



EU REGULAR ECONOMIC REPORT

2

SUSTAINING RECOVERY,
IMPROVING LIVING STANDARDS

▲
FALL 2015



WORLD BANK GROUP



The EU Regular Economic Report (RER), is a semi-annual publication of the World Bank Group and covers economic developments, prospects, and economic policies in the European Union.

The report uses four sub-groups that share broadly similar development patterns EU (see map): **Central Europe** comprises Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovak Republic and Slovenia; **Northern Europe** comprises Denmark, Estonia, Finland, Latvia, Lithuania and Sweden; **Southern Europe** comprises Cyprus, Greece, Italy, Portugal and Spain; **Western Europe** comprises Austria, Belgium, France, Germany, Ireland, Luxembourg, the Netherlands and the United Kingdom. While the report covers the European Union, it provides additional information on European countries which had historically a stronger operational engagement with the World Bank Group, in particular, Bulgaria, Croatia, Poland and Romania. The focus note of this RER covers “Welfare States and the Protection of the Poor in the European Union”.

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ACRONYMS AND ABBREVIATIONS

▶ <u>ABSPP</u>	ASSET-BACKED SECURITIES PURCHASE PROGRAM	▶ <u>PPP</u>	PURCHASING POWER PARITY
▶ <u>BRICS</u>	BRAZIL, RUSSIA, INDIA AND CHINA	▶ <u>PSPP</u>	PUBLIC SECTOR PURCHASE PROGRAM
▶ <u>CAB</u>	CURRENT ACCOUNT BALANCE	▶ <u>RER</u>	REGULAR ECONOMIC REPORT
▶ <u>CBPP</u>	COVERED BOND PURCHASE PROGRAM	▶ <u>SME</u>	SMALL AND MEDIUM ENTERPRISE
▶ <u>EAPP</u>	EXPANDED ASSET PURCHASE PROGRAM	▶ <u>SILC</u>	SURVEY ON INCOME AND LIVING CONDITIONS
▶ <u>ECB</u>	EUROPEAN CENTRAL BANK	▶ <u>UK</u>	UNITED KINGDOM
▶ <u>EU</u>	EUROPEAN UNION	▶ <u>US</u>	UNITED STATES
▶ <u>GDP</u>	GROSS DOMESTIC PRODUCT	▶ <u>QE</u>	QUANTITATIVE EASING
▶ <u>ICT</u>	INFORMATION AND COMMUNICATION TECHNOLOGY	▶ <u>VAR</u>	VECTOR AUTOREGRESSION
▶ <u>IMF</u>	INTERNATIONAL MONETARY FUND	▶ <u>VAT</u>	VALUE-ADDED TAX
▶ <u>MTO</u>	MEDIUM TERM OBJECTIVES	▶ <u>WEO</u>	WORLD ECONOMIC OUTLOOK
▶ <u>OECD</u>	ORGANIZATION OF ECONOMIC CO-OPERATION AND DEVELOPMENT		

LIST OF COUNTRIES

▶ <u>BG</u>	BULGARIA	▶ <u>CY</u>	CYPRUS
▶ <u>HR</u>	CROATIA	▶ <u>EL</u>	GREECE
▶ <u>CZ</u>	CZECH REPUBLIC	▶ <u>IT</u>	ITALY
▶ <u>HU</u>	HUNGARY	▶ <u>PT</u>	PORTUGAL
▶ <u>PL</u>	POLAND	▶ <u>ES</u>	SPAIN
▶ <u>RO</u>	ROMANIA	▶ <u>AT</u>	AUSTRIA
▶ <u>SK</u>	SLOVAK REPUBLIC	▶ <u>BE</u>	BELGIUM
▶ <u>SI</u>	SLOVENIA	▶ <u>FR</u>	FRANCE
▶ <u>DK</u>	DENMARK	▶ <u>DE</u>	GERMANY
▶ <u>EE</u>	ESTONIA	▶ <u>IE</u>	IRELAND
▶ <u>FI</u>	FINLAND	▶ <u>LU</u>	LUXEMBURG
▶ <u>LV</u>	LATVIA	▶ <u>NL</u>	NETHERLANDS
▶ <u>LT</u>	LITHUANIA	▶ <u>UK</u>	UNITED KINGDOM
▶ <u>SE</u>	SWEDEN		

EXECUTIVE SUMMARY

The European Union (EU) is gradually emerging from a protracted economic downturn that led to an increase in poverty in many countries. Poverty rates

– as measured by the share of the population with an income of less than 60 percent of the 2008 median income – increased between 2008 to 2012, particularly in Southern European countries that were most affected by the downturn. By 2012, poverty in Greece – according to

this measure – surpassed all other EU countries and poverty – measured by an absolute poverty line of USD5 in PPP terms – exceeded poverty in several Central European countries, including Hungary, Poland, Slovenia and Slovak Republic. The increase in poverty in the EU has been mainly due to a decline in labor incomes, employment and, to a lesser extent, social assistance spending.

Many EU countries cut social assistance spending during the crisis, which, combined with the design of the programs, sometimes contributed to an increase in poverty. While EU countries are among the biggest spenders on social protection in the world, some

EU countries are unable to provide effective protection for their poorest citizens. In some, cuts in social assistance spending during the crisis did not help ameliorate the

increase in poverty. Building on the lessons from the crisis, important reforms for making social protection systems more effective include the introduction of guaranteed minimum income (GMI) programs, maintaining the effective coverage and adequacy of existing social exclusion programs, and reducing the leakages of social assistance transfers to the rich.

Fueled by consumption, the EU recovery is gaining strength across all EU regions. Growing wages and employment, supported by low consumer-price inflation, have raised household incomes and supported households' willingness to consume. Real

GDP growth rose by a moderate 1.8 percent year-on-year in the first half of 2015, below the 2.2 percent OECD average and half the global pace of expansion. The economy of Central Europe expanded by 3.5 percent, the highest regional rate. Southern Europe's growth rate, at 1.5 percent, was the slowest, but was still a significant improvement

from 2014. After leading the recovery in 2014, robust private consumption growth was sustained in the first half of 2015 across all EU regions, as real disposable household income grew strongly. That was largely due to higher wages and employment combined with exceptionally low consumer price inflation, driven by low energy prices. Unemployment among the young – who suffered the largest increase in poverty during the crisis – is finally declining, but remains high in Croatia, Slovenia and Southern Europe. Estimates suggest that the recovery has led to a small decline in poverty in Bulgaria, Croatia Poland and Romania.

Investment remains the weak link to a more vigorous recovery.

Unlike the US, investment as a share of GDP is not yet trending upwards across the EU. Investment by firms remains weak despite increasing confidence and favorable financial conditions supported by the ECB's Quantitative Easing (QE). Despite declining world trade and weakening import demand from China and Russia, net

exports contributed positively to growth in the first half of 2015 in all regions of the EU except Southern Europe, as the Euro depreciated. After years of consolidation, the fiscal policy stance across the EU has become broadly neutral as fiscal deficits in 15 out of 28 EU member states fell to below 3 percent of GDP.

The recovery is expected to gain strength over the medium term, fueled by private consumption but investment is likely to be constrained by structural rigidities.

Private consumption is expected to continue to support the expansion, as inflation remains subdued

and labor markets continue to improve. However, growth is projected to remain below pre-crisis levels as investment remains subdued as private and public sector deleveraging continues. The output gap is projected to close slowly over the medium-term.

The EU needs to turn current tailwinds into self-sustaining growth through continued structural reform.

Countries need to continue to remove constraints on businesses by reducing rigidities in labor and product markets and ensuring labor has the right skills through investing in education and training. In this context, social assistance systems also need to continue to

increase the coverage of the poorest and most vulnerable groups, while ensuring that spending is efficient and affordable over the long-term. Well-designed social assistance systems also facilitate labor market activation of poor and vulnerable groups, supporting poverty reduction and long-term growth.

Significant risks to a more robust recovery remain.

The crisis has left a legacy of high public and private-sector debt. A prolonged period of low investment growth and below-target inflation, a slowdown in emerging-market

growth and higher financial volatility could all exacerbate these vulnerabilities and undermine the current outlook. Moreover, regional tensions could undermine confidence in the recovery.



CHAPTER ONE

▼

RECENT ECONOMIC DEVELOPMENTS

▼

06

AFTER A PROLONGED CRISIS THAT
LED TO AN INCREASE IN POVERTY

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THE RECOVERY IS GAINING STRENGTH,
FUELED BY PRIVATE CONSUMPTION AND SUPPORTED BY
LOWER OIL PRICES, A WEAKER EURO AND THE ECB'S QE

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LABOR MARKETS ARE IMPROVING

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FISCAL CONSOLIDATION IS SLOWING

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COUNTRIES CONTINUE TO IMPROVE BUSINESS
REGULATIONS IN AN EFFORT TO BOLSTER GROWTH

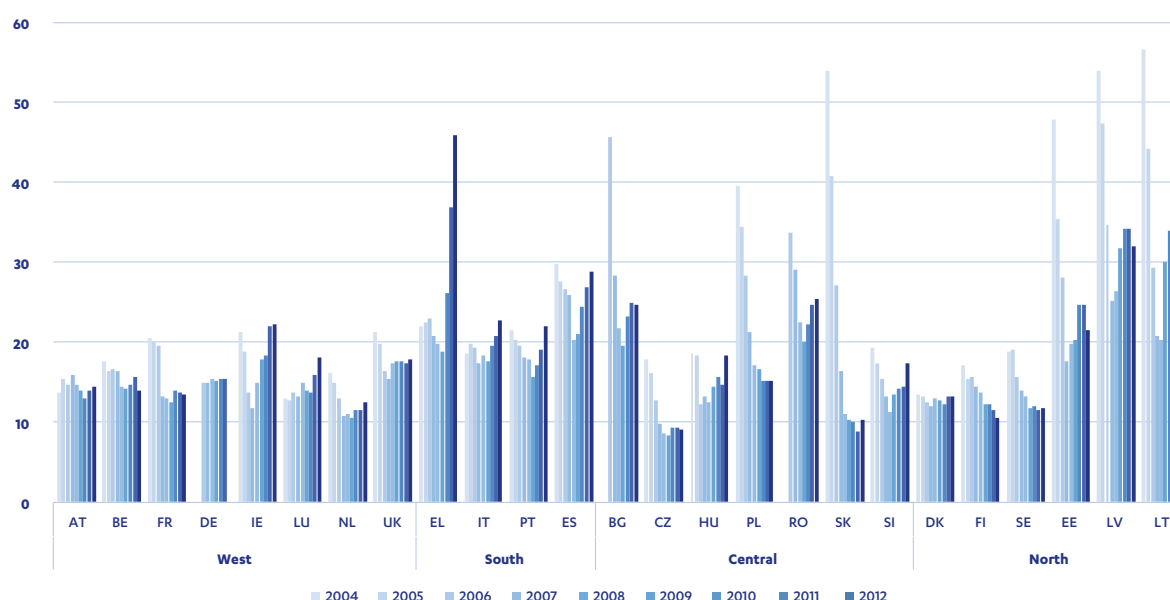
After a prolonged crisis that led to an increase in poverty...

The 2008-09 global financial crisis hit the EU hard, leading to an increase in poverty in many EU countries.¹ As the EU endured two contractions between 2008 and 2012, poverty, as measured by the share of the population with an income of less than 60 percent of the 2008 median income, increased in most EU countries and, particularly, in Southern European. Greece, which

went through an exceptionally steep and sustained economic downturn, suffered from a very large increase in poverty which in 2012 exceeded poverty in all EU countries.² In contrast, some Central European countries, such as Poland and the Slovak Republic, achieved significant and sustained declines in poverty during the same period **FIG. 1**.

► **FIG. 1 THE CRISIS LED TO A SIGNIFICANT INCREASE IN POVERTY IN SEVERAL EU COUNTRIES**

Poverty anchored at 60 percent of median income in 2008 in adult equivalent terms



Source: World Bank estimates using EU-SILC. Data for Croatia prior to 2010 is not available. / Note: Incomes have been measured in USD 2011 PPP terms. Income year 2012 is the latest year for which survey data is available.

¹ The EU typically uses a relative poverty line set at 60 percent of median adult equivalent income. In order to compare poverty over time, we anchor this poverty line at the 2008 value. For EU targets see: <http://ec.europa.eu/social/>

² In 2012, poverty in Greece – measured by an absolute poverty line of USD5 in PPP terms – exceeded poverty in several Central European countries, including Hungary, Poland, Slovenia and Slovak Republic

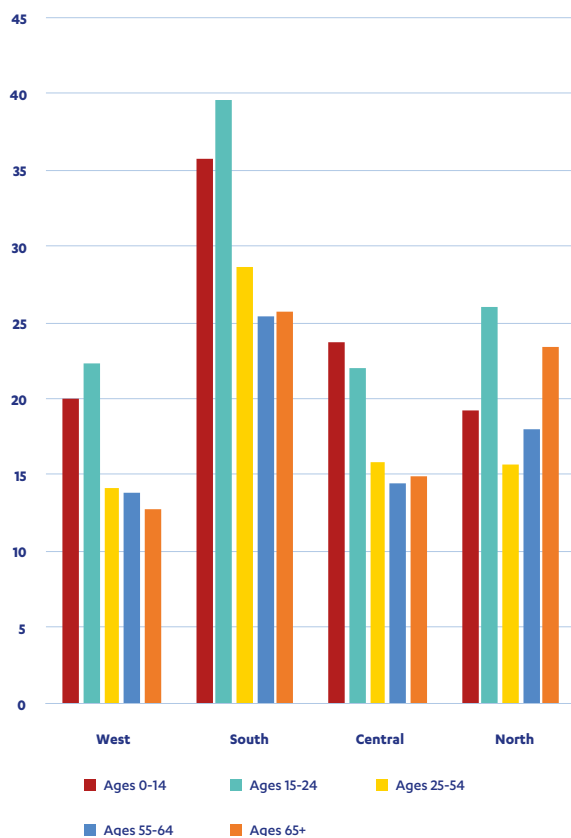
Young people and children were particularly affected by the poverty increase. In 2012, poverty rates were the highest for individuals aged 15-24, followed by those under 15 ^{FIG. 2A}. This was especially true in Southern Europe,

where poverty increased substantially more following the crisis, particularly for children and young people ^{FIG. 2B}. Poverty among the elderly declined on average in all regions, except in Southern Europe.

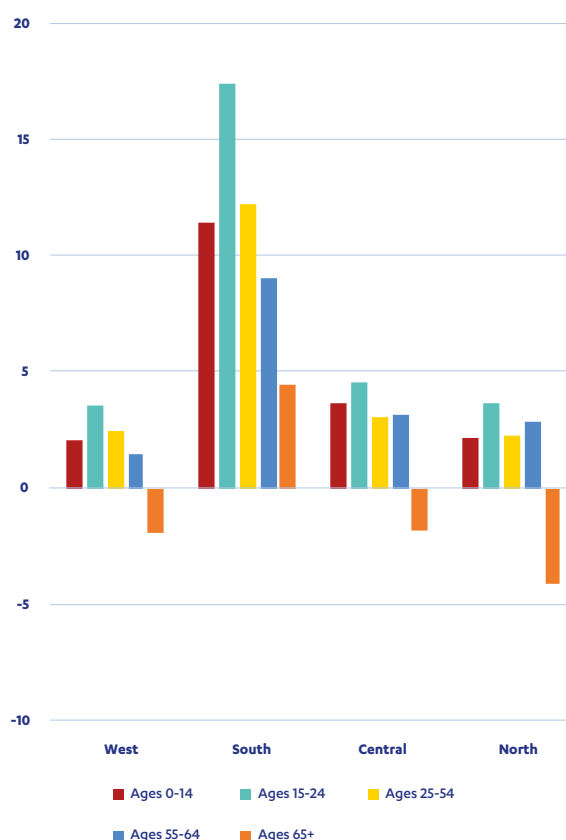
► **FIG. 2 YOUNG AND LESS SKILLED PEOPLE WERE MOST AFFECTED BY THE INCREASE IN POVERTY**

Poverty anchored to 60 percent of median income in 2008 in adult equivalent terms.

A. Poverty by Age in 2012



B. Change in Poverty by Age, 2008-2012



Source: World Bank estimates using EU-SILC. Note: Incomes have been measured in USD 2011 PPP terms.

BOX 1. POVERTY TRENDS IN GREECE

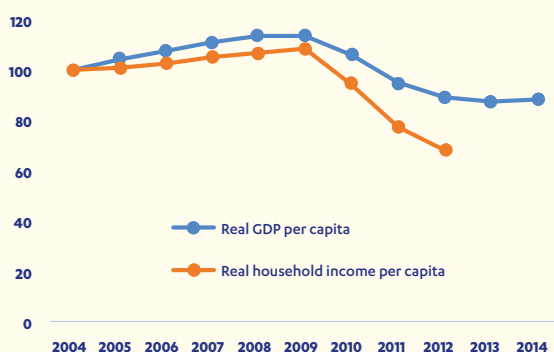
Greece has suffered from an exceptionally steep and long economic downturn that translated into an even steeper decline in household incomes.

