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DEEPENING THE EMU: HOW TO MAINTAIN AND DEVELOP THE EUROPEAN SOCIAL MODEL?

A STUDY FOR THE FEDERAL CHANCELLERY OF AUSTRIA

Sofia Fernandes
and Kristina Maslauskaite

Foreword by Jacques Delors

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TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

LIST OF BOXES

FOREWORD

by Jacques Delors

National welfare states, to which Europe's citizens feel immensely attached, play a central role in EU countries whatever the differences there may be among the member states. Even before the current crisis, the welfare state was facing a dual challenge in terms both of funding and of effectiveness, two key issues for national social models' long-term viability. The financial, economic and social crisis that has been rocking Europe since 2007 has only worsened the tension weighing down on the welfare state.

First of all, the crisis is having a strong social impact, especially in those peripheral countries in the euro area where unemployment (particularly youth unemployment) and the people at risk of poverty have both shot up while the average household income has dropped. Yet while it is the welfare state's task to come up with a solution to these growing problems, its own funding problem has intensified. The need to consolidate public finances has put pressure on social budgets, social spending being frequently used as a variable of adjustment in austerity policies. This development is a particular source of concern when we consider that certain forms of social spending (such as education) make a vital contribution to strengthening a country's growth potential.

A great deal of research has been conducted on the challenges facing national social models, yet there is one issue which does not get much attention, and that is the issue of the impact of the single currency and of the strengthening of the Economic and Monetary Union on the welfare state. The Austrian Federal Chancellery is to be commended for taking a serious interest in this issue, and it has commissioned a report from the *Notre Europe – Jacques Delors Institute* (NE – JDI) on the impact of the reforms either currently being implemented or being mooted in the EMU on national social models.

This report, which conducts an assessment of social Europe's current situation and presents three potential scenarios for EMU's future based on the degree of ambition displayed to complete it, is the result of that joint effort.

The analyses developed, and the conclusions drawn, by Sofia Fernandes and Kristina Maslauskaité confirm my contention that the consolidation of national social systems demands a political quantum leap on the EU's part as well as the completion of the EMU, based on an improved balance between increased solidarity and the strengthening of common disciplines.

Sure enough, the report warns of the potentially negative impact that an incomplete euro area can have on the welfare state.

First of all, as we can see today, the euro area member states can no longer resort to the devaluation of their currency in order to respond to cyclical shocks and so, having to adopt budget constraints, they have no choice but to engage in a painful internal devaluation process which comes at a heavy social cost. It is the peripheral countries that are suffering from this fragility in the EMU today, but all of the euro area member states are potentially exposed to the risk.

Moreover, given that there is stronger economic integration within the euro area and that certain countries are forced to sacrifice their social standards in the name of fiscal consolidation, there is also an increased risk of social competition among countries sharing the same currency. If the single currency jeopardises the European social model, there is no way that it can garner the support of Europe's citizens.

To achieve this political quantum leap, it is necessary, as the authors stress, to define a « sense of common purpose » in order to mobilise the member states and their citizens. Up until now, European decision-makers have been guided in their action by a sense of survival, their aim being to prevent the euro area from breaking up. To impart a fresh boost to the European project, on the one hand, and to reconcile the citizens with the concept of the EU, on the other hand, what is required now is a mobilising project that must rest on a proper balance between economic goals, social concerns and environmental issues.

This report was being put together at the very moment the heads of state and government were placing the "EMU's social dimension" at the heart of the European agenda.

The European Council of December 2012 asked President Van Rompuy to submit a report on the issue in 2013. The European Commission has recently published a Communication on the subject and we are now waiting to discover the guidelines adopted by the heads of state and government at the end of the year.

I have been denouncing the EMU's construction flaw caused by failure to place economic cooperation on the same level as monetary coooperation, since 1997. Making good this imbalance is the precondition for affording the social dimension the consideration that is its due.

While a strengthening of the EMU's social dimension is obviously a welcome development, it should not simply comprise a limited group of initiatives forming a kind of "fifth pillar" of the EMU. I subscribe to the appeal launched by the report's authors when they stress that the social dimension must be mainstreamed in all EU and member state's initiatives. In this connection, I would point out that the treaties already contain a horizontal social clause enjoining the promoters of all EU policies and initiatives to take their social impact into account. This clause deserves greater consideration in Europe's action than it has received in recent years.

Naturally, we should not forget greater Europe in this whole debate on the EMU's social dimension. Social initiatives adopted by the 17 must also act not as a curb on the deepening of the EU-28 Social Europe but as a driving force behind it.

I would like to congratulate the authors and the *NE – JDI* advisers on this reference work, which I hope will help to clarify and to further fuel the debate on the relationship between the single currency and the national welfare states.

