Fault lines and (still too few) silver linings in Europe's social market economy

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1. Democratic Europe caught between Scylla and Charybdis

The European welfare state and the European Union (EU) find themselves caught up in a double bind in the aftermath of the global financial crisis (Scharpf 2010, Ferrera 2005, Hemerijck 2013). On one hand, domestically, EU members are politically bound by widely cherished national social contracts on welfare provision, which in hard economic times are especially difficult to renege upon. On the other hand, at the supranational level, the (reinforced) rule-based macroeconomic governance structure of the EU, giving priority to low inflation and budget consolidation, commits its members to a long-term project of negative market integration, which in a downturn implies intrusive austerity reform of their welfare systems. This is especially pertinent for the so-called 'Troika economies'— the eurozone countries of Greece, Ireland, and Portugal (and to a lesser extent Spain), which under the surveillance of the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF) have been forced to drastically cut minimum wages, pensions, education, health and old age care expenditure and deregulate their labour markets and wage bargaining structures. When and where stagnation prevails, mass unemployment and rising poverty and inequality are the breeding grounds for Europhobic political extremism. Between rising anti-establishment populism and the EU's intrusive imposition of fiscal austerity, a 'political-institutional vacuum' has emerged at the heart of

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the European integration project, between the Northern ‘core’ economies and the embattled Southern ‘periphery’ on the one hand, and within national political arenas between mainstream parties and Eurosceptic populist movements on the other. This political vacuum, brought home with a vengeance by the results of the elections to the European Parliament, especially the victory of the far-right National Front in France, which won over a quarter of the French electorate, considerably jeopardises solutions to the incomplete architecture of the Economic and Monetary Union (EMU), one that is able to do justice to widely shared aspirations of social fairness across the European continent and the deep economic interdependency created by the euro. It remains to be seen whether a new Commission and a new leader of the European Council will muster enough courage to cross the Rubicon of creating a safe institutional haven for the besieged currency, against the rising tide of anti-EU and anti-establishment right and left-wing populism, in the autumn of this year.

By 2014, as the existential crisis of the euro has somewhat abated, the new policy imperative for Member States and the EU more generally is to manage the social aftershocks of the global financial and economic crisis. On average, 12% of the eurozone workforce is jobless, a quarter of economically active young Europeans are unemployed, and inequality and poverty levels are rising. Without a long-term strategic focus on improving human capital and capabilities, expanding employment opportunities, and easing labour-market and life-course transitions for individuals and families, the EU risks becoming entrapped in a permanent economic depression. The crisis is by no means over.

A daunting critical question is whether the welfare state and European cooperation, two of the most important feats of post-war social engineering, prove resilient in the aftermath of the global financial crisis. This chapter examines the deep ‘fault lines’ in the European construction, on the one hand, and explores a small number – admittedly too few – ‘silver linings’ that have taken root over the past two years. I begin, in Section 2, with a brief analysis of the three critical fault lines in the European architecture – in policy analysis, institutional makeup, and domestic politics – and how they have made effective and legitimate crisis management particularly arduous for the eurozone economy as a whole and in Member welfare states individually. Section 3 is devoted to three silver linings on the horizon of the Europe 2020 policy agenda: (1) the important lesson of proactive and reconstructive welfare reform under constrained macro-economic conditions over the past decade in most EU Member States; (2) the strong and renewed reinforcement by the European Commission of productive and active welfare states, exemplified by the launch of the Social Investment Package in February 2013; and (3) the rekindling of the debate concerning the social dimension of EMU.

In the concluding Section 4, I turn to the exploration of the available political space for making the European project once again more inclusive, consistent with the three silver linings and important macroeconomic changes enacted since the height of the euro crisis in 2012. Deep economic crises are often moments of political truth; so the history of the twentieth-century teaches us. While the social aftershocks of the euro crisis are putting grim economic and political strains on national welfare states and EU institutions, this could also engender positive consequences, as the unsettling of beliefs sometimes inspires ground-breaking social and economic policy recalibration.

2. Fault lines in the E(M)U architecture

European integration has always based itself on the promise of achieving both economic prosperity and social progress. In defining the European project, the Lisbon Treaty commits the Union to work towards the development of a sustainable 'social market economy', combining full employment with high levels of social protection and cohesion, gender equality and intergenerational solidarity, across all Member States. Both the welfare state and the European integration project emerged from the economic and political lessons of World War II and the Great Depression. The defining feature of the post-war welfare state was that social protection came to be firmly anchored on the explicit commitment to granting social rights as positive freedoms to citizens in areas of human need and wellbeing. By cushioning and compensating for market failures, the combination of Keynesian economics and Beveridgean social insurance, while guaranteeing access to high-quality education and health-care as citizenship rights, made modern capitalism fit for mass democracy. By contributing to economic growth, regional market integration allowed national welfare states to prosper autonomously. Gradually, a benign division of labour materialised, whereby the technocratic 'low politics' of free trade and market integration were relegated to the supranational institutions of the EU, while the 'high politics' of jobs and social security became core prerogatives of national democracies (see Hemerijck 2013: ch. 8).

Under the current crisis of widening economic disparities and deepening social imbalances, the EU and its Member States are at risk of failing to deliver on this promise of economic prosperity and social progress. Especially, the Troika economies under the surveillance of the European Commission, the ECB and the IMF, are obliged to push through painful social and labour market reforms in exchange for financial assistance. The political upshot is that European institutions, lacking in 'input-legitimacy', are increasingly perceived as playing de-constructive roles in much-cherished national welfare states.

