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Thinking ahead for Europe

Social Investment and State Capacity

Miroslav Beblavý and Alžbeta Hájková

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Abstract

The paper looks at the difference between the levels and nature of social policy expenditure in northern and northwest European countries and the countries of southern, central, and eastern Europe, and examines the relationship between social investment and state capacity in these country groupings. We show that southern and eastern countries have a greater preference for 'compensating' rather than 'capacitating' social policy spending. Furthermore, the state capacity in these countries is lower, which generates less state revenue. Based on these observations we conclude that low state capacity and low state revenue go hand in hand with the preference for capacitating social policies, as these policies involve less delegation and discretion than social investment policies. This document shows that high state capacity is probably a necessary precondition for effective social investment policies, although some limited alternative paths do exist.

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Social Investment and State Capacity

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Introduction

In recent decades, several European countries have carried out a major shift in social policy strategy to become more oriented towards social investment policies that represent “a move away from passive transfers and towards the maximisation of employability and employment” (Kersbergen and Hemerijck, 2012, p.475). Social investment strategy presupposes that the resources invested in social policy will pay off in the future, since this policy aims to increase the productive capacity of citizens, which in turn leads to economic growth (Nolan, 2013; Morel, 2013). However, as Kersbergen and Hemerijck (2012) note, there are remarkable variations in the ways in which different countries approach and deal with this new strategy.

This paper looks at the issues stemming from such differences. Using OECD primary data (2011) and following Dräbing (2014), we recognise that there is a significant difference between the levels and nature of social expenditure in northern and northwest European countries and the countries of southern, central, and eastern Europe. The paper examines these differences; it looks in particular at the relationship between social investment and state capacity in the abovementioned countries.

The paper has three sections. In the first we define capacitating and compensating social spending, and then look at their levels in northern, southern, central and eastern EU countries. We observe that southern and eastern countries have a much higher preference for compensating over capacitating spending. We start the second part of the paper with a discussion of state capacity, and then proceed to test the first part of our hypothesis – that smaller state capacity leads to smaller state revenue – by taking a close look at their levels in the country clusters we use. In the third part of the paper we examine the second part of our hypothesis, which holds that low state capacity and low state revenue go hand in hand with relative preference for capacitating social spending, as it involves less delegation and discretion than social investment policies. We conclude by proposing that for a genuine social investment policy to exist, the level of state capacity must be high, although there are some limited alternative paths.

Capacitating and compensating social spending in Nordic, southern, eastern and central European countries

While the post-war welfare state was designed to deal with ‘old social risks’ such as unemployment, senescence, ill health, disability, sickness, and the cost of raising children through providing health care, pensions, and cash benefits for the productive age population (Vandenbroucke & Vleminckx, 2011, p.452, p.458), contemporary societies are facing different kinds of social challenges. One such challenge is having low or outdated skills that are no longer compatible with the needs of the contemporary job market and do not meet the

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demands of open, knowledge-based economies (Vandenbroucke and Vleminckx, 2011, p. 452).

The idea behind social investment policy is that a flexible and skilled workforce, which is a solution to the abovementioned risks and a key to social stability, can only be created and maintained through investment in education and training, and in general through the continual life-long enhancement of skills matching the needs of today's job market (Morel 2013). Thus, this kind of social policy engineering relies heavily on preparation and activation, rather than guaranteeing ex post compensations, as was the case with 'old social risks'. While Nolan (2013) challenges the view that social investment policy is investment in the traditional sense of the word, i.e., "spending on the goods that are not consumed but are intended to be used for future production" (p.463), the desired and expected effect of capacitating social spending is to stimulate economic growth, to create more jobs and jobs of a higher quality, and to broaden the tax base (Morel, 2013).