Jacques Delors
Founding President of Notre Europe – Jacques Delors Institute

EXECUTIVE SUMMARY

- In the past decades, the **European welfare states have been under strain** coming from several challenges such as ageing population, increasing globalization and changing family life patterns. Recently, this **pressure has been exacerbated** further by both an unprecedented economic and financial crisis as well as significant reforms of EU economic governance.

- The **economic and financial crisis had important negative social consequences** in the EU, in particular in the euro area periphery which suffers the most from rising unemployment rates, growing poverty levels and shrinking demand. In addition, the crisis also accelerated labour market and pension reforms in many of the member states.

- The **real impact of the reform of economic governance** on national employment and social policies largely **depends on the position of EU countries** as regards the different European surveillance mechanisms: it goes without saying that the impact of the EU interventions is as minimal for the countries complying with the European macroeconomic and fiscal rules as it is substantial for the countries under financial assistance.

- The emerging **"social deficit"** in parts of the EU is threatening the legitimacy and the sustainability of the European project. It is, thus, essential to add the considerations regarding the **European social dimension to any debate about deepening of the EU/EMU**, as it has been finally acknowledged at the European Council of December 2012.

- Improving the social dimension of the EU as a whole is the "first-best" option, whenever it is feasible. Nevertheless, in the context of the common currency area, **action in the social field on the EMU level might not only be desirable, but also necessary**.

- A common currency implies that the **interdependencies between the member states increase beyond those created by the single market**; as a consequence, increased cooperation in social and employment policies is needed to (i) ensure the smooth functioning of the euro area and (ii) to avoid certain politically "undesirable" consequences of the EMU on national welfare systems.

- Reinforcing the four EMU pillars (fiscal, economic, banking and political) affects social questions directly and indirectly. Therefore, the **social dimension should be mainstreamed in the national and EMU level initiatives** responding to various short and long term challenges rather than treated as a separate pillar of a genuine EMU.

- **Three scenarios** are proposed for the future of the EMU's social dimension. They have different implications for the national welfare states:
  1. If member states **stick to the current course of action** and if the crisis does not deteriorate, it can be expected that EMU member states will not adopt new ambitious initiatives to address short and long term challenges for the EMU and for the national welfare states. The social dimension will not be developed enough to have a positive effect on improving the functioning and the legitimacy of the EMU.
  2. Even if the political will for deepening the EMU is absent in the current context, member states might be **forced to do so if the crisis intensifies**. Paradoxically, the aggravation of the crisis might lead to an overall improvement of the situation, at least in the longer term, as the adoption of new instruments/initiatives reinforces the EU/EMU. In addition, the mainstreamed social dimension of the EMU contributes, to some extent, to a better functioning and more legitimate common currency area. However, the modernization of the national welfare states in order to ensure their sustainability in the medium/long term is not addressed. Moreover, the social dimension is not developed to its full potential.
  3. Lastly, there might also be **a change of paradigm** in the EMU driven by growing threats to EMU's sustainability and prosperity (such as low growth, social unrest, rising Euroscepticism and declining role of European economies on the global stage). A new agenda for EMU's future would be built on a "sense of common purpose" instead of a

previously prevailing "sense of survival". The adoption of new instruments and policies would allow maximizing the chances of the member states to tackle the short and long term challenges related to their welfare states and ensure the smooth functioning of the EMU.

- The last scenario is the **most desirable one**; however, it is also **extremely difficult to implement**, in particular because building a "sense of common purpose" in the current context would be extremely challenging and because this scenario presupposes a revision of the Treaty.

- The first two scenarios, driven by a sense of survival, are thus **more likely to happen,** at least in the shorter term.

- However, in any possible future scenario for the EMU, the reinforcement of the social dimension is not just a political catch-phrase, but indeed a **burning necessity**. European policy makers are therefore called to treat social concerns and to develop EMU's social dimension with the **same urgency** as the four other pillars of the genuine economic and monetary union.

INTRODUCTION

The global economic crisis is putting EU welfare states under strain and the voices arguing that the EU suffers from a real "social deficit" are getting louder. In the countries most hit by the crisis, the economic downturn has translated into a significant rise of unemployment and poverty levels, whereas growing pressure to consolidate national budgets is forcing significant cuts in welfare programs. At the same time, the crisis has led to a major overhaul of the EU framework of economic governance, with special implications for the euro area countries, and the current debate suggests deepening the process of integration within the euro area with the creation of a "fiscal union", an "economic union", a "banking union" and a "political union". While there is still uncertainty on the profoundness and specific content of this "deepening" of the EMU, certain actors fear these reforms will translate into stronger pressures to slim down social budgets and into further constraints regarding domestic social and labour market policy choices.