Between 2008 and 2012, real GDP per capita plummeted by 21 percent, or 5.7 percent per year on average – by far the largest economic decline of any EU country in recent years. During this period, household income per capita fell 37 percent, or 10 percent a year ^{FIG. 3A}. As a result,

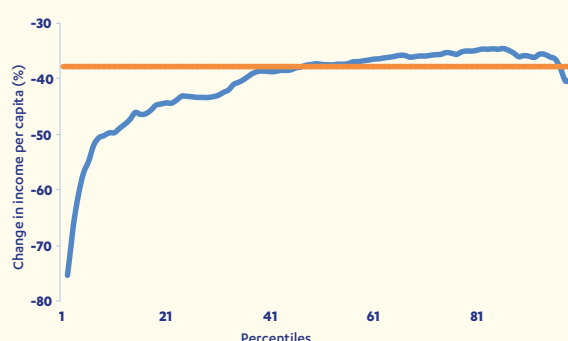
poverty, measured by the share of the population with an income below 60 percent of the median income anchored in 2008, more than doubled from 19.7 percent to 45.9 percent over the same period. Greeks at the low end of the income distribution suffered the most. While average incomes dropped by 37 percent, the income of the bottom 40 percent fell by 43.1 percent ^{FIG. 3B}.

FIG. 3 HOUSEHOLD INCOME HAS DECREASED MORE THAN GDP IN GREECE

A. Household income and GDP



B. Growth Incidence Curve, 2009-2012



Source: Real GDP per capita from Eurostat; EU-SILC UDB surveys 2009-2013.

Changes in employment and pensions explain the relatively steep decline in incomes of the bottom 40 percent. First, young and less-skilled people constitute a significant share of the population with relatively low incomes. They were the most affected by the increase in unemployment after 2008: their unemployment rates doubled, peaking at 58.3 percent for the young and 29.8 percent for the less-skilled in 2013. Second, labor earnings fell significantly after 2008, particularly in sectors that employ a relatively large share of lower-skilled workers. Third, patterns in social protection spending insulated

middle-income households. Pension incomes declined relatively little up to 2012, protecting pensioners and the relatives who lived with them. As a result, poverty among the elderly – which was relatively low at the onset of the crisis – barely increased. At the same time, social transfers were small, accounting for less than 5 percent of income of the bottom 40 percent of the income distribution – and covered few low-income households, thus playing a limited role in protecting them from falling into poverty (see *Focus Note*).

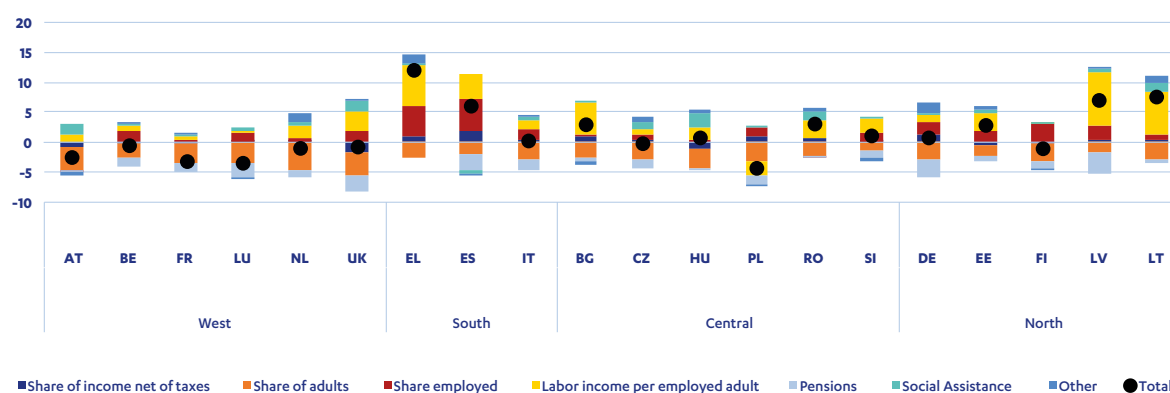
A decline in labor incomes, employment and in some cases government transfers contributed to the rise in poverty.

Labor income makes up the largest share of gross household income in EU countries, ranging from 55 percent in Ireland to 67.7 percent in Poland in 2012. Labor income declined significantly during the crisis, particularly among those in the bottom 40 percent of the income distribution.³ This decline increased Greece's poverty rate

by 6.8 percentage points between 2008 and 2011. Cuts in employment added an additional 5 percentage points. In Slovenia, declining labor incomes and employment contributed a total of 3.9 percentage points to the increase in the poverty rate [FIG. 4](#). By contrast, Poland saw its poverty rate decline as a real GDP growth of about 3.4 percent led to an increase in labor income. Cuts in social assistance contributed to a rise in poverty in many EU countries (see also *Focus Note*).

► **FIG. 4 THE DECLINE IN LABOR INCOME AND EMPLOYMENT CONTRIBUTED MOST TO THE POVERTY INCREASE**

Contribution to change in poverty per capita between 2008 and 2011 in percentage points



Source: World Bank estimates using EU-SILC panel data. Data for Croatia is not available. Note: Poverty anchored at 60 percent of the median income in 2008, measured in USD2011PPP.

Poverty estimates for 2014 and 2015 for some Central European countries suggest that the EU recovery is likely to alleviate poverty in many countries.

In fact, poverty in Bulgaria, Poland and Romania has likely declined in 2014 and 2015 (see *Spotlight on Central Europe*). The next section will look at recent economic developments

with a focus on those factors that are most likely to affect the evolution of poverty across the EU, such as household income, labor market development and social assistance spending. The focus note will discuss how well-designed social protections systems across the EU are for protecting the poor. ◀

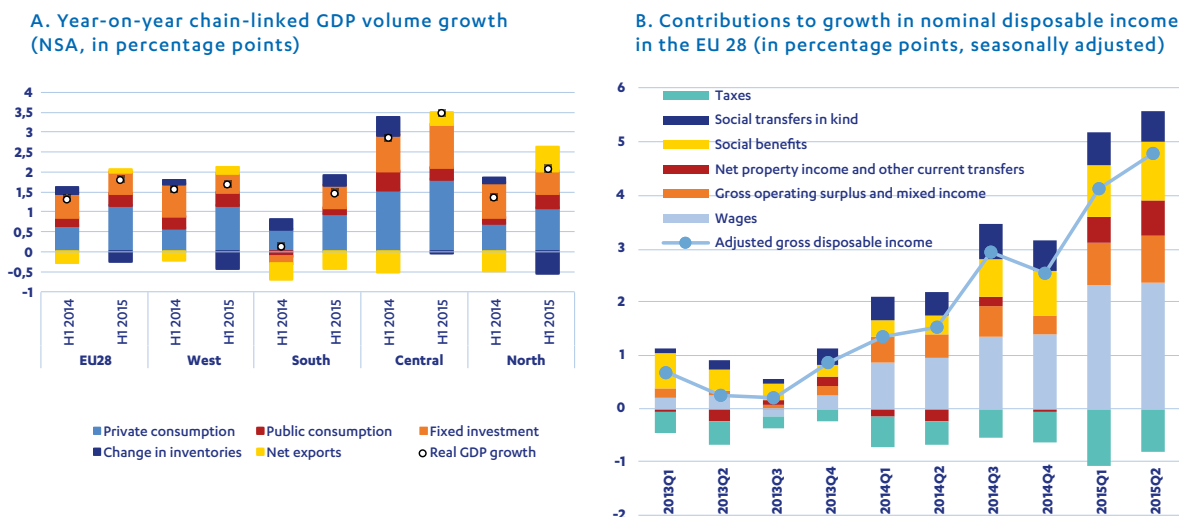
³ The labor income of the bottom 20 percent also declined steeply in Southern Europe, particularly in Spain and Greece, but increased in some EU member states, including in the Netherlands, the UK, Poland, and the Czech Republic.

...the recovery is gaining strength, fueled by private consumption and supported by lower oil prices, a weaker Euro and the ECB's QE.

The EU growth recovery is gaining strength but remains moderate. Real GDP growth quickened to 1.8 percent (y-o-y) in the first half of 2015 from 1.3 percent in the first half of 2014 ^{FIG. 5A}. The recovery has taken a firmer root in all regions, but particularly in Southern Europe, where real GDP growth increased from 0.1 percent in the first half of 2014 to 1.5 percent in the first half of 2015, largely driven by stronger growth in Spain and to a lesser extent Portugal. The Central Europe experienced the highest real

GDP growth in the first half of 2015 at 3.5 percent driven by a solid growth outturn in the Czech Republic, Poland and Romania. Flash estimates indicated that growth remained strong in the third quarter of 2015, with the EU continuing to grow at an annual rate of by 1.9 percent, despite contractions in Greece, Estonia and Finland. This year's economic acceleration notwithstanding, growth remained below the OECD average of 2.2 percent and half the global pace of expansion.

► **FIG. 5 GROWTH HAS PICKED UP PACE ACROSS ALL REGIONS FUELED BY CONSUMPTION**



The recovery has largely been fueled by private consumption as household disposable incomes increased due to a rebound in labor markets and lower oil prices.

Growth in private consumption contributed 1.2 percentage points to real GDP growth in H1 2015 and accelerated in all four regions [FIG. 5A](#). In fact, private consumption growth significantly outpaced real GDP growth in the first two quarters of 2015. Nominal disposable household incomes increased by 5 percent (y-o-y) in H1 2015, driven by a rebound

in labor markets, which led to higher wages and employment. Higher earnings of the self-employed as well as property incomes also supported household income growth.⁴ Contributions from social transfers in kind and social benefits remained broadly constant [FIG. 5B](#). Real disposable income grew even stronger as consumer price inflation remained below zero throughout the first quarter of 2015 and turned negative again in September 2015 due to falling energy prices⁵ as oil prices reached a multi-year low.

The Euro depreciated strongly, supporting net export growth.

The Euro depreciated by over 10 percent in real effective terms between August 2014 and March 2015, before appreciating by 3.7 percent between March and September 2015. As a result, extra-EU export growth across

the EU accelerated despite declining world trade and weakening import demand from China and Russia and net exports contributed positively to growth. The EU current account surplus reached a historical high of 2.2 percent of GDP in June 2015.

⁴ The Central Europe was the only region that saw household incomes decline in Q2 2015, as wage growth and net property incomes slowed down.

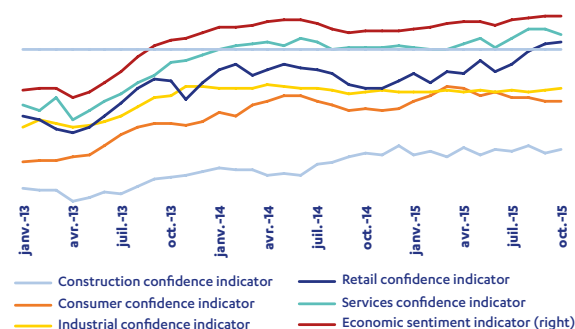
⁵ Consumer price inflation peaked at 0.3 percent in May 2015. Core inflation increased slightly to 1 percent in October 2015 as a result of the pass-through of the Euro's depreciation and the continued recovery in domestic demand.

⁶ Under its expanded asset purchase program (EAPP or "QE"), which comprises the "covered bond purchase program" (CBPP3), the "asset-backed securities purchase program" (ABSPP) and the "public sector purchase program" (PSPP), the ECB buys around €60 billion a month (currently planned to last until September 2015).

QE has helped the recovery by increasing confidence and easing financial conditions. After reducing policy rates to near zero in the wake of the global financial crisis, the ECB started to implement its quantitative easing policy in March 2015. In the six months through September 2015, the ECB purchased securities issued by Euro-area member states and selected institutions that amounted to €343.3 billion⁶, as most economic confidence indicators have gradually improved. The overall economic sentiment for the EU remains above its long-run average ^{FIG. 6}.

► **FIG. 6 CONFIDENCE IS IMPROVING**

Economic sentiment indicator long-run average=100



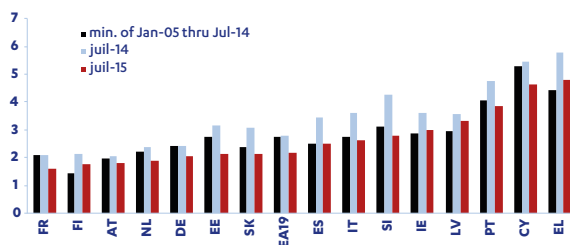
Despite accommodative monetary policy and favorable financial conditions, investment remains subdued as investors remain concerned about the strength of the recovery, and households and corporations continued to deleverage. Despite accommodative monetary policy and favorable financial conditions, investment remains subdued as investors remain concerned about the strength of the recovery, and households and corporations continued to deleverage. Rising confidence and favorable financial conditions have led to an increase in asset prices, contributing to improvements in private sector balance sheets. In fact, the net financial wealth of households and non-financial corporations in the Euro area has started to exceed pre-crisis levels. The cost of borrowing for both households and corporations has reached historic lows in both nominal and real terms, supporting credit demand ^{FIG. 7A & 7B}, respectively. For enterprises, the average interest rate charged on new bank loans has

declined in every country in the euro area, with the cost of borrowing ranging from 1.6 percent in France to 4.8 percent in Greece, as of July 2015.⁷ The average interest rate charged on new mortgages has also declined in all Euro area countries, except in Ireland, with the cost of borrowing ranging from 1.4 percent in Finland to 3.3 percent in Cyprus. The Euro area bank lending survey Q3 2013 (*ECB 2015a*) confirms that the interest rate level was an important factor in the increase in credit demand for households and enterprises within the EU. Credit growth was highest in Central Europe, closely followed by Western Europe, but remained subdued in Southern Europe, though underlying demand and supply factors differed across countries.⁸ Despite improvement in private sector balance sheets and favorable financial conditions, investment growth remains sluggish in the EU and is not yet trending upwards as a share of GDP. Investment by firms remains weak (see also ^{FIG. 8D}). ◀

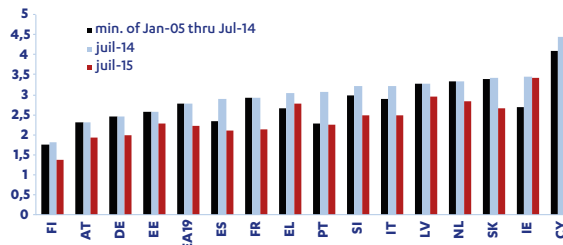
► **FIG. 7 THE COST OF BORROWING FOR ENTERPRISES AND HOUSE PURCHASES HAS REACHED A HISTORIC LOW**

Annualized Agreed Interest Rate on new loans in percent

A. Enterprises



B. House purchases



⁷ Not only has the cost of bank loans declined, but corporate bond spreads have also reached historically low levels.

⁸ While in Italy demand for credit picked up and supply conditions (credit standards and terms and conditions) eased, suggesting some signs of recovery, demand for credit and supply conditions remained unchanged in Spain.

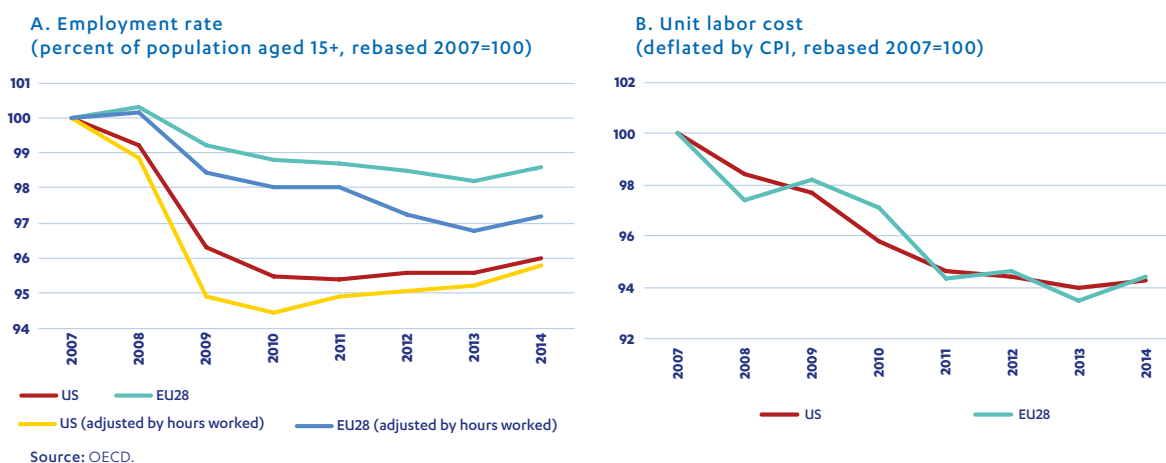
Labor markets are improving

Despite the prolonged crisis, the EU has lost fewer jobs than the US since 2007.

In 2007, the employment rate⁹ was 63 percent in the US and 53.1 percent in the EU. In 2014, the US rate was still 4 percentage points below its level in 2007, but only 1.4 percentage points lower in the EU [FIG. 8.A](#). There are two main reasons for employment declining less in the EU. First, labor force participation declined steeply in the US after the crisis. By contrast, labor force participation rates increased consistently in the EU28 as previously inactive groups, in particular elderly workers and women, joined the labor market. In fact, labor force

participation rates in Q2 2015 are higher than at the beginning of 2008 in most European countries, even in those with still high unemployment rates¹⁰. Second, Europe has relied more on reducing hours worked per job than on shedding jobs. With trends in unit labor costs similar between the US and Europe [FIG. 8B](#), but differing job losses, total employment compensation of firms in Europe seems to have been less reactive to the crisis and may have contributed to divergent trends in the operating surplus of firms and investment [FIG. 8C & D](#).