There are many reasons to be pessimistic about the prospects of a new era of constructive European integration and proactive welfare state restructuring (Saraceno 2013, Streeck 2013, Degryse *et al.* in this volume). I borrow the metaphor of 'fault lines' from the unrivalled diagnosis of the deep-seated policy fractures behind the global financial crisis by Raghuram G. Rajan, the former chief economist of the IMF (2010). In geology, fault lines are breaks in the Earth's crust where tectonic layers collide, building up pressures that can unleash life-threatening earthquakes. Here, the notion underscores the seismic tensions between the existing policy plates of European economic integration and national welfare provision and how they have come to collide, stronger than ever before, in the aftermath of the global financial crisis. It is worth discussing these fault lines in turn, as each displays a different dimension of the European predicament. In conjunction, however, they could be severely disruptive for the European project.

2.1 EMU policy regime failure

The first fault line results from the deep intellectual inertia in the economic policy paradigm underlying the governance of the Economic and Monetary Union (EMU), (mistakenly) reinforced with a vengeance after the eurozone sovereign debt crisis struck in 2009. Hegemonic policy paradigms are best viewed as coherent causal and normative frameworks for understanding economic trends and diagnosing impending policy problems from which fairly stable policy choices habitually ensue, also in turbulent economic times (Temin 1989, Hall 1989).

The introduction of EMU, with the adoption of the Maastricht Treaty in 1992, represented a major change of macro-economic policy paradigm, with important consequences for the functioning of European welfare states. The EMU policy framework, descended from the stagflation crisis of the 1970s and early 1980s, is firmly grounded in a rejection of Keynesian demand-management and the use of deficit social spending to counter deep recessions and mitigate social hardship. Erik Jones (2013) has aptly described the EMU policy framework in terms of an interlocking triptych of three basic supply-side ingredients: price stability, fiscal conservatism, and local- or domestic-factor market liberalisation, which together are believed to best guarantee productivity and employment growth. The neoclassical doctrinal triad of stable money, sound finances, and domestic market deregulation, informed by the axiomatic understandings of the micro-foundations of rational expectations, complete information, and self-correcting efficient markets – especially capital markets – for a long time allowed for a fairly coherent EU economic policy paradigm.

Doctrinal coherence in policy orientation, however, does not per se imply consistent implementation. As EMU never lived up to the textbook criteria of an Optimum Currency Area (OCA), because of low regional labour mobility and the deliberate choice not to make way for a central fiscal authority in order to pre-empt fiscal moral hazard, domestic structural reform had to take place (De Grauwe 2012). The ECB's singular and independent mandate to maintain price stability, together with the strong commitment to fiscal consolidation by Member State governments that was enforced by the Stability and Growth Pact (SGP) and the Excessive Deficit Procedure (EDP), was thought to raise competitive pressures, forcing democratic governments to launch incisive welfare and labour market reforms. Long-term unemployment from this perspective is a problem of supply-side 'hysteresis' of poor motivation and low search intensity resulting from generous social standards and employment protection, creating negative 'moral hazard' and 'adverse selection' externalities (see Addison and Siebert 1997, Bertola *et al.* 2001).

Prevailing macro-economic policy paradigms contain, implicitly or explicitly, a political understanding of the role of the state and its social policy functions. In this respect, the EMU regime adheres to a negative theory of the state, which is most ineffective when it tries to mitigate the inevitable trade-off between efficiency and equity in favour of the latter. In addition, its understanding of institutions is essentially one of 'market barriers' misused by 'distributive coalitions', in particular by 'rent seeking' trade unions. Here I add the neoclassical economic understanding of low (public) sector service productivity, often associated with so-called 'Baumol cost disease'. The core of the Baumol cost disease is that productivity improvements in labour-intensive services such as health and education consistently lag behind productivity improvement in competitive industries. When public service pay increases following wage developments in the more dynamic capital-intensive private sector, low productivity services become relatively more expensive. Assuming that social services are publicly funded, the tax share of GDP rises also, which in turn comes to burden and undermine competitiveness in the dynamic sector.

Similarly, Iversen and Wren (1998) have argued that advanced welfare states are confronted not with an inescapable 'trade-off' between equality and efficiency but rather with what they term the 'trilemma of the service economy'. Their central claim is that with the shift from an industrial to a service economy, it has become inherently more difficult for welfare states to attain simultaneously the triple goals of budgetary restraint, earnings equality, and employment growth. Governments may pursue any two of these goals but no longer all three at the same time. Within a tight budgetary framework, private employment growth can be accomplished only at the cost of rising wage inequality. If wage equality is a prime objective, employment growth can be generated only through the public sector, at the cost of higher taxes or public borrowing. Since international competition and technological innovation restrict job creation in the tradable (mainly manufacturing) sector, employment growth in advanced economies may be achieved either in well-paid public services, thereby undercutting budgetary restraint, or in low-paid private services, sacrificing income equality (see also Wren 2013).

Thus, the natural prescription is to make European labour markets truly flexible by giving employers greater freedom to hire and fire, aborting minimal restrictions on working hours, lowering taxes, reducing welfare spending, privatising pension liabilities, and curtailing trade unions and other 'distributive coalitions' in collective bargaining and social dialogue, as well as ensuring that states keep stagnant social services to a minimum, as 'wasteful' welfare provision is believed to 'crowd out' private economic initiative and investment.

