Canada, Switzerland, Japan and the United States. Our own attempts, applying various characteristics of welfare systems, yield similar results, although they also reveal a considerable sensitivity of the results to variations of the indicator set.

Table 1:
Characteristics of European welfare systems

	Nordic type	Continental type	Anglophone type	Southern type
Basic philosophy	Active support of all citizens, strong work ethic, based on dual earners' family, collective responsibility	Employment-based support, ambiguous work ethic, based on male-breadwinner family, collective/ family responsibility	Needs-based support of poorest, self-reliance as work ethic, neutral to family, individual responsibility	Insider-based entitlements, weak work ethic, based on extended family, family/ collective responsibility
Objectives	Earnings equality	Status preservation, income maintenance	Equality of opportunities, poverty alleviation	Status preservation and differentiation, income maintenance
Fields				
Tax redistribution	Strongly progressive income tax; high VAT and meritory taxes; moderate tax wedge	Progressive income tax, medium VAT; high tax wedge	Mildly progressive income tax; low VAT; low tax wedge	High VAT, high degree of tax fraud; moderate tax wedge
Social security	High, tax-financed transfers, central role to state	High transfers, social-insurance financed (contingent), separate public social assistance, divided role to social partners + state, family subsidiarity	Meagre tax-financed transfers, means-tested and targeted, residual but monopolistic role to state	Fragmented social-insurance-financed transfers, no safety net, central role to extended family subsidiarity, rudimentary roles to state + church
Labour markets	Moderately regulated by state, active labour market policy, publicly supported flexibility	Strongly regulated by state + social partners, strong job protection, flexibility at the margins of markets	Weakly regulated, labour market deregulation, individualised flexibility	Strongly regulated by state, strong job protection, flexibility at the margins of markets
Family support	Active, by state	Passive but generous by state, family subsidiarity	Neutral	Passive and limited by state, family subsidiarity
Vocational education	Vocational qualification by schools, life-long learning	Dual system, few incentives for re-qualification	On-the-job training, incentives for re-qualification	On-the-job training, few incentives for re-qualification

Source: Hemerijck (2013: 161–162); Hofäcker, Buchholz, Kolb, Blossfeld (2011: 307); summarized, own complements.

- First, we compare the degree of decommodification, i.e. the extent to which a country's welfare state regime protects the labor force from being regarded as a commodity. In regimes with high decommodifcation the individual is less dependent on the market to secure a sufficient income, for instance, when unemployed, old or sick (Esping-Andersen 1990), which are the most significant determinants for poverty (Eurostat 2010). Typically, decommodification is high for the Nordic type, and at minimum for the Anglophone type, the others ranging in-between (Esping-Andersen 1990).

- Second, we look at the degree of stratification, i.e. the degree to which the social layers of a society are actively arranged or re-arranged (Esping-Andersen 1990). Primarily, this is done through redistribution via the tax and transfer systems. Typically, the instruments of the welfare state are inclusive of all citizens for the Nordic type; involve segmentation into different groups and social classes (with privileges for middle class workers, entrepreneurs, civil servants, etc.) for the Continental and Southern type; and lead to social exclusion of the poorest for the Anglophone type where there is a dualism between the stigmatized poor and others left to fend for themselves in a market environment (Heien, Hofäcker 1999:11).
- Finally, we compare the magnitude of social investment to account for transformative changes in many European welfare states since the emergence of the social investment paradigm in the late 1990s (Hemerijck 2013). In fact, social investment had a much longer tradition in the Nordic welfare states, whereas Anglophone and Continental-type systems embarked on it only when the new paradigm emerged; Southern-type welfare systems are still reluctant to utilize it.

3.1 Decommodification

Table 2 shows the latest available data from the Social Citizenship Indicator Programme that measures decommodification by how well the average worker is taken care of in case of old age, unemployment, or sickness. For each situation, Table 2 indicates the coverage (i.e. the share of the work force eligible to receive benefits), the replacement rate (i.e. benefits relative to previous income), and how benefits are funded by the insured individuals themselves, the state, and the employer. For unemployment, we add the OECD Employment Protection Index that measures the "costs and inconveniences" for firms to dismiss employees (OECD 2013), giving us a measure of the extent to which workers are exposed to market forces and the flexibility of labour markets.

The five countries differ widely. Decommodification is most pronounced in Sweden which has coverage rates of 100 % for temporary unemployment, old age, and sickness, along with relatively high replacement rates (as much as 80 % in the case of sickness). This reflects the notion of social protection as a universal citizenship right (Hemerijck 2013: 155). Financing rests mainly with employers, while the state and the individual contribute for old age provision only.

By contrast, decommodification is lowest in the UK: Despite rather high coverage, replacement rates are the lowest in the sample. Financing relies largely on contributions by the individuals themselves. These figures are in line with the traditional Beveridgean or liberal position according to which only minimum income provision is a social right. Furthermore, it should be targeted to those in most dire need, while citizens are otherwise expected to self-reliantly turn to the market for earning a sufficient income (Hemerijck 2013: 156). This general trust in the welfare-maximizing qualities of free markets can also be seen by the low employment protection indicator that signals a highly flexible labour market.

Table 2:
Welfare systems in selected European countries, ca. 2000: decommodification

		Sweden	France	Germany	UK	Italy
Old Age	Coverage in % of population	100%	60%	60%	69%	57%
	Average Pension Replacement Rate	40%	30%	29%	22%	52%
	Financing Share Insured	32%	41%	37%	42%	31%
	Financing Share State	15%	7%	30%	8%	2%
	Financing Share Employer	53%	52%	32%	50%	67%
Unemployment	Coverage in % of labour force	100%	62%	69%	83%	51%
	Replacement Rate	64%	57%	32%	16%	30%
	Financing Share Insured	6%	31%	37%	42%	0%
	Financing Share State	0%	14%	25%	8%	14%
	Financing Share Employer	94%	55%	38%	50%	86%
	Employment Protection Index	1,9	3,1	2,1	0,8	1,9
Sickness	Coverage in % of labour force	100%	82%	73%	90%	62%
	Replacement Rate	80%	50%	63%	19%	50%
	Financing Share Insured	2%	6%	55%	42%	0%
	Financing Share State	0%	0%	1%	8%	0%
	Financing Share Employer	98%	95%	45%	50%	100%

Note: The colour scheme from green to red indicates the ranking of the five countries for each single category from the perspective of the average worker. Green coloured fields represent the country, in which decommodification is highest due to high coverage, high generosity or high financing shares by either the state or the employer.

Source: Social Citizenship Indicator Program (2000), OECD Statistical Database (2012).

Italy represents a yet different case: It combines low coverage with relatively high replacement rates (in particular in the case of old age) and relies heavily on financing through employers. It is thus a fragmented welfare regime where high decommodification for privileged groups, such as public servants, coexists with low decommodification for others. This cleavage can be explained by the existence of insider - outsider relationships between those employed in regulated labour markets and those working in the irregular, peripheral sectors (Ferrera 1996). Against this background, the employment protection indicator of 1.9 should be viewed as an average: While employment protection is very high for some groups, it is almost non-existent for others.

The Continental-type countries of Germany and France take up intermediate positions with fairly high replacement rates and coverage ratios. Instead of providing universal and uniform benefits as in the Nordic type, benefits in Continental welfare states tend to be entitlement based, i.e. their level depends strongly on previous earnings and social security contributions as well as on family status. They are thus fostering the traditional male-breadwinner family structure (Clegg 2013: 163). The high values of the Employment Protection Index, reflecting strong protection from dismissal (especially in France: 3.1), also demonstrate the focus on maintaining the social status of individuals (Palier 2010: 608).

