Five minutes with Tito Boeri: “We don’t just need a welfare state in Europe, we also need a welfare union”

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Are Europe’s welfare states fit to meet the demands brought on by the financial crisis? In an interview with EUROPP’s Managing Editor Stuart Brown, **Tito Boeri** *discusses the need for a ‘stress test’ of the European welfare state, why citizens in southern European countries have been much more susceptible to poverty during the crisis, and the role that EU cooperation should play in providing a more effective safety net for European citizens.*

You have argued that alongside bank ‘stress tests’, which aim to determine whether banks have the capacity to deal with adverse economic developments, Europe should also carry out something approximating a stress test of European welfare states. Has the importance of welfare states been overlooked in Europe’s response to the crisis?

Well in the last few years we have had several stress tests of the banking system in Europe. These tests have had the intention of assessing the vulnerability of financial institutions to negative economic developments, such as serious drops in GDP or changes in interest rates. But a similar analysis has not been carried out with reference to a key pillar of the European Union: the welfare state.

The welfare state is supposed to act as a safeguard, particularly during difficult times like those which have occurred in Europe since the crisis. It essentially has three key functions. The first function, which is perhaps its overriding purpose, is to provide relief from poverty or to prevent a rise in poverty rates. The second function is one of protecting against privately uninsurable labour market risks, such as providing unemployment benefits in case people lose their jobs. The third function is to promote labour force participation. In a period of economic crisis the first of these functions is clearly the most important.

Now during the Great Recession we haven’t seen many of the things that we saw in the Great Depression of the 1930s. It is true that for some countries the last few years have actually been even worse by some measures: the fall in GDP in some southern European countries was larger this time around than it was in the Great Depression. Also if you compare industrial production, which has been captured very nicely by Barry Eichengreen and Kevin O’Rourke, you do see that in some respects things have been worse.

But for the most part we have not seen anything like the classic image that we have of the Great Depression, with huge numbers of middle class people suddenly becoming poor. What we have seen is something different, with the numbers of homeless people rising, for instance. So it is very important to analyse precisely what impact welfare states are having, which is now feasible because we have good data on aspects like incomes, consumption patterns, and labour markets. This is the kind of ‘stress test’ of the European welfare state that I have been trying to do in my work.

What are some of the key findings from this analysis?

The first thing that I tried to do was calculate some basic threshold levels. For instance, how much would GDP have to decline in a given country for poverty to start rising? Although you can talk about poverty thresholds changing over time, I took poverty as an absolute value: I calculated the relative poverty threshold in a certain year, which is 60 per cent of the median income in a country, and froze it over time in real terms. So if someone slipped below this threshold in future years they would be classed as being in poverty, even if the median income also changes during this period.

It turns out that for the European Union as a whole, a recession which results in a drop of 0.7 per cent of GDP will significantly increase the poverty rate. However there is a large variation between EU countries. Whereas in some southern European countries even a milder recession will increase poverty rates, in the Nordic countries a recession as high as 5 per cent of GDP does not result in a rise in poverty rates. This underlines that there are substantial differences in the way in which different countries in Europe react to these conditions.

Similar findings come from analysing the poverty rates and unemployment rates. In southern Europe it is sufficient to have a rise in unemployment of around 1.3 base points for poverty to increase, while in the Nordic countries the relation between poverty rates and unemployment is almost flat: unemployment can rise significantly without affecting poverty. So clearly there is a problem of vulnerability in certain parts of Europe which does not exist in other countries to the same extent.

Why is this type of vulnerability more severe in southern European countries and what can be done to address the problem?

Part of the reason is that these countries have developed institutions which make them particularly vulnerable to economic shocks. In particular, these countries relied in the past to some extent on families providing support, which constituted a kind of informal welfare state. They also transformed and reformed their labour markets in a partial way. They introduced so called ‘two-tier’ systems, where there is a coexistence of workers with open-ended contracts and those with fixed-term contracts in the same labour market.

In these systems all of the risk falls on those with open-ended contracts. We saw this during the recession, where employers clearly found it more convenient to lay off those workers who did not have a permanent contract because it was far less costly to do so. This occurred even if the workers losing their jobs were younger or potentially more productive. At the same time, the system is heavily imbalanced when it comes to welfare. A pure unemployment insurance system requires a long contribution period, and given these workers typically have many short spells of employment, they often fail to reach the level of contributions that would make them eligible for full unemployment benefits.

So these issues need to be tackled. On the one hand these countries need to address the contractual dualism which exists and find a way to unify the labour market. This is something which can be done independently in each country. For example Italy recently introduced a graded security contract which is really aimed at absorbing temporary workers into permanent jobs. This worked just by making it easier for employers to lay off workers in the initial stage of their career, with protection gradually increasing throughout an individual’s employment.

Another reform which these countries should pursue is to make the coverage of unemployment benefits wider, while trying to build up a safety net for those who become unemployed. This would make their welfare systems more similar to those which exist in northern European countries. But this second approach is more difficult to implement at the national level. Whereas addressing contractual dualism has no fiscal implications, increasing the coverage of unemployment benefits has direct fiscal implications and is relatively costly to achieve.

In several Eurozone countries which are undergoing fiscal consolidation policies this just isn’t feasible. So a related policy conclusion that one could draw from this situation is that when you have asymmetric shocks within a monetary union, which hit some countries more than others, the fiscal rules that prevent these countries from adopting strategies to improve their welfare systems are extremely damaging.

These are policies which can be implemented at the national level, but how important is the European level in solving the problems you have discussed?

If you look at what is happening with unemployment in Europe, it has become increasingly divided in terms of countries rather than regions. Historically there have been very significant regional differences within countries, for example between the North and South of Italy, but the countries which have suffered during this recession have been damaged entirely – in strong regions as well as weaker regions, with a few exceptions. Meanwhile, the convergence in social spending within the EU that was taking place before the crisis has been interrupted.

So one wonders whether as a result of all of these factors we need to think more about coordination in terms of Europe's social model. There are clearly spill-overs across jurisdictions and there is a very important issue with poverty which should be one of our key priorities, given the founding principles of the EU. From a macro-standpoint there are also implications because greater coordination in terms of welfare spending would provide automatic stabilisers which are more efficient than those which have been used during the recession.

How should this be done in practice? Well there are proposals to introduce an EU-wide safety net. There are also proposals to introduce a European unemployment benefit system. In light of the current policy debates in Europe both of these proposals might seem like extremely difficult objectives to reach. But perhaps something a bit less ambitious, like an equal opportunity contract for young workers in Europe, which gives them some funding to pay for training or to buy pension or unemployment benefit rights, may be a better way to proceed. But definitely one of the key lessons that we can draw from this stress test is that we don't just need a welfare state in Europe, we also need a welfare union.

Tito Boeri presented his research at a recent public lecture hosted by the LSE's European Institute

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About the interviewee

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