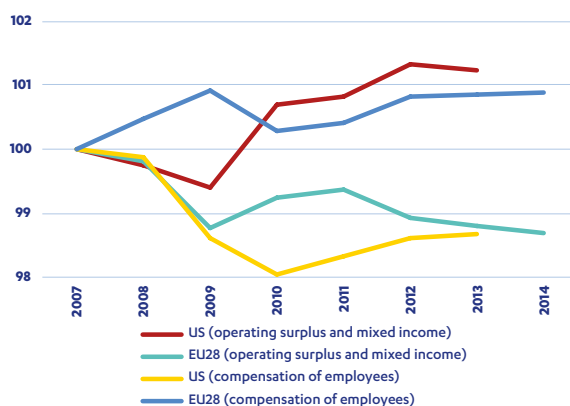
► **FIG. 8 THE EU HAS LOST FEWER JOBS THAN THE US BUT FIRMS PERFORM WORSE**



⁹ Employment rate denotes the number of employed relative to the working-age population.

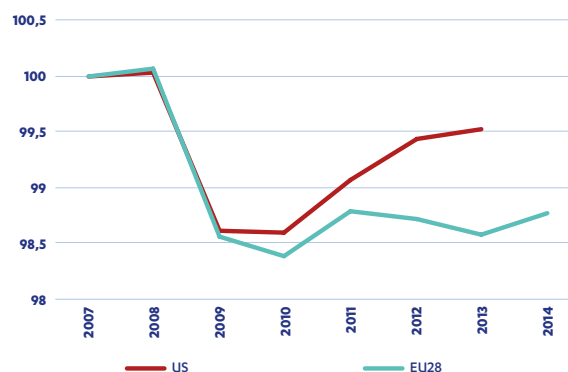
¹⁰ Portugal is one of the few countries where labor force participation in Q2 2015 was slightly lower than at the beginning of 2008.

C. Non-financial corporations operating surplus (share of GDP, rebased 2007=100)



Source: OECD.

D. Non-financial corporations fixed investment (share of GDP, rebased 2007=100)

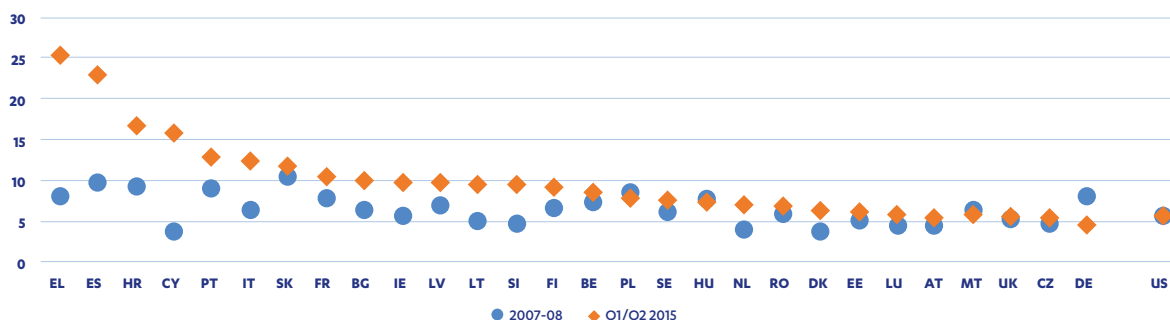


Wages are on the rise and unemployment is declining in most EU countries. Wages have been increasing in all sub-regions during the last three quarters. Unemployment fell in all regions, responding very strongly to the moderate recovery, and reached 2007-08 levels in Germany, Czech Republic, United Kingdom, Malta, Hungary and Poland [FIG. 9](#). The biggest gaps in unemployment remain in Southern Europe [BOX 2](#) and Croatia. Unemployment fell for all education groups, but on average less for the less

educated (*European Commission 2015b*).¹¹ Given the importance of labor income for poverty reduction, these labor market patterns suggest that poverty is again declining in most EU countries. Moreover, there were around 2 million unfilled vacancies in the EU in June 2015, which compares to 23 million unemployed. Filling these vacancies by enhancing labor mobility within the EU could further improve living standards.

► FIG. 9 UNEMPLOYMENT RATES ARE REACHING PRE-CRISIS LEVELS IN MANY EU COUNTRIES, EXCEPT IN THE SOUTH

Seasonally adjusted unemployment rate



Source: Eurostat; World Bank calculations.

¹¹ Long-term unemployment showed some timid signs of decline, falling from an EU-wide average of 5.1 percent in Q2 2014 to 4.7 percent in Q2 2015, but it remained high compared to 2.8 percent in 2008. Long-term unemployment rates were particularly high in Greece (18.2 percent), Spain (11.8 percent), and Croatia (9.8 percent) as of Q2 2015.

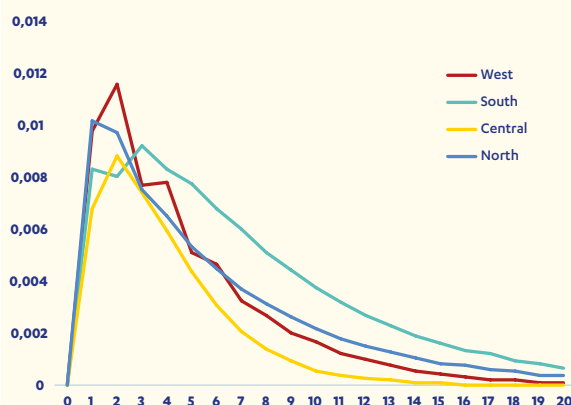
BOX 2. UNEMPLOYMENT ADJUSTMENT TO A GDP SHOCK IN EUROPE

Growth shocks appear to have a larger negative longer term impact on employment in Southern Europe. Estimates show that the initial response to a one-percent negative real GDP growth shock is on average the highest in Western Europe and, initially, the smallest in

Southern Europe. Yet, Southern Europe showed the most persistent increase in unemployment. In fact, after 5 years (20 quarters), the cumulative effect of a given negative GDP growth shock was 50 percent higher in Southern than in Western Europe.^{1/}

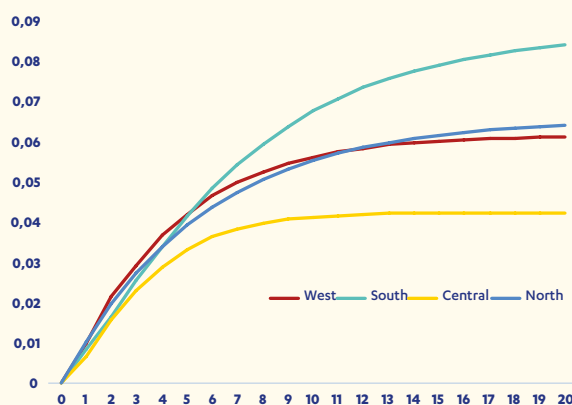
► **FIG. 10 THE CUMULATIVE UNEMPLOYMENT RESPONSE TO A GDP GROWTH SHOCK IS LARGEST IN SOUTHERN EUROPE**

A. Change in unemployment rate (in percentage points)



Source: World Bank staff simulations.

B. Cumulative change in unemployment rate



Several factors may explain this difference across regions. Theoretical and empirical literature on labor market institutions suggests that the initial response of unemployment is strong in countries with high labor market flexibility while the unemployment response is more persistent in countries with low labor market flexibility. In fact, Western European countries have lower

labor market rigidities than Southern European states, according to two key measures of labor markets flexibility: hiring and firing practices, and redundancy costs.^{2/} Alternatively, it has been argued that if wages were set by bargaining between insiders and firms, the equilibrium unemployment rate may increase after a shock (*the so called hysteresis in unemployment, see Blanchard and Summers, 1987*).

^{1/} Estimates are based on a panel VAR with country fixed effects and quarterly data from Q1 1999 to Q2 2015 using the 'Helmert procedure' (Arellano and Bover, 1995). This procedure removes only the forward mean, i.e. the mean of all the future observations available for each country-quarter, and preserves the orthogonality between transformed variables and lagged regressors. Lagged regressors are used as instruments and coefficients estimated by system GMM. This methodology deals successfully with the Hurwicz-type bias associated to the use of fixed effects in a dynamic panel framework.

^{2/} Source: Global Competitiveness Report 2014-2015 and Doing Business 2015.

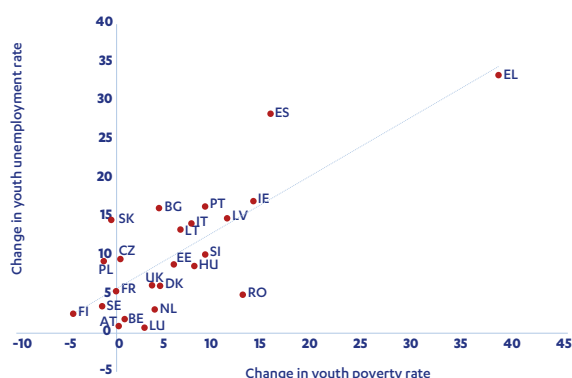
Youth unemployment is also declining but remains very high in some countries along with high levels of inactivity, suggesting that the recovery alone is not enough. Europe's youth faced the steepest surge in poverty among all age groups in the wake of the 2008 global financial crisis as unemployment in several EU member states soared [FIG. 11A](#). Young people are often the first to be fired once a crisis hits, and also first to be hired in a recovery. In fact, youth unemployment has started to decline rapidly in most EU countries and in particular, in Croatia, Estonia, Ireland, Latvia, Lithuania and Spain [FIG. 11B](#). The decline in youth unemployment has been supported by EU-wide policy initiatives, such as the Youth Guarantee schemes

along with other improvements in public employment services for young people as well as vocational training and education systems. Yet, youth unemployment remains very high in Greece, Spain, Croatia, Italy, Portugal, Cyprus, and Slovakia. Moreover, while youth unemployment is falling rapidly in many countries the rate of young people neither in education, employment or training (NEET) remains stubbornly high at 12.5 percent in 2014, compared to a peak of 13.2 percent in 2012, requiring the implementation of sound strategies in high NEET countries that focus on retaining young people in formal education and training and enable them to acquire marketable skills. ◀

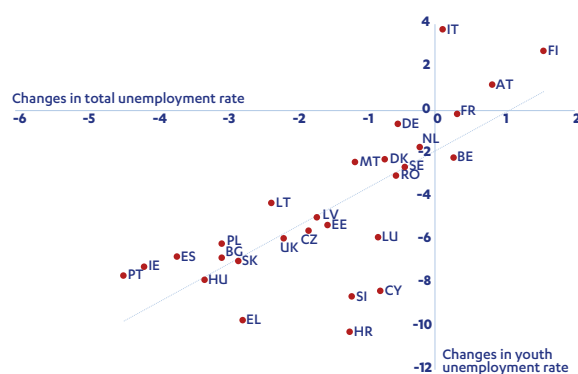
► **FIG. 11 YOUTH UNEMPLOYMENT IS DECLINING IN MOST EU COUNTRIES**

Seasonally adjusted unemployment rate

A. Change in youth poverty and youth unemployment rates 2008-2012 (in percentage points)



B. Change in youth and total unemployment rates Q2 2013 – Q2 2015 (in percentage points)



Source: Eurostat; World Bank staff calculations. / Note: Youth poverty is calculated as the percentage of young people with an income below the 60 percent median income as of 2008, measured in US\$2011 PPP terms.

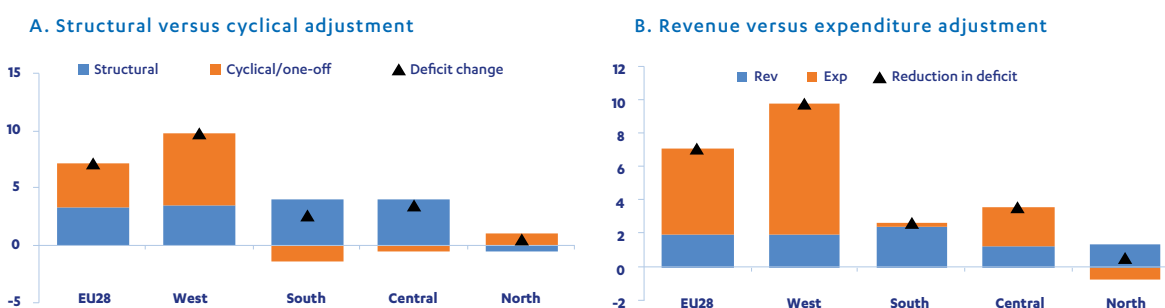
Fiscal consolidation is slowing

Governments have slowed fiscal consolidation as many EU countries seek to implement a more neutral fiscal policy stance. Saddled with high public debt, EU countries have reduced fiscal deficits sharply from a peak of 9.7 percent of GDP in 2010 to 2.7 percent in 2014 [FIG. 12A](#). The average deficit is now below 3 percent for the first time since 2008 (15 out of the 28 countries have deficits below the 3 percent limit but 9 are currently in an excess deficit

procedure). Both the headline and the structural deficits (the latter adjusted for the economic cycle and for one-off fiscal measures) changed little in the first half of 2015. The substantial fiscal adjustment during the last years masks considerable differences among EU countries. The Western and Central European countries relied more on expenditure reduction while countries in the Southern Europe focused largely on revenue increases [FIG. 12B](#).

► FIG. 12 SIGNIFICANT FISCAL ADJUSTMENT HAS BEEN ACHIEVED THROUGH DIFFERENT APPROACHES

Contribution to fiscal deficit reduction, 2010-2014, percent of GDP



Source: EU Ameco; World Bank calculations.

While most countries across the EU witnessed an increase in total social benefits during the crisis, social assistance spending actually declined in the Central and Southern Europe. Social benefits in percent of GDP increased across the EU during the crisis. Yet, this increase was to a significant extent driven by an upward trend in contribution-based social protection spending, in particular, pensions that cannot easily be adjusted in times of crisis and, in some EU countries, a declining GDP. Social assis-

tance spending, which is primarily designed to support vulnerable families and individuals, actually declined in most countries in Central and Southern Europe between 2008 and 2012 in real terms, reflecting sensitive political economy considerations associated with reforms to pension and disability systems and different types of social protection systems (see *Focus Note*). This decline in social assistance benefits has likely contributed to an increase in poverty.

Despite reductions in fiscal deficits in recent years, public debt levels remain elevated and are among the highest in the OECD, particularly in Southern Europe.

While the overall increase in indebtedness in 2010-2015 in the EU was very similar to that in the US, there were significant variations between countries. In particular, public debt in the Southern Europe increased by 30 percentage points of GDP and its level is now well above 120 percent of GDP, driven significantly by large output declines. The pace

of debt accumulation in the EU slowed markedly in 2014, and flattened in the first quarter of 2015, reflecting better fiscal positions of many countries and higher economic growth. Nonetheless, the significant debt overhang will continue to constrain governments' ability to relax fiscal policy over the long-term, and heightens their exposure to increased costs from interest rate movements, slow growth and low inflation.

Countries with the largest output gaps continue to have the highest levels of public debt, limiting their ability to use discretionary fiscal policy to boost growth.

The scope for fiscal stimulus is therefore constrained in many countries, particularly in Southern Europe, where output gaps are the largest and poverty increases were the steep-

est. Combined with the modest recovery in much of Southern Europe, this leaves few options but to continue to improve the efficiency of public spending, including of social protection systems, and implement reforms to bolster private-sector activity in order to boost growth and reduce debts to more manageable levels. ◀

Countries continue to improve business regulations in an effort to bolster growth

Structural reforms, in particular in Southern and Central Europe, have supported the growth recovery. Yet, the pace of reform implementation has slowed. Business environment reforms¹² and the implementation of the EC's Services Directives have boosted labor productivity in affected sectors by 4-9 percent in Portugal, Spain, Italy and Greece, respectively (Varga, Werner and t'Vled 2013).

De-regulation in the services sector significantly boosted total factor productivity of firms in the manufacturing and services sectors that use these services (*World Bank 2015a*, **BOX 3**). Yet, despite empirical evidence that the impact of structural reforms between 2008 and 2013 have helped boost productivity and export performance, the pace of reform implementation has recently slowed (*ECB 2015b*).

Though EU countries rank high in terms of Doing Business, there is ample room for further reforms to strengthen the EU's long-term growth potential. In 2015, one third of the top 20 countries in terms of ease of doing business were EU member states¹³ and all EU countries, except for Malta, Luxembourg and Greece, rank in the top 50 of the World Bank's Doing Business Ranking (*World Bank 2015b*). Yet, differences between the best and worst scores vary significantly **FIG. 13A**. For example, it still takes on average 590 days in the EU to enforce contracts,

compared to less than a year in Lithuania, Luxembourg and Sweden. A construction license is issued on average in the EU within 23 days. Yet, it takes more than 50 days in Belgium, Croatia and Slovenia. It takes more than 400 hours in Bulgaria and the Czech Republic to compile taxes, compared to 96 hours in Luxembourg, Estonia, Ireland and Finland. Table 1 highlights how countries perform within the EU, and where reforms might help to boost countries competitiveness. Countries are also increasingly looking at the implementation of reforms within a country (see **BOX 4**).