3.2 Stratification

Stratification refers to the active arrangement of social groups, mainly through redistributive taxation and transfers. Taxes influence inequality not only indirectly by financing government expenditure that benefits all citizens; different tax burdens may also be assigned directly to particular socio-economic groups to achieve a certain income distribution (Table 3). A cautionary note, however, is necessary: Institutional features of tax systems differ markedly across states; therefore, comparing tax systems on the basis of highly aggregated indicators may be misleading. For instance, expense deductions to reduce the tax base may create large differences between statutory and effective tax rates; differences in tax incidence may also alter the intended distributional effects (Joumard, Pisu and Bloch 2012).

The level of taxation measured by total tax revenue varies strongly from country to country, with France and Sweden having the highest tax revenue at around 44 % of GDP and Germany and the UK the lowest at around 36 %. The differences not only mirror different expenditure levels, but also the reliance of each state on other financing instruments such as social security contributions and public debt. Taxes play a dominant role in the Scandinavian welfare systems where high marginal income tax rates are used to finance the expenses of the welfare system (Hemerijck 2013). The situation in Central European welfare states is mixed due to high social security contributions that allow for lower overall tax revenue such as in Germany. The opposite is true in the Anglophone countries whose relatively small social security budgets are mainly financed by taxes while social security contributions play only a minor role. No clear result can be obtained for the Southern European type, where overall tax revenue tends to be lower than in Continental states while social security contributions are also fairly high (Kammer, Niehues and Peichl 2012). This similarity is one reason why the Southern type of welfare system has been described as a rudimentary version of the Continental type (Esping-Andersen 1990).

Table 3:
Taxes, social security contributions (SCC), and redistribution, 2012

	Scandinavian Model	Central European Model		Liberal Model	Southern European Model
	Sweden	France	Germany	UK	Italy
Tax Revenue in % of GDP	44.5	44.2	37.1	35.5	42.9
Top statutory income tax rate	56.5	47.8	47.5	40.0	44.9
Threshold for top statutory income tax rate	1.5	2.8	6.2	1.3	3.2
SCC in % of gross wage earnings	7.0	13.7	20.7	9.5	9.5
Tax wedge on average worker in %	42.8	50.2	49.7	32.3	47.6
Progressivity Index of household taxes	0.07	0.08	0.12	0.14	0.15

Notes: The threshold for the top statutory income tax rate is given in multiples of the average income. Social security contributions on gross wage earnings refer to a single individual with no children at the income level of the average worker. The progressivity index of household taxes is the Kakwani index computed as the concentration coefficient for taxes less the concentration coefficient for income after transfers and before taxes. The values are calculated by Joumard, Pisu and Bloch (2012) on the basis of OECD data for the late 2000s.

Source: OECD Statistical Data Base (2012); Joumard, Pisu and Bloch (2012).

Somewhat surprisingly, countries with high tax levels tend to have less progressive household tax designs. For instance, Sweden and France have the highest total tax revenue but the lowest degree of progressivity as measured by the Progressivity Index put forward by Joumard, Pisu and Bloch (2012). Despite the large differences in total tax revenue, the overall redistributive effect of household taxes therefore differs little across countries.

While European welfare systems differ widely in terms of the decommodification achieved (Section 3.1 above), tax policy is apparently not a distinguishing feature of national strategies to limit income inequality. Rather, it reflects differences in social expenditures and in the extent to which these are financed from social security contributions. However, while different financing mixes do not have a large impact on the reduction in income inequality, they do affect labour markets by generating varying tax wedges. Due to high social security contributions, the tax wedge is highest in the Continental and Southern European welfare systems, while Anglophone countries have relatively low tax wedges. Scandinavian countries take an intermediate position due to high marginal tax rates combined with low social security contributions.

3.3 Social Investment Expenditure

Public social investment may be defined as expenditures that promote labour market participation and employment through human capital development. Rather than supplementing low incomes with “decommodification“ cash benefits and replacing labour income during spells of unemployment, social investment aims to empower as many individuals as possible to participate productively in today’s highly specialised and knowledge-based economies (Morel, Palier and Palme 2012). Typical areas for social investments are families, education, and active labour market policies.

Accordingly, the new social investment paradigm that has become prominent since the late 1990s views the welfare state and the economy as mutually re-enforcing factors, rather than focussing on possible trade-offs between equality (to be achieved through income redistribution) and efficiency. Social investment is thought to equally promote social protection and the productive potential of the population (Hemerijck 2013: 133).

OECD data in Table 4 show public spending on families, education, and active labour market policies, plus on provisions for old age. Spending on old age is not part of social investment because senior citizens are no longer part of the labour force. However, it is a large category of social spending that may throw light on countries’ approaches to social spending.

Sweden and France have most strongly embraced the social investment approach to the welfare state, with aggregate expenditures on families, education and active labour market policies of 11.2 % of GDP in Sweden and 10.8 % of GDP in France. France, moreover, spends 12.5 % of GDP on old age provisions, whereas Sweden, with expenditure on old age at 7.2 % of GDP, appears to pursue a more carefully targeted approach to its social spending.

Table 4:
Public Social Investment on selected policy issues in % of GDP, 2012

	Scandinavian Model	Central European Model		Liberal Model	Southern European Model
	Sweden	France	Germany	UK	Italy
Public Spending on Families	3,7	4,0	3,1	4,2	1,6
Public Spending on Education	6,6	5,8	4,5	5,3	4,5
Public Spending on Active Labour Market Policies	0,9	1,0	1,0	0,4	0,5
Public Spending on Old Age	7,2	12,5	10,7	5,4	14,1

Source: OECD Statistical Data Base (2013).

By contrast, Italy invests comparatively little in families, education and active labour market policies, but spends substantially on old age (at 14.1 % of GDP). To a lesser extent, the same pattern is visible in Germany with 10.7 % of GDP in provisions for old age, but only 8.6 % of GDP in families, education and active labour market policies. In the UK, public social spending is on the low side overall; however, a relatively large share is invested in families, education and labour market policies while public provisions for old age are by far the lowest among our selected countries.

3.4 Convergence of European welfare systems?

Welfare systems in Europe are shaped by manifold historical and political forces and are thus exposed to slow but steady change (Flora and Heidenheimer 1981). As welfare systems differ quite substantially across the European Union, we may ask whether they are converging, for example as a result of European economic integration. Furthermore, we may ask whether European welfare systems are now flexible enough to adapt to foreseeable future challenges, such as more intense competition due to globalization, increased life expectancy with declining birth rates and ageing societies, changing gender roles, the shift from an industrial to a service economy, de-standardization of employment relations, etc. (Hemerijck 2013: 51).

Indeed, the 1990s and the 2000s saw considerable changes in European welfare systems, particularly the Continental, but also the Anglophone and Nordic ones. Reforms went in similar directions, rendering European welfare systems more similar: All three types saw less decommodification of labour, combined with increasing social investments - a policy that became known under the buzz words of “third way” or “flexicurity”. Thus under the “New Labour” government after 1997, the UK eliminated “traps” in welfare-to-work schemes and deregulated markets to create an “opportunity for all”, but also increased minimum wages, reformed tax codes, offered “new deals” targeted at different parts of the inactive population, and established a national childcare strategy.

Continental-type Germany that had been called the “sick man of Europe” in the late 1990s has embarked on profound institutional changes since then. The “Red-Green” government reduced the influence of the powerful “social partners” (trade unions and employers’ federations) and arranged for more job flexibility and more incentives for the unemployed to

accept low-paid employment, leading to a prolonged decline in real wages. Germany also began reforms towards a more inclusive and activating welfare state and gradually cut back on status maintenance and outdated family-related privileges (not without backlashes). To some but quite limited degree, France pursued a similar policy.

Nordic-type Sweden more or less continued along the path it had already pursued. Measures to activate individuals were strengthened from the mid-1990s, including more active family support and a deliberate strategy for human capital formation. At the same time, inactivity was made less attractive by cutting back on early retirement and generous sick pay schemes.

