The Social Protection Committee

14 September 2009

# GROWTH, JOBS AND SOCIAL PROGRESS IN THE EU

**A contribution to the evaluation of the social dimension of the Lisbon Strategy**

## KEY MESSAGES

**Message 1: Over the past decade, economic and employment growth has in general improved overall living standards and many governments have been able to devote more resources to social policy intervention. However, despite the clear redistributive effect of social protection, inequalities have often increased and poverty and social exclusion remain a major issue in most EU countries, although with substantial differences across Europe.**

Generally, richer countries spend a larger share of their GDP on social spending and economic growth has allowed many governments to devote more resources to social policy interventions. However, empirical evidence[1] shows that income inequalities have increased in most EU countries since the mid 80s. These trends were already flagged in the "Social Reality Stocktaking"[2]. Most increases in inequalities happened between the mid 80s and the mid 90s. In the last 10 years, in most cases inequalities have remained stable, except in some countries. Behind these overall evolutions, diverging trends were observed at different levels of the income distribution. In most countries, top incomes grew relatively faster than middle incomes. In some countries, low incomes caught up with median incomes, while in other countries inequalities also widened at the bottom of the distribution.

A major factor behind this is the **increase in earnings inequality** among full-time workers **further strengthened by the development of involuntary part-time and temporary contracts**. Labour market segmentation is an important determinant of widened earnings inequality not only because non-standard workers tend to work fewer hours per year but also because they are generally paid less per hour *after controlling for differences in education and experience*. Available data therefore suggests that, in many Member States, ceteris paribus, there is a substantial wage penalty from holding a temporary or part-time job.

Relative poverty risks increased in most Member States between the mid-1980s and the mid-1990s and in most cases they either increased or stagnated between the mid-1990s and the mid-2000s. Over this second decade a shift in poverty risks was observed from the elderly towards younger people. **Child poverty remained stable or increased** in most EU countries, while poverty risks generally decreased for the elderly (though remaining at relatively high levels in a few Member States) as a consequence of the maturing of pension systems (including reforms of minimum pensions).

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[1] Evidence draw from the "Growing Unequal?" OECD report http://www.criss-ineq.org and from the funded EC research project INEQ http://www.oecd.org/document/53/0,3343,en_2649_33933_41460917_1_1_1_1,00.html

[2] http://ec.europa.eu/citizens_agenda/social_reality_stocktaking/index_en.htm

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The **design of the tax-benefit system is crucial** in determining the way and the extent to which it affects income inequalities and redistributes resources to the poor. Important features include the progressivity of taxes and benefits and the degree of targeting and conditionality of benefits that can create disincentive effects, if badly designed. In most countries, the redistributive effect of benefits is higher than that of taxes (notably when excluding pensions). Available evidence highlights a large variation across Member States in net cash support to low-income households (ranging from the bottom value of 20% to the top value of 87% of the poorest decile group's disposable income in different Member States). EU data show that social transfers other than pensions effectively reduce poverty risks but the degree to which they do so varies substantially across Member States (ranging from a poverty reduction effect of 50% or more in some countries to one of 19% or less in others). This also reflects differences in the size of expenditure, which vary from 12% to 30% of GDP. Further work would be needed to better understand the determinants of the efficiency and effectiveness of tax-benefit systems.

In recent years (2005-2007), it is only in countries experiencing very high average growth rates per year (above 5%) that significant improvements in the standards of living of the poor were observed (as illustrated by wide declines in anchored at-risk-of-poverty or material deprivation rates). In these countries, growth indeed appears to have helped the poor. For countries with average growth rates below 5% the nexus growth-living conditions of the poor is much less clear. In general, economic growth has made it possible to "erode" the areas of severe deprivation, particularly (though not only) in new Member States, but relative poverty has not declined and has even increased in some countries that were traditionally "good performers".