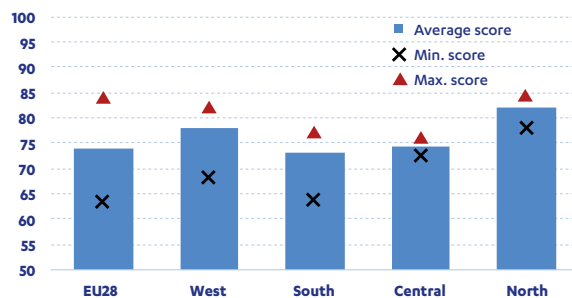
¹² According to the World Bank's Doing Business (2015) Southern European countries improved their regulations and administration for enforcing contracts, minority investor protection, paying taxes and getting electricity. Regulations on insolvency and taxes were significant areas of improvement in the Central Europe. In contrast, Northern European countries made it easier to start a business by simplifying pre-registration and registration formalities (Estonia, Sweden) or introducing more online procedures (Denmark, Lithuania). Similar to the Southern Europe, but to a lesser extent, the Western Europe made broad-based improvements, notably in starting a business, protecting minority investors and paying taxes.

¹³ Singapore and New Zealand remained at the top of the ranking, and the US remained seventh. The top-ranked EU member states in 2015 were Denmark (third), United Kingdom (sixth) and Sweden (eighth).

► **FIG. 13 DIFFERENCES IN THE BUSINESS ENVIRONMENT IN THE EU VARY SIGNIFICANTLY WITHIN AND ACROSS REGIONS AND OVER TIME**

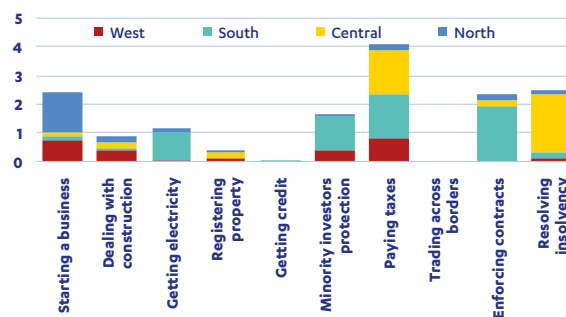
Doing Business Scores and Distance to Frontier

A. Overall ease of doing business, distance to frontier (100 = best practice)



Source: World Bank Doing Business.

B. Contribution to change in doing business scores by country grouping

► **TABLE 1 EASE OF EUROPEAN DOING BUSINESS RANKINGS**

	STARTING A BUSINESS	DEALING WITH LICENSES	GETTING ELECTRICITY	REGISTERING PROPERTY	GETTING CREDIT	PROTECTING MINORITY INVESTORS	PAYING TAXES	TRADING ACROSS BORDERS	ENFORCING CONTRACTS	RESOLVING INSOLVENCY
DENMARK	8	1	5	2	6	6	3	1	13	4
SWEDEN	7	5	2	5	18	3	9	16	14	11
UNITED KINGDOM	3	7	3	16	2	1	2	26	22	8
FINLAND	12	12	4	12	13	24	4	24	10	1
PORTUGAL	2	13	8	6	23	24	18	17	6	3
AUSTRIA	23	9	7	10	16	11	21	1	2	12
ESTONIA	9	4	17	4	6	26	8	20	9	19
LITHUANIA	1	6	18	1	6	15	12	19	5	26
GERMANY	26	3	1	22	6	16	19	23	3	2
NETHERLANDS	10	24	12	7	20	20	7	1	21	6
LATVIA	5	8	22	8	2	17	6	21	11	20
SLOVENIA	16	16	14	19	26	2	11	1	19	7
FRANCE	6	15	6	26	20	9	22	1	7	16
IRELAND	4	18	10	15	6	5	1	27	23	14
SLOVAK REPUBLIC	17	11	15	3	13	27	20	1	20	17
POLAND	27	14	13	17	2	18	14	1	16	18
SPAIN	21	25	24	13	16	9	13	1	12	15
CZECH REPUBLIC	20	26	11	14	6	19	27	1	25	10
BULGARIA	13	21	27	18	6	3	26	18	18	22
ROMANIA	11	20	28	20	1	21	17	14	17	21
BELGIUM	14	10	19	28	23	23	23	1	15	5
ITALY	18	17	21	9	23	13	28	1	24	13
HUNGARY	25	23	25	11	2	22	25	15	8	25
CROATIA	24	28	23	25	18	7	15	13	4	24
GREECE	15	19	16	27	20	14	16	22	28	23
CYPRUS	19	27	20	21	13	8	24	28	27	9
LUXEMBOURG	22	2	9	24	27	28	10	1	1	27
MALTA	28	22	26	23	28	12	5	25	26	28

Source: Doing Business 2016 database. / **Note:** The intensity of the color reflects the rank (out of 28) of a country for an indicator. The lower the number, the better the performance. Colors range from green (strong performance) to yellow (average performance) and red (low performance).

Labor market and product market reforms could strengthen the EU recovery. In particular, further reforms which enhance labor mobility within and across EU member states and reduce labor market rigidities would be important. Moreover, a continued investment in high quality general education and marketable skills remains important. Continued product market reforms will be essential to support long-term growth. These include strengthening

the EU's Single Market¹⁴ – notably by implementing fully the EU Services Directive, easing financial fragmentation through the Capital Markets Union and enhancing labor mobility and the deregulation of professions – as well as complementary measures to boost investment through the so-called Juncker Plan to leverage private resources for investment, including for SMEs.◀

BOX 3. DIGITAL DIVIDE OR DIVIDEND?

In October 2015, a ridesharing service arrived in Croatia, which local taxi drivers vowed to fight.

Many cities around the world require drivers to hold a license to operate a taxi; entering the market is often associated with high fixed costs since licenses are issued rarely and must be bought from current owners. In New York City, costs for taxi licenses skyrocketed from about \$400,000 in 2004 to more than \$1,100,000 in the beginning of 2013. They started to decline only after the introduction of ridesharing services, which can enhance com-

petition and the efficiency of transport services. In San Francisco, the birthplace of ridesharing companies, taxi use fell 65 percent between January 2012 and August 2014. No wonder that many local taxi drivers feared income losses. Yet, taxi companies in various cities responded by enhancing the quality of their customer services to compete with the ridesharing services, such as developing joint smartphone applications enabling online payment, rating and vehicle tracking in real time.

Service providers now rely on digital technology that create significant opportunities for growth, but that faces severe opposition in sectors most protected from competition and innovation.

The internet has created new types of startups that base their business model entirely on the web but offer traditional services, such as retail trade, finance, transport, logistics, tourism, media, publishing and advertising. Airbnb, for example, operated in more than 40 countries in 2014, enabling owners to let their homes for short-term rents, putting competitive pressure on the hotel and tourism industry, which has frequently enjoyed high rents due to local market segmentation or exclusive contracts in

developing countries. The Estonian startup TransferWise and the U.S. startup Xoom match requests for international currency transfers online, saving direct and indirect transaction fees by clearing reciprocal currency transfer requests. The two startups reduce regulatory rents by reducing the prices of international currency transfers by up to 90 percent. Postmates and Parcel provide local logistic services in U.S. urban centers and have started to compete with traditional service providers such as FedEx but also with existing e-commerce platforms by matching customers demanding any type of locally available goods with a pool of couriers.

Digital technology can create unprecedented opportunities for growth. They are often missed because they are largest in sectors that are typically the most protected from competition and innovation. Yet, it is precisely

in highly protected sectors like retail and wholesale trade, finance, transport or public utilities, that digital technology can increase productivity and, consequently, growth the most.

Source: World Bank, World Development Report 2016 "Digital Dividends" (forthcoming)

¹⁴ See EU Communication on upgrading the Single Market: http://europa.eu/rapid/press-release_IP-15-5909_en.htm

BOX 4. THE IMPORTANCE OF LOCAL BUSINESS REGULATION: THE CASE OF POLAND AND SPAIN

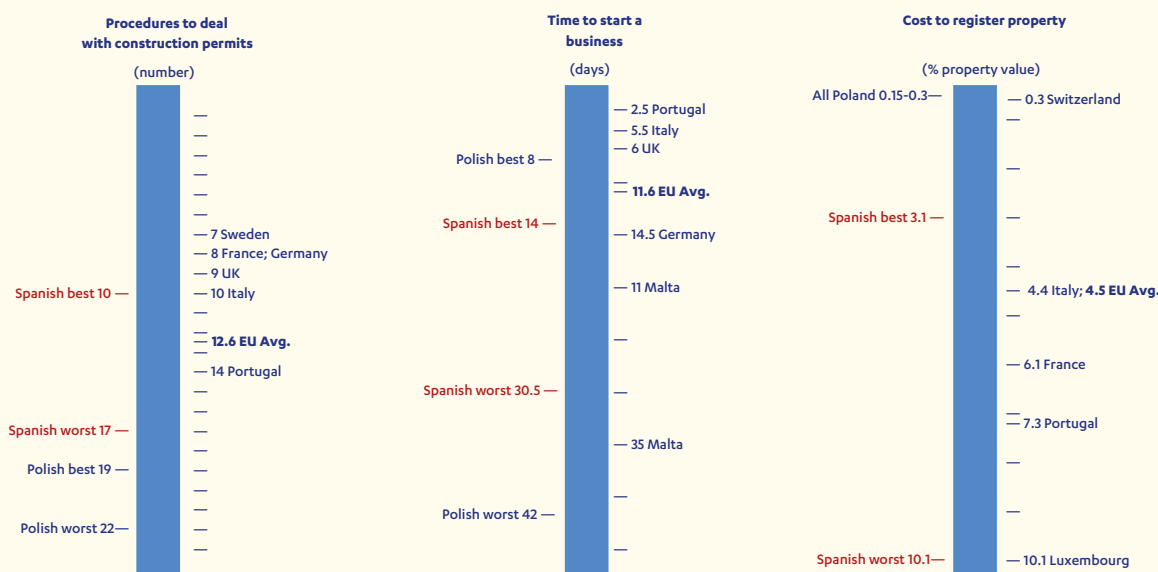
At the national level, Poland and Spain have been reducing the complexity and cost of business regulation and administration in line with global best practices. Since 2008, both countries have made considerable progress in reducing the regulatory and administrative burdens faced by companies, moving closer toward the frontier of good practices in many areas, as measured by the World Bank's *Doing Business* survey. However, at the local level within each country, the picture is more nuanced as many regulations and administrative measures

are determined by local authorities. Coordinating different levels of government and institutions is essential to reduce the regulatory burden for companies. From an entrepreneur's point of view, it is irrelevant whether a requirement comes from the municipality, the region or a national institution. This is a particular problem for SMEs, who employ a significant number of people and are responsible for a large share of net job creation in the EU.

In both in Poland and Spain, the regulatory environment varies significantly at the subnational level, suggesting the need for greater policy coordination. No single city benchmarked (out of the 18 in Poland and 19 in Spain) does equally well in all *Doing Business* indicators (see FIG. 14). Starting a business in Seville, Spain, for example, takes only 7 steps, but 12 in Pamplona. In Poland, obtaining a construction permit in Opole takes four

and a half months, while in larger cities, such as Krakow, Poznań and Warsaw, more than six months. With the exception of Kielce, all Polish cities do better than average on at least one indicator. Similarly, all but two Spanish regions obtained an above-average score in at least one area, and all have at least one area where they rank below-average, suggesting a large potential for inter-city learning.

► FIG. 14. LARGE DIFFERENCES IN REGULATORY PRACTICES DEPEND ON WHERE SMES LOCATE THEIR BUSINESS.



Source: Doing Business 2015 data.

There are many reasons that explain differences between subnational regions.

In Poland, variations often result from the local interpretation and implementation of national laws. Spanish entrepreneurs face regulatory complexity and red tape as they interact with three levels of government – national, regional and municipal – each with its own competencies and legislation. While entrepreneurs in both countries face regulatory complexity and different levels of administrative efficiency, SMEs in

Spain grapple with higher costs. Spain's average cost is more than twice that of the EU average for dealing with construction permits, and 75% higher for getting electricity and registering property. Poland typically has lower costs than the EU average. While Spain's average cost to transfer property is nearly 8 percent of the property's value, it's only 0.32 percent in Poland. Similarly, to deal with construction permits, entrepreneurs pay 5 percent of the warehouse value in Spain but only 0.22 percent in Poland.

Subnational *Doing Business* surveys thus provide more information on how government might support good practices within a country and provides a tool for specific locations to share their experiences.

Because cities in the same country operate under a common legal framework, the good practices of the best performing cities can usually be replicated, although this may require support and shared experiences from more successful jurisdictions. Sharing comparable data on the

ease of doing business across different locations within the same country may thus help drive reform, since it is difficult for local governments to justify why doing business in their city or province is more burdensome than in neighboring locations. Uneven performance can guide local policymakers to areas where improvements are possible, and these administrative improvements can make a big difference in the life of an SME.

Source: World Bank Subnational *Doing Business*.



CHAPTER TWO



OUTLOOK



26

THE EU NEEDS TO TURN TAILWINDS
INTO SUSTAINED GROWTH

28

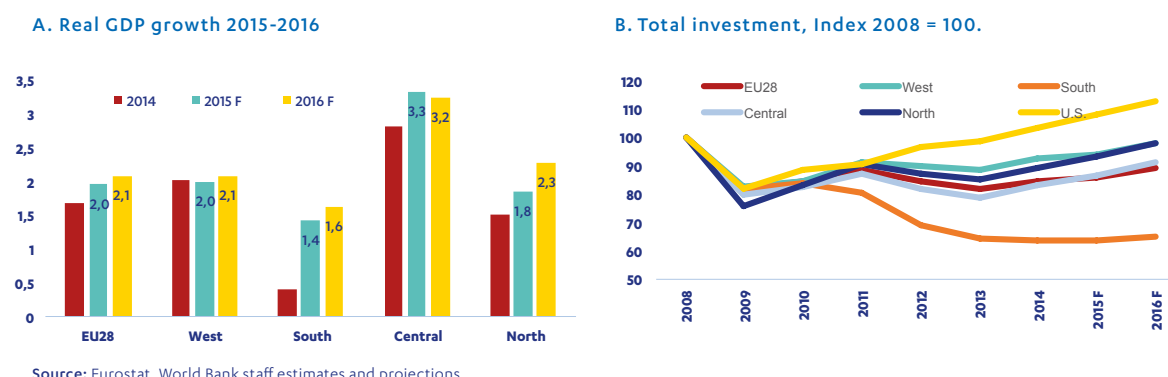
MEDIUM-TERM RISKS
ARE SUBSTANTIAL

The EU needs to turn tailwinds into sustained growth

Continued easing of financial conditions, improved confidence, low commodity prices and a reduced drag from fiscal consolidation will continue to support growth in 2015 and 2016. The EU's modest recovery looks set to continue to strengthen with more balanced growth between regions [FIG. 15A](#). Still, growth in the EU is expected to remain modest at 2.0 percent in 2015 and 2.1 percent in 2016. Despite the moderation in activity in China and the uncertain outlook for Greece, consumption will continue to fuel growth as employment and wages grow.

Investment is projected to pick up in 2016 as confidence improves and financial conditions remain favorable [FIG. 15B](#). Yet, with slowing global demand and continuing downside risks, investment growth is expected to remain subdued. Residential construction is likely to increase on average as real disposable household incomes and house prices continue to rise and mortgage rates remain low. Growth of investment in non-residential construction and equipment is likely to remain sluggish as firm-level profits remain subdued and corporate deleveraging continues.

► **FIG. 15 GROWTH RATES ARE PROJECTED TO RISE ACROSS THE EU THOUGH INVESTMENT GROWTH REMAINS MODEST**



Fiscal policy is expected to remain broadly neutral, as high debt levels will continue to restrict public spending. Governments across Europe have significantly lowered fiscal deficits over the past few years, with most countries' deficits expected to be below the formal Maastricht criteria of 3 percent of GDP in 2015. As the

recovery gains strength across Europe, further structural reforms and favorable financial conditions are expected to increasingly support the consolidation effort. The pace of adjustment and its drag on overall economic growth is expected to moderate.

Inflation across the EU is likely to gradually rise as output and employment gaps narrow. The latest ECB survey of inflation forecasts suggests that EU inflation is likely to fall from 0.4 percent in 2014 to around zero in 2015, before very gradually rising toward the ECB's price

stability objective of below but close to two percent in 2017. Core inflation is likely to rise as output gaps close, while petroleum and commodity prices look set to remain relatively subdued over the medium-term as global demand remains weak.

The economic recovery is likely to ease poverty rates across the EU (see *Spotlight below*). However, the rate at which poverty is reduced will depend on both the speed and the depth of the recovery in labor markets as well as the efficiency of the social protection systems that

support the vulnerable and help families and individuals find jobs as the economy recovers (see *Focus Note*). Poverty forecasts for Bulgaria, Croatia, Poland and Romania suggest improvements in poverty rates between 2014 and 2017 (see *Spotlight on Central Europe*).

While the QE has provided a strong tailwind for the recovery, it is unlikely to be enough to put Europe on a high, self-sustaining growth path. Financial net wealth has increased, but it is unlikely to fuel a large and sustained increase in consumption, as those who gained the most from the increase in net wealth are less likely to

spend their gains (*Carroll, Slacalek and Tokudaoka, 2014*). Only sustained improvements in labor markets will be able to consolidate consumption growth. While QE has significantly helped improve financing conditions, investment growth is expected to remain moderate.