Nordic countries appear to display the most faithful embodiment of this philosophy of social investment. According to Dolvik, Goul Andersen and Vartiainen (2012), the social policies carried out in Scandinavian countries in the past two decades represented a transition towards more egalitarian society, high labour market mobility, a more skilled workforce and higher value-added production. Kersbergen and Hemerijck (2012) characterise the Nordic welfare system as combining "generous maintenance benefits, well-developed public social services and active labour market policies, which sustain high participation rates for both men and women" (p.481) Jochem (2011) agrees and adds that the ideal social policy mechanism that the Nordic regime represents does not simply protect people from economic changes, it enables them to successfully adapt to these conditions and organise themselves within them. It thus combines the two necessary pillars of the new welfare state, where the more traditional forms of social protection and social investment create a balanced whole (Vandenbroucke & Vleminckx, 2011). The status of Nordic countries as leaders in social investment policies is also confirmed by the social policy country assessments conducted by the European Social Policy Network (2015). The country reports make it clear that in north European countries social investment is the backbone for social spending strategies.

For the purpose of this paper, we distinguish between three different groups of countries with regard to their capacitating (that is, in line with the idea of social investment) and compensating (i.e. helping the socially disadvantaged through direct and immediate benefits) social spending, drawing on primary data from OECD (2011) and following Dräbing (2014). EU member states that are not members of OECD: Bulgaria, Latvia, Lithuania, Romania, Malta and Cyprus – are not included. Greece and Luxembourg are also excluded as for them there is no key data on public education and expenditure.

The first group, which we call social investment vanguards (SIV) includes Denmark, Finland, the Netherlands and Sweden. The south; that is Italy, Portugal, and Spain make up the second group. The last group represents the east, and in our sample includes Czech Republic, Estonia, Hungary, Poland, Slovakia and Slovenia. The expenditure of each of these groups is also compared with the EU average of 19 countries.

Table 1. *Capacitating social spending as a % of GDP, 2011*

Country Cluster	Capacitating
average	9.13
SIV	13.53
South	7.15
East	7.40

Source: Authors based on OECD/Eurostat data, following Dräbing (2014).

Table 1 shows that the south and east present us with almost the same picture when it comes to their average capacitating social spending. This spending lies below the EU average and below the SIV average, which at an average expenditure of 13.53%, is a clear leader among the country groups.

Table 2. *Compensating social spending as a % of GDP, 2011*

Country Cluster	Compensating
Average	14.32
SIV	13.19
South	17.49
East	12.47

Source: Authors based on OECD/Eurostat data, following Dräbing (2014).

Table 2 reveals a significantly different situation. Here, the SIV and east have low average compensating spending, placed a little below the EU level. The south, on the other hand, has a very high level of average compensating social spending, outstripping the EU level by 3.17%.

Table 3. *Total of compensating and capacitating social spending, in % of GDP, 2011*

Country Cluster	Total	Ratio - compensating / capacitating
Average	23.46	1.69
SIV	26.72	1.03
South	24.64	2.49
East	19.86	1.69

Source: Authors based on OECD/Eurostat data, following Dräbing (2014).

In Table 3, we see that the east has lower total social spending than the south. However, from tables 1 and 2 we also learned that the east manages to distribute this spending between capacitating and compensating spending much more evenly than south. The EU average here falls between the south and the SIV total social spending, which is once again at the top of the chart.

From tables 1 and 2 we can conclude that there is indeed a contrast between the nature of social expenditure in SIV and the eastern and southern country clusters. While the SIV's capacitating and compensating social policy expenditures are almost even, the south and east have a clear preference for compensating social spending, and have significantly lower

levels of capacitating social spending than the SIV. We will now move on to the discussion of state capacity and state revenue, in order to examine the link between social spending and these two factors in the last part of the paper.

Size of social expenditure and state capacity

State capacity is defined as the power that enables the government to govern - it is “the ability of a political system to enforce rules and to deliver services” (Ottervik, 2013, p.3). Chang (2014) notes that people can benefit from a democratic government only insofar as this government has the capacity to *enforce* its democratic principles; a state can only be viable if it has the actual power through which its ideological foundations come to fruition in the form of policies.