Although EMU brought highly different varieties of welfare capitalism under one monetary umbrella, the architects of the single currency believed that the discipline of the new macroeconomic policy regimes and the single market would push European political economies towards convergence on rather minimalist competitive institutions (Hall 2014). The equation of national competitiveness and lean welfare provision and deregulated labour markets went hand-in-hand with a colossal blind spot as to the incisive interdependence created by the inescapable common currency. The financial crisis, particularly the aftermath of its sovereign debt hangover, exposed the critical failings in the EMU policy paradigm. Focusing on inflation and public deficit and debt, policy makers in Brussels and Frankfurt were entirely ignorant of how, in the aggregate, the sum total of public and private debt levels deepened Europe's sovereign debt and banking conundrum. In Ireland, Spain and the Netherlands, households were (fiscally) stimulated to take on massive private debt to buy property and reconstruct homes, while public investments in education and public infrastructure were de facto prohibited by the SGP. In addition, higher inflation led to lower real interest rates, making borrowing cheaper. Treaty-based budgetary obligations were sidestepped when Italy and Greece joined the EMU and also when France and Germany exceeded deficit limits in 2004. The 'one-size-fits-all' interest rate policy, which caused diverging real interest rates across the eurozone economy, together with the explicit no-bailout clause in the Maastricht Treaty, set the scene for growing imbalances between two country groups before the onslaught of the credit crunch of 2008. A periphery group with positive output growth but high inflationary pressures, profiting from the low real interest rates that EMU brought along for them, started to diverge from the core cluster with Germany at the centre, which was confronted with stagnation as a consequence of too high real interest rates. This development revealed that uniform base interest rates can be both *too high* and *too low* in real terms at the same time across a currency union, thereby frustrating sustainable economic convergence. As a result, structural labour market and social reform did not happen where it was needed the most, in the Southern periphery with the most rigid labour and insider-biased welfare systems. Low interests on debt and deficits apparently eased welfare reform pressures, as their superior growth performance provided massive outlays to financial speculators, which in combination with the lack of a pan-European system of financial governance also explains why the instabilities ingrained in American financial markets contaminated Europe so quickly (Tsoukalis 2009). When ultimately the sovereign debt crisis struck, capital flows shifted into reverse gear from the periphery back to the core of the eurozone, leaving the Southern periphery in the worst of possible varieties of welfare capitalism. Barring the option of currency devaluation, the Southern European economies and Ireland were practically overnight compelled to push through 'internal devaluations', as the single strategy left on the menu of macro-economic adjustment to asymmetric shocks under the incomplete currency union, designed without a fiscal backstop and constitutionally ruling out a 'lender of last resort' mandate to the ECB. The widening gap between the competitive North, now paying close to zero interest rates on moderate levels of public debt and deficits and hovering at manageable rates of unemployment, and the uncompetitive South, and also the Irish experiment in privatised Keynesianism, facing exceedingly high spreads on high debt and deficits at two-digit levels of unemployment and catastrophic rates of youth unemployment, ultimately threatened to destabilise the entire eurozone economy by 2012, as belated structural reforms in besieged Member States offered little relief under distressed macroeconomic conditions across the wider European economy (Schulten and Mueller 2013). In other words, deepening competitive divergences and social imbalances are in important ways the consequence of the misguided EMU policy paradigm, designed without a fiscal backstop and a 'lender of last resort' ECB-mandate, inherited from the era of the Great Stagflation of the 1970s and 1980s.

Within this overall divergence, an important illustration of the resulting social imbalances is the divergent trend in unemployment rates since the onslaught of the crisis. While the gap between low- and high-unemployment countries stands at ten percent within the euro area, it stands at only one percent for countries that are not members of the single currency. In other words, EMU, designed to foster convergence, is pushing member economies onto highly divergent trajectories of unemployment. Youth unemployment is similarly affected. By 2013 it had increased to around 23% in the EU, with large increases in Greece and Spain, where well over half of young people aged 15-24 in the labour force were jobless. In terms of relative poverty, again the biggest hikes are in Greece, Spain and Italy. Banking support and greater social protection spending have been met with considerable reductions in public investment, particularly in education in the eurozone countries hardest hit by the Great Recession. While future developments remain difficult to predict, the tendency towards divergence will not easily be turned around because of the distinct lack of an adjustment mechanism for correcting macroeconomic and social imbalances at the EU level.

2.2 Intergovernmental drift

Policymakers are not merely locked into a monetary and fiscal regime for reasons of intellectual failure and cognitive capture. Closely related to the failure in policy paradigm, the second fault line pertains to the minimalist governance structure of EMU, based on the intergovernmental makeup of the European Union, which created the eurozone with an extremely weak institutional capacity for policy-coordination. While macro-economic rules have become truly European, decision-making powers have remained doggedly national. Moreover, EU rules are quintessentially inflexible as they are the products of hard-won and lengthy treaty negotiations between 18 eurozone and 28 internal market Member States (Fabbrini 2013). With each wave of enlargement, the likelihood of joint-decision traps in the European Council is raised almost exponentially, as treaty alterations require unanimous consent (Scharpf 1999). Intergovernmental agreement is particularly hard to come by in times of economic distress, when intellectual disagreement over crisis management touches on national (economic) interests and deep normative beliefs about the appropriate role of politics and economics.

