# Reforming Welfare States

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## 1 Introduction

Advanced welfare systems in developed nations perform numerous important economic and social tasks. Governments provide more or less encompassing social insurance against the risks of unexpected income losses, they offer specific services, most notably health care and education, and they redistribute income and wealth via taxes and transfers to facilitate economic efficiency, to reduce poverty, to weaken social exclusion and to establish greater equality of starting positions. Expenditures related to social issues have become by far the largest spending category in the budgets of EU Member States. According to functional National Accounts statistics, general government outlays for social protection, health and education sum up to an average of 32.5 % of GDP in the EU28 (2012), reaching a maximum of 41.7 % of GDP in Denmark. The share of welfare spending as a percentage of overall government spending is above 50 % in all Member States except for Cyprus (at 48.9 %), and the (unweighted) budget share across all EU28 countries in 2012 sums up to 62.7 %.

Moreover, to accomplish objectives like protecting workers from arbitrary or unfair treatment and ensuring more efficient contracting, advanced welfare states frequently rely on systems of complex labour and employment laws. The available data demonstrate that such regulations differ significantly across countries in Europe (Koster et al. 2011), allowing for various configurations of labour market regulations and social expenditures, and there is almost no evidence for the development of a uniform "European Welfare State" (Hall and Soskice 2001). Despite the absence of a common definition and understanding of the role of the welfare state among the individual member states, in its Europe 2020 strategy, the EU envisions a new growth path for Europe that will be simultaneously "smart",

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"sustainable", and "inclusive". Nonetheless, with respect to the goal of inclusiveness, there is some evidence that the redistributive capacities of advanced welfare states have declined in recent decades. An OECD (2011) report highlights that market-income inequality went up in almost all OECD countries over the past 20 years. Since the mid-1990s, however, cash transfers and progressive income taxes no longer offset this development, despite higher overall cash transfer spending (Immervoll and Richardson 2011).

The possible causes for inequalities in incomes (and wealth, education, and health) are manifold. For overall well-being and sustainability, the problem of inequality of opportunity may be by far most important (Atkinson and Morelli 2011). There is some "fairness accord" that unequal outcomes of an income-generating market process are to a certain extent acceptable, particularly when they are rooted in different levels of individual effort. Ethically or morally based notions of fairness and justice, however, suggest that differences in external circumstances that are beyond an individual's control are mostly not considered tolerable sources of inequality (Lefranc et al. 2008). "Fair inequalities" may thus co-exist with "unfair" ones (Checchi et al. 2010). Already from this perspective, the impact of external factors (such as family background, gender, or ethnicity) on individual success and/or intergenerational mobility should be reduced.

Furthermore, inequality of opportunity seems to play an important role beyond questions involving justice and fairness. Removing certain forms of inequality may lead to the achievement of other economic objectives. For instance, whereas previous empirical studies do not produce clear-cut results regarding how income inequality affects growth performance (e.g., Banerjee and Duflo 2003), Crespo Cuaresma et al. (2013) analyse the impact of unequal educational outcomes on economic growth and find that beyond the link between educational attainment and income developments, intergenerational education mobility is positively related to economic growth. In particular, countries with reduced educational disparities in their younger cohorts have grown more rapidly over the last five decades than have countries with greater educational disparities in those cohorts.

This finding is consistent with recent results suggesting that unequal outcomes due to dissimilar efforts contribute positively to economic development as incentives to work hard may be strengthened, whereas inequalities of opportunity are an obstacle for growth through reduced opportunities (Aghion et al. 1999). Marrero and Rodriguez (2013) explicitly investigate the relationship between these two different sources of inequality and growth and find a robust negative relationship between "inequality of opportunity" and growth and a positive relationship between "inequality of returns to effort" and growth. Taken together, these results lead to a revised understanding of the modern welfare state not just as an agent for the ex post redistribution of unequal incomes and wealth but more as a promoter of equal opportunities and labour market participation.

Against this background, advanced welfare states across Europe face broadly similar challenges.

- The emergence and diffusion of new technologies and the transformation from more traditional modes of industrial production towards those of post-industrial society, in addition to the associated impact of changes in life-styles and habits on the work environment, which not only generates new economic opportunities but also breed new forms of social risks. An on-going process of the individualization of lifestyles and pluralization of family forms, which has been accompanied by a shift in gender roles, also challenges traditional forms of insurance by welfare states.
- Globalization amplifies competitive pressures from within the EU and—even further—from non-European low-wage countries. On the one hand, this pressure may reduce employment prospects for particular societal groups, generating higher demand for new welfare state provisions. On the other hand, competitive forces and the increasing international mobility of tax bases further pressure the generosity of certain welfare regimes in Europe, particularly in the light of an on-going sovereign debt crisis.
- Demographic developments generate further reform challenges. Most European countries will face rapidly ageing societies and increasing diversity in foreign-born populations in the future. Rising longevity and falling fertility rates generate additional spending requirements for old-age-related issues such as public pensions and health care and simultaneously intensify fiscal strains as a result of rising old-age dependency ratios and potentially reduced economic growth (European Commission 2011). Increasing diversity, by contrast, is likely to raise demands on welfare states in terms of integrating foreign-born populations and will in all likelihood reframe the debate regarding equal opportunities among different segments of the population.
- Over time, maturing welfare states establish mutual dependencies among beneficiaries (voter groups), politicians and the welfare bureaucracy. Developed social security systems lead to entitlements for many social groups. Changing the rules creates winners that are often difficult to discern because benefits often accrue in the future and are diffuse and well-identifiable groups of losers that are often politically vocal. Implementing welfare state reforms is therefore a difficult and sometimes risky task for governments aiming to remain in office.

