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# Europe's power is built upon its social contract

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The social contract, namely the arrangements and expectations, often implicit, that govern exchanges between individuals and institutions, finds its practical realisation in the welfare state. Welfare states' role in supporting workers facing interrupted income (through unemployment, retirement, or illness), providing them with public services such as education and healthcare, and sustaining society and the economy through periods of crisis, is still a fundamental element of the social contract today. However, hard-pressed from decades of neoliberal policy and austerity measures, welfare states have struggled to address new social risks, leading to further decay in social cohesion, working conditions and level of inequality. As Europe's welfare states are now scrambling to respond to even more disruptive, exogenous shocks, calls for a new reform agenda that can respond to new social risks are growing louder. Revamping the European social model does not only serve to curb socioeconomic inequality and enable the twin transition, but has the potential to reduce the pull of populist parties, which exploit the demise of welfare states in their efforts to woo voters and tend to emphasise traditional forms of social consumption (i.e., old-age pensions, and low or flat taxes) while opposing social investment.

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## Introduction

*“Europe will be forged in crises and will be the sum of the solutions adopted for those crises.”*

— Jean Monnet, *Memoirs*, 1976.

Seismic changes to the economy, resurgent authoritarianism, international trade disputes, climate change, clashes around border management and the pandemic have provided more than enough crises to test this much cited hypothesis. Russia's invasion of Ukraine has added new tragic dimensions. Europe's ability to thus far 'fail forward' should not, however, be taken for granted. The EU's response to Covid-19 in the form of the Recovery and Resilience Facility (RRF), centred around the green and digital 'twin transition' and now rendered imperative by Russia's invasion of Ukraine, demands rapid and extensive change across society. Public support for such extensive change should not be assumed.

Similarly, the consequences of this *Zeitenwende* are severely testing the commitment of member states to the European project, and placing significant pressure on citizens, with likely political ramifications. The impact of global economic turmoil, supply chain breakdowns, inflation, rising interest rates and financial instability is uneven across the EU. Those countries that are heavily dependent on Russian fossil fuels such as Italy and Germany, and those member states likely to face a colder winter, have been and will continue to be affected disproportionately by these trends, and their economic fallout is more likely to hit low-income households.<sup>1</sup> The fiscal space available to some – but not all – member states to support their economies and societies is fragmenting the internal market.

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This conundrum must now be addressed in a less-than-ideal climate. To do so, Europe should reflect on the strength and stability of its core and how it can best demonstrate its value as a “responsible global leader”, as stated in the 2019 Sibiu Declaration.<sup>2</sup> This requires that Europe – despite the multitude of crises

demanding attention – address its ‘social deficit’: the gap between the current state of its social contract and what it wishes to achieve.

## The welfare state facing old and new challenges

The social contract, namely the arrangements and expectations, often implicit, that govern exchanges between individuals and institutions, finds its practical realisation in the welfare state. European welfare states, although belonging to different regimes and prioritising different needs, have historically acted as providers of those needs that were not adequately met through the markets.<sup>3</sup> Their role in supporting workers (mostly male) and households facing interrupted income (through unemployment, retirement, or illness, for example), providing them with public services such as education and healthcare, and sustaining society and the economy through periods of crisis, is still a fundamental element of the social contract today.

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The welfare state has, however, suffered from decades of neoliberal policy which envisaged a small state and promoted the market as the main instrument for the efficient allocation of jobs and resources.<sup>4</sup> Between the 1970s and the early 2000s, Europe converged towards a “common neoliberal trajectory”<sup>5</sup> in its industrial relations systems and eventually in the retrenchment of welfare policies in most EU member states.<sup>6</sup> As far back as 1981, the Organisation for Economic Co-operation and Development (OECD) declared that the welfare state was undergoing a profound crisis, witnessing a shift from post-war economic boom to an age of “permanent austerity”.<sup>7</sup> Since then, inflation targeting, public finance austerity and labour market liberalisation in many EU member states have weakened the backbone of the European social contract. The fiscal stability required by the European Monetary Union (EMU) integration of the early 2000s further depressed government spending, especially in key social policy areas such as income redistribution schemes.<sup>8</sup>

Years of neoliberal deregulatory policies have added to the impact of the eurozone crisis, notoriously leading to further decay in social cohesion, working conditions and level of inequality.<sup>9</sup> In the immediate aftermath of the financial crisis, welfare states' benefits were scapegoated for the long stagnation of European economies, with public spending being restrained to comply with 'structural reforms', or austerity, which became the main macroeconomic framework to address the Great Recession across many European countries.

In such a constricted environment, European welfare states have been hard-pressed to adapt to megatrends such as demographic ageing, technological change, deindustrialisation, and the increasing flexibilisation of the labour market. The new social risks rising from these structural changes, such as precarity, long-term unemployment and work-life imbalances, demonstrated the inadequacy of most European welfare states, still calibrated on the premise of an industrial society.

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Investment in the welfare state, either in social services (e.g., education and training, childcare, active labour market policies) or social infrastructure (e.g., healthcare, and long-term care facilities, educational facilities, social housing), has been decimated in many member states, either classed as policies that governments can no longer afford, or replaced by processes of decentralisation and privatisation.<sup>10</sup>

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To curb such worrying trends, some governments have recalibrated their social policy agenda to a more investment-oriented welfare state, developing and rolling out new instruments to better deal with new social risks and mobilising funds borrowing on the financial markets.<sup>11</sup> Nonetheless, despite such brief neo-Keynesian phase,<sup>12</sup> even a run of multiple crises and their severe impacts did not change the status of social investment as, at best, a peripheral issue on the EU agenda.<sup>13</sup> However, as Europe's welfare states are now scrambling to react to even more disruptive, exogenous shocks, calls for a new reform agenda that can respond to new social risks are growing louder.