With the exception of the ECB, national governments (of the stronger economies) have steered the European reaction to the crisis. In the process, the European Council has taken over the agenda-setting role of the European Commission, and within it, Germany has become the most prominent leader, thereby weakening the previous Paris-Berlin axis (Amato *et al.* 2013).

Unable to agree on a new governance structure for EMU, government leaders inevitably fell back on the rules-based framework of the status quo *ex ante* as the best available 'lowest common denominator', thereby obliging besieged Member States to take individual responsibility in domestic austerity reforms, rather than trying to reach agreement on correcting EMU's incomplete design. When in early 2011 the European Commission proposed to increase the lending capacity of the EFSF, Germany made its agreement contingent on the adoption of a 'competitiveness pact', to ensure 'stronger economic convergence' within the eurozone by enshrining a 'golden rule', prohibiting countries from exceeding national debt limits 'tout court', in national constitutions. The European Stability Mechanism (ESM) and the tightening up of the Stability and Growth pact received inter-governmental consent. The Fiscal Compact, now including automatic sanctions, was concluded outside the Lisbon Treaty because of opposition from the UK. The Treaty on Stability, Coordination and Governance (2012) was ultimately adopted by 25 Member States, including all eurozone countries, on 30 January 2012. Implementation of the ESM Treaty was brought forward by a year from the designated expiry date of the EFSF in 2013. Thus far, however, the new fiscal governance framework of the EU and the euro area has resulted in a further deepening of competitive divergences and social imbalances between the prospering North and the stagnating South, as adverse 'fiscal multipliers' of public contraction turned out to be much higher than anticipated, probably because of massive private debt deleveraging with deflationary consequences (IMF 2012).

The only European institution that did not fall prey to intergovernmental drift was the ECB. Its independent intervention (strongly criticised by German authorities) to buy government bonds on secondary debt markets so as to thwart speculative attacks on Spain and Italy in 2011 subsequently led to the resignation of the President of the Bundesbank, Axel Weber, followed by the withdrawal of Juergen Stark from membership of the Executive Board of the ECB. Both German central bankers are known as adamant believers in ordo-liberal monetarist orthodoxy.

2.3 Political polarisation and the rise of welfare chauvinism

The third and final fault line stems from the incipient weakening of national statehood and domestic policy autonomy under the internal market and the currency union. European welfare states have become more semi-sovereign with the progressive deepening of the internal market and monetary union (Leibfried and Pierson 1995). By centralising monetary policy and monitoring fiscal discipline, the introduction of EMU has been a game-changing step towards an irreversible deepening of economic interdependence between the members of the currency union, with severe constraints on domestic fiscal, economic, and social policy choices. Irrespective of the loss in nation-based fiscal and monetary policy autonomy, however, political identification, mobilisation and accountability have remained overwhelmingly national. Electorates hold national leaders accountable for socioeconomic (mis)fortune. High and rising youth and long-term unemployment and strained pensions, resulting from agreements reached at the level of the EU and the eurozone, put enormous pressure on nationally elected politicians in the majority of EU countries where citizens continue to hold high expectations of social protection. Protracted failures to resolve the euro crisis at the supranational level, in turn, are increasingly mirrored by EU-sceptic domestic political pressures to water down ruling governments' commitment to European solutions. Intrusive austerity requirements, agreed to at the EU level, fuel anti-establishment political mobilisation, as the 2014 EP elections have revealed, from the successes of the Greek Golden Dawn fascists to the landslide victory of Marine Le Pen's National Front in France.

The crisis was preceded by these three fault lines; it did not produce them. The economic policy tragedy of the eurozone is that it confronted EU institutions and national governments with a 'demand deflation' mass unemployment conundrum for which EMU was not equipped. Institutionally, to the extent that Europeans struggle to agree on a shared economic diagnosis of the crisis, EU policy change is inhibited by Treaty rules, established at Maastricht in 1992, which quasi-constitutionalised the norms of price stability and fiscal conservatism, setting the scene for further intergovernmental drift. Finally, xenophobia and euroscepticism are nothing new. Long before the near economic meltdown of 2008, middle-class fears of falling behind created a narrative of a lost 'golden age' of welfare capitalism. The 2005

French referendum over the proposed Constitutional Treaty of the European Union culminated in a heated ideological battle between different socio-economic models, revolving around two polarised options: the 'French' social model, offering a high degree of social protection, versus the (false) stereotype of the 'Anglo-Saxon' model of capitalism, described as a 'free market without a safety net'. Procrastination and protracted failures to articulate a solid supranational crisis resolution mechanism for the eurozone have brought anti-EU and anti-establishment populism to new heights, putting pressure on existing governments to limit or at least hide EU engagement. The cocktail of the three fault lines conjures up an image of a disintegrating continent, a far cry from the original ideal of an 'ever closer union' as proclaimed in the Rome Treaty sixty years ago.

3. (Too few) silver linings on the Europe 2020 horizon

The three fault lines at the heart of the European construction, critically exposed by the euro crisis aftershock, run deep. Current economic and social imbalances are the products of long-cherished and embedded policy strategies. Tinkering with low interest rates, raising consumption taxes, and perhaps introducing a levy on financial transactions will surely not salvage the eurozone as an aspiring and sustainable social market economy. But on a more positive note, the breakup of the eurozone has thus far been avoided, by buying time with an appeal to the fear of a life outside the single currency (Tsoukalis 2014).