McAdam, Tarrow and Tilly (2001) touch upon the classical Weberian notion of the state when they define state capacity as the “degree of control state agents exercise over persons, activities, and resources within their government’s territorial jurisdiction” (p.78). The fact that they mention “persons” points to the truth that the exercise of state capacity is never a one-way relationship but can encounter both the voluntary and non-voluntary compliance of citizens. One of the ways to measure compliance with state power is to look at how effectively a state collects resources, since this is a process that clearly requires compliant behaviour on the part of citizens (Ottervik, 2013).

The level of state capacity undoubtedly has an effect on the social policy of the state. In fact, Rondinelli and Shabbir (2003, pp.247-248) define the role of a *competent* state in the 21st century through the perspective of social investment policy: governments should aim to achieve sustainable economic and social progress, which can be done through focusing on policies that “enhance the capacities of people... to participate more effectively in productive activities on which their livelihood depends.” We see that here sufficient state capacity is not only a necessary precondition for social investment policies; it is also the means of carrying them out effectively.

Fukuyama (2013) rightly notes that since state capacity varies across different levels and functions of government, we would ideally want to measure it for all major governmental institutions. Such an option is beyond our current possibilities; for the purpose of this paper we identify three crucial indicators that represent different aspects of the concept of state capacity. We choose to focus on the tax compliance level (Ottervik, 2013), which, as was mentioned, is a widely accepted method of measuring state capacity. Even though it is criticised as carrying various possible limitations (Fukuyama, 2013), the fact remains that the ability to extract resources is one of the main conditions of the very existence of the state (Chang, 2003). Secondly, the perceived level of corruption as measured by Transparency International’s CPI index tells us about the respect of citizens for the institutions that oversee the economic and social conditions that citizens find themselves in (Kaufmann, Kraay and Mastruzzi, 2010 in Ottervik 2013). Finally, the World Bank’s Government Effectiveness (GE) indicator helps us to determine “the capacity of government to effectively formulate and implement sound policies,” “the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies” (Kaufmann, Kraay and Mastruzzi, 2010, p.4).

When these indicators are applied to the country clusters introduced in the previous section, we can see (Table 4) that the level of corruption is similarly high in the south and east, while government effectiveness is, by contrast, comparatively low. At the other end of the

spectrum in terms of corruption levels and government effectiveness, the SIV are surpassing not only the EU average, but also that of the east and the south.

Table 4. State capacity, most recent data

Country Cluster	Transparency International's Corruption perception index	World Bank's Government Effectiveness indicator
Average	68.84	1.30
SIV	87.75	1.95
South	53.33	0.94
East	57.17	0.83

Source: Authors based on Transparency International Corruption perception index (2014) and World Bank Worldwide Governance indicators data (2014).

When it comes to tax compliance, as shown in Table 5, the south and east are on the same level, which is lower than both the EU and SIV average. Furthermore, the east and south have a much higher VAT gap than the EU average. The VAT gap of SIV is significantly lower than the EU average, and is at the opposite end of the scale to that of the east and south. With regard to total public revenue, Table 5 shows that the total revenues of the south and east are below the EU average, while the SIV's total revenue is markedly higher than those of the remaining groups.

Table 5. State capacity and revenue, most recent data

Country Cluster	VAT gap	Tax compliance	Shadow economy	Public revenue
Average	15.05	0.84	19.54	43.85
SIV	6.25	0.86	16.60	50.55
South	19.67	0.81	24.15	41.40
East	22.33	0.81	23.73	40.35

Source: Authors based on QoG data (2014).

When seen together, tables 4 and 5 present us with a link between state capacity and tax compliance: the lower the state capacity, the lower the tax compliance. This points us to the conclusion that smaller state capacity goes hand in hand with lower state revenue. Of course, correlation is not causation and we do not suggest this. Rather, we think that it shows parallel consistency of the two.

State capacity and the nature of social expenditure

In the last part of the paper, we examine how low state capacity and state revenue influence the nature of social policy rather than just the size of public expenditure.