The remainder of this paper is based on the results of the recent 7th framework project (WWWforEurop—see: http://www.foreurope.eu/) and discusses these challenges in light of the current state of research in the respective fields. Section 2 is dedicated to the "new social risks" faced by European citizens as a consequence of socio-economic changes that are subsumed under the heading of "post-industrialization". Sections 3 and 4 address the challenges to welfare states stemming from globalization and the demographic evolutions of European societies resulting from ageing and migration. Section 5 tackles the question of welfare state reform from the perspective of political economy, whereas Sect. 6 discusses avenues for future research and draws some policy conclusions.

## 2 Post-industrialization, New Perspectives on Social Risks

The first of the challenges to European welfare states discussed above has led to wide-ranging discussions regarding the capacity of these states to address social risk in an effective and sustainable manner. These discussions have often been framed by the notion of “new social risks”, which can generally be understood as situations in which individuals risk experiencing welfare losses as a consequence of long-term trends, such as de-industrialization and tertiarization of employment, women’s entry into the labour market and the increased instability of family structures (Bonoli 2007, Pintelon et al. 2011). The problems associated with such risks include precarious positions on the labour market, the working poor, lack of sufficient social insurance and/or the inability to reconcile work and family. Thus, new social risks are typically related to changes in the sphere of the labour market or the family, and frequently result from the intersection of these two life domains (Bonoli 2006).

Depending on the definition and the perspective of interest, a list of new social risks can be home to a varying number of risk categories. There is, however, broad agreement with respect to the identification of social risk typologies. Their “novelty” must be interpreted broadly, emphasizing the quantitative dimension with respect to the quality dimension. Although most risks were also present in the past, their quantitative importance and relevance as specific social policy targets have greatly increased over recent decades (Huber and Stephens 2006). Most of the recent research—and controversy—has focused on understanding the driving forces behind these risks, their distribution across population groups and the interaction between different risk typologies. Following the synthesis by Pintelon et al. (2011), we can distinguish between three different and semi-competitive perspectives on social risk: the notion of the individualization of risk, the life course perspective and the more traditional social stratification approach.

The first perspective stresses that contemporary societies have become more fragmented and biographies more individualized, thus diminishing the role of social class and of its intergenerational transmission as structuring factors of social risk. From this angle, horizontal life trajectories and lifestyle have become more important than hierarchical determinants of inequality (Vandecasteele 2007). Social class and other external constraints have been losing importance, whereas preferences and individual agency have become increasingly relevant. Hakim (2000) for instance, has developed a “preference theory” to emphasize the role of preferences as determinants of women’s life choices, arguing that social structural factors and the economic environment are declining in importance. There are indeed some indications that social stratification matters less than it used to with respect to certain risks, such as the likelihood to be affected by short-term poverty (Vandecasteele 2007). Similarly, unemployment today is more broadly spread across the population than it was in the “Golden Age” of post-war Europe, when it was confined to small groups in the workforce. These observations have led some authors to speak of a “democratization” of risk, arguing that the expansion of

flexibility and precariousness and the de-standardization of life-courses lead to a "risk society" (Beck 1986).

The life-course approach shares certain common ground with the individualization perspective, emphasizing the role played by biographical events as determinants of welfare. Welfare losses such as poverty spells can be triggered by life-course transitions (e.g., family formation and the transition from education to employment) as well as by "risky life-events", such as family partnership dissolution and health shocks, and must be understood in this context. Additionally, problems experienced during any specific life-cycle phase may be either a consequence of earlier difficulties or a precursor to later ones (NESC 2005). Both the life-course and the individualization approach emphasize the importance of agency in responding to biographical events. The life-course approach is, however, more likely than the individualization thesis to incorporate elements of hierarchical stratification in its analysis.

The fact that "traditional" determinants of social outcomes are less relevant than in the past should in fact not lead us to overstate the case for a "democratization" of risk. Social stratification research continues to emphasize the relevance of socio-economic background, gender, ethnicity and social class for numerous outcomes, including the duration of poverty, unemployment and health (Whelan and Maître 2010). For instance, Wiborg et al. (2010) examine how social origin affects unemployment risks and social assistance reception over the early life course and find that social background has a stable impact over the life course on the probability of being disadvantaged.

This finding is consistent with the findings in the literature on cumulative (dis) advantage processes, which posit that the relative (dis-)advantage of an individual or social group over another grows over time, which means that inequality with respect to factors such as cognitive development, wealth and health increases over time (DiPrete and Eirich 2006). In the framework of life-course analysis, this research has focused on how events experienced earlier in the life-course influence lifelong development and have enduring consequences on life chances (Schafer et al. 2011). A large body of literature confirms the existence of long-term consequences of childhood adversities on later life trajectories, particularly with respect to well-being and health outcomes (e.g., Brandt et al. 2012). These findings highlight the importance of early life circumstances and lend support to the view that modern welfare states should pay attention to addressing inequalities in opportunities.