A significant structural reform agenda needs to be advanced to raise the productive potential of the EU. Despite major reform efforts in recent years, significant impediments to growth remain. The EC estimates that full implementation of the Services Directive could add 1.8 percent to EU GDP (*EC 2015*). Similarly, an emphasis on improving the business environment at both the national and subnational levels is welcome, as discussed in the earlier section (*World Bank 2015c*), although the EU could go further with the aim of making the EU the most business-friendly global region over the medium term. Other high-priority structural reforms include the following:

continuing to reduce labor market rigidities and promoting the skills needed for dynamic job creation and innovation (*World Bank 2013*); fully implementing the capital market union to help deal with the remaining financial market fragmentation and to boost the availability of venture capital ; and implementing the EU's Digital Single Market Strategy to improve access and reduce Internet costs for businesses and consumers and by encouraging more efficient networks. This will need to be combined with affordable social policies that help to protect the most vulnerable, while promoting greater social and labor market inclusion. ◀

Medium-term risks are substantial

Risks to the outlook for the EU are tilted to the downside as divergent global trends increase uncertainty over external demand. Key downside risks include:

(i) Structural rigidities:

Continued weakness in the recovery of investment would constrain the sustainability of the EU's growth over the medium term, once the impact of the current tailwinds have abated. Despite the ECB's quantitative easing and favorable financial conditions, credit growth remains weak. Deleveraging pressures and a high share of non-performing loans remain in some EU countries. Private sector investment remains sluggish. Although investment activity could be bolstered by the 315-billion-Euro European Fund for Strategic Investment (EFSI), also known as the Juncker Plan, which is intended to stimulate growth and create jobs, implementation arrangements are still being put in place and it may take considerable time before its impact is felt in many countries. Reducing structural rigidities in product, labor and capital markets would help boost private-sector performance and investment;

(ii) Slower external demand resulting from a continued slowdown in emerging markets, most notably China as it seeks to restructure local government financing

and rebalance growth toward domestic demand, or the imminent monetary policy tightening in the US, could slow the EU export growth. A protracted recovery could hamper market confidence, slow investment and adversely affect growth prospects and financing costs;

(iii) An upsurge in financial-market volatility related to the timing of U.S. interest rate rise, set in a context of divergent monetary policies in the EU and Japan, could trigger further swings in exchange rates and capital markets and reduce the predictability of funding for investment;

(iv) Regional geopolitical tensions also pose economic risks for the EU and could undermine confidence in the recovery. A strong European commitment will be important for building confidence. In particular, the recent refugee and migration flows calls for common solutions ^{BOX 5}.

On the upside for the EU, improvements in efficiency of public spending and further progress in the development of the banking union may help bolster the outlook for growth over the medium term, as may low commodity prices and the weak euro.

BOX 5. THE EU AND THE REFUGEE CRISIS

The European Union is encountering an unprecedented influx of refugees and migrants as forced displacements accelerated significantly in 2014, turning it into the year with the highest number of internally displaced on record and the highest annual increase in a single year (*UNHCR 2014*). Historically, the number of refugees increased from the 1950s (after the refugees involved in the huge population transfers that followed World War II were resettled) until the peak of 17.8 million persons following the collapse of the Soviet Union. The

number of refugees then diminished, but shot up again in the past couple of years. The vast majority of international refugees remain in countries close to their own. Refugees equal less than 8 percent of the total of more than 250 million international migrants, and 0.2 percent of the global population. The number of Syrian refugees has reached 3.8 million, the largest in absolute numbers currently, but less than the 5.6 million Afghan refugees in 1989.

As a result of the larger influx of refugees, the number of people seeking asylum in Europe increased dramatically. In Q2 2015, the number of first-time asylum applicants reached 213 200. This was an increase of 85 percent compared to the same quarter in 2014 of which 69.7 percent was due to applications from Syrians, Afghans, Albanians and Iraqis. The highest number of first-time asylum applicants in the second quarter of 2015 was registered in Germany (38% of total applicants in the EU), Hungary (15%), Austria (8%) and Italy, France and Sweden (about 7% each). These six Member States together accounted for more than 80% of all first applicants in the EU-28. In fact, Hungary saw its number of asylum seekers jump more than 13 times compared to the same quarter of 2014.

Yet, the Nordic and Baltic EU countries, which have the highest share of first-time asylum applicants, are about 0.2 percent of the total. Between April 2011 and October 2015, a total of 679,240 Syrian asylum applications were filed in Europe, equal to 0.13 percent of the EU28 population at the end of 2010. This number remains very small compared to Syrian refugees registered in neighboring countries. The total number of registered refugees in Turkey, Lebanon, and Jordan amount to 3.249 million, and make up 10.4 percent of their 2010 populations. The number of Syrian refugees in Turkey, Lebanon and Jordan alone is eight times higher than those in all European countries (400,000 Syrian refugees in 2014).

While the refugee crisis is likely to bring costs in the short term, there are potential benefits in the medium to long-term. In the short-term, this influx to the EU is likely to put a strain on public services provided in some transit and destination countries and may lead to a moderate increase in spending as a share of GDP in the most affected countries, notably for delivery of public services and integration support. In the medium-term, the net fiscal impact and net economic benefit of immigration is likely to turn positive, in particular for rapidly ageing societies, provided efforts to integrate refugees into domestic labor markets are successful. Compared to

most other countries that have received a large influx of immigrants, Europe has the resources, the experience and the capacity to turn the refugee influx not only into an opportunity for the refugees but also for domestic economies. Economic inclusion including access to employment will facilitate, not only integration, but also, ultimately, larger fiscal contributions of refugees. Policy responses should focus on helping to contain the crisis in the source country, alleviate capacity constraints in transit countries and develop monitoring mechanisms and policies and regulations to accelerate the integration of migrants into domestic labor markets. ◀



CHAPTER THREE

▼

SPOTLIGHT ON CENTRAL EUROPE

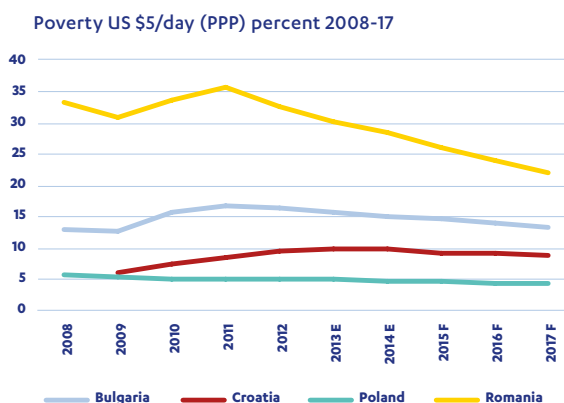
SPOTLIGHT ON CENTRAL EUROPE

The Central European countries continue to enjoy some of the fastest growth rates in the EU, though the expected pace of recovery, and thus poverty reduction, varies widely.¹⁵ Economic growth in the region

is driven by domestic demand and continuing robust export growth, mainly due to demand from the rest of the EU. Consumption has generally been bolstered by improving employment and wage growth, low inflation from petroleum and food products, and easing credit conditions. The acceleration in the absorption of EU Structural and Cohesion Funds (before the deadline for use of budgeted amounts for 2007–13) also boosted growth in Central Europe in 2015, but the impact is expected to moderate in 2016 as the new budget funds start to be spent. In most countries, unemployment rates have declined to their lowest levels since 2009. The pace of recovery is slower in Bulgaria and Croatia than in the Czech Republic, Poland, Romania and the Slovak Republic,

which are all projected to grow 3 percent or more in 2015. The differing speeds of recovery, and particularly employment, will impact the rate of poverty reduction.

► **FIG. 16 POVERTY IS PROJECTED TO DECLINE**



Source: World Bank projections.

Bulgaria's recovery is projected to be modest, which is likely to translate into a slow pace of poverty reduction. Growth is projected at 2.9 and 2.2 percent in 2015 and 2016 respectively. Growth in 2015 is likely to be

higher than initially expected, supported by strong exports to the EU in the first half of 2015, the recovery of investments, mainly public ones from improved implementation of EU-funded projects, and better labor market performance. However, inflation was minus 1.2 percent in October 2015 with the annual rates having been negative since July 2013. The substantial fiscal consolidation planned for 2015 is likely to be achieved due to buoyant revenue performance while some of the expected savings in spending are not likely to materialize. The deficit (accrual basis) is projected

to decline to 2.8 percent of GDP, following the increase to 5.8 percent in 2014, mainly due to one-off factors related to the payout of guaranteed deposits by the Bulgaria Deposit Insurance Fund. The government is also expected to further reduce the fiscal deficit by about 0.5 percentage points of GDP per year in 2016 and 2017. Increasing child benefits and heating subsidies for children and the elderly, as well as minimum wage increases and the Youth Guarantee Program to help youth in finding jobs are expected to contribute to poverty reduction. However, given the modest pace of recovery, poverty – measured at US\$5 per day in PPP terms – is expected to remain above pre-2008 levels and decline slowly to 14.1 percent in 2016.

¹⁵ This section looks at economic and poverty developments in the Central European countries, where the World Bank has historically had the strongest engagement. It provides additional information on selected countries, in particular Bulgaria, Croatia, Poland and Romania, where the Bank is supporting efforts to bolster growth and shared prosperity.

In Croatia, economic activity is expected to recover at a very modest pace, after contracting for twelve quarters, with poverty projected to decline only marginally.

The economy is expected to grow by 1.5 percent in 2015, with the construction sector finally growing, supported by a doubling of EU funds two years after accession, together with a gradual rise in personal consumption and exports. Unemployment remained high, at about 17 percent in the first half of 2015 (four-quarter moving average), despite active labor market policies and reduced labor shedding with slower corporate restructuring. While real wages grew by 3.7 percent year-on-year in the first nine months of 2015, real pensions declined by 1 percent annually by September 2015, with adverse poverty impacts on households dependent on pension income. Real per-capita income remained flat in 2014 at 8 percent below its pre-crisis level. It is estimated that the poverty rate, measured at \$5/day PPP 2005, remained essentially unchanged in 2014 at 9.8 percent. In the absence of stronger private employment and wage growth, poverty is projected to decline only marginally, to 9.3 percent in 2015

and 9.0 percent in 2016. One of the most pressing problems is the high fiscal deficit, which averaged 6 percent over the last six years. The general government fiscal deficit was 5.6 percent in 2014, and is expected to remain high at 4.9 percent in 2015, the highest level in the EU, as public debt has more than doubled from 2008, to 85.7 percent of GDP by August 2015. Over the medium-term, government consumption is projected to remain subdued due to a much-needed fiscal consolidation required under the EU Excessive Deficit Procedure (EDP) that has set ambitious targets to reduce the deficit. Although the European Council in June 2015 decided not to activate any corrective action against Croatia for its large deficit, it pointed out that the “level of ambition remains below expectations in a number of areas,” and has given six new recommendations that the Croatian Government should meet in 2015 and 2016. Credit growth also remains subdued, with high levels of household (12.1 percent in September 2015) and corporate non-performing loans (31.1 percent) and public debt hampering the financial sector.

In contrast to the previous two countries, growth in Poland is projected to reach 3.6 percent for 2015 and remain above 3.5 percent over the medium term, supporting a pickup in poverty reduction.

Private consumption in the first half of 2015 continued to benefit from higher real disposable incomes as a result of improved labor market conditions as the unemployment rate declined by almost 2 percentage points over the first half of the year, to 7.4 percent in the 2nd quarter of 2015. It also benefited from relatively strong credit growth to households, from consumer price declines and from higher wages (private sector wages have been growing at 2.5 percent and pensions at 2.3 percent). Investment was supported by solid corporate profits, growing confidence, record low interest rates and final disbursements from the EU’s previous financial perspective (budget). Since February 2013, headline inflation has been below the Central Bank’s 1.5-3.5 percent target range and since July 2014, consumer prices have fallen as energy and food prices declined. Poland’s economy is expected to grow at a rate above 3.5 percent over the

medium term, with negligible internal and external imbalances. Domestic demand is likely to remain the main driver of growth amid robust private consumption (around 3.5 percent), as employment and wages continue to rise, and solid investment growth. Having exited the EU Excessive Deficit Procedure in 2015, a year ahead of schedule, Poland is projected to decrease its headline deficit modestly, from 3.2 percent in 2014 to 3.0 percent of GDP in 2015, before increasing to 3.2 percent of GDP in 2016. Social expenditures are poised to rise with the introduction of new social benefits and programs supporting families with children, the elderly or more generous pensions’ indexation resulting from commitments made during the current election year and the budget will be amended to reflect these changes. Underpinned by these developments, poverty, measured by the US\$5/day in 2005 PPP, is expected to decline at a faster pace than recent years and reach 4.6 percent in 2015, down from an estimated 4.8 percent in 2014, and to fall to 4.2 percent by 2017.

Romania's economy is expected to grow at 3.6 percent in 2015 and 3.9 percent in 2016, contributing to further declines in poverty.

Economic growth has been led by a strong rise in private consumption, which reached an annual growth rate of 5.4 percent in the first half of 2015 on the back of increases in wages and a decline in the VAT rate for food from 24 percent to 9 percent in June 2015, which contributed to inflation falling to negative 1.9 percent in August 2015. The construction and industrial sectors have recovered strongly, but public investment has remained subdued, reflecting lower-than-expected absorption of EU funds. Despite the positive developments, growth for 2015 is projected to slow slightly to 3.6 percent for the entire year, due in part to a drought-induced decline in agricultural production. GDP growth, however, is expected to rise to 3.9 percent in 2016, supported by strong domestic consumption and investment. The Fiscal Code approved

by the Parliament in September 2015 envisages several tax cuts, starting in January 2016, which could amount to 1.1 percent of GDP, according to the Fiscal Council, including a cut in VAT rates from 24 percent to 20 percent. Poverty is projected to have declined from 35.8 percent in 2011 to 28.4 percent in 2014, using the US\$5.00/day PPP poverty line, driven by improved labor market conditions and increased support to vulnerable categories. These include increased allocations to the minimum guaranteed income, to family benefit and heating benefit programs, as well as increases in the minimum wage. Continued recovery of domestic demand and growth in employment and real wages, aided by low inflation should boost real incomes and lead to further declines in poverty incidence. The US\$5.00/day PPP poverty rate is projected to decline to 22.1 percent in 2017. ◀





FOCUS NOTE

WELFARE STATES¹⁶ AND PROTECTION OF THE POOR IN THE EUROPEAN UNION

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EU MEMBER STATES ARE AMONG THE BIGGEST SPENDERS
ON SOCIAL PROTECTION IN THE WORLD

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HOWEVER NOT ALL COUNTRIES PROVIDE
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WITH DIFFERING OUTCOMES FOR THE POOR

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GOING FORWARD, EU MEMBER STATES NEED TO PROVIDE
ADEQUATE PROTECTION AND SOCIAL INVESTMENT
FOR THE POOREST WHILE ENSURING FISCAL SUSTAINABILITY

EU member states are among the biggest spenders on social protection in the world...

How well positioned are European countries to protect the poor in the context of Europe's fragile economic recovery?

While the European Union's growth recovery is gaining strength, poverty across EU still remains high, especially in Southern Europe (see *Recent Economic Developments*). Higher incidence of poverty, especially among the young, undermines education outcomes and bodes ill for future labor market prospects, with adverse consequences for long-term growth. While unemployment rates have declined to their pre-crisis level in most EU countries, the youth unemployment and inactivity remain

high in several EU economies. Youth unemployment has been found to significantly depress future earnings; long spells of unemployment are likely to affect the minimum contribution periods needed to become eligible for retirement pensions, increasing the likelihood of future old-age poverty. Risks to the outlook for the EU remain tilted to the downside, raising the question how fiscally constrained governments can provide an effective protection. To address these challenges, EU member states need to focus on providing well-targeted and adequate protection to the poorest most vulnerable population.

Seventeen out of 28 EU member states spend more than the OECD average on social protection expenditures

^{FIG. 17}. A large proportion of this expenditure is on social insurance (see ^{BOX 6}), and in particular on old age pensions, in part reflecting the high median age of its populations in many countries. As the relative size of

the working age populations are projected to decline, continued long-term growth requires investment in children, youth, and otherwise weaker segments of society in order to fully maximize their productive potential. This highlights the importance of robust social protection systems.

Social assistance expenditure constitutes a small fraction of overall social protection spending but has a particularly important role in protecting and investing in the poor.

Expenditure on social assistance programs range from a low of about 9 percent of overall social protection expenditures in Poland and Portugal, to

a high of 33 percent in Denmark and 35 percent in Sweden. Although expenditures are small when compared to the social insurance pillar, social assistance programs are very important in terms of cushioning the chronic poor and the most vulnerable against potential risks across their lifecycles. Last resort social assistance programs help

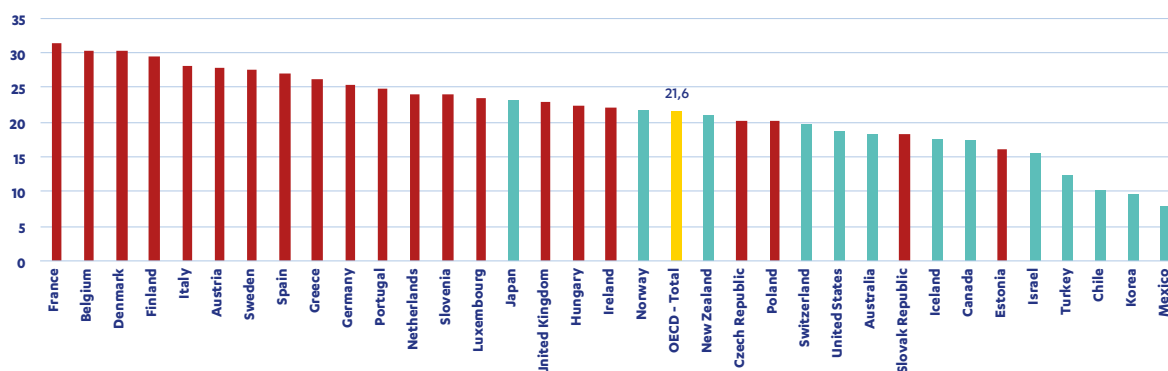
¹⁶ The welfare state is usually defined as consisting of cash benefits like social insurance, social assistance and labor policies, and in-kind benefits like health, education, housing and other social services (Barr, 2012). For the purposes of this note, the welfare state is defined more narrowly with a primary emphasis on its ability, through non-contributory social assistance programs, to protect the poor.

alleviate chronic poverty and potentially activate those that are able to work, enabling for investment in human capital; child benefits protect and invest in families with

children; disability benefits support the disabled that may be excluded from the labor market, and can help connect others back to jobs.