As a consequence, today the need to counteract the negative social consequences of the crisis and to take social implications of the deepening of EMU into account are leading many experts and decision makers to call for the creation of a "social union" or "social pact" complementing current reforms of the EU economic governance. These calls come not only from the academic community[1], but also from the highest political circles. For example, a "social union" or social pact has been recently requested by the Commissioner for Employment and Social Affairs, Lázsló Andor[2], by the Committee of Economic

1. Vandenbroucke, Frank, "Europe: The Social Challenge Defining the Union's social objective is a necessity rather than a luxury", *OSE*, Opinion Paper No. 11, July 2012.
Vandenbroucke, Frank, Hemerijck Anton and Palier Bruno, "The EU Needs a Social Investment Pact", *OSE*, Paper Series, Opinion paper No. 5, May 2011.
2. Andor, Lázsló, "State of Europe: Escaping the doldrums", speech at the *Friends of Europe* 9th Annual VIP round table, Brussels, SPEECH/12/72, 11 October 2012: "My conclusion is, therefore, that greater coordination of the European and national levels on employment and social matters has become necessary if we want to further integrate financial, budgetary and monetary union. We need a stronger social union if we want to have a genuine Economic and Monetary Union".

and Monetary Affairs of the European Parliament[3], and by a group of Socialist Ministers for Social Affairs and Employment[4]. Finally, Herman Van Rompuy has been asked by the Heads of State and Government at the European Council of December 2012 to present a report on EMU's social dimension in 2013 with the decisions expected in December 2013.

The first difficulty one encounters when discussing the shape of the new "social dimension" is that of separating general arguments in favour of further developing EU's social dimension from arguments specifically related to the euro area. Indeed, there are different possible arguments, more or less convincing but not mutually exclusive, to plead for a reinforcement of the social dimension of the EU in current times[5]. One might argue, for instance, that the social consequences of the single market are not sufficiently taken into account, and that there is a need to accompany current efforts to deepen the single market with actions to ensuring that further economic integration does not undermine the foundations of national social protection systems. One could also argue – as many proposals to build up a "EU social pact" do today – about the need to counteract the effects of the crisis and of national austerity policies by a more resolute EU-level action in order to promote sustainable growth, employment and social investment.

On top of that, virtually all of the EU member states are confronted with the challenge of welfare state reform that was present long before the financial and economic crisis had started. These challenges do not stem directly from the process of European integration. Instead, they are related to the fundamental changes, which have been going on within the European societies for several decades now, as well as to global geopolitical shifts of power due to intensifying globalization. On the one hand, European welfare states face "internal" problems such as population ageing (caused by low fertility rates and unprecedented longevity) and the increasing risk of social polarization related to new family life patterns[6]. On the other hand, changing technologies and intensified globalization force European countries to search for new

3. European Parliament, *Resolution: Towards a genuine Economic and Monetary Union*, 2012/2151, 20 November 2012.
4. Party of European Socialists, "Towards a Social Union", Declaration of the PES Ministers for Social Affairs and Employment, Brussels, 4 October 2012.
5. Vandenbroucke, Frank, Hemerijck Anton and Palier Bruno, "The EU Needs a Social Investment Pact", *op.cit.*
6. See, for instance, European Commission, *Regions 2020 Demographic Challenges for European Regions*, *Background document to Commission Staff Working Document SEC (2008)*, November 2008.

sources of competitiveness – as a failure to deliver on growth would threaten the sustainability of national welfare systems – and to reform labor and social policies – not to sacrifice them.

All the aforementioned arguments, however, refer to the whole EU. A hefty amount of research has already been carried out on the ways to reform the European welfare states in the changing context of modern times or the channels to better utilize the existing EU-level instruments to internalize the negative social consequences of the single market. Contrary to the majority of proposals and reflections that circulate about an eventual EU "social union" or "social pact", this study intends to explore the case for developing a social dimension specific to the EMU. In this respect, it aims to explore whether there is a need to add a social component to current proposals for a "genuine EMU", which would go further than the social policies of the EU28 today, and to discuss the specific features of this social component.

The reflections on the need to reinforce the social dimension of EMU are not new. In the years preceding the launch of the euro, researchers and decision makers were concerned about two different issues: a short-term issue was whether the transition to EMU (that is, the application of the Maastricht convergence criteria) was likely to have socially harmful effects in certain countries and a long-term issue was whether the establishment of a common currency and the new EMU architecture attached to it would have socially adverse effects (for instance, pressure to downsize welfare states or a risk of social dumping). In a similar manner, today just as in the 1990s, two types of social concerns coexist in the debate about the future of EMU: a short-term concern about the social consequences of the current management of the euro area sovereign debt crisis (particularly of the harsh austerity measures and structural reform programmes imposed to countries under financial assistance) and a medium-to-long term concern about the social implications of major reforms in the EMU framework of economic governance.