From today's perspective, the most promising avenue of research to identify levers for social policy development is thus the combination of the life-course and social stratification perspectives on social risks. For instance, Whelan and Maître (2008) show that social class and life-cycle stage influence the occurrence of social risks in an interactive manner. Vandecasteele (2011) finds that life course events do not trigger identical poverty effects for different social classes and affect the most vulnerable groups disproportionately. Social class and life-course perspectives should therefore be viewed as complementary—rather than competing—hypotheses (Pintelon et al. 2011). This interdependence between stratifying ("vertical") and

biographic ("horizontal") elements is further complicated by the role of institutional factors. Welfare state institutions and policies thus have a profound effect on the occurrence and distribution of social risks.

Comparative studies reveal substantial differences between welfare states in their efficacy with respect to equalizing opportunities, to prevent risks and/or to compensate persons for welfare losses. Numerous findings highlight the relevance and usefulness of clustering exercises in the tradition of Esping-Andersen (1990) to facilitate the interpretation of institutional effects on welfare state outcomes. There are, however, a number of caveats with respect to classifying countries according to Esping-Andersen's welfare state typologies. In recent decades, European countries belonging to the same "welfare regimes" have undergone reform experiences of different magnitudes and speeds, resulting in specific reform patterns and increased heterogeneity within welfare regimes. In addition, recent research has shown that the outcomes of a classification exercise can change depending on the policy or welfare state dimension chosen. The usefulness of welfare state categorizations, thus, must be judged on an ad hoc basis, depending on the time period, the country selection and the topic under scrutiny.

The heterogeneity of welfare policies and institutions thus represents a further challenge for researchers, while providing scope for comparative analysis and identification of best practices. As suggested by Bonoli (2007) some welfare states, particularly Nordic states, have been more successful than others in adapting to changed social risk patterns and can provide useful benchmarks for reform. In light of institutional complementarities and country-specific reform patterns, detailed policy recommendations must rely on analyses that pay great attention to national circumstances.

A field in which such an analysis can provide important insights is the reconciliation of family and work, which has important repercussions on female labour market outcomes because of the continuing unequal gender division regarding unpaid work. The emergence of post-industrial labour markets has been accompanied by far-reaching changes in family life. The strong increase in the participation of women in the labour force, which was fuelled by a substantial leap in women's educational attainment, is arguably the most important trend in labour markets of the twentieth century (Goldin 2006) and certainly a salient trait of post-industrialization. On the one hand, it reflects an expansion of women's opportunities to pursue their individual self-fulfillment, to choose between different combinations of family and career involvement and to achieve economic independence. On the other hand, it has led to new tensions and needs. Because the increased level of female employment has resulted in neither an equal gender division of unpaid work nor an equivalent externalization of household activities to public or private service providers, it is primarily women who are exposed to the increased risk of experiencing some type of work-family conflict. A rapidly growing body of literature scrutinizes the opportunities and constraints associated with the multiple exigencies of family and working life as well as the outcomes that result from different individual strategies and a variety of policies (e.g., Janus 2012).

Theory and empirical evidence indicate that paid work is generally beneficial for physical and mental health and that employed persons enjoy better health than the intermittently or non-employed (Frech and Damaske 2012). This finding seems plausible because stable and steady employment is conducive to achieving economic security and is one of the most effective protective factors against poverty. Longitudinal studies confirm the findings of cross-sectional research showing the beneficial or neutral effects of employment on women's health (Klumb and Lampert 2004). Early life-course disadvantages tend to accumulate over time because more disadvantaged women are less likely to experience the work pathways associated with the greatest health benefits at later stages in life. However, the combination of work and care activities might also result in work overload and work-family conflicts. Moreover, outcomes may differ by country and country group, as work and family choices—as well as health outcomes—are shaped by different institutional settings.

This position is confirmed by Leoni and Eppel (2013), who find that women who enjoy favourable initial conditions, such as a parental home with high socio-economic status, good childhood health conditions and high cognitive skills, are more likely to reconcile care for children with continuous employment over their life-course. This finding indicates that the moment at which women reach adulthood and start a family represents a crossroads for their future labour career. The results confirm that the pursuit of continuous employment for mothers is associated with more favourable health outcomes than career choices with only marginal or intermittent employment. This positive link however differs among welfare regimes. It is strongest in the Nordic and Eastern European countries, weaker in Continental European countries and insignificant for Southern European countries. In Southern Europe, where full-career mothers are in the minority, observable characteristics such as education and income are sufficient to explain the existing differences in health between groups. In the other welfare regimes in which employment of mothers is more common, the health effects may depend on opportunities to reconcile family with employment. These findings therefore are additional evidence that the combination of family and continuous employment is beneficial for individual well-being in a number of dimensions, which strengthens the case in favour of continuous efforts to expand policies in support of work-family reconciliation (even in times of tight budgets).

## 3 The Globalization Challenge for Welfare States

The notion that economic globalization is a challenge for established welfare state structures is based on theories of fiscal competition and on research into trade and factor market integration (Oates 1972, Garrett and Mitchell 2001). The conventional line of reasoning is that eliminating the barriers to international trade and factor movements, in combination with new technological developments, substantially reduces the costs of international transactions. While it is associated with a

number of important benefits (such as increased aggregate welfare) as a result of deepened international division of labour, globalization also increases competitive pressures for domestic firms to reduce production costs and for governments to adapt welfare state structures. Low-skilled workers at the bottom of the income distribution, in particular, are expected to bear the highest share of this burden in developed countries, whose comparative advantage is expected to be in the production of goods requiring the intensive use of high-skilled labour. Globalization—defined either as increasing trade or increasing foreign direct investments—is expected to be associated with a number of adjustments.