Only *Southern-type* Italy seems to have missed the road to convergence: While lip service was paid to the slogan “more to children, less to fathers” (Hemerijk 2013: 199), attempted reforms, e.g. towards more “activating” family support, suffered serious setbacks in the 2000s. While the run-up to Italy’s entry into European Monetary Union put some productive external pressure for reform on the Italian government, this pressure subsided once the Euro was introduced.

While these national developments were mostly unrelated, there were also efforts by the EU Commission, EU Council and European Parliament to harmonize welfare system regulations. These would usually take place under the heading of competition policy, purportedly aiming to eliminate unfair restrictions to trade in the Single Market. Institutionally, social policy initiatives at the EU level find themselves in a “double bind” (Scharpf 1999, Hemerijck 2013): on the one hand, to European institutions that are committed primarily to economic integration by the relevant treaties; and on the other hand, to member states that are committed to their national consensuses on social policies and therefore tend to resist all-European initiatives.

Nevertheless, in the early 1990s, a coalition of European trade unions, several national governments, and the EU Commission began to work towards a social union that was meant to complement economic union and comprise Europe-wide minimum social standards, labour market regulations, and a pro-active European employment policy including fiscal transfers (for surveys of this policy initiative see O’Connor 2005, Addison 2009, Stuchlík, Kellermann2009, Hemerijck 2013: 290ff). The milestones of this initiative over the years (Table 5) range from the 1989 *Social Charter*, a letter of intent on Europe-wide social standards, most of which have since been implemented, to the *Horizontal Social Clause* of the Lisbon Treaty which requires the EU to consider explicitly the social and environmental impact of any action it takes.

Throughout the process of European integration, there has always been an underlying notion that economic integration would also promote political and social integration. This idea was most explicit and unchallenged during the early years of the then European Economic Community. It also underpinned European Commission President Jacques Delors’ strategy for the creation of the Single Market, even though, at the surface, the Single Market seemed to shift the balance towards purely economic integration. More recently, the European Commission’s *Europe 2020 Strategy* outlines policy visions inspired by social investment policy thinking and represents a renewed commitment to a Social Europe (Hemerijk 2013: 324f).

Table 5:
Milestones and implementations of European social policy

Milestones / *Implementations*	**Contents**
Social Charter 1989 Letter of intent (UK excluded)	Willingness to introduce Europe-wide social standards
Social Action Programme 1989 (1990–1995) *renewed* (1998–2000)	50 suggestions on regulations and directives, mostly come into force, e.g., on health security at workplace, working times, collective redundancies, pregnant workers, European works councils, posted workers; some agreed upon by social partners, e.g., on part-time work, temporary labour contracts, parental leave
Agreement on Social Policy appended to ***Maastricht Treaty 1993*** as Social Protocol (UK excluded) **= Social Chapter** in ***Treaty of Amsterdam 1997*** as integral part (UK included)	Procedures for implementing Social Charter: qualified majority (for work safety and equal opportunities regulations); unanimity (for social security, dismissal protection and employment funding schemes regulations); explicit role to European social partners
Employment Chapter in ***Treaty of Amsterdam 1997***	Coordination of national employment strategies on base of uniform labour market monitoring (*European Employment Observatory* EEO)
European Employment Strategy (EES) 1997 Part of *Lisbon Strategy* 2000 implementing Employment Chapter	New *Open Method of Coordination (OMC)* consists of guidelines and national plans, monitored via annual national reports plus a joint European report, and readjusted via country-specific recommendations passed by the Council (by majority voting). Package of measures against discrimination put in force 1999.
Social Policy Agenda (2000–2005) Part of *Lisbon Strategy* 2000 implementing Social Chapter	Pursues social objectives, supports OMC in area of youth, social protection and social inclusion as well as development of social dialogue, civil dialogue and active European citizenship.
Social Agenda (2006–2010) Part of *Revised Lisbon Strategy* 2005 implementing Social Chapter *renewed* (2008–2011)[a]	Initiatives for supporting children and youth, development of labour law, health and safety at work, corporate social responsibility.
Horizontal social clause (Art. 8–10) in ***Lisbon Treaty 2009***	"Social mainstreaming": All EU activities are to consider promotion of high employment, adequate social protection, high education level, health protection, fight against social exclusion, discrimination, reduction of inequality.
Europe 2020 Strategy 2010 with specific social focus implementing Lisbon Treaty	Priorities, Targets and Flagship initiatives with specific social focus; thereby integrating social objectives stronger than before into overall policy agenda of EU.

[a]At the same time, the so-called Bolkestein Directive (includes the principle of origin for services, initiated 2004, put in force 2006) was amended that counteracted to some degree the initiatives of the Social Agenda.

Source: O'Connor 2005; Addison 2009; Stuchlík, Kellermann 2009; Hemerijck 2013: 290ff.

4 Impact on Inequality and Economic Performance

In Section 3 above, we have discussed the input side of European welfare systems: policy instruments, financing, regulatory and institutional context. We find that, in spite of some convergence, differences between the four main types (Nordic, Continental, Anglophone, Southern) remain large. In this section, we examine the performance of European welfare systems in terms of their main challenges at present: to limit the impact on households of rising inequality in market incomes and to prevent social exclusion of the poor. We consider three sets of indicators (Table 6): first, measures of inequality and relative poverty as well as their reduction through taxes and transfers (similar to Section 2 above); second, polarization at the extremes of the income distribution; and third, macroeconomic variables to indicate possible adverse effects of the welfare system on "efficiency" – specifically, employment, output growth, and the sustainability of public finances.

With respect to inequality and relative poverty, Sweden, with its Nordic-type welfare system, performs particularly well. The Gini coefficient before taxes and transfers is relatively low at 0.43, in line with Sweden's long-standing emphasis on human capital formation and activation. Taxes and transfers lead to a Gini coefficient of 0.26 for disposable income, again the lowest of our selected countries. By contrast, the UK and Italy start out with much higher inequality in market incomes (Gini coefficients of 0.51 and 0.52, respectively); they redistribute less, relatively speaking, through taxes and transfer; and they end up with elevated levels of inequality in disposable incomes (Gini coefficient of 0.34). While high income inequality in the UK may be the deliberate result of relying on the welfare-maximising quality of free markets, high inequality in Southern Europe probably reflects the cleavages in the labour market and the 'lack of adequate safety nets for youth, single mothers, and the long-term unemployed' (Hemerijck, 2013, p. 235).

Table 6:
Inequality and poverty indicators during the late 2000s

	Scandinavian Model	Central European Model		Liberal Model	Southern European Model
	Sweden	France	Germany	UK	Italy
Gini Coefficient before T&T	0.43	0.48	0.50	0.51	0.52
Gini Coefficient after T&T	0.26	0.29	0.30	0.34	0.34
Percentage Reduction of Gini Coefficient	39%	39%	41%	32%	34%
Poverty Rate before T&T	30	38	36	35	38
Poverty Rate after T&T	16	14	15	18	20
Percentage Reduction of Poverty Rate	45	64	58	47	47
Top 1% Income Share	7.0	8.1	12.7	13.9	9.4

Source: OECD Statistical Database (2013), The World Top Income Database (2013).

France and Germany with their Continental welfare systems stand on middle ground. Market incomes before taxes and transfers are relatively unequal (Gini coefficients of 0.48 and 0.50, respectively); however, national welfare systems redistribute income on a large scale, resulting in Gini coefficients (0.29 and 0.30, respectively) that are located between Sweden, on the one hand, and Italy and the UK, on the other. The relative poverty rate (the share of the population whose income is below 60 % of median income) is relatively low at 14 % in France and 15 % in Germany, compared to 16 % in Sweden, 18 % in the UK and as much as 20 % in Italy. Since the median income may be viewed as indicative of the "normal" standard of living in a society, the relative poverty rate is usually interpreted as the share of the population that is "at risk" of poverty and social exclusion.