The study is divided in two parts. Part I deals with the overview and the analysis of the state of "Social Europe" today whereas Part II is "forward-looking": among other things, it provides three scenarios for the future of the EMU and some considerations on their economic, social and political implications.

Following this introduction, the study proceeds in nine chapters:

Chapter 1 of part I gives a general overview of welfare state diversity within the EU/EMU. It discusses theoretical difficulties of classifying European welfare states according to certain "types" and illustrates these difficulties by mapping out several features of welfare state functioning and financing using statistical data. The definition and the issues surrounding the concept of the European Social Model are also raised.

Chapter 2 of part I provides a brief historical background of the EU's social dimension and puts the emphasis on the Europe 2020 Strategy which acts as a framework for the coordination of employment and social policies in the EU.

Chapter 3 of part I analyses the impact of the new EU framework of economic governance, which has emerged from the crisis, on the social policies and national welfare states. It shows that the potential impact of the new instruments is very different depending on the situation of each member state: it is as minimal for the countries complying with the European macroeconomic and fiscal rules as it is substantial for the countries under financial assistance.

Chapter 4 of part I highlights the impact of the global economic crisis on social and labour market policies in Europe. The ultimate purpose of this chapter is to show that the current crisis has resulted in growing divergences between the EMU member states and that social policies have been used as adjustment variables while dealing with a negative economic shock. The chapter describes various trends in social indicators and social spending in the euro area and reviews the main reforms on pension systems and labour market regulations introduced by EU member states as a response to the crisis. It also explores the social impact of the crisis in EMU peripheral countries, which have been hit the hardest.

Chapter 1 of part II is devoted to the theoretical analysis of the reasons for reinforcing EMU's social dimension. It discusses the need for a stronger social dimension of the EU as a whole; in addition, using functional and political arguments, it builds a case for a deeper EMU-specific social dimension. The links and the intersections between "Social Europe" and "EMU's social dimension" are explored.

Chapter 2 of part II defines the main challenges that the EMU member states are facing today. These challenges are divided between the short term (mostly relating to the consequences of the crisis) and the long term ones (related to the incomplete architecture of the EMU). The chapter also introduces the three scenarios for the EMU's future.

Chapters 3 to 5 of part II present three different scenarios for the future developments of the EMU and, in particular, for its social dimension. Each scenario consists of a set of assumptions, a number of adopted policy initiatives and an analysis of economic and social impact of these initiatives.

The concluding section summarises the main results and policy recommendations put forward by the study.

PART I
THE STATE OF SOCIAL EUROPE TODAY

1. Welfare diversity and the european social model

The objective of the EU enshrined in the Treaties is to create prosperity by developing a highly competitive social market economy. The EU committed itself to the creation of a fully functioning internal market between the member states while simultaneously promoting social progress of its societies. The debate on whether these two aims are contradictory and mutually exclusive or rather complementary and self-reinforcing is as old as the European Union itself. The EU as a whole has tended to favour the latter point of view. Indeed, the assumption that economic and social progress can go hand in hand is the basis for the much-escalated concept of the European Social Model (ESM), which was famously introduced by Jacques Delors. The fact that the EU is not only concerned with economic growth, but also with social progress, is thus the cornerstone of the European project.

This first chapter describes the differences in welfare states that exist within the EU (1.1.), with a particular attention given to welfare diversity within the EMU (1.2.). It also provides some reflections on the concept of "European Social Model" and its relevance today (1.3.).

1.1. Typology of welfare state regimes

It has been widely documented that the European Social Model is a poorly defined concept as there are more than one social model present within the EU. Indeed, even though European societies do share a number of fundamental values and convictions, there are deep running differences across national borders. Over the decades each and every Member state has developed its own equilibrium between social concerns on the one hand and economic efficiency on the other hand depending on national preferences and historical experience.

These distinct models have been famously grouped together in different "welfare state regimes", following the typology first proposed by Esping-Andersen[7] and subsequently developed by other authors. Four main types of welfare state regimes are usually identified in Europe: Nordic (or social democratic), Continental, Anglo-Saxon (or liberal) and Mediterranean[8]. Table 1 summarizes the four models according to their main features. As it can be noticed, the four regimes differ in terms of their overall finality and the structure of social stratification they create, as well as in key aspects of the policy design and institutional characteristics of their social protection systems (such as the method of funding or the coverage and generosity of welfare benefits).

7. Esping-Andersen, Gøsta, *Three Worlds of Welfare Capitalism*, Cambridge: Polity Press, 1990.
8. Initially Esping-Andersen distinguished three models only because his analysis has not included Spain, Greece and Portugal.