- The first adjustment will involve wage cuts as firms try to compete with imports from low-wage countries. According to this view, economic integration will exert downward pressures on the wages of unskilled workers in wealthy countries, thus leading to a substantial increase in wage inequality. If wages are not downwardly flexible, globalization will worsen employment prospects for some groups in society and amplify distributional conflicts. High wages for unskilled labour can only be maintained if firm productivity in developed countries is also high enough to maintain unit labour costs at competitive levels.
- Whereas globalization may increase wage inequality among skill groups, it may also affect other forms of inequality, such as those caused by ethnic and/or gender discrimination. In this regard, a recent World Bank report has taken a cautiously optimistic view—in contrast to conventional wisdom—based on the notion that discrimination may become unsustainable in international competition and because globalization goes hand in hand with better access to information, which may lead to the diffusion of less conservative gender norms and attitudes (World Bank 2011).
- Increased international competition and market integration may also erode the ability of welfare states to tax mobile goods and factors. To attract footloose industries, governments exposed to globalization will be "forced" to lower the tax burdens on capital and high-skilled labour. As a consequence, increasing net income for capital owners and high-skilled workers may also contribute to a rise of inequality within wealthy economies.
- Intergovernmental competition for internationally mobile tax bases will also shift public spending priorities. According to the conventional view, governments will have to cut social spending primarily, which benefits predominantly poorer segments of society. Moreover, state competition for capital will require more and better infrastructure inputs that also benefit mainly mobile firms (Keen and Marchand 1997).
- Likewise, regulations that drive up firms' production costs, such as environmental regulation or employment protection law, are also under scrutiny to become less strict or abolished. Competition for foreign direct Investment may undermine the regulatory capacities of countries and may lead to a "race-to-the-bottom" on social and environmental standards.

Therefore, globalization may simultaneously increase the need to redistribute and provide social insurance for the poorer segments of society and diminish the

ability of welfare states to redistribute income and wealth. The observed increase in market and disposable income inequality among many OECD countries noted in the introduction may therefore partly be attributed to the effects of globalization, on the one hand, and a reduced effectiveness of redistribution policies, on the other.

In the previous literature, the expected impact of globalization on welfare state expenditures and regulatory provisions is typically discussed as the “efficiency hypothesis” versus the “compensation hypothesis” (Garrett and Mitchell 2001). The efficiency hypothesis states that trade integration and international capital mobility generally constrain the welfare state. Under the assumption that governments maximize social welfare functions, competitive forces ultimately constrain benevolent politicians in striving for equality and efficiency. Hence, globalization is considered a danger for the functioning of the welfare state and, as a consequence, leads to calls for policy harmonization to mitigate downsizing pressures. From the perspective of political economy, globalization may, however, also serve as an indispensable corrective to tame a Leviathan state that redistributes tax revenues to influential interest groups and an ever-expanding public bureaucracy (Brennan and Buchanan 1980). This view of globalization is much more positive, as international competition forces governments to contain inefficient redistribution and wasteful spending. The welfare implications of the efficiency hypothesis hence differ, depending on the assumptions about the effectiveness and quality of government behaviour.

By contrast, the compensation hypothesis assumes that democratic governments face increasing political demands for social protection against a higher exposure of the economy to external shocks and a de-compressed wage structure (Iversen and Cusack 2000). From this perspective, governments respond with more protection against increased the social risks resulting from globalization, regardless of the higher costs of redistributive policies. One potential benefit of this reaction is that it increases employees’ acceptance of trade liberalization and may thus improve the preconditions for a country’s stable globalization path (Rodrik 1998).

Recent empirical studies find little or no confirmation of the “race-to-the-bottom” in taxation or welfare spending as a response to the forces of globalization (e.g., Meinhard and Potrafke 2012). Evidence on these issues is far more in favour of the compensation hypothesis, confirming Iversen and Cusack’s (2000: 346) view that trade and financial liberalization has generated stronger policy interdependence among countries but that the seemingly causal primacy of globalization factors in shaping welfare state structures “. . . appears to be greatly exaggerated.” In a more differentiated analysis Leibrecht et al. (2011) provide evidence in favour of the compensation hypothesis only for Western European countries. The results for Central and Eastern European countries imply that globalization leads to a significant decline in the share of social protection spending, which is more in line with the efficiency hypothesis.

This lack of clear evidence for a “race-to-the-bottom” may also be explained with “simple models” of states competing for mobile firms and taxpayers not fully captured by the complex interactions in institutional competition. A single policy instrument is typically not decisive for the locational choice of a firm; instead, it is

the quality of a bundle of policies and institutions associated with a country or region that tend to impact such locational choices. Governments imposing higher tax burdens can compensate firms with better legal or physical infrastructure or other investment incentives. Hence, there is no inevitable race to the bottom in social standards, welfare state spending or taxation.

A different problem pertains to the 'first round' effects of trade and financial markets integration: Does globalization really increase the need for social protection, and which forms of welfare state intervention are required as an adequate policy response? From this perspective, the dynamic process of adjustment following economic integration and trade liberalization remains underexplored (Dewit et al. 2009). Trade and technology may play mutually reinforcing roles in shaping labour market developments in wealthy countries. Modelling wage dynamics and unemployment has sparked research interest but remains incomplete. Thus, there is little knowledge regarding how welfare policies might be employed to spread the gains from globalization more equally.