We have previously defined state capacity as the enabling power of the government to govern. In this section, we show that high state capacity is in addition to the ability to design and implement complex policies with a high level of discretion. We look at the policies through the lens of the principal-agent framework, where they can be seen as incomplete contracts between the state (i.e., the policy-makers) and citizens (i.e., the individuals) (see e.g.

Tirole, 1999). Their 'enforcement', or the fulfilment of their objectives and the successful dealing with any contingencies that might arise depend on state capacity.

If we return to our initial distinction between compensating and capacitating social spending, it is the latter whose 'enforcement' is of a more complex nature and requires greater discretion. Honig (2006, p.4) concludes that the implementation of education policies, which, along with training, belong to the core of skill-enhancement oriented social investment, is a "complex and highly contingent enterprise in which variation is the rule, rather than the exception." All in all, social investment policies require predicting future needs of the labour market and often encompass several stages (see Kluve et al., 2007). They also require big and continual investments (e.g. Kluve et al., 2007), which makes them less affordable to those countries which, due to their low state capacity, have lower state revenue, as we saw above.

Our hypothesis stands on the assumption that smaller state capacity, along with lower state revenue, leads to a relative preference for compensating social spending, as it requires less delegation and discretion than capacitating spending. High state capacity, on the other hand, enables states to pursue social investment policies that are of a more complex character. When we return to Table 1 and Tables 4 and 5 and compare them in light of this hypothesis, we see a link between the level of state capacity and capacitating social spending: country clusters with low state capacity (in the east and south) have low levels of capacitating social spending. By contrast, the SIV have primacy in both capacitating social spending and state capacity.

In order to test our hypothesis more fully, we distinguish between three different levels of social spending. The first level is cash benefits for certain groups of population, which belong to compensating social spending. The next level includes universal services, such as child care or retirement homes, the provision and sustainment of which require greater discretion than the provision of cash benefits. Finally, high intensity capacitating social expenditure, such as Active Labour Market Policies or Research & Development, stands on the third level. The first level fully corresponds to the compensating spending while the third level corresponds to social investment policies, and is the most complex when it comes to design and implementation. The second level can be split between the two, with capacitating policies predominating.

Using a principal-agent framework, we see that cash benefits contain the least discretion and delegation from policy-makers to those responsible for implementing policies. They are not only entitlements to which citizens have a legal right, eligibility is also prescribed in detail by legislation and tends to be quite clear. The substance of delivery - cash - is also clearly and unambiguously described (see Daly, 1997).

The situation is similar in terms of eligibility and citizen entitlement for universal services. However, there is much more inherent incompleteness in terms of describing the substance of the service, which is invariably impossible to monitor completely. While governments can and do utilise both ex ante and ex post tools to structure the content of universal services, there is an inherent limit to what a curriculum or a government inspector can do to make sure that precisely the same kind of education service is determined in advance and is delivered everywhere and every time (e.g. Honig, 2006).

For high intensity capacitating expenditure, such as research and development or active labour market policy, both eligibility and substance tend to be delegated by policy-makers to those implementing them. The reason is that while the desired outcomes can be described ex

ante, their implementation (e.g. awarding and managing a research grant) is too complex and contingent on tacit knowledge that a measure of delegation and discretion is needed (see e.g. Hartlapp and Leiber, 2010, pp.472-473).

Our hypothesis that low state capacity results in a preference for the kind of social spending that involves less discretion and delegation is also indirectly supported by the series of country reports on social investment by the European Social Policy Network (2015). The assessments of the east European countries included in our country clusters frequently overlap in their remarks on the inability of this or that particular country to deliver more complex social policies and to present them as a consistent package. Lack of coordination, personalisation, and the integrity of social policies are also noted. Furthermore, with the exception of Slovenia, reports on all countries from our eastern cluster conclude that social investment is a term that is not explicitly present in the social policy strategy of the country, even if we might find some particular policies that implicitly adhere to the concept of social investment. When it comes to southern European countries, reports concur that in the post-crisis years, efforts to consolidate state budgets were carried out at the expense of cuts on welfare and consequently left less room for social investment policy. As a result, social investment is a notion that is not fully articulated and remains quite weak in the social policies of any of the countries belonging to our southern cluster.