TABLE 1 ► Types of welfare wtate in Europe

	ANGLO-SAXON	MEDITERRANEAN	CONTINENTAL	NORDIC
OVERALL PURPOSE OF THE SYSTEM	Combating poverty and social exclusion	Protecting workers from adverse labour market or lifecycle risks	Protecting workers from adverse labour market or lifecycle risks	Reducing overall inequality
MAIN ACCESS CRITERIA TO WELFARE BENEFITS	Means-based	Employment	Employment	Citizenship
GENEROSITY OF WELFARE BENEFITS	Low	Low on average but unequal levels of generosity, depending on to whom they benefit (insiders/outsiders of the labour market)	High on average but unequal levels of generosity, depending on to whom they benefit (insiders/outsiders of the labour market)	High
ROLE OF THE STATE IN THE PROVISION OF SOCIAL SERVICES IN KIND	Very modest supply of social services beyond health and education, strong reliance on the market	Very modest supply of social services beyond health and education, strong reliance on the family	Very modest supply of social services beyond health and education, strong reliance on the family	A broad supply of social services beyond health and education
LABOUR MARKET REGULATION AND POLICIES	Low levels of employment protection, residual labour market policies	High levels of employment protection, strong emphasis on passive labour market policies	High levels of employment protection, strong emphasis on passive labour market policies	Low levels of employment protection, strong emphasis on active labour market policies
LEVEL OF SOCIAL SPENDING	Low	Medium	High	High
DEGREE OF SOCIAL INEQUALITY	High	High	Medium	Low
COUNTRIES	UK, Ireland	Italy, Spain, Greece, Portugal	Germany, France, Luxembourg, Austria, Belgium, the Netherlands	Denmark, Finland and Sweden

Source: own elaboration

Albeit popular, this attempt to "cluster" welfare states into clearly defined types is by no means perfect. Welfare regime typologies account for differences in social protection systems (basically including pensions, unemployment, social assistance and family policies) and labour market regulation and policies, but differences in important social areas such as health and education are not taken into account. Besides, many countries have integrated features of different regimes in their social protection systems. For instance, the Dutch welfare system combines features of the Continental and the Nordic type. There is also a discussion about whether to classify Mediterranean welfare systems as a distinct regime or if they are just a variant of the Continental model. Last but not least, this typology does not cover the eleven Central and Eastern European member states (CEEs).

Indeed the new post-communist member states are clearly difficult to classify according to the classic welfare regime typology. In the past two decades, these countries have been in transition, (re)developing their institutions to reflect new political and economic realities. Arguably, the transition period has not come to its end yet making the classification of clear cut welfare state models even more difficult.

CEEs have been implementing policies associated with all different aforementioned welfare types and have thus developed "hybrid" models of welfare states. Nevertheless, the CEEs are often seen as pursuing what Vaclav Klaus called the "market economy without an adjective"[9]. Indeed, in terms of social policies these countries share several common features, which are associated with the liberal welfare state type[10]. For instance, in all the CEEs the income tax rates (both personal and corporate) and the level of public social expenditure remain relatively low. At the same time, however, the CEEs rely on state provision of services and have not gone through full-fledged privatization reforms in many areas of social provision. Healthcare is the prime example as none of the CEEs is willing to denounce universal access[11]. In addition, the

9. Interview of Vaclav Klaus by John Fund, "No Third Way Out: Creating a capitalist Czechoslovakia", *Reason*, June 1990.
10. Fuchs, Susanne and Offe, Claus, "Welfare State Formation in the Enlarged European Union Patterns of Reform in the Post-Communist New Member states", Hertie School of Governance Working paper 14, 2008, p. 28.
11. Hacker Björn, "Hybridization instead of Clustering: Transformation Processes of Welfare Policies in Central and Eastern Europe", Social Policy & Administration, 2009, VOL. 43, No. 2, p. 166.

CEEs share some features with Mediterranean welfare type in terms of family-based provision of social care.

On top of these differences, the eleven CEEs are quite heterogeneous when compared to one another. They are, in fact, "as different from each other as the Fifteen are"[12]. Some of them tend to converge to a more continental model. This is the case of Poland, which has put the principle of social market economy and solidarity as the basis of the economic system in its constitution (Art. 20). Others, like the three Baltic States, tend to adopt much more liberal policies. Overall, the differences of social types between the CEEs and the EU15 and in between the CEEs themselves make the clear cut distinctions of welfare types in Europe close to impossible.

1.2. Mapping out welfare diversity within the EMU

The previous section has given a brief theoretical discussion of the welfare state types in the EU28; however, in this study the analysis is centred on the euro area member states. The classic welfare regime typology is a good starting point to map out welfare diversity within the common currency area. However, this section shows that even within the restricted group of EU countries, the EMU, the welfare state diversity is significant.