A first case in point involves the effects of globalization on wage inequality. Until recently the dispute over the causes of increasing wage inequality in many developed countries over the past decades seemed to be settled in favour of skill-biased technological change. Katz and Autor (1999) identify skill-biased technological change as the main contributor to rising wage inequality. OECD (2011) also does not support the idea that globalization is a major source of increased wage inequality, as "[. . .] neither rising trade integration nor financial openness had a significant impact on either wage inequality or employment trends within the OECD countries. The wage-inequality effect of trade appears neutral even when only the effects of increased import penetration from emerging economies are considered." However, whereas traditionally advanced economies have traded mainly with other developed countries in the past, the recent rise in trade with low-income/low wage-countries (most notably China and India) has resulted in a shift in the structure of trade, which is associated with re-appearing fears that low-skilled workers from developed countries might lose out in competition with workers from developing countries.

Against this background, Lechthaler and Mileva (2013) differentiate between the short- and long-term distributional consequences of trade liberalization. These authors show that over both the short and long-runs, income inequality increases following trade liberalization. In the short-run, the increase is driven by a rise in the wage differential between skill-intensive and low-skill-intensive sectors. Over the medium to long-run, inequality increases due to a rising skill premium in the exporting sector. Thus the skill premium reacts only slowly to globalization, whereas wage inequality across sectors jumps on impact and then slowly recedes. As a consequence, labour market policies of developed countries should concentrate on providing moving subsidies to high-skilled workers so that they can switch the sector of their employment more easily or, equivalently, provide well-functioning matching services to reduce mobility costs to high-skilled workers. In addition, low-skilled workers value the option to train and become high-skilled in

the exporting sector; in fact, having this option drives the result that these low-skilled workers are not the main losers from trade liberalization.

By contrast, Kopasker et al. (2013) argue that country-specific productivity responses to shocks, which have been explained by differences in labour market institutions and/or in aggregate economic structures, may also impact the effectiveness of active labour market policies (ALMP). If firms of differing productivity levels are exposed to a globalization shock, then optimal ALMP suggest taxing firms and subsidizing workers in most cases. This toughens export selection, increases average industry efficiency, and expands aggregate demand by increasing workers' income. From a welfare perspective, a policy that entails picking winners by taxing exporters to sustain aggregate demand and employment via worker subsidies is preferable to a policy that does not discriminate between production for the domestic markets and exports. These policy results therefore go against the widespread assumption that hiring subsidies are more effective than worker subsidies in encouraging labour force participation as well as in generating employment. Thus, ALMP can be understood as effective in sustaining labour market participation and employment levels.

## 4 Demography

The demographic challenges facing the welfare state arise from two parallel developments: a noticeable ageing and a substantial increase in the ethnic diversity of the resident population. Thus, the European Commission's (2011) population forecast predicts a noticeable increase in old age as well as total dependency ratios for the overall EU and for each and every country of the EU until 2020. The old age dependency ratio (i.e., the population aged 65 or older as a percentage of the population aged 20–64) is thus predicted to rise from 28 to 42 %, and the total dependency ratio (the population aged 19 or under and the population aged 65 or older as a percentage of the population aged 20–64) from 63 to 78 % by 2020. Simultaneously, this forecast also predicts a substantial increase in migration to the EU and suggests a cumulative net immigration of approximately 13.3 million persons or 2.7 % of the EU population by 2020. Whereas this increase in migration is sufficient to keep the population from falling below its current level, it will not prevent a decline in the working age population, which would require immigration of a number equal to approximately 5 % of the EU's total population (or 24.6 million people) by 2020.

With respect to migration, however, more is at stake than just the number of migrants arriving from a sending country because its structure in terms of ethnicity and education can also have important effects on economic development. A substantial body of literature discusses the potential impact of increasing ethnic diversity on regional development and frequently argues that increasing ethnic diversity in a country may have a substantially positive effect by increasing productivity and innovation, although it may also result in increasing decision-making

costs and the potential for ethnic conflicts (Alesina et al. 2002). Similarly, migration experts (e.g., Chiswick 2005) have frequently argued that developed countries such as the EU countries should aim to attract more highly educated migrants and several studies have shown that highly skilled migrants can have a substantially positive impact on the competitiveness of an economy in terms of innovation, founding of new enterprises and exports as well as in terms of foreign direct investments (e.g., Hunt and Gauthier-Loiselle 2008). Nonetheless, many studies (e.g., Belot and Hatton 2008) also indicate that the EU as a whole is not as successful at attracting high-skilled migrants as other major receiving regions, such as Canada, Australia and the USA.

A further issue with respect to the potential challenges that migration poses for the welfare state, are the potential costs of migrants to the welfare state. In this respect, the literature frequently arrives at contradictory results. Whereas comparative studies such as OECD (2013) suggest that migrants are typically not a burden to the welfare state, a recent survey of the European country study literature concludes that "the general picture to emerge is one of higher immigrant use" of welfare programs (Barrett and McCarthy 2008). Huber and Oberdabernig (2013) show that these differences in results are likely due to the heterogeneity among immigrant populations in the EU. Not controlling for observed characteristics, these authors show that in about half of the 19 EU countries analysed, migrants receive more benefits than natives. Similarly, in about half of the countries, migrants contribute more to the welfare state than natives, measured in net terms.