If transformative fundamental change does happen, it will be slow in coming. When changing external conditions alter the functioning of existing policies and institutions, they also tend to modify – with a considerable time lag – the power positions and interests of relevant actors, together with their perceptions and concerns of how to steer policy in new (and old) directions (Streeck and Thelen 2005).

The aftermath of crisis, I believe, has ushered in a period of transition, which can be demonstrated in a series of important policy changes and institutional adjustments. After the brief interlude of fire brigade Keynesianism in 2008 and 2009, the euro crisis in 2010 was swiftly branded a crisis of fiscal profligacy, requiring immediate 'internal devaluations' through welfare state retrenchment and labour market deregulation in crisis-ridden economies. The impetus was to restore the stable money, *ex ante* sound budget policy framework, in agreement with the highly decontextualised neoclassical economics textbook 'one-size-fits-all' approach to welfare retrenchment and labour market deregulation under EMU.

Since the onslaught of the sovereign debt crisis, we have observed impressive 'economic governance' change, including the introduction of the European Semester, the Six-pack and Two-pack, and the Euro Plus Pact, reinforcing stricter EU control of Member State public finances. A number of fiscal backstops have been introduced ad hoc under significant pressures from bond markets. In October 2011 the European Financial Stability Fund (EFSF) was ratified, and its successor, the more permanent European Stability Fund (ESF), became fully operational in 2013. The new 'European Semester' feeds into Member States' national reform programmes (NRPs), meant to speed up recovery (Natali and Vanhercke 2012). Although the new monitoring procedures of real economic performance are a welcome half-answer to the predicament of intergovernmental drift, to this day privileged policy recipes have remained ruggedly pro-cyclical, thereby defeating the purpose of sustainable and inclusive growth as laid down in the Europe 2020 agenda.

While the Treaty on the European Union did not grant the ECB serious competences in financial sector supervision, a Banking Union with a single supervisor and a common bank restructuring mechanism is under construction. By the summer of 2012, finally, the ECB committed itself 'to do whatever it takes', in the words of Mario Draghi, by purchasing eurozone government bonds in the secondary market in an attempt to stave off new speculative attacks. Coined as Outright Monetary Transactions (OMT), this instrument in effect turned the ECB into a 'lender of last resort' (De Grauwe 2013).

These examples go to show that the E(M)U's macroeconomic policy regime in recent years has undergone a major – although half-hearted, haphazard and incremental – change (Amato *et al.* 2013). The initiatives of the European Semester and ECB economic stabilisation interventions can be interpreted as attempts to finally respond to the problem of deep interdependency of the eurozone economy with weak intergovernmental institutions, together with a deflationary bias at the heart of the EMU construction. Sceptics could argue that fiscal bailouts, lender of last resort interventions, and timid steps towards a banking union only go so far as to stabilise the financial system, having little bearing on already weakened national social contracts and no serious implications for strengthening the social dimension in the Europe 2020 policy agenda.

I agree that the glass is more half-empty than half-full. But I do believe that the change from a single focus on inflation targeting and country specific austerity, towards fiscal, monetary and financial interventions, which can only be interpreted as testifying to an older Keynesian insight that economic stabilisation is more than pro-cyclical market deregulation and social retrenchment, is something for social actors in national and EU policy-making arenas to take seriously and actively try to build on, in an attempt to foster renewed social progress.

From this vantage-point, I wish to highlight three important silver linings in national and EU social policy practice and thinking, which can be made compatible with the recent macroeconomic shift, and which in conjunction may subsequently help to usher in a new socioeconomic policy synthesis between an integrated coupled currency union, and a growth-friendly macro policy of long-term stabilisation, allowing active welfare states to prosper economically as well as socially.

3.1 Changing welfare states

The first silver lining concerns the broad historical lessons that 1) inclusive welfare states are far from reform-resistant and 2) that the more generous and active welfare provisions are compatible with regional market integration and fiscal sustainability under a single currency (Hemerijck 2013). The onslaught of the euro crisis calls into question whether different varieties of welfare capitalism can really be made to operate under a single currency union. Peter Hall conjectures that EMU favours Germany and the Northern European export-led growth models, but that the demand-led economies of the Southern periphery are institutionally incompatible with a one-size-fits-all currency regime that cancels out strategic devaluation in the aftermath of domestic booms (Hall 2014). Reasoning from a welfare state perspective, with social protection spending accounting for 16 to 30% of GDP across the EU, I am less sure about the institutional incompatibility of differently organised European political economies.

Since the late 1980s, a majority of European governments have come to enact a wave of social reforms to make their social policy systems more efficient and employment-friendly. The empirical record reveals that national social policy reformers have not been merely blind followers of the competitive retrenchment-deregulatory adjustment recipes espoused by the ECB, the European Commission and Finance Ministers. Far from it! Alongside retrenchments, there have been deliberate attempts to rebuild social programmes and institutions and thereby accommodate welfare policy repertoires to the new economic and social realities of the knowledge-based economy. The European welfare states' gradual self-transformative change process is best told in terms of a sequence of cumulative policy alterations across a wide range of policy areas:

— In *wage policy*, wage moderation in many countries was pursued through social pacts among the trade unions, employer organisations, and government, often linked with wider packages of negotiated reform. The EMU entrance exam of the mid-1990s played an especially critical role in helping to forge national social pacts in the hard-currency latecomer countries, such as Italy, Spain, and Portugal, as an alternative to straightforward labour market deregulation and collective bargaining decentralisation (Avdagic *et al.* 2011).