The final inequality indicator in Table 6 is the income share of the top one percent of income earners. The Occupy movement has recently drawn attention to the high income level and rapid income growth enjoyed by these very rich individuals in many countries, including in Europe. Across Europe, the top one percent share closely reflects overall inequality, ranging from 7 % in Sweden to 14 % in the UK but still lower than in the US at 17.4 % (2011; The World Top Income Database, 2013).

Our second set of indicators relates to the polarization of incomes. Across Europe, average household income has grown far less in the first (lowest) than in the tenth (highest) decile (Figure 2 above). In all our selected countries except France, a similar pattern of polarization is very pronounced (Table 7). The UK registered the fastest average GDP growth at 3.1 % per year, while incomes in the bottom decile grew only at 0.5 % per year. Median income grew at a more robust 2.5 % per year, and average income in the top decile grew by fully 4.2 % per year. A similar pattern is found in Germany and Italy, albeit at lower growth rates of GDP overall. Sweden saw median income grow at 2.4 % per year, or close to overall GDP growth. Incomes in the bottom decile still grew at 1.9 % per year, while top incomes grew at 3.4 %. The French experience was sharply different in that incomes in the bottom decile actually grew faster (at 1.9 % per year) than both median income and average income in the top decile. According to these figures, income distribution must have become more equal in France.

Table 7:
Average annual real disposable income growth mid-1980s to 2008 for different income groups

	Scandinavian Model	Central European Model		Liberal Model	Southern European Model
	Sweden	France	Germany	UK	Italy
Average real annual GDP growth rate	2.5	1.8	1.5	3.1	1.3
Lowest decile	1.9	1.9	0.2	0.5	0.5
Median	2.4	1.3	0.6	2.5	0.8
Highest decile	3.4	1.5	1.6	4.2	1.5

Note: Disposable Income growth of the median is approximated by the average growth of deciles five and six of the income distribution. The real annual GDP growth rate is obtained as an average for the years 1992 to 2008.

Source: Bonesmo Frederiksen (2012), Eurostat (2013).

To the extent that the different experiences of Sweden and France are due to differences in their welfare systems, a comparison between the two countries demonstrates the value judgements that underlie the design of welfare systems and economic policies more generally. Given that average income in the bottom decile grew at the same rate in Sweden and France, is it preferable to have faster GDP growth, even if the rich become relatively richer - which presumably makes them better off without making the bottom decile worse off in strictly material terms (as in Sweden)? Or is it preferable to have less GDP growth (maybe as a consequence of more redistribution through the welfare system), combined with more social cohesion due to lower income growth among the rich? In any case, Sweden was obviously able to combine relatively rapid GDP growth with a large welfare system. This observation suggests that it may be the design of the welfare state rather than the existence of public welfare policies themselves that determines the impact on economic growth.

Our third set of indicators relate to labour market conditions and the sustainability of government debt (Table 8): the unemployment rate (which is in itself a major determinant of inequality and poverty – cf. Section 2), the total and female employment rates, and the public debt ratio. According to these criteria, Sweden excels through low unemployment (surpassed only by Germany), the highest total and female employment rates of all five countries, and the lowest debt-to-GDP ratio by far. By contrast, Italy displays the second-highest unemployment rate among our selected countries (exceeded only by France), the lowest total and female employment rates, and by far the highest debt-to-GDP ratio. The performance of France, Germany, and the UK falls in between the extremes of Sweden and Italy, with the German performance the most favourable.

While involuntary unemployment may lead to social exclusion and thus hurt individual well-being far beyond the loss of income, it is often the employment rate that has a greater impact on inequality and poverty. Employment gives individuals an independent source of income and the social security that comes with it. Economy-wide, a high employment rate implies a large tax base that may help to finance government expenditures, including for the welfare system, in a sustainable manner. Indeed, our five selected countries display a strong negative correlation between the total employment rate and the debt ratio, suggesting that the

Table 8:
Employment Indicators and Public Debt as of 2012

	Scandinavian Model	Central European Model		Liberal Model	Southern European Model
	Sweden	France	Germany	UK	Italy
Unemployment Rate	7.5	9.3	5.9	7.8	8.4
Employment Rate	79.4	69.3	76.7	74.2	61.0
Female Employment Rate	76.8	65.0	71.5	68.4	50.5
Public Debt in % of GDP	38.6	94.9	86.9	104.9	126.3

Source: OECD Statistical Database (2013).

link between high employment and sound public finances may be important – notwithstanding the fact that actual debt levels reflect many different factors, including shocks to government revenue and expenditures.

Female employment is lower than male (and hence, total) employment in all five countries, though by different margins. The high female employment rate in Sweden at 77 % reflects the *Nordic* model's quest to integrate as many citizens as possible in the labour market by investing in their productive capacities. By contrast, female employment is very low in Italy at 51 %, in line with the *Southern* model's traditional focus on supporting the male-breadwinner family structure. Furthermore, low labour force participation by women may be a consequence of segmented labour markets that protect the interests of insiders over outsiders (including women).

Overall, the limited evidence that we can present in this section suggests that the *Nordic* welfare system model, with its emphasis on empowering individuals to seek employment, rather than replacing income lost during spells of unemployment, is compatible with robust economic growth and fiscal sustainability (complying with similar results by Sapir 2006). Polarization between the rich and the poor has apparently increased, but remained within reasonable limits. These lessons drawn from the Swedish experience are supported by other Scandinavian countries. One important element in the Nordic model is support for families that focusses on enabling both men and women to participate in the labour market, rather than on providing income support for stay-at-home parents.

The *Southern* model exemplified by Italy appears to reached a dead end. Its fiscal sustainability is now in question, GDP growth has been slow, and unemployment is rather high. It seems plausible that the low employment rate, especially for women, reflects enforced inactivity rather than individual preferences, given labour market structures that protect insiders (often men) over outsiders (often women).

The UK with its emphasis on letting markets work and correcting outcomes only to the minimum extent necessary has seen relatively high GDP growth combined with growing polarization between the rich and the poor. Its public debt has recently increased sharply, though mostly as a result of government measures to counter the impact of the financial crisis. As long as polarization is compatible with the values and preferences of the UK electorate, there may be no immediate pressure for major changes in the UK approach to the welfare system

The performance of the two Continental European countries has been markedly different. France, which undertook hardly any fundamental reforms to its welfare system during the last two decades, has seen high unemployment and growing social exclusion in some immigrant communities, but no increase (likely, even a decline) in income polarization between rich and poor, and only modest economic growth. Public debates in France at this time suggest that high and growing unemployment along with the need to contain the fiscal deficit and maintain public confidence in the government debt may lead to a crunch that may clear the way to major labour market and welfare reforms.

By contrast, Germany's labour market performance is now quite favourable in terms of the unemployment rate and labour force participation, due to its major labour markets reforms in the early 2000s and the resultant decline in real wages. However, GDP has grown only slowly and incomes have become more polarized between the rich and the poor. With the fiscal deficit under control and growing labour shortages at prevailing wages for some skill groups, there may now be an opportunity to promote more rapid wage growth, including for low-skilled workers, along with more social investment from public budgets.

5 Welfare Systems and Underlying Norms and Values

As we have shown in Sections 3 and 4 above, European countries vary widely in terms of inequality in disposable income, the extent of redistribution, the degree of social exclusion, the strategies employed (decommodification, stratification, social investment), and the mix of instruments. Some of these differences (such as those between Sweden and the UK) may reflect different underlying norms and values regarding economic freedom, equality among citizens, and redistribution by the government. Other differences may persist because even a failing welfare system (such as Italy) may be difficult to reform because reforms would be resisted by special interests.