**Message 2: Having a job remains the best safeguard against poverty and exclusion. However, recent employment increases have not sufficiently reached those furthest away from the labour market, and jobs have not always succeeded in lifting people out of poverty. Some groups still face specific hurdles such as poor access to training for the low skilled, lack of enabling services, or poor design of benefits that create financial disincentives. Labour market segmentation persists combined with a lack in job quality. The development of precarious forms of employment, often characterised by a strong gender dimension has contributed to persistently high levels of in-work poverty. Lessons need to be drawn from these facts when preventing that the crisis considerably aggravates persistent exclusion. Active inclusion strategies are not only crucial to support the most vulnerable in the crisis, but also to limit losses to human capital and preserve future growth potential.**

While acknowledging the overall benefits of broader participation in the labour market, the report highlights a number of key trends showing that employment growth did not always reach the most excluded and that the jobs created did not always provide for decent living standards.

Significant progress has been made in raising employment rates across Europe, especially of women and also in reversing negative trends such as the decline in participation of older workers. Indeed, unemployment rates were significantly reduced in the EU (from 8.6% in 2000 to 7.1% in 2007) and the increased participation of women as second earners and of older workers (notably through the availability of part-time work) has helped improving the income of many households.

However, at the outset of the crisis, about one third of the working age population in the EU was out of work (unemployed or inactive). Furthermore, evidence shows that the increases in employment rates observed in all EU countries before the crisis coexisted alongside **significant numbers of workers in precarious jobs, working poor and jobless households**. Under-employment and precarious forms of contracts mitigate the positive impact of including more people in the labour market. Single and lone parent households whose numbers have grown in the last decades tend to be more vulnerable on the labour market.

**The experience of this decade has confirmed that improving access to good quality employment helps people out of poverty**. Having a job remains the best safeguard against poverty and exclusion, since the risk of poverty faced by working age adults without work (unemployed or inactive) is more than 3 times higher than those in work (27% against 8%). However, a job is not always a guarantee against the risk of poverty and the **working poor** represent 1/3 of the working age adults at-risk of poverty. In 2007, 8% of the people in employment were living under the poverty threshold. In-work poverty is linked to the employment situation of the individuals such as low pay, low skills, precarious employment and under-employment. Since 2000, the **development of temporary work, part-time work** (including involuntary part-time) and sometimes **stagnating wages** have **increased the number of individuals with low yearly earnings**. These trends particularly affected women and the young. It is also important to note that for part of the workers, these jobs are not stepping stones towards better jobs.

Importantly, situations of poverty are also linked to the type of household in which people live. In-work poverty is often related to low work intensity, i.e. situations where there are too few adults working in the household, or not working enough to make a living (too few hours or only part of the year). Single and lone parent households, as well as one-earner families face the highest risks of poverty.

The last decade has also seen the persistence of **groups of people that remain outside or at the margin of the labour market**, often facing multiple barriers to enter the labour market (among which low skills, care responsibilities, age, migrant background, and other factors of discrimination, etc.). The direst situations concern those households in which nobody works. In 2007 in the EU27, 9.3% of adults in age of working were living in **jobless households** against 10.2% in 2001. These improvements have not reached families with children to the same extent and in 2007, 9.4% of children still lived in jobless households against 9.5% in 2001 and the crisis is likely to increase the number of families having to rely entirely on social benefits.

Employment growth has been mainly driven by an increase of female labour market participation and to a certain extent by the prolonged working life of older workers. However, in many countries the **women who are furthest away from the labour market** (lone mothers, the low skilled, etc) still face important barriers to find a job, and a job that pays (lack of childcare or of care for other dependants, involuntary part-time, lack of reconciliation measures). The situation of **migrants** has also hardly improved over the period. In particular, in long-standing host countries migrants have much lower employment rates than the native population, even among the second generations. The current crisis may considerably aggravate the situation of these workers who were already vulnerable before the crisis.