► **FIG. 17 EU MEMBER STATES SPEND ON AVERAGE MORE ON SOCIAL PROTECTION THAN OECD COUNTRIES**

Social protection spending, Europe and comparators as a share of GDP in 2012



Source : OECD. / Note : The definition of social protection expenditure differs across various sources. The data for this graph derive from the OECD SOCX database. The rest of the note uses Social Protection data (including breakdown into individual components) from ESSPROS with 2012 as the most recent data available, with adjustments as defined in Annex 1.

BOX 6. SOCIAL PROTECTION FUNCTIONS

Social protection can be divided into three main pillars:

1. Social insurance aims to cushion workers in the formal labor market against risks of sickness, disability, or old-age poverty. It is mostly financed through contributions. Old-age pensions are often the largest expenditure element in the social insurance pillar; and the goal of old-age pensions is to provide some form of replacement of labor income when a worker retires.

2. Social assistance primarily aims to support the poor and vulnerable families or individuals and is financed from the general government budget. The social assistance pillar has the dual objectives of protecting the poor and vulnerable from shocks, but also tackling

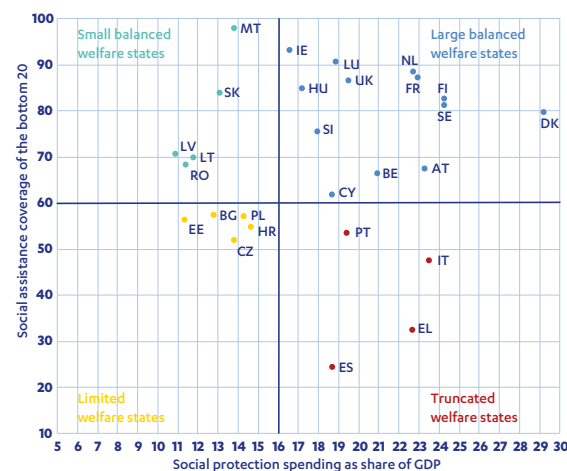
poverty and investing in people to promote their escape from chronic poverty/vulnerability. They can include guaranteed minimum income programs (which are generally captured in Eurostat surveys under the “social exclusion not elsewhere classified” function, see below), housing benefits, heating benefits or child or family benefits. Based on the objective of the program they can be categorical (e.g. disability benefits) and/or means-tested (e.g. guaranteed minimum income programs).

3. Labor market policies play both an insurance role (in the case of passive measures such as unemployment benefits) and an active role to facilitate (re-)entrance into the work force through employment services, wage subsidies and public works programs.

There is no single European welfare state. Social protection systems across the EU are classified using two key dimensions that are intermediate outcomes of the underlying social contract between the state and the citizen. The first dimension is the social protection spending as a share of GDP, which is a proxy for the overall resources a society allocates to the provision of social protection. Yet, it says little about how willing a society is to protect its poorest citizens. The second dimension is the coverage of the poorest¹⁷ by overall social assistance which is a proxy for the effectiveness of allocated resources or the types of instruments that can be potentially leveraged to tackle chronic poverty and protect the poor in a crisis¹⁸ (see ANNEX 1 for a definition of coverage). Countries that spend more than 16 percent of GDP in 2012 on social protection are classified as high spenders¹⁹; and countries that cover more than 60 percent of the poorest 20 percent of the population as countries with high social assistance coverage FIG. 18. On this basis, countries can be divided into 4 categories: **Large balanced welfare states** with high social protection spending and high social assistance coverage; **truncated welfare states**²⁰ with high social protection spending, but low social assistance coverage; **small balanced welfare states** with low social protection spending,

but high social assistance coverage; and **limited welfare states** with low social protection spending and low social assistance coverage. These groups have fairly distinct characteristics as described in BOX 7 and analyzed in this note.

► **FIG. 18 THERE ARE FOUR DISTINCT EUROPEAN WELFARE STATES**
Social protection spending and social assistance coverage, 2012



Source: World Bank staff calculations using ESSPROS 2012 and EU-SILC 2013. /
Note: Labor market spending data for 2012 for Greece are from 2010, for Cyprus and the UK are from 2011. Germany is not ranked, since we do not have coverage data for Germany.

¹⁷ For the purposes of this note we assume that the poorest 20 percent of the population (bottom quintile) are representative of the most vulnerable segment of the population in each country. In fact, the relative at risk poverty rates in 2012 (from SILC 2013, latest year data is available) range between 9 to 21 percent with 16 percent as the simple average for the EU.

¹⁸ When well-targeted and well-functioning programs with a reasonably high coverage of the poor already exist, countries are better placed to leverage such programs to respond quickly and efficiently to a crisis. In contrast, countries with smaller coverage and without an effective poverty targeted program often have had to rely on less efficient instruments (such as providing subsidies or using pensions as the main crisis response instrument), which may make crisis response prohibitively expensive and leave the population with little protection.

¹⁹ The median (and mean) expenditure on SP among all member states in 2004 was 16 percent and is used as the cutoff point for the typology.

²⁰ As outlined in Fiszbein (2004) truncated welfare state refers to systems where public social protection is offered to a certain group (in most cases formal sector workers) and the protection drops sharply at the lower parts of the income distribution.

BOX 7. TYPOLOGY OF SOCIAL PROTECTION SYSTEMS

Large balanced welfare states are characterized by high social protection spending that goes hand in hand with high social assistance coverage of the poorest quintile and includes most Western European countries – **Austria, Belgium, Cyprus, Denmark, France, Finland, Hungary, Ireland, Luxembourg, the Netherlands, Slovenia, Sweden, and the United Kingdom**. Averaging 21 percent of GDP in 2012, their social protection spending is relatively high. They have a relatively more balanced breakdown between social assistance and social insurance spending, enabling them to offer protection and income replacement (upon retirement) to formal sector workers while also providing safety nets for the poor and vulnerable. These countries are able to cover a significant portion of the bottom quintile (around 80 percent on average) through their social assistance programs. The social protection system includes a more balanced mix of programs with basic elements that buffer against different risks (e.g., risk of unemployment, of disability, of poverty). It also includes instruments to connect people back to opportunities, such as providing job search assistance, counselling, social services, and so on. It is important to note that large balanced welfare states are expensive. Fiscal sustainability of the system provides the key risk in terms of whether such countries can continue to provide protection during future crisis episodes. A fall in GDP could necessitate cuts in expenditure, and the quality of fiscal consolidation will determine if these states are able to become leaner, but still maintain protection of the vulnerable.

Truncated welfare states are characterized by low coverage of the poorest quintile by social assistance despite high levels of social spending. The Southern European countries, **Greece, Portugal, Spain, and Italy**, fall in this group. Their overall social protection spending around 21 percent of GDP is similar to that of large balanced welfare states. Yet, a relatively large share of their spending is dedicated to social insurance. This system thus focuses on covering formal sector workers and managing the lifecycle risk of old age poverty. Overall social assistance programs, or indeed coverage, of the non-formal sector, is not well-developed. The system is therefore not well



designed to protect vulnerable groups, such as the young and the poorer segments, of society against risks.

Small balanced welfare states are characterized by low social protection spending, but high social assistance coverage of the bottom quintile. **Latvia, Lithuania, Romania, Slovakia**, and the island of **Malta**, fall under this group. Most have reformed (and continue to reform) their social protection systems since the 1990s transition and have steered them to a relatively more balanced approach which offers a mix of programs that cover various risks and covers a large share of the poorest population mostly through categorical/universal programs but still at relatively low costs.

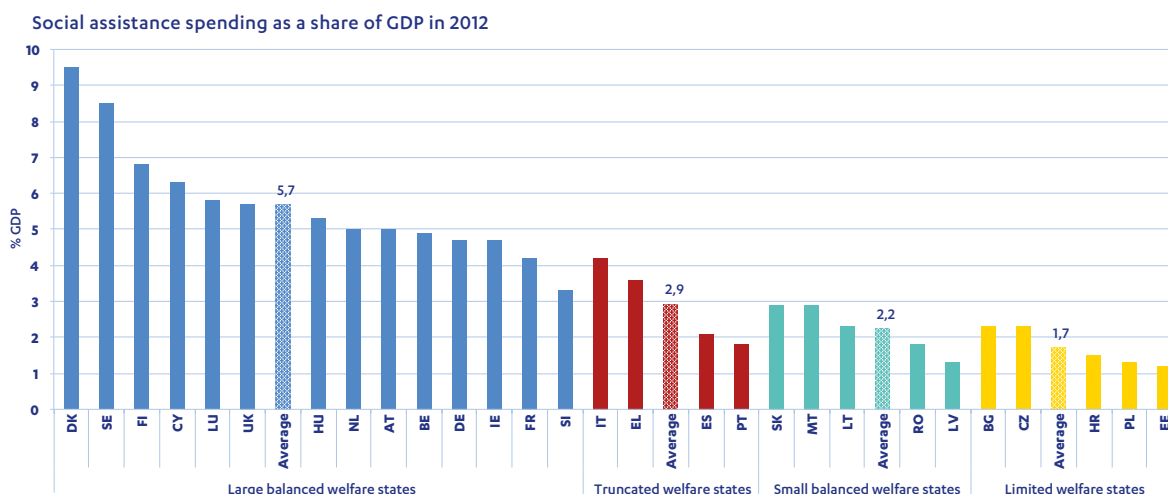
Limited welfare states are characterized by low social protection spending and low coverage of the poorest quintile by social assistance. **Bulgaria, Croatia, Czech Republic, Poland**, and **Estonia** fall in this group. Similar to the small balanced welfare states, these countries started to reform the social protection systems they had inherited from socialist times. Yet, they chose a different direction by limiting the protection offered by the public sector, resulting in minimal protection of the poorest segments against various shocks. ◀

...however not all countries provide effective protection for the poor

Higher spending on social assistance does not automatically mean higher coverage. Small balanced welfare states spend less on social assistance than truncated welfare states (2.2 percent vs 2.9 percent of GDP, respectively) [FIG.19](#),

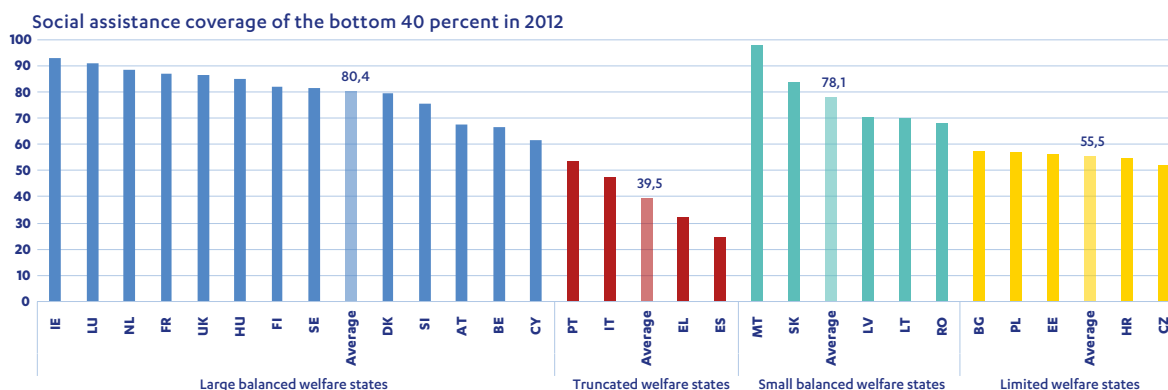
yet they achieve much better coverage of the bottom 20. Even limited welfare states, which spend the least on social assistance (1.7 percent), manage to cover a larger share of the poor at 56 percent [FIG.20](#).

► **FIG.19 SOCIAL ASSISTANCE SPENDING VARIES WIDELY ACROSS EUROPEAN WELFARE STATES...**



Source: World Bank staff estimates using ESSPROS

► **FIG.20 ...WITH VARYING IMPLICATIONS FOR THE COVERAGE OF THE BOTTOM 40 PERCENT.**



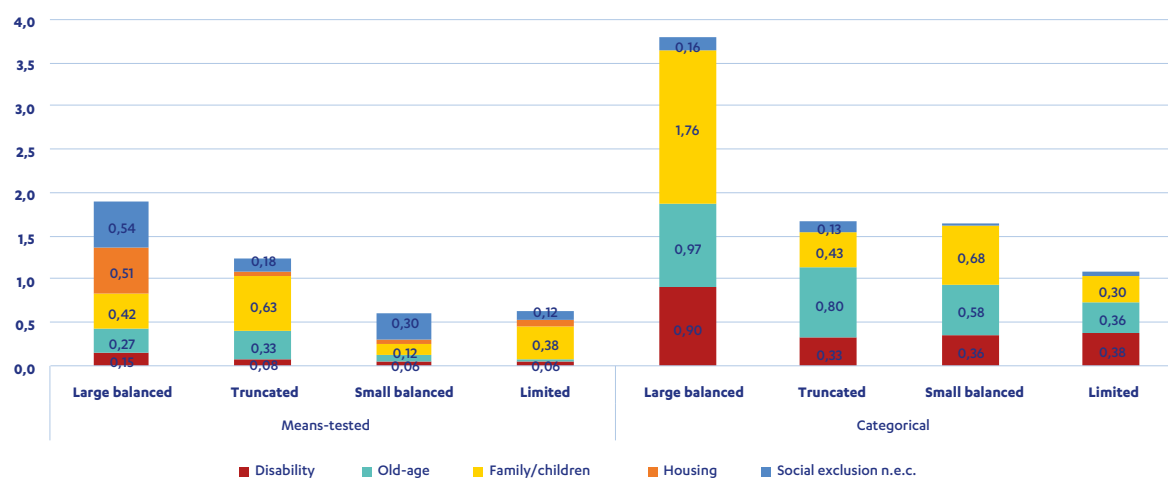
Source: World Bank staff estimates using EU-SILC. / Note: Germany is not ranked, since we do not have coverage data for Germany.

The composition of spending matters; large and small balanced welfare states achieve higher coverage through a combination of family benefits (which are mostly universal) and “social exclusion n.e.c.” programs (which are mostly means-tested)²¹. Most welfare states spend a larger proportion of social assistance expenditures on categorical programs than on means-tested programs **FIG. 21**. The largest spending sub-category across all programs is the universal family/child benefits in both large balanced (1.76 percent of GDP) and small balanced (0.68 percent of GDP) welfare states, which are expensive

due to their universal nature. Large balanced welfare states also spend more than 1 percent of GDP on means-tested housing and social exclusion benefits; however this is much smaller (0.3 percent of GDP) among small balanced welfare states. Both large and small balanced welfare states achieve high coverage of the bottom 20 through the social exclusion benefits (22 percent and 40 percent, respectively **FIG. 22**). Coverage of the bottom 20 through family benefits is also high in the large (61 percent) and small (59 percent) balanced welfare states.

► **FIG. 21 CATEGORICAL PROGRAMS DOMINATE SOCIAL ASSISTANCE SPENDING ACROSS EUROPEAN WELFARE STATES**

Means-tested vs. categorical spending, by program in percent GDP in 2012



Source: World Bank staff estimates using ESSPROS.

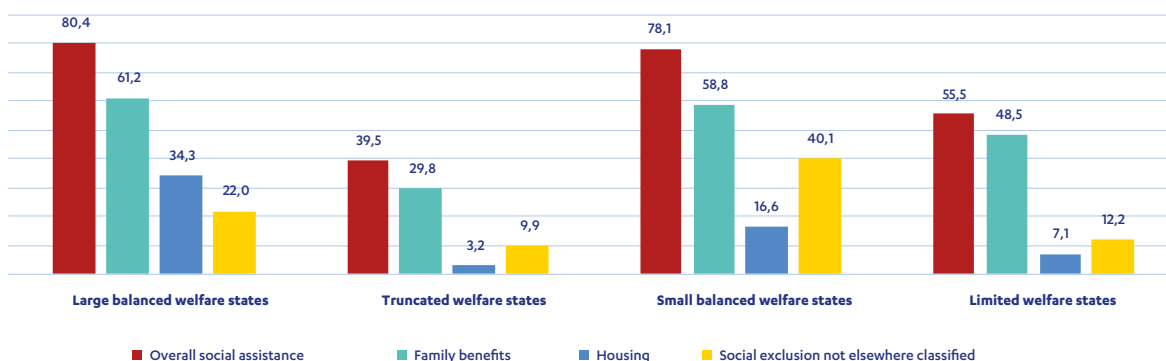
The quality of means-testing and who is targeted matter for coverage. Even though truncated welfare states spend more than 1 percent of GDP on family benefits (combined between means-tested and universal programs), they achieve much lower coverage compared to lower spending small balanced and even limited welfare states **FIG. 21 & 22**. This raises questions about the types of means-tests used to target various benefits. Similarly, truncated welfare states spend 0.18 percent of GDP on means-tested social exclusion benefits, they achieve even lower coverage (10 percent) than limited welfare states, which spend a meagre 0.12 percent of GDP. Both Greece and Italy lack a

national poverty targeted program, and this significantly reduces their ability to cover the poor. For instance, Italy spends 4.2 percent of GDP on social assistance and only spends 0.1 percent of GDP on means-tested social exclusion benefits. In contrast, Slovakia spends 2.9 percent of GDP on social assistance, of which 0.4 percent goes to the main poverty focused program, Benefit in Material Need. In addition, the disability benefit is also income-tested. Consequently, Slovakia covers more than 80 percent of the poorest through its social assistance system whereas Italy covers less than 50 percent **FIG. 20**.