Once individual and household characteristics—as well as income—are controlled for, however, these differences disappear across countries. Among the differences in characteristics contributing to this effect, differences in age, education and marital status of the household head contribute most, in addition to differences in household sizes between native and migrant households contribute most. Moreover, in a number of countries, the lower incomes of migrant households—which may result from labour market discrimination—also contribute significantly. Selective migration and sound integration policies—coupled with programs aimed at avoiding the marginalization of migrants into informal and black market activities—thus would most likely be the most effective policy measures to prevent increased migration from having detrimental fiscal effects on state budgets.

In addition, ageing has far-reaching implications for economic development and financial sustainability. In the ageing literature, there is some debate regarding whether older cohorts are less productive than younger cohorts, with quite a number of studies finding an inverse U-shaped relationship between age and productivity (Lindh and Malmberg 1999) according to which productivities peak between 30 to 44 years of age. Via its impact on consumption, ageing may also impact the savings rate and the production structure of economies. Martins et al. (2005) found that economies with a high share of elderly also tend to have lower savings rates and show that the share of consumption expenditures not only for health but also for housing increases with age, whereas expenditures for entertainment, transport and education decrease with age. Based on these results, Martins et al. (2005) predict a

substantial increase in the aggregate share of health expenditures for the OECD based on ageing. Another strand of the literature has focused on the potential impacts of ageing on labour markets but provides mixed results. Although Shimer (2001) finds a strong relationship between the proportion of youth and unemployment rates in the US—with a larger share of young persons increasing aggregate unemployment rates—Foote (2007) finds that changes in the age structure of the population have no significant impact on aggregate unemployment rates.

However, the major challenges posed by demographic ageing are associated with the fiscal sustainability of welfare states and old age pension systems. For instance, the European Commission's (2012) ageing report estimates that strictly age-related budgetary expenditures in the EU will increase by 4.1 % points of GDP until 2060, with countries such as Belgium, Cyprus, Luxembourg, Malta, the Netherlands, Slovenia and Slovakia experiencing increases in excess of 7 % points. Given these projections, Hammer et al. (2013) argue that the consequences of population ageing for overall economic development and public finances, in particular, not only depend on the extent of demographic change but are also determined by the design of the economic life cycle (i.e., by the relation between the age of individuals and their economic activities). Introducing economic dependency ratios built on data measuring age-specific averages of consumption and labour income extended by the time used for unpaid work, these authors find substantial differences across countries.

Hammer et al. (2013) find that the life cycle deficit (LCD—as a measure for the total consumption of children and elderly persons that cannot be covered out of their own labour income) for young people lies between 20 % of labour income in Austria and 29 % in Italy, and in old age it amounts to between 21 % in Sweden and 30 % in Hungary. In Sweden, the average person has a life cycle surplus of 38 years. Conversely, in Slovenia, Italy, Finland and the UK, the average person has only 32 years with a life-cycle surplus, which indicates that the design of the economic life cycle plays an important role in the redistribution of resources. For instance, the low value of the LCD in younger ages for Austria is driven by early-age entry into the labour market on average, whereas the low value of the LCD in old age for Sweden can be explained by the late exit from the labour market. As a consequence, reforms of welfare states directed at increasing the fiscal sustainability of pension systems must consider the interactions between various institutional arrangements and life cycle surpluses and deficits.

## 5 Social Acceptance and Implementation of Welfare State Reforms

European welfare states thus face enormous reform challenges. On the one hand, governments are confronted with political demands to address old and new social risks rooted in globalization, migration, ageing, technological change, revised

patterns of work, shifting family structures and other forms of social modernization and life-style changes. On the other hand, these same governments are confronted with an imperative to improve competitiveness and consolidate public finances. The pursuit of these objectives typically requires a substantial overhaul of established welfare state structures (i.e., either large parametric or encompassing structural reforms). Moreover, implementing such policy changes in advanced welfare states involves not only certain economic challenges but also poses inherent political problems. In democratic systems, the interactions of voters, politicians, vested interest groups and the public bureaucracy give rise to numerous impediments to reforms and (seeming) irrationalities.

Policy persistence is frequently said to be rooted in institutional factors of the political decision-making process, whereas successful implementation of welfare state reforms is often attributed to a crisis-type culmination of economic problems. Conventional wisdom holds that cutbacks of social benefits and welfare services, increasing the retirement age, or easing of strict labour market regulations carry with them huge electoral risks for an incumbent government (Pierson 1996, Buti et al. 2010) as resistance to reform often stems from concerns about its asymmetric distributional effects.

Welfare state reforms almost always create groups of winners and losers. The unpopularity of reforms that are beneficial for the long-run economic and social prospects of a society is mainly attributed to the fact that the potential winners from such a policy change large and heterogeneous societal groups, whose members are neither informed about the gains nor well-organized. By contrast, the potential losses from welfare state reforms are mainly concentrated in well-defined constituencies. They are frequently well-informed beneficiaries and insider groups, including the welfare bureaucracy, that are able to organize effectively and voice opposition to disadvantageous policy changes. As a consequence, voters expecting to lose from reforms will dominate at the ballot box over the potential winners, making retrenchment policies highly unlikely. Thus, the central question becomes the following: "Under what circumstances are governments able to pursue unpopular and politically risky reforms of the welfare state?"