— With respect to *social insurance* and *assistance,* most countries today preside over universal minimum income protection programmes, coupled with 'demanding' activation and 'enabling' reintegration measures, targeting labour market 'outsiders' such as young, female or low-skilled workers (Clasen and Clegg 2011).

— The area of *employment policy* saw a considerable increase from the 1990s onwards (Bonoli 2013), alongside social security activation, of spending on active labour market policies, and training and education servicing to improve life course employability.

— With respect to *labour market regulation*, several European countries have moved towards a greater acceptance of flexible labour markets, with new elements of security introduced for labour market outsiders, governed by more flexible employment relations (Schmid 2008).

— For *pensions*, financing problems due to population ageing and lower growth have prompted the reversal of the trend towards early retirement policies, together with initiatives to promote longer and healthier working lives. A key shift has been the growth of (compulsory) occupational and private pensions and the development of multi-pillar systems, combining pay-as-you-go and fully funded methods, with relatively tight (actuarial) links between pension benefits and contributions, with a view to factoring in life-expectancy (Ebbinghaus 2011).

— *Family policy*, covering childcare, parental leave and employment regulation, and work and family life reconciliation policies, has experienced a profound upgrade in both scope and substance (Lewis 2006, Orloff 2010).

Even though social spending has largely been consolidated at the levels reached in the 1980s, practically all advanced European welfare states have been recasting and reconfiguring their basic policy repertoires. The overall extent of change has varied widely across the Member States of the European Union. With their tradition of high quality child care and high employment rates for older workers, the Scandinavian countries performed particularly well throughout the past quarter century, both in terms of efficiency and equity. In the period leading up to the financial crisis, we also observed, however, reconstructive change in countries such as the Netherlands (social activation), Germany (dual earner family support), France (minimum income protection for labour market outsiders), the United Kingdom (fighting child poverty), Ireland (much improved education) and Spain (negotiated pension recalibration). In the process, European welfare states did not become the sort of lean welfare states that European central bankers and fiscal policy authorities in Frankfurt and Brussels hoped EMU would deliver; instead they became 'active welfare states' at higher-than-before levels of employment, some even with a competitiveness bonus attached to the new policy mix! In this respect, the employment-centered Lisbon agenda was a reform success. On the other hand, the Lisbon era revealed the growing inadequacy of welfare systems that singularly tried to hold on to passive social protection provision, especially in the Mediterranean region (Cantillon and Vandenbroucke 2014).

The overall experience in welfare recalibration in Austria, Finland, Germany, and the Netherlands, on the other hand, shows that a common currency can be made compatible with generous and inclusive welfare provision and balanced budgets. I would partly associate the halting of the reform momentum in the pension-heavy and segmented welfare systems of Southern Europe with the adverse effects of the incomplete construction of EMU and its weak governance structure, as well as homemade social failures to accommodate policy repertoires to the new economic and social realities of the knowledge-based economy. In other words, there are reasons to believe that today's poorly performing Italian, Portuguese and Spanish welfare states are not per se structurally incapable of effective welfare recalibration under the umbrella of a single currency

3.2 Long-overdue EU social investment reinforcement

The second silver lining, very much built on the experience of proactive and reconstructive welfare state recalibration, has recently culminated in the launch of the *Social Investment Package for Growth and Social Cohesion* by the European Commission in early 2013 (Vanhercke 2013, European Commission 2013a), which has been at the forefront of reclaiming the scope for social investment in the aftermath of the financial crisis. An emphasis on the productive function of social policy stands out as the distinguishing feature of the social investment perspective, highlighting policies aimed at preparing individuals, families and societies to respond to the new risks linked to a competitive knowledge economy, by investing in human capital and capabilities from early childhood through old age (Morel *et al.* 2012). The 2000 Lisbon Strategy, which committed the EU to become the 'most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth and more and better jobs and greater social cohesion', was already strongly influenced by the 'social investment' perspective. By 2005, however, with the mid-term review criticising the Lisbon Strategy for a lack of focus and the multiplication of objectives and processes, the social investment baby was thrown out with the bathwater.

The extensive background documentation of the Social Investment Package makes a strong case for *social investment no longer being* *dismissed as 'fair weather' policy* when times get rough, which is what happened with the Lisbon Agenda. The overall message boils down to not allowing human capital to go to waste through semi-permanent inactivity, as was the case in the 1980s and 1990s in many continental European welfare systems. Given the ageing predicament, European welfare states are confronted with a formidable social investment challenge. A careful reading of the package reveals a quiet paradigm revolution. On various occasions, DG Employment, Social Affairs and Inclusion explicitly distances itself from the traditional stable money, fiscal austerity and structural reform paradigm by explicitly arguing that active social policies 'crowd in' economic growth and competitiveness, high productivity job creation and tax revenues, thereby reducing long-term fiscal pressures. In the context especially of demographic ageing, attention should not only be paid to social expenditure and the costs of ageing populations, but also to exploring and exploiting new sources of revenue from high-quality childcare in promoting talent, reducing early school dropout, and improving employment opportunities for adult family members, especially mothers. The Social Investment Package and DG Employment and Social Affairs break away from the negative theory of the (welfare) state by underscoring the key importance of activating social services as core providers for dual-earner families and labour markets. The problem in other words is not welfare spending, but in essence welfare state design.