²¹ Social exclusion not elsewhere classified (n.e.c.) includes programs that are not classified under the non-contributory old age and disability benefits, family benefits, and housing benefits. They mostly include guaranteed minimum income programs and other types of last resort social assistance programs, and are mostly targeted towards the poor.

► **FIG. 22 HIGHER COVERAGE OF BOTTOM 20 PERCENT IS ACHIEVED MOSTLY THROUGH FAMILY BENEFITS AND SOCIAL EXCLUSION PROGRAMS**

Social assistance coverage of the bottom 20 PERCENT by program in 2012



Source: World Bank staff estimates using EU-SILC. / Note: Germany is not ranked, since we do not have coverage data for Germany.

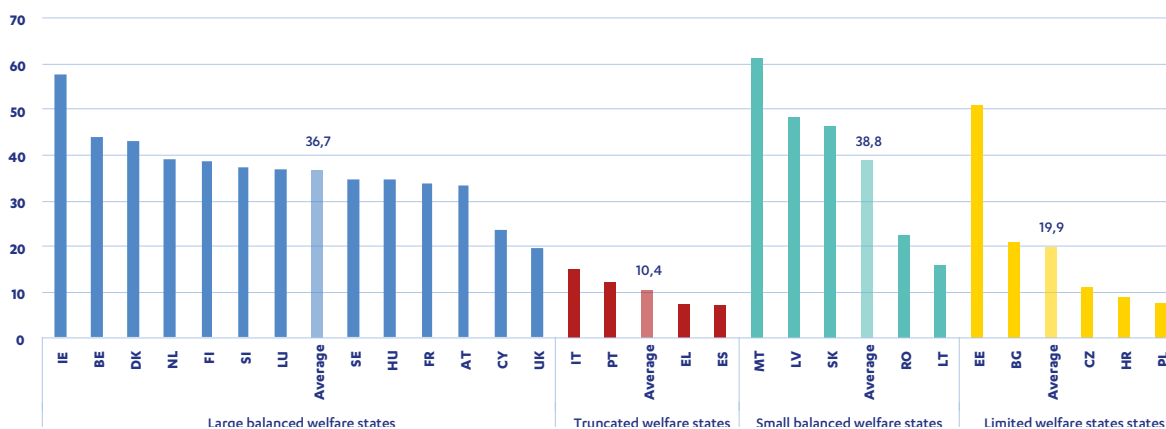
Leakage of social assistance benefits to the rich is significant in several EU member states.

Containing leakage could provide fiscal savings. Universal family benefits lead to good coverage of the poorest in large and small balanced welfare states. At the same time, many in the richest 20 percent of the population also receive social assistance benefits in these countries (FIG. 23). Much of the coverage of the rich comes from family benefits (FIG. 24).²² The leakage to the rich is particularly acute in some Baltic states – for instance, Estonia covers 56 percent of the poorest 20 percent of the population with social assistance, but also 51 percent of the richest 20 percent. Similarly, Latvia covers 70 percent of the poorest, but also 48 percent of the richest. Some large balanced welfare states, such as Belgium, also show a

similar pattern – covering 67 percent of the poor, but 44 percent of the rich. By contrast, the United Kingdom is effective in containing leakage to the rich – 86 percent of the poor in the UK receive a social assistance transfer; only 20 percent of the rich get such a transfer. Likewise, Poland minimizes leakage – only 8 percent of the rich get any social assistance. However, Poland achieves this at the cost of also excluding some of the poorest, with only 57 percent of the poor covered by social assistance. Better targeting of social assistance, especially categorical programs such as family benefits, would free up resources, which can then be channeled into savings or investments in countries with high coverage of the poor, or redirected to increase coverage of the poorest in countries with insufficient protection of the poor.

► **FIG. 23 SOCIAL ASSISTANCE LEAKAGE TO THE RICH IS SUBSTANTIAL IN MANY EUROPEAN WELFARE STATES**

Social assistance coverage of (leakage to) the richest 20 percent in 2012

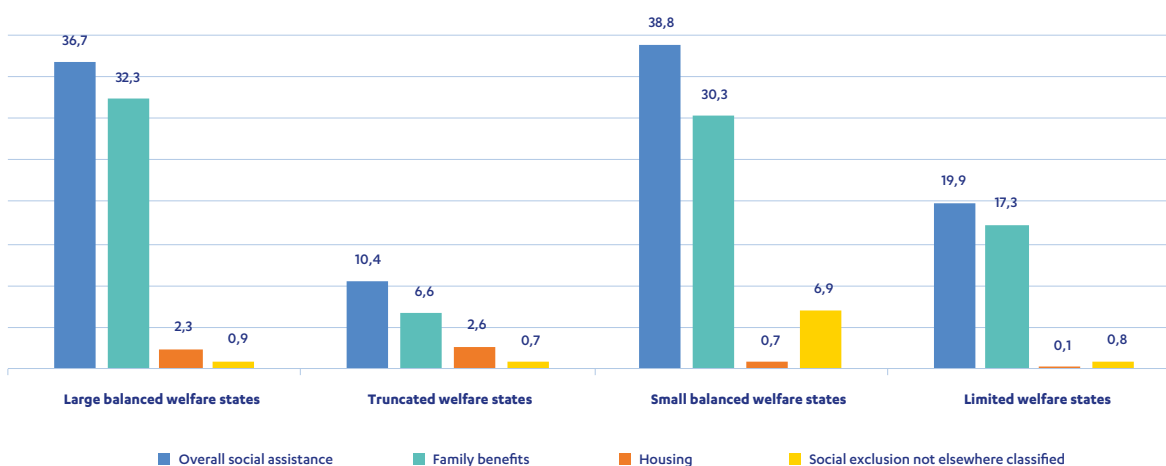


Source: World Bank staff estimates using EU-SILC. / Note: Germany is not ranked, since we do not have coverage data for Germany.

²² Universal family benefits may have an additional social policy objective of increasing fertility. However, there's mixed evidence on pro-natalist policies on fertility and labor force participation rate of women. Purely financial measures are

► **FIG. 24 LEAKAGE TO THE RICH IS MAINLY DUE TO FAMILY BENEFITS**

Social assistance coverage of (leakage to) the richest 20 percent by program in 2012



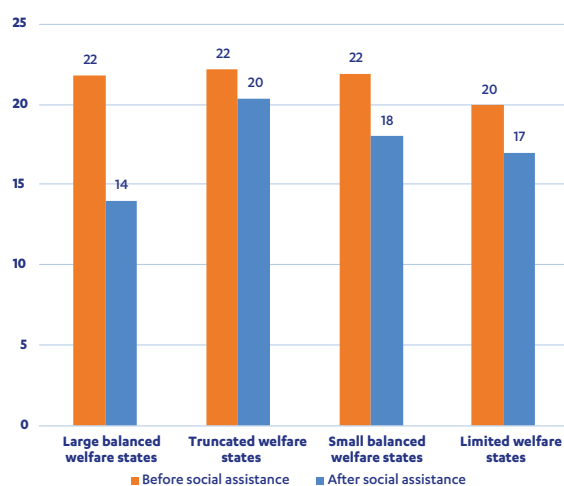
Source: World Bank staff estimates using EU-SILC. / Note: Germany is not ranked, since we do not have coverage data for Germany.

In addition to coverage, the adequacy of transfers is important to lift people out of poverty; yet not every country can afford high coverage and reasonable adequacy. The adequacy of benefits, measured as the share of transfers relative to the total disposable income of the beneficiary households, is a complementary dimension of the extent of protection offered to the poor. Large balanced welfare states, which also have the highest adequacy of social

assistance, have had the greatest success in reducing poverty through social transfers²³, reducing the poverty rate from 22 percent to 14 percent through social assistance transfers, an impressive 8 percentage point reduction [FIG. 25](#). Spending less, the small balanced welfare states achieve high coverage, but at lower adequacy levels [FIG. 26](#). Therefore, they are not able to pull as many people out of poverty. Still, they obtained a 4 percentage point reduction in the “at risk of poverty rate” in 2012.

► **FIG. 25 LARGE BALANCED WELFARE STATES ARE THE MOST SUCCESSFUL IN POVERTY ALLEVIATION THROUGH SOCIAL ASSISTANCE**

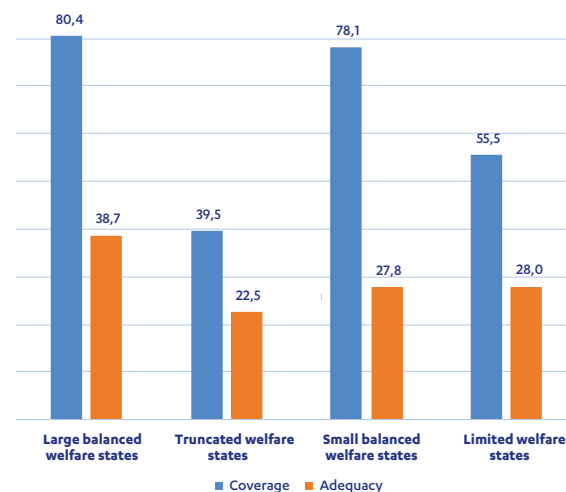
At risk of poverty -before and after transfers, 2012)



Source: World Bank staff calculations using ESSPROS.

► **FIG. 26 ONLY FEW COUNTRIES CAN AFFORD HIGH COVERAGE AND REASONABLE ADEQUACY**

Coverage and adequacy of overall social assistance for the bottom 20, 2012)



Source: World Bank staff calculations using EU-SILC 2013.

Note: Germany is not ranked, since we do not have generosity data for Germany

²³ Social assistance programs are typically not designed to fully lift families out of poverty – their purpose is to mitigate poverty and connect people to opportunities that can lift them out of poverty. A transfer given to an extremely poor family will enhance their welfare, and reduce the poverty gap. Transfers given to families closer to the poverty line are more likely to have an impact in terms of fully lifting them out of poverty and therefore reducing the poverty headcount.

Most welfare states cut social assistance spending during the crisis...

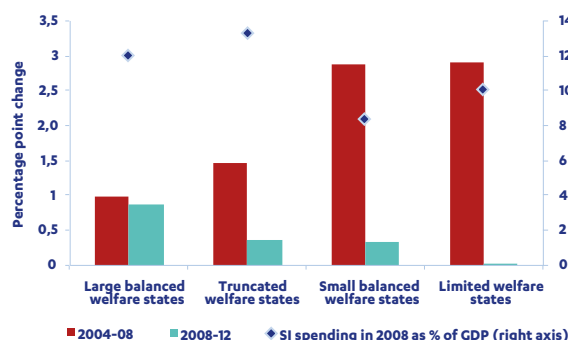
Discretionary policy choices did not allow social assistance programs to play the role of “automatic stabilizers” over the economic cycle. It is expected that expenditure and coverage of social assistance programs will automatically expand during a downturn as more people become poor, and contract as the economy recovers. In other words, social assistance programs that are responsive to shocks and the resulting economic needs are often counter-cyclical. However, contrary to expectations, real social assistance spending in the EU over the last decade was pro-cyclical in all but the large balanced welfare states. Due to policy changes, average real social assistance spending in terms of 2008 GDP²⁴

increased across all social protection systems between 2004 and 2008, particularly in the small balanced welfare states. Only 4 countries cut social assistance spending during the boom period, these were the United Kingdom, Germany, France, and Slovenia. This changed during the crisis years when most European countries entered a phase of fiscal consolidation. Social assistance spending as a share of 2008 GDP fell on average in all social protection systems but the large balanced welfare states between 2008 and 2012. The latter even expanded social assistance spending after 2008 though their social assistance spending was already on average far higher **FIG. 27B**.

FIG. 27 SOCIAL ASSISTANCE SPENDING FELL IN SEVERAL COUNTRIES DURING THE RECESSION WHILE SOCIAL INSURANCE SPENDING WAS PROTECTED

Change in Real Social Insurance and Social Assistance Spending in 2004-2012

A. Change in Social Insurance Spending (as share of 2008 GDP)



B. Change in Social Assistance Spending (as share of 2008 GDP)



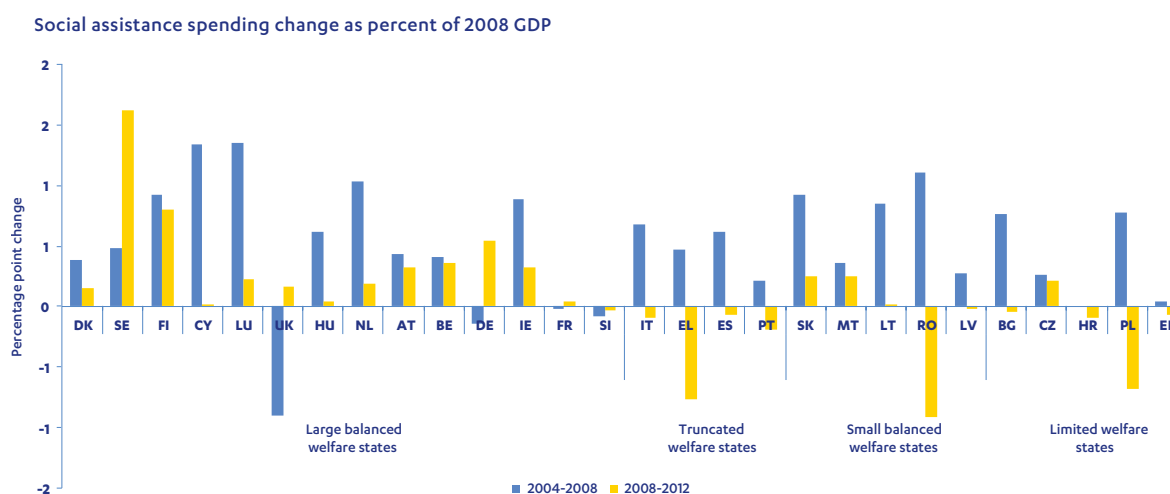
Source : EU-SILC. / Note : Germany is not ranked, since we do not have generosity data for Germany with adjustments as defined in Annex 1.

²⁴ After the crisis in 2008/2009, many EU countries suffered a decline in GDP. Spending, measured as a share of GDP, may therefore no longer capture the real spending. Real spending (in constant 2005 Euros) is anchored at the share of 2008 GDP – the peak GDP for many countries in recent years – to compare the actual spending over time while taking into account the country differences on the level of the spending.

Expenditure on social assistance fell between 2008 and 2012 in 11 EU member states, including in every truncated welfare state. Eleven countries experienced a decrease in social assistance expenditure during the recession period, (a) Slovenia among the large balanced welfare states; (b) all 4 countries in the truncated welfare states – Greece, Spain, Italy, and Portugal; (c) Romania and Latvia among the small balanced welfare states; and (c) all countries in the limited state except for the

Czech Republic, i.e. Bulgaria, Croatia, Poland, and Estonia **FIG. 28**. Thus, only 3 countries exhibited a true countercyclical pattern, with expenditures declining during the boom period and increasing in the recession –the United Kingdom, Germany, and France. By contrast, every single truncated state cut social assistance spending between 2008 and 2012; the largest cut was in Greece, where expenditures declined by 0.77 percentage points in the midst of a severe recession, from an already low base.

FIG. 28 THE DECLINE IN SOCIAL ASSISTANCE SPENDING WAS MOST COMMON IN TRUNCATED AND LIMITED WELFARE STATES²⁵



Source: World Bank staff estimates using ESSPROS

By contrast, expenditure on social insurance were protected during the recession between 2008 and 2012. Social Insurance expenditures are financed largely through contributions, and are determined by longer term factors such as demography, retirement ages, and stage of development of the private pension systems. In several European countries (Romania, and Lithuania, for instance)

cuts in pensions were reversed by the Constitutional Court reflecting the difficulty of cuts in social insurance protection spending during periods of fiscal consolidation. In fact, real spending on social insurance increased as a share of 2008 GDP on average across all four groups **FIG. 27A**. The increase was smallest in the limited welfare states. ²⁶

²⁵ The real spending is measured in constant 2005 Euros. Changes in the exchange rates during this time may explain part of the changes in spending in countries outside of Eurozone.

²⁶ Therefore, it is important, during periods of economic expansion, to carefully consider expansions to pensions and social insurance programs as these expenditures are often difficult to cut during a period of recession or slow economic growth.

...with differing outcomes for the poor

Cuts in social assistance expenditures resulted in lower coverage for the limited welfare states.