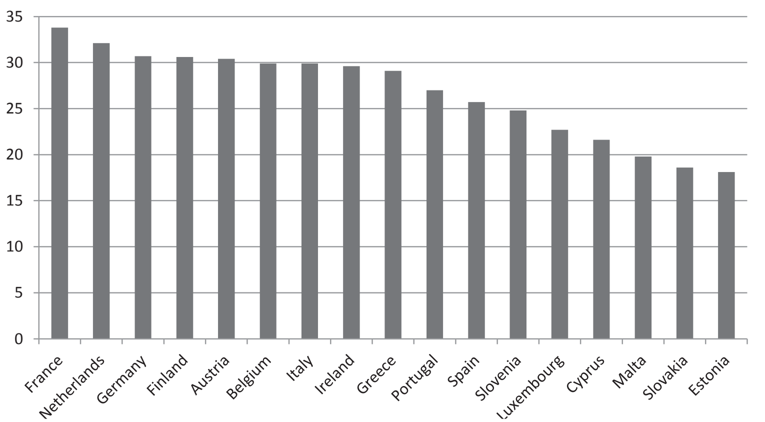
The majority of EU member states pertaining to EMU have a welfare state of Bismarkian tradition, that is, oriented to protect workers and mostly funded through social contributions. Six of them can be ascribed to the Continental model (Germany, France, Austria, Belgium, Luxembourg and the Netherlands), whereas four (Italy, Greece, Spain and Portugal) have Mediterranean-type welfare states. There is only one country having a Nordic-type welfare state (Finland) and one country having a liberal-type welfare state (Ireland). The remaining five countries (Cyprus, Estonia, Malta, Slovenia and Slovakia) are the "new" member states with different welfare traditions and structures.

Figure 1 reports the differences in levels of social protection spending among EMU countries, measured as a proportion of GDP. Unsurprisingly, social

12. Jouen, Marjorie and Palpant, Catherine, "For a New European Social Contract", *Notre Europe Studies & Research*, 2005, No.43.

spending is highest in Finland and four countries of the Continental welfare-type (France, Netherlands, Germany and Austria): these countries devote more than 30% of their GDPs to finance their social protection systems. Social spending is only a bit more moderate in Belgium, Italy, Ireland and Greece (between 29,9% and 29,1%) and clearly lower in Portugal, Spain and Slovenia (27%-24,8%). The smallest euro area countries (Luxembourg, Cyprus, Malta and Estonia) are, together with Slovakia, the member states that present the lowest levels of social protection spending measured as a proportion of GDP.

FIGURE 1 ► Social protection spending in EMU countries as % of GDP, 2010



Source: Eurostat, " Social Protection : EU spent 29.4 % of GDP on social protection in 2010. Highest ratios in France, Denmark and the Netherlands", Eurostat news release 165/2012, 27 November 2012.

Table 2 reports the level of social expenditures disaggregated by its main functions. As seen in the table, there are marked differences in the relative importance of various budget lines. In all euro area countries social protection expenditure is the first budget line among social spending but the differences among member states range from 26,1% in Cyprus and 43,3% in Germany. Six EMU countries (Germany, France, Italy, Luxembourg, Austria, Finland) devote more than 41% of their general budget to social protection. The majority of EMU countries devote more public resources to health than to education; only Estonia, Cyprus, Luxembourg and Malta – the smallest EU countries – do not follow this rule.

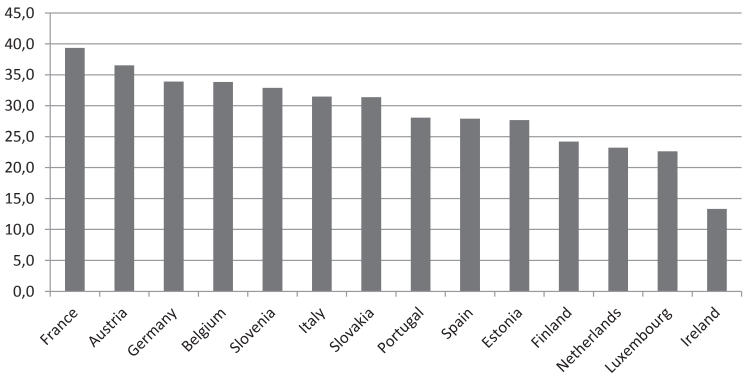
TABLE 2 ► Main functions of social expenditure in EMU countries as a % of total public spending, 2011

	HEALTH	EDUCATION	SOCIAL PROTECTION
EU 27	14.9	10.9	39.9
EA-17	14.9	10.1	40.7
Belgium	14.8	11.6	36.6
Germany	**15.5**	9.4	**43.3**
Estonia	13.3	**16.9**	34.2
Ireland	**15.6**	10.9	35.9
Greece	11.5	7.9	39.3
Spain	14.1	10.5	37.4
France	14.7	10.8	**42.6**
Italy	14.7	8.5	**41**
Cyprus	7.3	**15.6**	26.1
Luxembourg	11.4	**12.1**	**43.2**
Malta	13.3	**13.9**	34.3
Netherlands	**17**	11.6	34.5
Austria	**15.3**	11	**41.6**
Portugal	13.8	12.9	36.7
Slovenia	13.5	13.1	37.3
Slovakia	**15.5**	10.6	31.3
Finland	14.2	11.6	**43.1**

Source: Eurostat, "General government expenditure in 2011-Focus on the functions 'social protection' and 'health'", Statistics in focus 9/2013, April 2013.