### **Is public provision back on the EU agenda?**

Until recently, the EU's economic governance regulations remained anchored in the assumption that state intervention or stronger welfare provisions would trigger suboptimal competitiveness and sluggish growth.<sup>14</sup> However, the Covid-19 pandemic marked a notable shift. Thanks to NextGenerationEU and the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE), public provision has returned to the EU agenda.

While this move from "ex-post" to "ex-ante" solidarity is welcome, as Alcidi and Corti argue, this crisis response does not yet demonstrate a deep-seated commitment to rebuilding welfare states.<sup>15</sup> Common debt issuance programmes such as the RRF can only offer a credible solution to current and future crises if they are underpinned by reforms and social investment in welfare states at the national level. This is unlikely to take place unless the EU's economic governance framework is adjusted to provide fiscal space for investment or a similar instrument to SURE - though a permanent rather than temporary mechanism - is created at the EU level. Furthermore, to obtain RRF funds, governments have to comply with milestones and targets that measure the progress towards the achievement of reforms and investments, based on estimated spending. While quantitative thresholds are set with respect to investments for the green and digital transitions, with 37% and 20% of resources to be allocated to these two targets respectively, a strong link between the RRF and social objectives is missing.

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In such times of change and vulnerability, citizens must know that support is available and will remain so. European welfare states are crucial to providing that support. They act as shock-absorbers for rising inequalities and are vital in assisting citizens through the transition, ultimately playing a significant role in revamping social cohesion and trust in political institutions. Despite their retrenchment in the decade following the Great Recession, European welfare states have proved to be of key importance for the protection of citizens and households and as economic stabilizers.

**Welfare states as key enablers of the twin transition**

Welfare states should therefore be reinforced in their role as buffers for citizens, with more resources dedicated to repairing creaking social safety nets at a time when increasing numbers of people require their support. This means not only developing programmes that are more resilient to higher selectivity in the allocation of social benefits, increasing commodification and marketisation, but also strengthening their redistributive function.

Progressive taxation can be used as a policy lever to counter inequality and precarity. The European Commission has widely documented how corporate taxation and progressive taxation on personal income have a positive effect on overall growth, fostering direct and green investment.<sup>16</sup> While windfall taxes for energy companies are currently being proposed, and big tech regulation is discussed to reconnect taxation with the creation of digital value, it is imperative that this income is used to fund cash transfers to low and middle-income individuals, especially since many European households risk sliding into poverty for the first time.<sup>17</sup>

At the same time, however, a redistributive approach alone does not adequately respond to the complex situation European societies are facing. Redistributive policies should go hand in hand with pre-distributive and social investment policies and value creation,

which occupy an essential yet still marginal place in the European social agenda.

Complementing the welfare state with a social investment framework can produce long-term social and well-being returns beyond redistribution trade-offs, whose effects risk vanishing in the long term. Within this framework, social and economic inequality is tackled not only “ex-post”, through redistribution of wealth, but “ex-ante”, by intervening at the source of its formation, at the pre-distributive level, such as through early investment in children and work-care reconciliation policies.<sup>18</sup> One-off policy responses at times of crisis have shown their limits in sustaining individuals from the early years through to adult life. Whereas a long-term strategy of social investment can boost labour supply, improve the quality of human capital and ease work-life balance, in turn strengthening trust in and support for political institutions.

Welfare states can also act as a benchmark for the design and implementation of green and social policy.<sup>19</sup> Structural changes in labour markets, such as the creation of green jobs in construction and energy sectors, can promote the upskilling and reskilling of workers. National legislation in EU member states, following the principles of the welfare state, should guarantee decent wages, employment rights and safety conditions, thereby facilitating the transition of workers towards greener jobs. As stated in the 2021 Porto Declaration: Europe should invest more in education, lifelong learning, vocational training, upskilling and reskilling to stimulate employment and employment transitions and preserve occupational health and rights.<sup>20</sup>

Targeted investment in social housing and mobility can similarly act as a buffer to the potential distributional impact of the transition, protecting fragile households, alleviating energy poverty, and maintaining public support for the transition. Furthermore, according to the EU Directive on the Energy Performance of Buildings, every 1% increase in energy savings would reduce gas imports by 2.6%.<sup>21</sup> The proposed European Social Climate Fund aims to ensure support is available for the poorest, but it will likely be too little and too late to make a significant impact. Instead, a new SURE mechanism should be quickly established to ensure member states have sufficient finance to alleviate the social impact of rising energy prices in the form of social compensation (temporary

income support) and green investment targeted at those most in need.

## Conclusion

Europe's permacrisis<sup>22</sup> must now compel the EU to recall the immense importance of its social contract. Revamping the European social model does not only serve to curb socioeconomic inequality and enable the twin transition, but has the potential to reduce the pull of populist parties, which exploit the demise of welfare states in their efforts to woo voters<sup>23</sup> and tend to emphasise traditional forms of social consumption (i.e., old-age pensions, and low or flat taxes) while opposing social investment aimed at lifelong learning, education, and equality of opportunity.

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Without revitalisation and reinforcement, the current crises may prove insurmountable for the European project. This is unlikely to be an immediate demise but a 'death by a thousand cuts' as national governments increasingly look to their own solutions to complex geopolitical challenges. And populations, afraid and angered by unkept promises and non-existent or dysfunctional public services, vote in

populist governments that offer easy answers to complex questions while doing nothing to address fundamental challenges.

If reaching a compromise and making progress in the EU is hard now, the difficult years ahead have the potential to be insuperable. Ultimately, to be a powerful and credible actor in this unstable world, Europe must first fix its crumbling social contract.

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