Inspired by James Musgrave's (1959) functional approach to public finance, the analysis supporting the European Commission's Social Investment Package (2013a) identifies three key functions of social policy: macroeconomic stabilisation, income redistribution to support at-risk groups, and more future-oriented social investments. Musgrave's public finance perspective, conceptualised in the late 1950s, is a good starting point for a functional policy analysis of social investment. At the same time, it does not and cannot take proper account of important subsequent changes in global economic relations, labour markets and family structures. Hence there is a need to expand and enrich the Musgrave framework. I distinguish between three interdependent and complementary welfare functions of social investment policy: (1) easing the 'flow' of contemporary labour-market and life-course transitions; (2) raising the quality of the 'stock' of human capital and capabilities; and (3) maintaining strong minimum-income universal safety nets as social protection and economic stabilisation 'buffers' in ageing societies.

The 'buffer' function aims at both securing income protection and distribution, and at the same time securing economic stabilisation. The 'flow' function is aimed at the efficient use and allocation of labour resources and their allocation over the life course. The 'stock' function is linked to the future productivity of labour inputs in ageing societies. 'Buffers', 'stocks' and 'flows' must be viewed interactively through the lens of the life-course contingencies of modern familyhood, within which gender equality and intergenerational solidarity are central concerns (Hemerijck 2014).

Adequate minimum income protection 'buffers' are imperative to any effective social investment strategy, as they help to mitigate social inequity while at the same time stabilising the business cycle. The function of 'flow' is to help bridge critical life course transitions from schooling to the first job, during the crunch hour of making a career while raising children, taking up additional training and lifelong learning to extend the transition to (flexible) retirement, while making it possible to take care of frail family members throughout the life course. The social investment function of labour market 'flow' should thus not be mistaken for one-dimensional labour market deregulation and social retrenchment. In early-childhood, childcare, and pre-school education the expected pay-off is highest. There are 'multiple dividends' at work. Quality childcare services, alongside effective parental leave arrangements, supported by appropriate tax and benefit incentives and active labour market policies, enable more parents to engage in gainful employment without career interruptions in terms of 'flow', creating additional job opportunities especially for mothers, thereby boosting household incomes, while at the same time helping their offspring to a strong start. At the more mature phase of the life course, high investment in lifelong learning is associated with more older worker employment participation and a higher average exit age.

As the risks of the life course and the labour market have fundamentally become less predictable – and thus less insurable in a strict actuarial sense – welfare states in advanced economies have to provide for enabling or capacitating social services not automatically provided for by markets, to better equip individuals and families and to mitigate the unanticipated hazards they face. The central importance of *capacitating* public services *ex ante*, a term coined by Charles Sabel (2012), tailored to particular social needs caused by life course contingencies, has important consequences for our rather poor economic understanding of (public) service sector productivity, associated with the Baumol cost disease and service-sector trilemma exemplified above. A critical empirical problem is that the conjectures of Baumol and Iverson and Wren do not stand up to evidence of the competitive successes of Europe's most service-intensive Nordic welfare states before and after the onslaught of the financial crisis. This is because their analytical conjectures are entirely ignorant of the important indirect effect of high quality employment-intensive capacitating welfare services as contributing in important ways to productivity growth in competitive private sectors, through the provision of high human capital inputs in terms of 'stock' and 'flow'. The overwhelming empirical evidence compiled by DG Employment suggests that social investments, understood in terms of 'packages' of institutionally complementary sets of 'stock', 'flow', and 'buffer' policy provisions, mean that a far more effective use of available employment potential over the life course can be achieved, whereby the fiscal balance between outlays and revenues can perhaps be maintained despite a growing cohort of elderly citizens.

3.3 Socialising EMU

It is important to underscore that the social investment agenda is in essence a supply-side strategy and therefore cannot serve as a real alternative to an effective macro-economic policy. On the other hand, the more supply-side social investments are embedded in a credible macroeconomic policy framework, the higher and more robust are the social investment returns listed above. Under current conditions, to the eurozone member countries of the Mediterranean in dire fiscal straits and social malaise, the social investment message is entirely lost. Fiscal consolidation, prescribed by the Troika, MoUs, and the reinforced SGP, requires them to slash active labour market policies and retrench preventive health care programmes – a strategy which we know, in the long run, critically erodes job opportunities for men and women and thereby undermines the capacity of the economy to shoulder the ageing burden. This is where the third and final silver lining of the rekindling of the debate about a genuine 'social dimension' of the EMU, in line with the social investment prerogative, gains importance (Fernandes and Masauskaite 2013).

Over the past two years, the absence of a eurozone-wide counter-cyclical stabilisation capacity has slowly but surely come to be recognised as a critical design flaw in the EMU architecture. The euro crisis has revealed that stable money, sound finances, efficient markets and effective and productive welfare systems, as well as partaking in a currency union, do not shield Member States from adverse asymmetric shocks and trade imbalances. Under such conditions, counter-cyclical macro-economic management, rather than price deflation and wage flexibility per se, are more efficient in a situation with scarce human capital resources, supporting high unemployment in an ageing society. As such, the financial credit crunch and its euro crisis aftermath have brought home with a vengeance how important counter-cyclical management remains.