The first finding is that the adverse electoral effects of such reforms may be overstated. In an analysis of structural reforms in OECD countries, Buti et al. (2010) find that market-oriented welfare state reforms are not automatically associated with electoral losses by the acting government during the following elections. The electoral impact of such policies differs strongly depending on the type of reform considered. Policy measures that hurt large groups of insiders such as changes in the pension system or reductions of employment protection legislation seem to reduce the electoral chances of the implementing government. Particularly in countries with rigid product and labour markets in which reform needs appear to be most pressing, reform-oriented governments tend to be voted out of office.

Another strand of the literature has developed the idea that governments facing both electoral constraints and severe welfare reform requirements tend to follow a strategy of "blame avoidance" (Pierson 1996). Governments aim to mitigate the

negative electoral consequences of economically necessary austerity programs and welfare benefits cuts by means of “scapegoating” (e.g., reforms that appear to be imposed by international organizations), reducing the visibility of reforms, restricting the losses to certain segments of the voting population, or by means of the development of direct and indirect schemes and political bargains to compensate (potential) losers (Pierson 1996). Such a policy strategy will, at best, produce incremental policy changes and will not enable ruling governments to push through substantial reforms (Bonoli 2011).

The role of partisan politics for welfare state reforms is debatable. Against the background of increasing fiscal consolidation pressures in many Western European countries, partisan differences seem to have become less important to the reform of welfare states (Castles 2001). Giger and Nelson (2011) argue that certain governments or parties within ruling coalition governments—depending on their ideological backgrounds or partisan positions—can even claim credit for retrenchment policies. Cuts in social policies may be tolerated or supported by some voter groups, and retrenchment policies are politically rational under certain circumstances, particularly for religious or liberal parties. The results by Van Vliet et al. (2012) indicate that left-oriented governments must provide higher unemployment protection than their non-leftist counterparts but that this effect depends on the background economic situation. Rising unemployment rates leading to increased budgetary pressures reduces left-wing governments’ inclination for stronger unemployment protection.

Although such political difficulties in implementing welfare state reforms are almost universal in Western democracies, the ability of reform-oriented governments to overcome impediments to change also depends on a country’s institutional framework. Constitutionally fixed decision-making rules and governance structures are of extraordinary importance to implement reform and can prove to be a major obstacle to substantial policy changes. The persistence of inefficient policies is often explained by formal institutional arrangements that generate gridlock and lead to veto positions for powerful political players. Most prominently, Tsebelis (2002) argues that increasing the number of veto actors impedes decisive political action. Thus, political systems with numerous veto points may be less suited to implement significant reforms. Applied to questions of welfare state reform, it follows that a large number of institutional and non-institutional veto players with strongly opposing partisan interests tend to inhibit both expanded benefits and the implementation of new services as well as radical cutbacks (Bonoli 2001). In line with these hypotheses, Ha (2008) reports that globalization exerted an upward pressure on welfare spending in 18 industrial countries over the 1960–2000 period, but the extent to which governments responded to rising welfare demands is negatively related to the number of political veto actors and their ideological distance in the structure of those governments.

The implementation of “more than just incremental” policy reforms is thus frequently attributed to a crisis-like culmination of economic problems, which will finally lead to a substantial shift from the previous political equilibrium (Pitlik and Wirth 2003). In the wake of a crisis, status quo preserving interest groups are

more likely to accept uncertainties associated with substantial reforms, and governments also have a greater propensity to bear the higher risks of the temporary economic hardships associated with structural changes. Crises may also stimulate change based on the policy learning of government officials, interest groups and the electorate. In revealing that the current policy model has failed, an economic downturn may convince policy makers and voters about the inferiority of the status quo policy strategies and generate incentives to implement fundamental alternatives.

However, reforms may also be impeded by the characteristics of the particular government sector that they apply to. For instance, in their case study of the rehabilitation services for the disabled, Scharle and Váradi (2013) suggest that fiscal constraints, historical commitment to equal rights, policy making capacity, and decentralization are important drivers of change. Whereas some of these factors may be, at least in the short-run, beyond the control of policy makers, some can be strengthened by governments wishing to promote the long-term performance of the welfare system. This strengthening can be achieved by enhancing the capacity of the public administration to commission and communicate empirical evidence supporting the case for reform, designing adequate policy changes and by monitoring the implementation of these changes. In addition, setting up more or less independent agencies to monitor policy implementation can also help strengthen the reform commitment of governments and defend their case in the face of opposition.

Moreover, the reform preferences of citizens may also be shaped by factors other than narrow self-interest. Behavioural economics stresses that these preferences may also be shaped by the perception of the procedural and distributive fairness of the available reform options (e.g., Alesina and Angeletos 2005), in addition to relatively stable cultural and social norms, conventions, moral values, and/or personal traits, such as informal institutions (Margalit 2013). Highly persistent core beliefs might thus be at the heart of explanations for the lack of willingness to undertake fundamental welfare state reforms. In addition, the empirical literature shows that trust and examples of reform from other countries can positively affect reform acceptance. Trust is an important driver for reforms because it lowers societal transaction costs for all types of compromise and compensation mechanisms that are conducive for a successful crisis strategy but might also lead to welfare state expansion if lower transaction costs reduce free riding (Aghion et al. 2010). Reform examples in comparable and/or neighbouring countries can help with information problems of all types. Further handicaps for reforms may stem from high societal discount rates in ageing societies—causing overemphasized of up-front reform adjustment costs to long-run reform benefits (Lechthaler and Mileva 2013)—and from poor economic knowledge about the future benefits of policy changes and from behavioural phenomena that tend to favour the status quo (Heinemann 2004). In addition, social capital or social cohesion may promote the social acceptability of reforms because it is easier overcome reform resistance in cohesive societies with high levels of horizontal and vertical solidarity (Easterly et al. 2006).