In this section, we explore available evidence on relevant norms and values in European societies and relate it to the extent of redistribution and other features of national welfare systems.

Since European countries are parliamentary democracies, we posit that differences in voter preferences for redistribution across countries should be reflected by differences in the extent of redistribution through national welfare systems (measured similar to Sections 2 and 3 by the relative difference in Gini coefficients before and after taxes and transfers). Information on norms and values comes from surveys (Section 5.1) and from economic experiments (Section 5.2).

5.1 Survey Data on values regarding inequality and redistribution

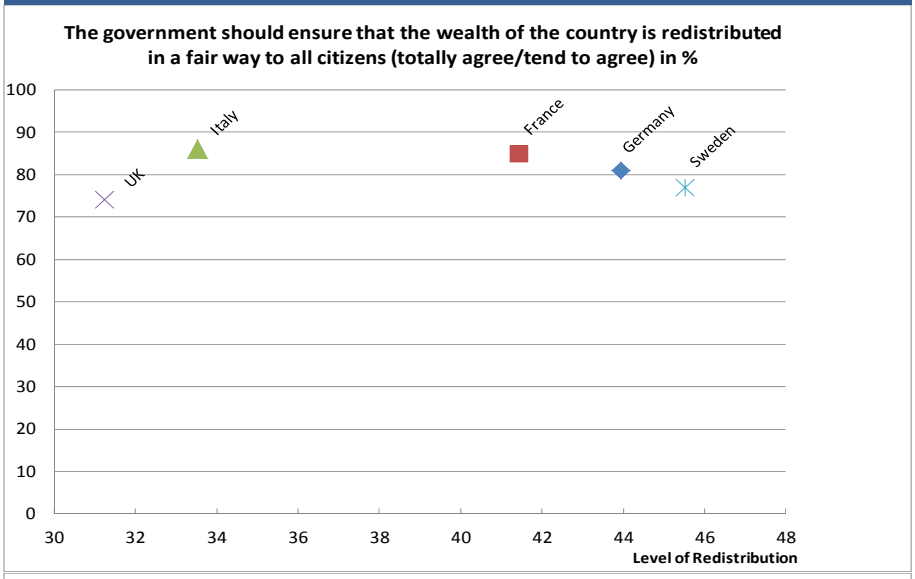
Both the European Values Study Survey (EVS) which is part of the World Values survey and the Euro Barometer include several related questions on attitudes towards income equality and the government's possible responsibility for redistributing income. Figure 5 summarizes responses in our five selected countries to two questions that refer to redistribution without suggesting any particular underlying motivation:

- Euro Barometer for 2009: "The government should ensure that the wealth of the country is redistributed in a fair way to all citizens" - The graph indicates the share of those who "totally agree" or "tend to agree".

- EVS for 2000/2001: In order to be considered just, what should a society provide?: Eliminating big inequalities in income between citizens.' – Possible answers range from 1 (very important) to 5 (not important).

Between 70 % and 90 % of respondents "agree totally" or "tend to agree" that the government is responsible for a fair distribution of "the wealth of the country". Similarly, in all five countries, respondents consider it rather important to eliminate income inequality (values between 3 and 2 on a scale from 1-very important to 5). Thus there appears to be a strong consensus that the government should redistribute income to ensure that inequality does not go beyond an acceptable level. While differences between our five countries are small, it is remarkable that support for redistribution is lowest in Sweden (which redistributes the most in relative terms) and in the UK (which redistributes the least).

Figure 5:
Inequality aversion and redistribution through the welfare system – survey results



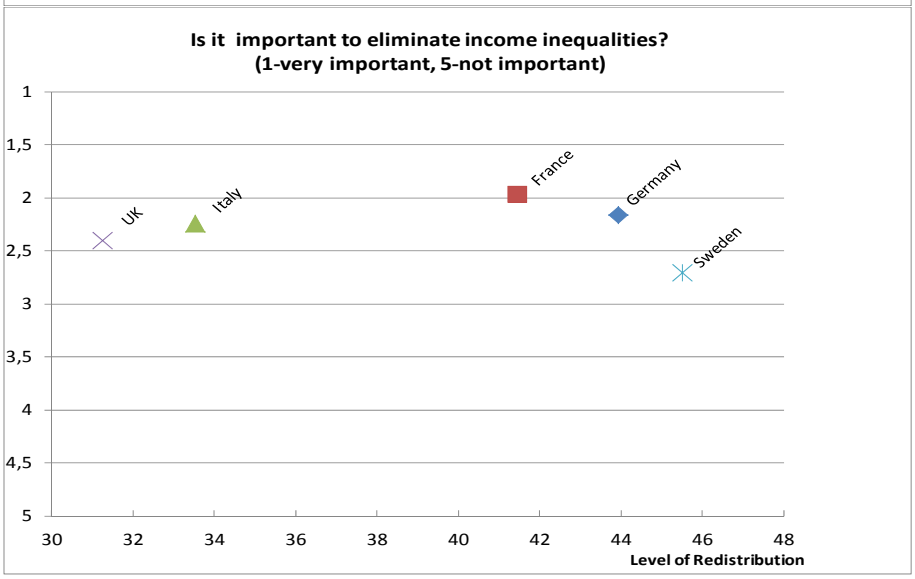
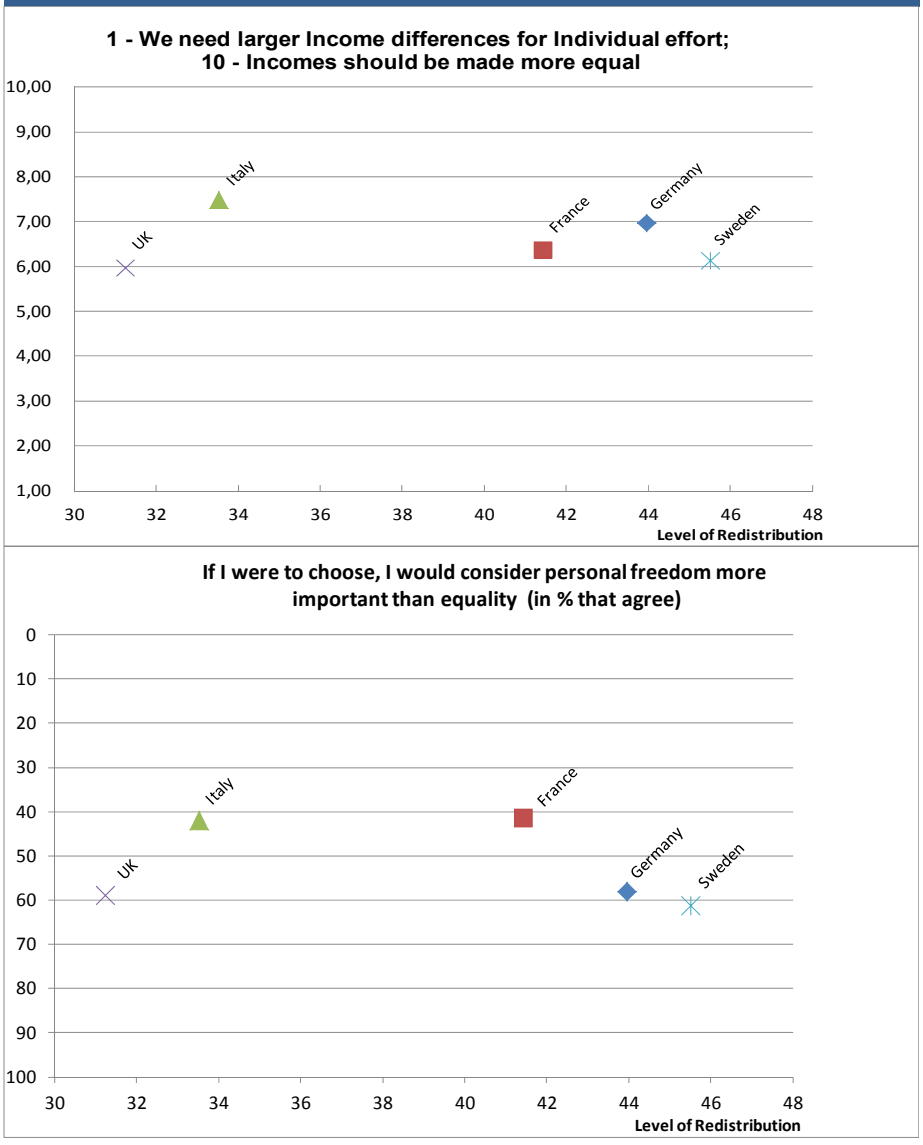