**National experiences from past crises** show that in some instances short-term responses to rises in unemployment not only resulted in individual withdrawals from the labour market, but also have had long-term negative impacts on society as a whole. **Stocks of long-term**

**unemployed or inactive tend to persist long after recovery has set in** which points to the importance of **active social security policies**. Among the long term impacts of the crisis observed in some countries are the increasing numbers of people moving into long-term sickness and disability benefits, or early retirement schemes. Of these people, many are likely never to enter or return to the labour market.

A review of the main policy developments that were meant to address the trends described above shows that some progress has been made in enhancing activation measures across EU countries, but more needs to be done to reach the most vulnerable workers, especially concerning access to Life Long Learning, since evidence shows that **the low skilled continue to participate much less in training than the average worker**. This highlights the importance of sustained investments in education and training. The review also shows that specific activation measures are needed to reach different categories of workers: youth, women (child care and reform of family support), older workers.

The analysis also shows that while some **progress has been made in reducing financial disincentives** to take up work or work more, **attention should be paid to the adequacy of benefits**, especially in Member States with major weaknesses and loopholes in their safety nets. This shows that both goals need to be pursued at the same time. Furthermore, financial disincentives are not the only barriers to labour market participation, adequate and individualised support services play a key role. Finally, the inadequacy of safety nets is not only a cause of poverty persistence, but also an obstacle to re-integration in the labour market and society.

The report illustrates that more needs to be done to ensure that EU labour markets are truly inclusive and lead to greater social cohesion. In order to reach the most vulnerable, without necessarily increasing spending, the effectiveness of the measures described above can be reinforced if they are **integrated into active inclusion strategies.**

**Message 3: Past decades of reforming social protection systems have improved their long-term financial sustainability. However, there remain issues to be resolved regarding the accessibility and adequacy of social protection. Higher employment rates, longer working lives, and increased healthy life expectancies will play an important role in ensuring both adequacy and sustainability of social protection. In the case of pensions this would apply to funded as well as pay-as-you-go schemes. Efforts to modernise all functions of social protection should be sustained in order to ensure effective access to quality services for all while contributing to the efficiency of public expenditure. Notably, modernisation in health care and long-term care can improve the health of the whole population and of the work force.**

The extent to which social protection systems encourage social and active inclusion as the population ages has been a vital element in past reforms. Countries spend a larg share of their GDP on social spending and economic growth has allowed many governments to devote more resources to social policy interventions. Old-age pensions and sickness and healthcare benefits represent the bulk of spending in all EU Member States. In the last years the SPC has carried out important analytical work focusing on the adequacy and universality of protection, the sustainability of the systems, and the need to balance these two objectives through modernisation.

**Pensions** represent by far the greatest item of expenditure of social protection (46% in 2006). In the past years, Member States reformed their pension systems by tightening the eligibility for public pensions, reducing the projected levels of pensions relative to wages, increasing incentives for individual to work more and longer and increasing the role of privately managed pension provision. As a result, although the effect of demographic change in the absence of reforms would push public pension expenditure by around 9 percentage point of EU GDP between 2007 and 2060, recent reforms of pension systems are expected to reduce this increase to only 2.4 percentage points, so that projected expenditure would reach 12.5% of GDP in 2060.

As a consequence of the reforms the role of public pension benefits in overall pension provision would decline, though public pensions are expected to remain the major source of income for pensioners in all but a few Member States. Theoretical replacement rates which reflect pension levels relative to the last wages received are projected to drop on average by several percentage points, and some Member States should record decreases of around 20 percentage points. This negative impact on adequacy of pensions could be partially offset by extending working lives, through improving the ability and opportunities for all workers to remain in employment, by reinforcing contributivity and by improving the financial and administrative management of pension systems. For instance two additional years of contributions could raise theoretical replacement rates in the majority of Member States by 4 to 9 percentage points and help reduce the adequacy gap and the tension in the triangle of increasing contributions and declining expenditure. Replacement rates from privately pensions are also expected to increase as contribution to these pensions increase as a response to ageing and demographic changes. The current economic crisis and past studies have, however, highlighted the need to monitor the risk involved with such pensions for various socio-economic groups and have stressed the relevance of sufficient minimum pensions.