These additional constraints may be particularly relevant for the on-going large-scale reforms in Southern Europe. Heinemann and Grigoriadis (2013) show that several of these reform obstacles are empirically correlated with the individual inclination to accept reforms. The perception of procedural fairness (i.e., satisfaction with the way democracy works) together with trust are key to accepting reforms. Trust in national institutions fosters reform acceptance, and there is a strong correlation between trust in EU institutions and reform acceptance. Thus, Southern European countries may face severe handicaps in any reform process as the combination of party patronage, prevalence of corruption, and inefficient public administration undermines trust in acting politicians and bureaucrats.

More generally, Pitlik and Kouba (2013) suggest that people are willing to confer an important role to government only if this role is consistent with core beliefs *and* if the quality of the public administration is considered high (Rothstein et al. 2011). These authors find that trust in people is generally associated with greater support for redistribution and for government intervention only if the perceived quality of administration is high and confidence in companies is low. Employing Rotter's (1990) concept of a "locus of control", these authors find that the feeling of individual life control is strongly negatively related to attitudes for income equalization and government intervention (Bavetta and Navarra 2012). Nonetheless, the higher the confidence in government in relation to confidence in major companies, the smaller is individual opposition to redistributive and interventionist policies, given the level of life control. Among people who do not believe in the ability to control their own lives, both a high perceived quality of public administration and a low confidence in major companies enhances the preferences for redistribution and intervention. With regards to the external locus of control, Pitlik and Kouba focus on religiousness or belief in God. Here, the results are ambiguous. People who are religious seem less favourable towards income equalization, which indicates a proximity to the substitution theory between religion and state as two possible types of insurance against adverse events (e.g., Scheve and Stasavage 2006).

Andréasson et al. (2013), define social cohesion as a multidimensional concept that consists of five orthogonal components that they label "social divisions", "modern values", "traditional nationalism", "institutional commitment", and "fairness as merit"; these authors find that most dimensions of social cohesion do not influence the occurrence of reforms. However, fairness as merit is shown to positively affect on policy changes. Moreover, a certain degree of social division seems to be helpful in handling a crisis. From this perspective, therefore, social cohesion promotes reforms only when based on an understanding of fairness as merit.

## 6 Conclusions and Directions of Future Research

To the extent that policies in welfare states are directed at removing inequalities of opportunity, the literature surveyed in this paper indicates that re-distributional policies following a social investment approach are more likely than not to be conducive to growth. The frequently postulated trade-off between efficiency and equality thus does not generally apply. Countries looking for growth-friendly social policies should focus primarily on policies that provide equal opportunities and avoid exclusion or discrimination on the basis of gender, ethnicity or other characteristics. Although this conclusion may seem trivial, the empirical evidence on differences in economic outcomes between genders, ethnicities and socio-economic groups documented in the contributions surveyed (and in many others) suggest that EU Member States still have some room to improve with respect to providing equal opportunities to all residents.

Realistically, a policy based on removing inequalities in opportunities alone is unlikely to meet the changing demands on the welfare state. Some form of "traditional" redistribution and social insurance against the risks of unexpected income losses must also be a feature of any future European welfare state. The literature suggests that an analysis of redistribution over the life cycle and the impact of life-cycle events—as well as a more detailed analysis of unpaid work—is required to design effective polices. This analysis, particularly, applies to areas in which gender aspects enter the analysis.

In any case, welfare state reforms entail not only economic questions regarding the design of optimal policies but also problems regarding how the general public, third-party actors and vested interests can be motivated to support reforms. Theoretical reasoning and empirical results jointly suggest that a theory of welfare state reform resistance is severely flawed if it is simply based on the view of reform-resistance driven only by narrow self-interest. By contrast, the evidence underlines the role of core beliefs in the process of attitude formation and procedural fairness considerations. Voters require minimum confidence in their democratic institutions to accept the uncertainties involved in far-reaching institutional changes.

These findings are not only helpful in understanding the difficulties and constraints of designing sustainable reform strategies; they may also support the development of more convincing crisis strategies. Reforms cannot be successful if they only address market inefficiencies and weaknesses of the social and economic system. In addition, a promising reform strategy must also aim to build up faith in governmental institutions and public administration. A shortfall of credibility is one of the serious bottlenecks for a successful and comprehensive recovery of a region.

It should, however, also be acknowledged that different EU member states have largely different experiences with reforms and are also characterized by different reform needs. Some of these countries have addressed employment and social challenges far more effectively than others. Some have used more gradual means

of adjustment, often following a major reform step, whereas others seem only to be able to adjust by means of a radical break. Similarly, member states differ vastly in their reform requirements and readiness within different subsystems of their welfare states (education, health care or the pension system), such that it is difficult to identify one reform pattern for all EU countries. Therefore, there is substantial need for more in-depth country level analysis of the needs, preconditions and impediments of welfare state reforms.

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