Figure 6 summarizes responses to two questions that ask respondents to consider the disincentives and the loss of freedom that may result from redistribution:

- EBRD Transition Report 2011 : How would you place your views on this scale: 1 means that you agree completely with the statement on the left “Incomes should be made more equal”; 10 means that you agree with the statement on the right “We need larger income differences as incentives for individual effort”;
- European Values Survey for 2008: “A: I find that both freedom and equality are important. But if I were to choose one or the other, I would consider personal freedom more important, that is, everyone can live in freedom and develop without hindrance B: Certainly both freedom and equality are important. But if I were to choose one or the other, I would consider equality more important, that is, that nobody is underprivileged and that social class differences are not so strong” – The graph gives the share of those who prefer freedom.

Figure 6:
Income redistribution, incentives, and loss of freedom – survey results



Average responses to the first questions in our five countries range from 4 (Germany) to 6 (Italy), suggesting that by and large respondents are content with current levels of redistribution. Responses to the second question indicate that around 60 % of respondents emphasize freedom over equality in Sweden, Germany, and the UK, vs. about 40 % in France and Italy. Thus, broadly speaking, both values are held in similar esteem. At the same time, again, support for redistribution is lowest in countries with the least as well as the most redistributive welfare system (similar to Figure 5).

5.2 Experimental Data on values regarding inequality and redistribution

Surveys (as in Section 5.1 above) are a useful instrument to obtain information on individual preferences on a wide range of subjects at limited cost. However, the quality of responses in surveys depends on many factors that investigators find difficult to control, such as the framing of questions and how they are understood in a particular cultural context, the translation of the questionnaire, interviewers' ability to establish a rapport with respondents, respondents' willingness to spend time answering the questionnaire, etc.

During the last couple of decades, economic experiments, especially "games" played in a laboratory context, have become popular as an alternative methodology to investigate individual preferences and behaviour under controlled conditions with incentivized real monetary decisions. In the context of attitudes towards equality and redistribution, controlled experiments allow investigators to observe whether those who stand to benefit in monetary terms view redistribution differently from those who stand to lose.

In this section we use information on two types of experiments that have been conducted in many different countries: the 'Dictator Game' and the 'Ultimatum Game'. Both are typically played in controlled computer laboratory environments, for real money, and with a comparable student population. While these games may not cover all possible aspects of preferences for redistribution, they have been used widely to test the behavioural economic theory of inequality aversion (Fehr and Schmidt 1999) and have been found to predict real-life behaviour in a meaningful way.

In the Dictator Game, a participant has to split a given amount of money (usually around $10) between himself and another anonymous participant that has to accept any offer. We use the amounts sent as an indication of the first participant's willingness to redistribute his wealth in a situation where he is richer than the second participant. The data was taken from 27 dictator game studies[3] conducted between 1999 and 2012. These studies vary in their experimental setup, so the data is not completely comparable[4].

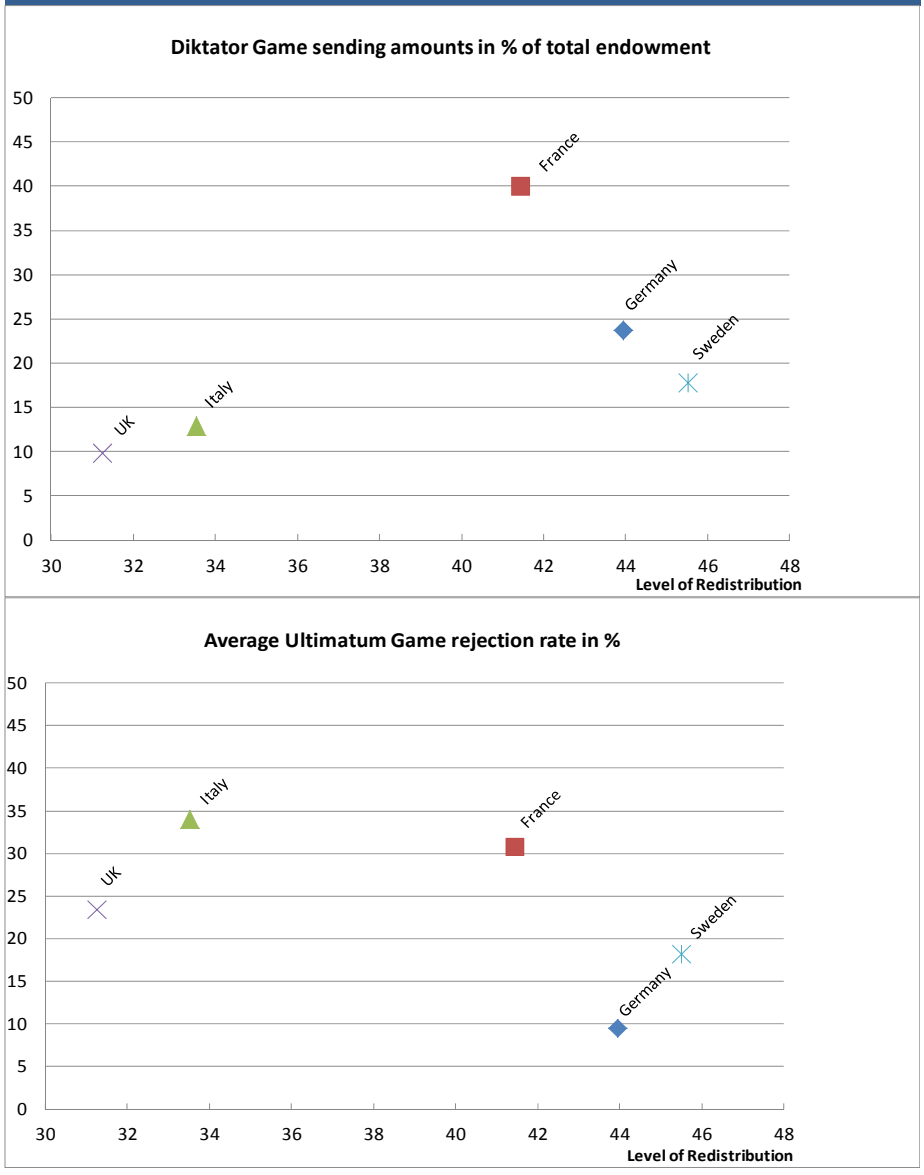
[3] A list of the used experimental studies is available on request

[4] We take the average of several studies if possible but for France, only one Dictator game study that reports sending amounts was available.

In Figure 7 we report the average amounts sent in percent of the original sum to be split. A value of 0 % represents no money was sent at all, while 50 % means the sum was split equally. With the exception of France (where 40 % was sent on average), the amounts sent range from 10 % (UK) to 24 % (Germany).