In the limited welfare states, consolidation (cut) of social assistance expenditures resulted in lower social assistance coverage of the poorest quintile, with coverage falling from 61 percent in 2008 to 56 percent in 2012 [FIG. 29](#). This is due to a decline in the coverage of all types of social assistance benefits. In particular, tight eligibility thresholds, which have not been updated to reflect the economic growth in good times, have led to gradual marginalization of targeted benefits. For instance, in Bulgaria, overall social assistance expenditures increased between 2004 and 2012; however the expenditure on the Guaranteed Minimum Income program (that mitigates poverty among the extreme poor)

in 2012 is just 40 percent of expenditure in 2004. As a result, both the coverage and the adequacy of social exclusion benefits to the poorest 20 percent of the population declined (*ECA SPeeD*). In Poland, the number of recipients of means tested family benefits declined sharply, from 3.8 million in 2008 to about 2.3 million in 2013—the drop in entitled families is partially explained by the absence of indexation of the income threshold in a context of mostly positive GDP growth and slightly declining fertility (*World Bank 2015d*). The marginalization of means-tested programs had already begun in the pre-crisis period, with an average decline in social assistance coverage by nearly 11 percent between 2004 and 2008 in the limited welfare states.

Among countries in small balanced welfare states, Slovakia, Malta, and Lithuania increased social assistance spending as well as coverage from 2008 to 2012.

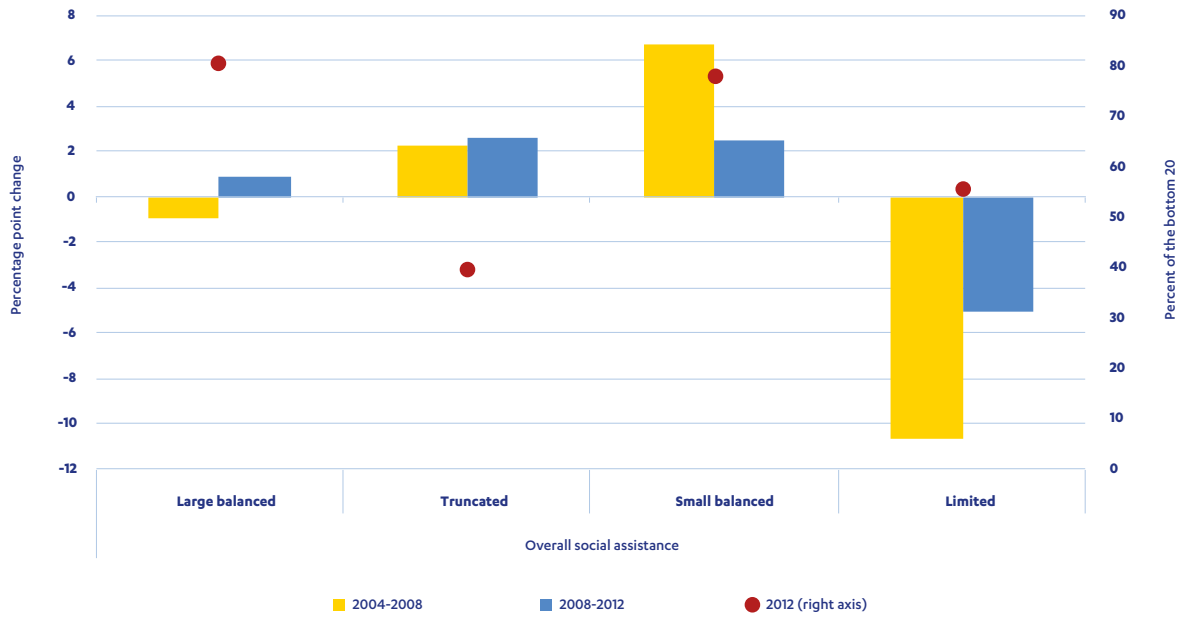
On the other hand, Latvia and Romania cut spending during the recession; the cut was very large in the case of Romania, from 2.7 million Euros in 2008 to 1.6 million in 2012²⁷. As a result, there was a large drop in overall social assistance coverage of the poor, from 89 percent in 2008 to 68 percent in 2012. Latvia also cut expenditures marginally over this time period; however there was an increase in real spending on means-tested programs, with the result that overall coverage expanded in Latvia, with coverage of social exclusion benefits doubling from 13 percent in 2008 to 27 percent in 2012. Slovakia,

Malta, and Lithuania expanded spending as well as coverage during this time period. As a result, the small balanced welfare states expanded coverage from an already high 76 percent in 2008 to 78 percent in 2012, by expanding the poverty targeted housing and social exclusion programs [FIG. 29](#). Not only did coverage expand, but this expansion has been achieved along with an increase in targeting accuracy [FIG. 30A](#) – resulting in making the systems more cost effective in reducing poverty. For instance, real expenditures on the Guaranteed Minimum Income program in the Slovak Republic in 2011 was 20 percent higher than in 2008; and the number of beneficiaries had increased by 12 percent (*Sundaram, Strokova, Gotcheva, 2012*).

²⁷ Denoted in constant 2005 terms.

► **FIG. 29 CUTS IN SOCIAL ASSISTANCE SPENDING HAD DIFFERENT OUTCOMES ACROSS WELFARE STATES IN TERMS OF COVERAGE OF THE POOREST**

Change in Coverage of Bottom 20 in 2004-2008 and 2008-2012

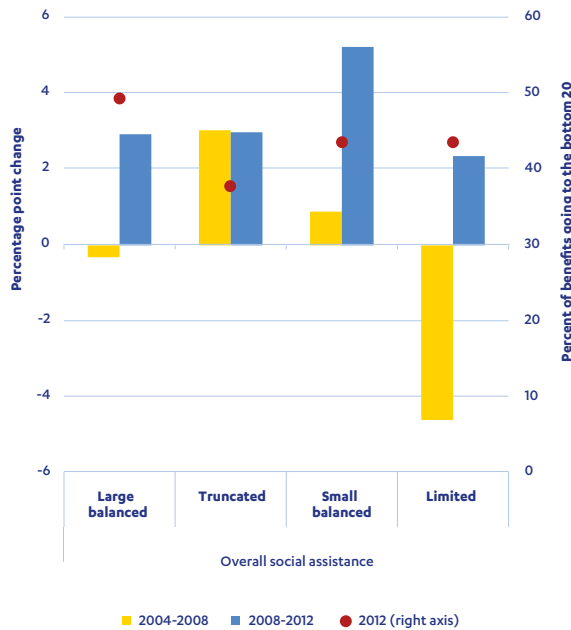


Source: EU-SILC. / **Note:** Germany is not included, since we do not have coverage data for Germany.

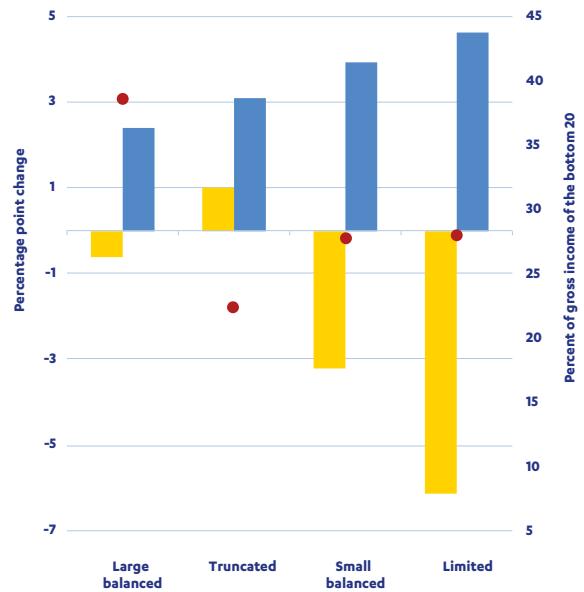
► **FIG. 30 INCREASE IN COVERAGE WAS ACHIEVED PARTLY THROUGH IMPROVEMENTS IN TARGETING ACCURACY**

Targeting Accuracy and Adequacy of Bottom 20 in 2004-2008 and 2008-2012

A. Change in Targeting Accuracy



B. Change in Adequacy



Source: EU-SILC. / **Note:** Germany is not ranked, since we do not have targeting accuracy and adequacy data for Germany

Truncated welfare states, which were hit the hardest by the economic crisis, lacked effective poverty targeted instruments; that could have helped them scale up social assistance quickly and efficiently.

In Greece, severe fiscal constraints and the need for consolidation in the midst of a severe recession (see [BOX 1](#) in *Recent Economic Developments*) led to cuts in social assistance spending (starting from a low base). The real value of all transfers (family, housing benefits, old age benefits) declined between 2008 and 2012. However, adequacy increased slightly, as recipient household incomes declined by even more [FIG. 308](#). Portugal, which entered the

crisis with a fairly effective Guaranteed Minimum Income program (the RSI), tightened eligibility conditions for the program in 2010, making it harder for the poor to access the program. The number of program recipients declined from about 400,000 in January 2010 to less than 300,000 by August 2012 (Portugal RSI, mimeo). Despite declining coverage in Portugal, the average coverage increased in truncated welfare states between 2008 and 2012 mainly due to large increases from a very low base in the case of Spain. Spain increased coverage by overall social assistance to the poorest 20 percent of the population from 12.3 percent in 2004 to 17.7 percent in 2008 and 24.4 percent in 2012.

The different responses across welfare states during the crisis contributed to differential effects on the incomes of the poor.

Declining labor income was clearly an important driver of decreasing income for the bottom 20, especially among truncated welfare states. Social assistance transfers mitigated this negative impact in many large balanced welfare states (Hungary and Ireland being exceptions with large declines²⁸), and in small balanced welfare states (with the exception of Romania). Hungary introduced various eligibility restrictions along with a nominal freeze on social transfers since 2008, and the unemployment benefit period was cut back to 3 months.

There was a large drop in coverage of both social assistance and social exclusion benefits in Romania – coverage of the poor by social exclusion benefits dropped from 53 percent in 2008 to 31 percent in 2012. More recently, Romania has started to take policy measures to reverse these trends with increases in the budgets and benefit levels of the Guaranteed Minimum Income and Family Support Allowance (FSA) programs. The FSA benefit level was doubled in October 2014. Social assistance transfers did not mitigate impacts in the truncated welfare states (with the exception of Spain), or in limited welfare states.

²⁸ The Hungarian Government opted for scaling up its public works program to reduce unemployment. In 2015 the government spent 0.8% of the GDP for this purpose and this ratio will increase to 1.2% until 2018.

Going forward, EU member states need to provide adequate protection and social investment for the poorest while ensuring fiscal sustainability

European member states are some of the biggest spenders on social protection in the world, but some are unable to provide effective protection for some of their poorest citizens. Adopting a poverty reduction lens, this note identifies four distinct European

models: namely **large balanced welfare states, truncated welfare states, small balanced welfare states, and limited welfare states**. These models differ along the size of social protection spending; and on the extent of protection offered to the poor.

The composition of spending matters for effective protection. The types of programs, extent of means-testing, and who is targeted through means-tested programs matters in terms of coverage of the poor and in mitigating poverty. For instance, small balanced welfare states spend less on social assistance than truncated welfare states, yet they achieve much better coverage of the bottom

20 percent of the population largely due to having well-functioning guaranteed minimum income programs that target poor families, and due to universal child benefits. In contrast, truncated welfare states, despite spending more on family benefits, cover only a small share of the bottom 20 percent, raising questions on the quality and types of means testing.

Several EU member states cut spending on social assistance during the recent recession. Contrary to expectations, real social assistance spending was procyclical in all but the large balanced welfare states. This had an impact on crisis response. Countries with truncated welfare states were hit hardest, but lacked poverty targeted instruments they could scale up. Consequently poverty increased sharply and the social protection system was

unable to mitigate the effects. In limited welfare states, poverty targeted programs have become marginalized and thus the crisis response was less effective than in large balanced welfare states. Small balanced welfare states reoriented resources during the crisis away from categorical programs toward means-tested programs and were better able to both contain spending as well as provide protection.

Looking ahead, the challenge for EU member states is how to balance the sustainability and effectiveness of the welfare state with the constraints imposed by

fiscal consolidation. With the challenging global economic outlook, aging populations, and declining working age populations, demands on social protection systems will

grow even as fiscal space shrinks. At the same time, shrinking younger cohorts make it imperative to invest in opportunities in all youth, including through well-designed social assistance to the poorest. In addition, the world of work is changing. Technological change, urbanization, and globalization have accelerated, creating unparalleled economic opportunities and challenges leading to rapid labor market changes. Providing efficient protection through

well targeted social assistance systems will become even more important in the future, as the number of self-employed entrepreneurs increases, unemployment spells become more frequent, and if fewer are covered through the current pension systems (World Development Report 2016 –forthcoming). The ongoing refugee crisis in Europe also poses a question on how welfare states can help integrate refugees.

Social assistance and labor market programs play an important role in alleviating poverty, managing risks, and supporting investment in the poor. They can improve individual productivity and income through contributing to preserving and building human capital, and through promoting access to better jobs and income. Building a robust and cost-effective social assistance pillar is important in terms of investing in and promoting the poorest members of society.

Going forward, important reform priorities include:

a. Introduce guaranteed minimum income (GMI) programs that target poor families: This is especially relevant for truncated welfare states; the lack of a national poverty targeted program in Greece and Italy limits their ability to protect and invest in the poor. The main challenge is to introduce and sustain efficient, well targeted poverty programs that provide protection to the poorest while simultaneously consolidating the large and fragmented plethora of programs. Greece is currently piloting a guaranteed minimum income program, with a plan to roll this out nationally starting in 2017.

b. Maintain effective coverage and adequacy of existing social assistance programs (especially poverty-focused programs such as guaranteed minimum income), particularly during downturns. Guaranteed minimum income programs are cost-effective and provide mitigation against idiosyncratic as well as systemic shocks. Ensuring access to these programs, particularly during downturns, is crucial for families that lose jobs and that are not covered by

unemployment benefits; do not have family members receiving pensions; and do not have children receiving benefits. Tightening eligibility conditions during a crisis (e.g. Portugal, Hungary) or marginalizing coverage during periods of growth, as was the case in many limited welfare states (e.g. Poland, Bulgaria), need to be reversed to ensure robust coverage and adequacy.²⁹

c. Reduce leakage of social assistance transfers to the rich: Several countries, particularly among the large and small balanced welfare states, cover more than 40 percent of the rich through social assistance transfers – for instance, 61 percent of the rich receive transfers in Malta; 58 percent in Ireland; 51 percent in Estonia; 48 percent in Latvia; 46 percent in Slovakia; 44 percent in Belgium; and 43 percent in Denmark. Such high coverage accruing to members in the richest 20 percent of the population is often through universal transfers that are categorically targeted (i.e. universal child benefits). Ensuring fiscal sustainability will involve cutting back on spending and reducing leakages to the rich. Better targeting of social assistance transfers would free up resources, which can then be channeled into savings or investment (in countries with high coverage of the poor), or redirected into increased coverage of the poorest (in countries with insufficient protection for the poor).

d. Do not wait for an economic crisis to reform social assistance; strengthening the protection capacity of social assistance programs requires time and political effort. ◀

²⁹ It is also important to facilitate the connection back to the labor market for beneficiaries of poverty-focused programs through better integration of employment services with social assistance services. Several countries, such as Bulgaria, are taking initial steps towards better integration (World Bank Dimitrov and Duell 2014).

ANNEX 1. DATA SOURCES AND DEFINITION OF INDICATORS

Data on social protection spending comes from the European system of integrated social protection statistics (ESSPROS), managed by Eurostat.

It provides a coherent classification system of social benefits to households across European countries, thus making cross-country comparison possible. ESSPROS includes spending on both cash and in-kind social benefits for different functions (sickness/health care, disability, old age, survivors, family/children, housing, social exclusion not elsewhere classified, and unemployment). As this note focuses on the social protection system in countries, we adjust social protection data to (a) exclude spending on some health care functions such as health care and social care services; (b) exclude overall administration costs; (c) exclude unclassified spending; and (d) replace spending on the unemployment function with labor market spending reported from Eurostat's Labor Market Policy database since the unemployment function of ESSPROS does not capture the expenditures on active labor market programs (ALMPs) and public employment services.

Social protection performance indicators are estimated from the EU statistics of income and living conditions (EU-SILC) – a compilation of individual country survey data on personal and household incomes managed by Eurostat. It collects information on the transfers that individuals and households receive on old-age benefits, sickness benefits, disability benefits, survivor benefits, unemployment benefits, housing allowance, family/child benefits, education allowance, and social exclusion not elsewhere classified. Similar to spending data, these benefits are also classified into social insurance (which includes old-age benefits, sickness benefits, disability benefits, and survivor benefits), social assistance (housing allowance, family/child benefits, education allowance, and social exclusion not elsewhere classified),

and labor markets (unemployment benefits). Given that the spending and performance data come from two different sources and that the income data do not necessarily reflect all the programs that are available, there is not a full alignment between spending and performance indicators.

The main indicators of performance of social assistance cash transfers include:

- ▶ **Coverage:** What portion of the population receives the transfers (focusing on the share received by the poorest quintile)?
- ▶ **Targeting accuracy:** What portion of social assistance transfers goes to each quintile (with particular focus on the share of transfers that goes to the bottom quintile)?
- ▶ **Adequacy (or dependency):** How much is the transfer as a fraction of disposable income? If this fraction is large, it would imply that the household is fairly dependent on the transfer. This could be either due to (i) the transfer being large so that the household is able to depend only on this transfer and does not have to find other means of generating income or (ii) the household finds it hard to generate any other income. In the latter case, it is particularly important to additionally assess adequacy of provided income support by comparing the size of the transfers to a more objective measure such as the poverty line.

For the purposes of the analysis, individuals are ranked on the basis of equivalised disposable income before all social assistance cash transfers and then divided into five equally sized groups, representing 20 percent of the population ("quintiles") to form the bottom, second, third, fourth, and top quintile.

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