EMU welfare states also differ in the method of financing social policies. This is, for example, reflected in the weight of social contributions on wages. Figure 2 reports OECD's estimates of the weight of social contributions on labour costs in 14 EMU countries (all except Cyprus, Greece and Malta for which data is not available). As seen in the graph, in 7 EMU countries (France, Austria, Germany, Belgium, Slovenia, Italy and Slovakia) social contributions account for more than 30% of wages. In the other extreme, the impact of social contributions on wages is particularly low in Ireland (less than 13,3%), and relatively low in Luxembourg, the Netherlands and Finland.

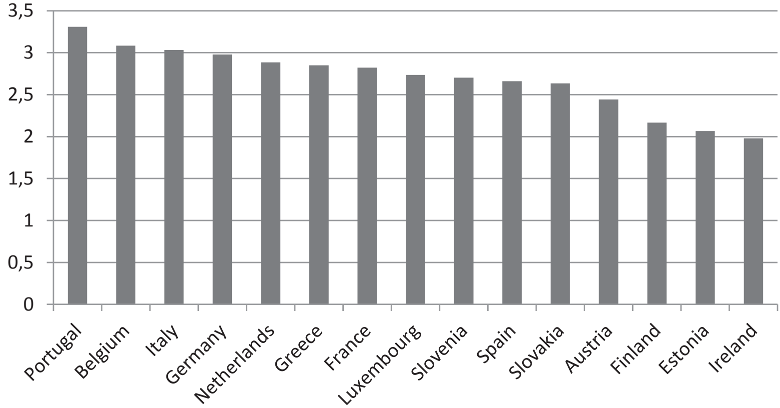
FIGURE 2 ► The weight of social contributions on labour costs, 2011



Source: OECD, Taxing wages database.

Finally, there are also differences in the level of employment protection in EMU countries. As shown in figure 3, Portugal, Belgium, Italy and Germany are those having the highest levels of employment protection in the euro area. At the other extreme, Austria, Finland, Estonia and Ireland are those having the lowest levels of employment protection in the EMU.

FIGURE 3 ► Strictness of employment protection – individual and collective dismissals (regular contracts), 2010



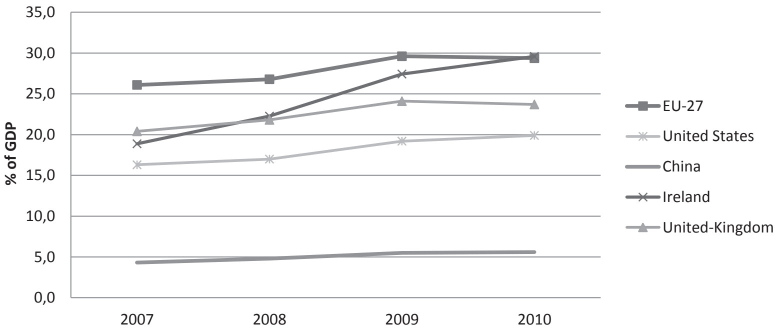
Source: OECD, Employment protection index.

1.3. European Social Model: more than just a common denominator

Considering the four welfare state types with their pronounced differences together and adding the new member states outside of them, the heterogeneity of welfare state traditions on the European continent becomes obvious. In this context, the concept of a "European Social Model" might seem superfluous. What are the place and the meaning of the ESM if all of the member states adhere to different welfare traditions?

In fact, the ESM is much easier to identify when the analysis is zoomed out to compare the European welfare state types and traditions of social policies to other continents of the world. Some features, which are shared to such an extent that they seem natural in the EU, clearly distinguish the European countries from the USA, China or Brazil. For example, generally speaking, European citizens prefer more equality and less private provision than their American counterparts[13]. Access to social welfare in Europe is also much more universal and much less conditional than in the United States or China. Moreover, as figure 4 suggests, even the UK and Ireland, the European adherents to the "Anglo-Saxon" tradition, have more social spending than the USA, which illustrates on average a more generous and more redistributive welfare state.

FIGURE 4 ► Expenditure on social protection in EU27, UK, Ireland, China and US



Sources: Eurostat for EU, UK and Ireland; OECD data for United-States; OECD Economic Survey: China 2013.