The Ultimatum Game is a variant of the Dictator Game. Again the first participant splits up a given amount of money between himself and another anonymous participant. This time the second participant chooses to accept or reject the offer. If she accepts, the sum is split as proposed by the first participant. If she rejects, both participants receive nothing. The rejection rate (i.e. the average amount of rejected offers) gives us a measure of what those who start out without wealth consider adequate redistribution; it is equal to the profit that the second

Figure 7:
Dictator and Ultimatum game – experimental results



participant gives up on average by punishing the first participant for sending too little. The data was taken from a meta study by Engel (2011). Italy was not included in this meta study so we use average rejection rates from three ultimatum game studies conducted in Italy[5].In the lower panel of Figure 7 we report the average rejection rate of offers. A rejection rate of 0 % means that all offers are accepted while a rejection rate of 50 % means that only a fair split is accepted. Interestingly, "second" participants in the UK and Italy demanded larger payments (at 24 % and 34 %) than "first" participants were willing to send voluntarily in Dictator games (top panel; 10 % and 13 %, respectively). By contrast, "second" participants in France and Germany were willing to accept less than "first" participants were willing to send voluntarily in Dictator games. This comparison makes it clear that attitudes toward redistribution, whether reported in surveys or observed in experimental situations, need to be interpreted with a view to whether the individual in question stands to benefit or lose from redistribution.

To summarize, relating the size of national welfare states (measured by the extent of redistribution) to national attitudes towards income inequality and redistribution, we find remarkably robust results over a range of indicators drawn from surveys as well as experiments: Individuals in the UK and Sweden (i.e. the least and the most redistributive country in our small sample) are usually the least inequality-averse. Individuals in France, Italy, and Germany, with their intermediate volumes of redistribution, tend to be somewhat more inequality-averse. Different interpretations could accrue: Individuals in Sweden may sense a certain fatigue with the extensive redistribution policies in their country and may wish to contain it – or they may feel the equality realised in their country so evident and sufficient that they may not regard (further) redistribution an issue. We have not been able to resolve this puzzle – except to note that these differences across countries are small. Overall, we find broad public support for redistribution in all five countries under study.

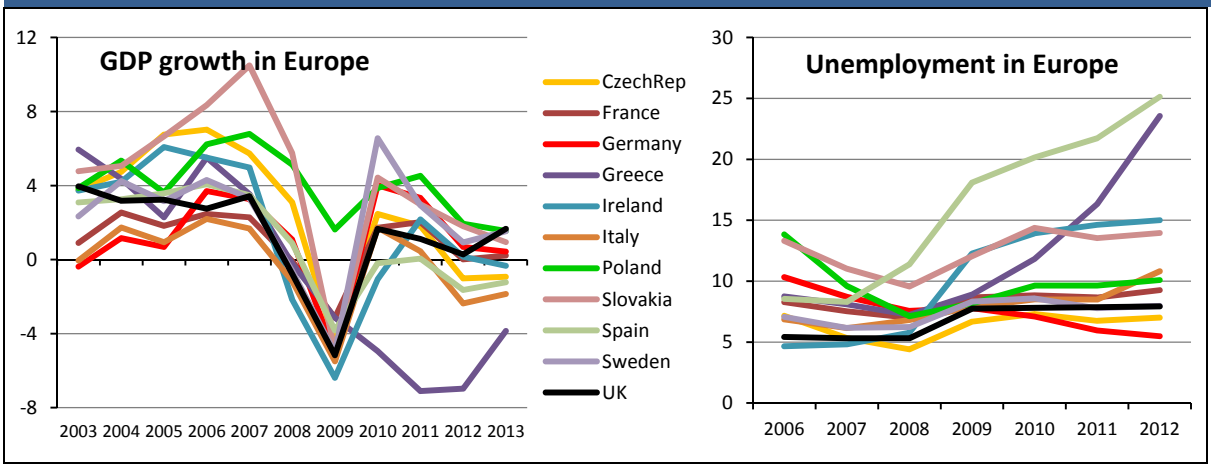
6 Challenges and Adjustment Requirements

6.1 Welfare system reactions on the financial and debt crisis

The 2008 financial crisis and its further mutation to the European debt crisis revealed the sensitivity to contagion of economies in a globalised world and provided a major test case for the appropriateness of welfare systems. The crisis considerably affected EU countries, dramatically increasing unemployment in many of them and thereby challenging the social welfare systems from two sides (Figure 8). On the one hand, the need for more support and benefits from the welfare system increased, on the other hand, obligations to reduce sovereign debts resulted in demands to cut back strongly on welfare expenditures.

[5] A list of the used experimental studies is available on request

Figure 8:
The crisis in Europe



The EU countries reacted quite differently to this two-sided challenge, depending, of course, inter alias on the degree to which they were affected. The Scandinavian countries and some of the Central European countries such as Germany, Austria and the Netherlands, went through the crisis quite smoothly, allegedly *because* their welfare systems were already flexible, demanding and supportive enough to master the double challenge of the crisis. By contrast, even France and more particularly most South European countries, notably Greece, Portugal and Spain, suffered considerably both from the crisis and from the cures to the welfare systems set out to heal the crisis. A particularly outstanding feature in these countries is the high amount of youth unemployment, indicating a high degree of dualism between insiders and outsider to these welfare systems. The Anglo-Saxon countries UK and Ireland, as still another case, also suffered considerably but were able to recover relatively fast.

What to learn from these reactions on the adequateness of the different types of welfare systems? The *Nordic-type* countries apparently did not see much need to change their policies. Largely they stayed on track, trying, after all, to improve the inclusiveness of their educational system (OECD 2015c).

Several of the *Continental-type* countries like Germany had already adapted their welfare systems by their reforms of the late 1990s. As a result, real wages stagnated or even declined throughout the 2000s improving the economic competitiveness and thus contributing to huge export surpluses. This helped weathering the crisis. However, an increased polarization between wage gainers, on the one side, and capital owners and top managers, on the other side, started worrying the public and many politicians. Hence, in Germany, since 2013, the “Great Coalition”-government started a certain realignment of the welfare policies by implementing minimal wages and, anew, early retirement schemes. While the actual effects of these measures on inequality are highly open to question (as the beneficiaries of these policies are by far not generally the poorest), they represented a considerable shift back to status maintenance and to the ideal of the one(male)-breadwinner family. In France, similar motives prevented more determined steps towards increasing both flexibility and

active support in the welfare system. This was demonstrated, e.g., by the considerable resistance put forward in the public against rising retirement ages from 60 years to (still low) 62 years in 2010, which has subsequently been somewhat blurred again by the new socialist government in 2013.

Many of the *Southern-type* countries remained reluctant as to real reforms. Being forced to diminish sovereign debt, governments reduced or abolished already low unemployment benefits, social assistance benefits, retirement benefits and pensions, state aid for health care schemes, and funds for education, but they hardly fought determinedly enough against fraud and corruption in their welfare systems, against cleavages between regulated and peripheral markets, tax exiles and free-riding. In Italy, however, in December 2014 the government of Matteo Renzi adopted a "Jobs Act" foreseeing a more flexible employment protection combined with more active labour market policies and measures to improve female labour market participation (OECD 2015a). This means taking steps in similar directions as the Nordic countries did long ago and the Continental countries did more recently.

The *Anglophone-type* countries largely maintained their low-scale safety net, though taking some action in extending education and active labour market policies, particularly for young non-regular work force (OECD 2015b). The quick recovery of their economies was, however, mainly organised by expansive monetary and fiscal policies. It seems that in fact in these countries monetary policies are utilised to account for the lack of built-in social security in the welfare system, since high unemployment rates are far less tolerated by the electorate than in other countries.

6.2 Challenges ahead for European welfare systems

As shown in the above Sections, European countries vary considerably with regard to the strategies and instruments implemented in their welfare systems and they also vary with regard to the success of these strategies and instruments in containing inequality while at the same time safeguarding economic efficiency. This is to be seen at the background of citizens revealing a high preference for a sufficient degree of equality in all countries under study. The above Section 6.1, however, pointed out that even in times of crisis – or should one say, especially in times of crisis – governments seem to meet considerable difficulties while trying to shape their welfare systems according to some sort of best practise.