Table 6. Three types of social spending based on the principal-agent framework, % of GDP, 2011

Country Cluster	Cash benefits	Universal services	Active labour market policies / Research and development
Average	13.29	7.55	1.38
SIV	12.58	11.52	2.24
South	15.43	5.76	1.22
East	12.07	5.79	0.90

Source: Authors.

Table 6 shows that when it comes to cash benefits, the SIV and east are on a similar level, slightly below the EU average. The level of the south is higher than both the EU average and the SIV and the east. A closer look at the levels of universal services presents an interesting picture – the south and east have much lower levels than the SIV. For high intensity capacitating spending, both the south and east lie below the EU average, with the east having a slightly lower level than the south. The SIV, on the other hand, stand almost one point above the EU average.

Conclusion

This paper explored the relationship between social investment and state capacity in the European Union. It started by comparing the size of capacitating and compensating social spending in selected country clusters, which demonstrated a strong preference for compensating social spending in the east and south. It then proceeded to a discussion of state capacity and state revenue. With regard to these categories, the performance of the east and south was again lower than that of the north-western member states.

Finally, the paper tested the assumption that small state capacity and state revenue lead to a preference for compensating social spending. It showed that the SIV states have the highest level of expenditure on social investment policies, which requires the most delegation and discretion. The SIV states also spend more (although the gap is lower) when it comes to universal services, which are easier to implement than high intensity capacitating policies, but still require more discretion than cash benefits. By contrast, countries in Europe's south and east, whose levels of state capacity and state revenue were significantly lower than those of SIV, show a strong preference for cash benefits, which belong to the compensating social spending category.

In order for the 'peripheral' countries to converge to the SIV level of social investment spending, there is a need to increase their state capacity. Hanson (2015) suggests that states with greater capacity and a 'competent bureaucracy' actively participating in the formulation of governmental policies inherently provide better services to their citizens; social investment policies being one type of such services. A weak state might devise a strong incentive to deliver a certain kind of public service – but if it is lacking in state capacity, its implementation will not meet the desired outcomes (Hanson, 2015). Building state capacity is a long-term process, however.

This stark conclusion begs two questions. First of all, are there alternative ways in which even states with lower state capacity can successfully engage in a partial social investment trajectory? Second, if not – is this divergence in state capacity a threat to the successful functioning of the eurozone, if not the whole Union?

Regional averages belie significant differences between countries. For example, the Baltic states have managed to build up state capacity significantly throughout more than 20 years of independence. On perceptions of corruption, Estonia now ranks between Austria and France (Transparency International, 2014). In some of the peripheral member states, of which the Czech Republic is a good example, the ability of civil society to substitute for lower state capacity is remarkable in some areas – for example, in research and development. However, these are exceptions to a broader trend that is much less heartening.

With regard to the second question – the growth performance of the southern and eastern European member states over the past decade presents a much differentiated picture, with some countries with low social investment expenditure managing a rapid convergence with the rest of the EU, despite the financial and economic crisis (e.g. Estonia, Slovakia). However, even successful peripheral EU member countries have not managed to fully converge with the economic performance of the 'core' and there appears to be a specific EU version of the 'middle income curse' where the convergence of such countries stops well short of full catch-up (Czech Republic, Greece, Portugal and Slovenia are examples of countries that had been closest to the core at some point, but then lost ground again) (Beblavý, 2013). In other words, the divergence in state capacity (and other factors) between north-west European countries and the rest of Europe might be an obstacle to full economic convergence, but it does not necessarily imply *increasing* gaps. On the one hand, such gaps between the core and the periphery have been a longstanding feature of European history. On the other hand, how sustainable they are in a more closely integrated economic and social union remains an open question.

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