In December 2012, the European Council pressed its President Herman Van Rompuy to conceive a report on the social dimension of EMU in 2013, as part of the roadmap for a genuine monetary union. Next, on 28 February 2013, a little over a week after the launch of the *Social Investment Package*, the Council agreed to systematically address key employment and social challenges in the monetary union (European Commission 2013b). The June 2013 European Council then reached a consensus over monitoring and benchmarking social and labour market conditions in the 'European Semester' process, bringing together different strains of EU economic and social policy coordination under one umbrella, with the aim of increasing coherence across different policy instruments and heterogeneous coordination procedures. While the first AGS of January 2011 singularly underlined the need for fiscal consolidation and structural reform fully consistent with the EMU *ex ante* default policy regime, subsequent AGSs started to recognise that 'tackling the social consequences of the crisis' was a European priority.

Finally, on 2 October 2013, the European Commission issued an important Communication on Strengthening the Social Dimension of the Economic and Monetary Union, based on a scoreboard of social indicators for systematic social benchmarking, including unemployment rates and changes therein, the proportion of youngsters not in education, employment, or training (so-called NEETs), real disposable income of households, at-risk-of-poverty rates, and income inequality. Similarly to the Macro Imbalances Procedure (MIP), the scoreboard should alert policy makers in a timely fashion to looming social imbalances, potentially undermining the viability and integrity of EMU. To the extent that capacitating welfare provision adds to economic competitiveness and social progress, it is in the interest of European policy-makers to support domestic authorities in maximising the return on social investments. What is therefore needed is a balanced macro-economic coordination process inciting governments to pursue medium-term budgetary discipline *and* long-term social investment reforms (Vandenbroucke *et al.* 2011, Hemerijck and Vandenbroucke 2012), by giving greater breathing space with tangible support to Member States that opt for social investment strategies based on well-defined Europe 2020 ambitions, while making maximum use of mutual learning. If the option of social investment only applies to the core rich economies of the eurozone, countries in the Southern periphery would remain entrapped in bad equilibria, thereby destroying the economic and political viability of the single currency.

Commissioner Andor and Council President Van Rompuy, alongside leading European economists such as Paul De Grauwe (2011) and Jean Pisani-Ferri (2014), have tabled proposals for improved countercyclical macroeconomic management for the eurozone. Some proposals emphasise a structured solidarity 'interstate insurance' instrument using Eurobonds, protecting Member States from self-fulfilling solvency crises, coupled with strong conditionality requirements to pre-empt moral hazard. Others argue for a European unemployment insurance scheme to mitigate asymmetric and symmetric business cycle shocks (see Fichter in this volume). I tend to advocate a macro-economic demand stabilisation device that incentivises Member States to pursue supply side social investment reforms in sync. In the context of the European Semester, it is essential for embattled countries opting for a social investment strategy to receive necessary support to enable them to move forward by taking on reform ownership. Conditional social investment contracts, bolstered perhaps by specially designed social investment project bonds, could be based on generous access to structural funds at low interests. Another strategy would be to discount social investments in national budget accounts, thereby exempting them from SGP deficit requirements.

4. Towards a currency union of active welfare states

I have opted to examine the deep fault lines in the European policy architecture, but also to explore a number of silver linings of progressive policy reorientation. These could act as ways out of the prevailing cul-de-sac of lecturing 'profligate' countries to redo their homework without considering the inherent design flaws in the EMU policy framework. The three silver linings – the already existing proactive and reconstructive welfare reform, the renewed endorsement of the social investment perspective by the Commission, and the rekindling of the social dimension of EMU – surely do not constitute silver bullets for overcoming the deeper fault lines of austerity deflation, intergovernmental drift, and raging national welfare chauvinism with which the EU is confronted today. They are merely hopeful seeds of policy redirection, at an early stage of gradual transformative change towards a more robust and sustainable European social market economy, as written down in the Lisbon Treaty. On the supply side, it is now beyond dispute that effective and efficient social investment, depending on its country-specific design and the scope of measures, incur 'multiple dividends'. When it comes to demand, Pareto-optimal social investment returns press us to fundamentally rethink the larger macro-economic EMU policy framework. The decisive factor, however, will be the political resources and institutional backing that the EU is able to muster behind a novel macroeconomic policy regime, able to make high and robust social investment returns viable for the entire eurozone.

The euro crisis teaches us that the implicit permissive consensus is past its prime, that macroeconomic policy *cannot* best be determined at the supranational level in a currency union while social policy is best left to the policy space of the national state. The EMU construction was intellectually incomplete, institutionally weak, and unable to deliver positive output performance by upward social convergence. The austerity reflex has made the EU less inclusive and consequently more politically contested than ever before. Any successful attempt to save the euro today is politically bound up with the rescue of the welfare state as an integral part of the European construction. In their paramount contribution to the debate, Vandenbroucke and Vanhercke (2014) draw the critical economic lesson from the euro crisis that managing deep interdependency in a currency union requires a significant degree of social convergence (see Vandenbroucke *et al.* in this volume). The political implication of this conclusion is that EMU, more than ever before, is in need of a substantive *political* consensus on the social order that a monetary union should serve. This they coin a 'European Social Union', which should not be mistaken for a 'European welfare state' but rather denotes a systemic support structure at the EU level for national welfare state sustainability, based on a strong political commitment to a ‘caring and capacitating’ European social market economy as a common purpose, on a par with the complementary prerogatives of price stability and fiscal discipline over the economic cycle and free market competition.

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