**Health and long-term care systems** are the second biggest social protection component and the availability, affordability and quality of care can strongly influence the likelihood of overcoming disease, avoiding mortality and ensuring independent living. The considerable improvement in the health status of the EU population in recent decades has been associated with more widely available healthcare i.e. a rising share of resources devoted to healthcare systems and a more equitable distribution of these resources. It has also been recognised that good health contributes to economic prosperity through improving labour market participation and improving productivity as well as increasing participation in other societal activities.

However, **health inequalities** exist between different EU Member States and between social groups within Member States and **have widened in recent decades**. This is partly due to the fact that some health care systems are under-resourced and that in many countries, various financial and organisational barriers prevent access to timely and effective healthcare for some groups of the population. It is also important to note that high levels of poor health in sections of the EU population imply substantial opportunity costs for the Union as they are detrimental to employment, productivity and growth. Avoidable ill-health also puts unnecessary pressure on public budgets.

Nevertheless, expenditure has risen over time and ageing, technology and growing expectations are creating further pressure on resources. Without investments in preventive measures, public expenditure on health-care is projected to grow by 1½ percentage points of GDP in the EU between 2007 and 2060. The evolution of future spending will depend on effective management and balancing of the costs and benefits of technological advancement, as well as achieving better value for money through strengthened primary care, prevention and health promotion, and through better coordination and rational use of resources.

Long-term care has been identified as an important social protection issue in view of an ageing population. Health and long-term care services are dependent on sufficient numbers of both high and low skilled staff and represent an opportunity for job creation in the care sectors.

Modernisation has happened also in other branches of social protection to improve coverage of new risks and improve responsiveness of the system, for example by increasing expenditure of active labour market measures, or by addressing financial disincentives to take-up work or work more (see message 2). Since modernising efforts have to continue in all the social protection functions to improve effective access for those that need it in a sustainable manner, it is vital to monitor all the different social protection benefit systems extensively.

<u>Message 4</u>**: Social protection systems can play a crucial role as automatic stabilisers and sustain the productive capacity of the economy. However, Member States are in very different positions to face the crisis. In some countries, there are significant weaknesses and loopholes in social safety nets. In others with mature social protection systems that cushion the impact of the crisis, financial sustainability is questioned in the long run. Countries faced with major public finance imbalances are left with little room for manoeuvre to address the social consequences of the crisis. This raises particular concern for those who also have weaker levels of protection.**

**Promoting labour market participation while improving the fairness, efficiency and effectiveness of social spending will be crucial for all countries, both in view of ensuring counter-cyclicality towards economic growth and addressing fiscal imbalances.**

Over the last 50 years, notably between the early 1970s and the 1990s, we have seen **a structural rise in the share of social protection expenditure** as a percent of GDP in Member States. There several reasons behind this trend. First, social protection systems are maturing and coverage is increasing. Second, new types of benefits are introduced – as happened with family, child benefits and long-term care benefits. Third, demographic and social and economic changes (e.g. evolution of family structure) can increase demand for social protection even in the context of constant set up of social protection systems. Fourth, relative price trends as well as indexation rules can lead to long term increases or declines in the share of GDP devoted to social protection – notably in the health care area. Fifth, inefficiencies in provision and lack of clear budget constraints and accountability can also contribute to long-term expenditure rises. Finally, we can observe a **hysteresis effect when increases in short-term unemployment persist and lead to long term labour market exclusion**.

The last mentioned of these effects takes place when there is a recovery on the labour market and the unemployed do not reintegrate the labour market and end up in long-term unemployment or into incapacity or early retirement benefits.

An analysis of the evolution of social spending and public deficit against the economic cycle illustrate to which extent social spending are counter-cyclical, both in bad and good times. **Social protection expenditure can be more or less responsive to the economic cycle**. Firstly, some cases reveal that reactivity to the cycle can be increased or decreased by the design of rules on granting different kinds of benefits. Eligibility criteria and benefit levels clearly affect benefit take up. Secondly, the relationship of social protection expenditure with economic growth depends on how much the growth is creating employment.