Even worse, governments and the public frequently indulged in sham debates and sham actions instead of developing effective ways of assisting the needy. Thus, for instance, in Germany, minimum wages were propagated as a means of reducing current poverty as well as future old-age poverty, disregarding the fact that the strongest poverty risks come from underemployment, not from low hourly wages. This is not to say that minimum wages are altogether meaningless: Whenever governments pay benefits to top-up below-subsistence wages, a certain minimum wage may be required to prevent employers from setting wages below the actual marginal productivity (e.g. for chambermaids, care assistants), or to avoid subsidizing services without effective demand at market prices (e.g. cold call advertising

centres). Yet, for reducing poverty in the work force, it is more effective to increase employment opportunities, particularly regarding young people and females, and for reducing old-age poverty, it is more effective to introduce minimum pension schemes.

Or, as another example for sham actions, retirement ages were reduced in some countries to allow for the hardship of workers having laboured intensely for forty years or more, disregarding the fact that to date only a minority of old employees still looks back at a lifetime of hard-work labour and thus only a minority of them is as physically wrecked as this was frequent some 50 years or more ago. It would thus be much more effective to considerably improve pensions means-tested for such persons that are truly disabled, while overall generating more flexible arrangements for gradual transitions from work to retirement.

Real challenges lie ahead to the welfare state systems and they deserve considerate debates on how to solve them, and effective instead of sham solutions:

Inequality: Globalisation is usually suspected of at the same time raising inequality and eroding the fundaments of welfare state systems (by a race to the bottom in social standards, due to a credible exiting threat of mobile production factors). However, more recent studies revealed both theoretically and empirically (Molana, Montagna 2006, Görg, Molana, Montagna 2009, Chen et al. 2014 and the literature mentioned there) that free-trade integration and welfare policy improvements may be mutually reinforcing one another. In a world of increasing returns to scale in production and of monopolistic competition, the actual production may always tend to be too low as compared to consumer utility, and thus inefficient. In such situation, welfare expenditures may step in to close the gap in a virtuous circle, raising consumption and production, improving efficiency, and thereby even lowering tax rates for mobile capital. These ideas provide a stark argument for drawing on welfare policies to encounter the increase of inequality observed in recent decades. In line with the successful Nordic model, welfare policies should particularly focus on better education for more social mobility and on active labour market policy with more support for life-long learning and for occupational changes. Special attention should be paid to the increasing gap between regular and non-regular work, requiring more inclusive welfare policies.

Demography: Ageing societies in Europe tend to deteriorate the ratio of the inactive to the active population, and this problem is likely to continuously rise in the next decades to come. Worries concern old-age poverty, on the one hand, and a high burden of social security contributions to the young generation, on the other. Many measures taken so far are not effective in curing the underlying problem: Neither minimum wages (assumed to imply higher pension contributions) nor motherhood premiums in pensions, let alone early retirement schemes are apt to ban old-age poverty. Even supplementing public pay-as-you-go pension provisions with private asset-backed pension insurances does not really help; since even then actual payments to retirees have to be taken from what is actually produced by the active population. The best way to deal with an ageing population is thus flexibly extending retirement ages in line with extended life expectancies, activating families to offer parents attractive conditions for both working and raising children, and welcoming and integrating immigrants more open-mindedly to expand the active labour force.

Family modernization and gender equality: Improving female labour market participation and opening-up new chances and opportunities to women is a challenge in itself, and it also helps to some degree managing demographic problems. So far, kindergarten-solutions and various allowances for parents have been provided. Policies, however, need to become more consistent; supporting measures are often highly fragmented on various small issues. The policy objectives are sometimes contradictory, e.g., with some aiming at activating families and others at fostering the traditional "mother-at-home" model, and the overall effect is often unclear.

Healthcare systems: Healthcare tends to get ever more expensive both due to technological progress and to the ageing of the population. Moreover, in most countries it is organised in a private-public mixture that is in danger to bring about the worse of both organisation forms: On the one hand, some (usually poor) people do not receive the treatments they need, and on the other hand, other (often but not always the wealthy) people get treatments that are unnecessary or even detrimental to them. Required would be a system offering the right incentives both to patients and to the healthcare industry to economise as much as possible, while also providing as much medical help as required, without making this contingent on the patients' ability to pay. Such optimal system is still to be developed.

Debt caps: In several countries, new debt caps to public budgets have been established by law or are discussed to be introduced; subsequent to excessively high debts in the past, these caps now often require zero new indebtedness for public budgets and thus put welfare systems under considerable strain. Such measures arguably are justified in view of the burden debts may impose on future generations. However, zero debt caps also severely impede the scope for issuing new loans and bonds even to fund investment that is likely to increase future growth. Debt caps thus disregard the benefits that may accrue to future generations from well-positioned investments, be it infrastructure or social investments, for instance, thinking of education.

7 Conclusions

Looking for innovative ways to limit inequality in societies, this paper examines the experiences of different types of European welfare systems. These welfare systems are challenged to limit inequality in disposable household income and living standards, contain polarization between the rich and the poor at the margins of the income distribution, support GDP growth, and remain fiscally sustainable. In Europe, different of these systems, exemplified in this paper by the countries of Sweden, Germany, France, the UK and Italy, are doing differently well.

The Central European countries France and Germany, for instance, do not perform particularly well in these respects, though for different reasons. GDP growth has been lacklustre in both countries. In France, polarization between the rich and the poor was avoided, but high unemployment led to social exclusion and unrest. With both unemployment

and its fiscal cost apparently set to rise further, reforms to increase flexibility in labour and product markets to permit faster GDP growth may become inevitable in the near future. The alternative would be for France to descend into a Southern-European-style situation like that of Italy. In Italy, the sustainability of public finances is now in question, the employment rate and hence the tax base are low, labour markets are segmented to protect insiders over outsiders, and reforms face serious hurdles because of special interests and limited fiscal space.

In Germany, labour market indicators (unemployment as well as total and female employment) are favourable, reflecting labour market reforms during the early 2000s that increased flexibility and pushed many unemployed to accept low-paid work. Partly as a result, polarization between the rich and the poor during the last two decades was profound. The example of Nordic-type Sweden, however, suggests that a focus on social investment, including on extended child-care to facilitate more female employment, may provide a way forward that limits polarization and lays the foundation for sustained GDP growth by utilizing all available human resources.

Looking at the European experience, we find little evidence of the trade-off that was traditionally thought to exist between efficiency (measured, say, by GDP growth) and equality (measured by the extent of redistribution). Of the countries that we considered in some detail, GDP growth in Sweden during the last two decades was almost as high as in the UK although Sweden redistributes income on a much larger scale. Our analysis suggests that the Nordic welfare state model, with its emphasis on social investment, activation, and human capital formation, has rendered the traditional notion of an inevitable trade-off between efficiency and equality irrelevant. In effect, these welfare systems allow societies to enjoy the efficiency gains due to fully functional markets and the creative destruction inherent in capitalism (Schumpeter).

We have also sought to relate the size of national welfare states (measured by the extent of redistribution) to national attitudes towards income equality and redistribution. It is remarkable that on a range of indicators drawn from surveys as well as experiments, individuals in the UK and Sweden (i.e. the least and the most redistributive country in our small sample) are usually the least inequality-averse. Individuals in France, Italy, and Germany, with their intermediate volumes of redistribution, tend to be somewhat more inequality-averse. We have not been able to resolve this puzzle – except to note that these differences across countries are remarkably robust to the choice of indicators, but still small overall when compared to the broad public support for redistribution in all five countries.

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