Anti-cyclical behaviour in social spending helps maintain the productive capacity of the economy as it allows for room for manoeuvre in a recession. An anti-cyclical behaviour in public spending, especially on social expenditure, is an important part of re-bounding an economy in recession. As GDP contracts, however, Government budget balances are often strained, therefore bringing to light the issue of how to finance increases in expenditure whiles avoiding ballooning deficits. Increases in social protection expenditure should be seen as part of a recovery package, rather than a permanent feature, thus acting as an automatic stabiliser. Hysteresis effects and persisting fiscal deficits accumulating over the years can thus be avoided.

Countries with mature social protection systems where social spending increases when unemployment rises and decreases substantially afterwards, tend to also show solid fiscal positions. In countries where stabilizers played their role well in times of crisis but social expenditure was not significantly reduced in good times, the fiscal situation is less favourable. In other countries, social spending does not show a strong relation to the business cycle, and have rather increased steadily since the 80s reflecting the building up of the welfare state. Others have used the latest periods of low unemployment rates to improve their safety nets and address high poverty rates through improving the situation of the most excluded from the labour market. In many countries, efforts have been made to address the lack of incentives to enter the labour market through adequate transfers, active labour market policies and a balance between rights and obligations.

At the same time, the analysis shows that there are **substantial gaps in coverage and adequacy in a number of Member States**, showing that there is a need to complete and/or reinforce social protection systems, including support for the unemployed, access to healthcare for all and ensuring adequate retirement benefits including for those with non-standard careers. In such a process it is important to learn from the mistakes of the past and create protection systems that encourage active participation and cover all the central social risks.

The analysis documents that Member States have taken steps towards **reshaping social protection systems so that they encourage activity and inclusion**. However, it is also clear that good economic performance is a precondition for well functioning social protection systems. Good employment performance has always been crucial for the sustainability of social protection systems but with ageing open labour markets that attract those who are still underrepresented in employment are becoming essential. Hence modernisation of social protection needs to go hand in hand with rapid progress with effective strategies for growth and more and better jobs.

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Talking about health care, US President Obama said recently "If Europeans have done it, why could we not achieve it?" Indeed, this report based upon the joint experience of 27 Member States working in the context of the social OMC shows that Europeans can be proud of the achievements of their social protection systems. Not only has it very significantly contributed to avoid that the economic and financial crisis turns into a political disaster; but it has undergone, in line with the whole Lisbon strategy, a deep modernisation. However, social protection is not enough to limit or prevent poverty and exclusion. Having a job remains indeed the best safeguard against poverty and exclusion, in that sense confirming and important stance of the Lisbon Strategy. Precisely this report stresses that the virtuous circle of participation in employment and living out of poverty has not always functioned as it should have in the last decade: serious obstacles still face the most vulnerable groups, such as the low skilled, lone parent families, or migrants. In addition, some of the recent developments have not paid enough attention to interaction between flexible labour markets and quality of work, notably in relation to its impact on the gender dimension. As a consequence, while the emphasis should still be on promoting growth and jobs, fighting child poverty, engaging closely in active inclusion and more generally fighting labour market segmentation and encouraging job quality will have a crucial importance.

This is not to say that the task of modernising social protection is over: quite the contrary. Building on previous achievements, reforms should be further pursued and fully articulated with growth and employment strategies. The consolidation of pension reforms will require further efforts to promote longer working lives, which in turn makes a strong case for fighting health inequalities and improving health and safety at work.

The stance of promoting active social protection policies will not be undermined, but on the contrary should expand to domains beyond health and pensions, deserving more attention from policy makers.

Finally, looking beyond 2010, it appears that truly accessible and financially sustainable provision of basic services such as child care, health and long term care, lifelong learning, will be a key component of any post-crisis strategy.