These shared features have been generalized by European policy makers in an attempt to reach a common agreement on what exactly constitutes the ESM. Having been first defined in the White Paper of the European Commission in 1994 as a collection of shared values (namely "democracy and individual rights, free collective bargaining, the market economy, equality of opportunity for all and social welfare and solidarity")[14], the ESM is viewed as a set of lowest common denominators among member states relating to social standards and societal preferences[15]. These constitute a basis of common agreement among all EU member states which is preserved through various policy initiatives at the European level (see Chapter 2).

13. Alesina, Alberto, Di Tella Rafael and MacCulloch Robert, Inequality and Happiness: Are Europeans and Americans Different?, Journal of Public Economics, vol. 88(9-10), Elsevier,2004.
14. European Commission (1994), « European Social Policy – A Way Forward for the Union » White Paper, p.2.
15. For example, see Reppas, Dimitris, Foreword, in Sakellaropoulos, Theodōros D. Sakellaropoulos, Berghman Jos and Amitsis Gabriel (eds.), *Connecting Welfare Diversity Within the European Social Model*, p. 6.

It is important to underline that the definition of a "European Social Model" and the development of policies aimed at preserving it stem from the perception that, if left alone, the process of EU economic integration might have negative social consequences at the national level. Indeed, there is a permanent tension within the market-expanding logic of EU "negative integration" of free movement and cross-border competition and the market-correcting functions in national policy arrangements, ranging across industrial relations, labour market regulation, social insurance, key public services and progressive taxation[16]. To prevent the process of economic integration from endangering social cohesion and welfare structures at the national level, the EU complements its "market making" policies with "market correcting" policies ("positive integration"). The latter include interventions in the social area, be it in form of legislation (hard law), coordination processes (soft law) or financial support (via the structural funds).

However, the ESM and the development of EU social interventions might not only be a matter of preserving shared European values, but also a necessity for the good functioning of the EU. Indeed, a certain level of social harmonisation has been always seen as a necessity to permit the good functioning of the single market. Today, in the context of a globalised economy and with a process of deepening the EMU, one might wonder whether more EU/EMU level social legislation, coordination, benchmarking or even financing are relevant for achieving common goals of prosperity and social progress. These issues are the subject of the following chapters of this study.

16. Ferrera, Maurizio, "National Welfare States and European Integration: In Search of a Virtuous Nesting", *Journal of Common Market Studies*, Vol 47 N° 2, pp. 219-33, 2009.

2. European social policy before the crisis

Over the last 60 years of European integration member states developed a "European social policy", defined in the Green Paper of 1993 as "all of the policies in the social area, including labour market policies"[17]. This "Social Europe" does not intend to replace national social policies. Indeed, unlike policies known as common policies (such as competition policy or external trade policy), which imply a complete transfer of competences from the member states to the Union, European social policy supplements, and sometimes acts as a framework for national social policies, in accordance with the application of the principle of subsidiarity.

In this part of the study, we shortly go through the history of European social policy over the last 60 years of European integration (2.1) and we present the EU growth and jobs strategy – from Lisbon to Europe 2020 – which sets member states vision of EU's future and acts as a framework for employment and social policies coordination in the EU (2.2.).

2.1. A brief history of Social Europe

When European integration started, in the 1950s, the prevailing idea was that the European community should concentrate on economic opening, while the member states would stay responsible for expanding their welfare state for themselves. The deal was "Keynes at home, Smith abroad"[18]. Not only both processes (EU integration and national welfare expansion) were seen as compatible, but there was also the perception that the process of economic integration would automatically trigger an improvement in social conditions. Consequently, in the Treaty of Rome, "the need to promote improved working conditions and improved standard of living for workers (...)" was expected

17. European Commission, *European Social Policy - Options for the Union/Green Paper*, COM(93) 551, November 1993.
18. Gilpin, Robert, *The political economy of international relations*, Princeton: Princeton University Press, 1987, p. 355.

mostly thanks to "the functioning of the common market, which will favour the harmonization of social systems" (Article 117 of the Treaty of Rome).

Having said so, there were some provisions in the Treaty of Rome concerning social and employment policies. The European Economic Community (EEC) was given the competence to legislate in certain social areas, deemed necessary to ensure the free movement of workers (such as the coordination of social security systems, health and safety at the workplace, gender equality and the fight against discrimination). In addition, the Treaty foresaw the creation of the European Social Fund, a funding mechanism intended to accompany the restructuring of industry and facilitate the migration of workers from South to North within the Community.

During the first decades of the European project, these Treaty provisions proved sufficient. As Hemerijck[19] puts it, "prosperity progressively allowed for both international economic opening and national social closure to proceed side by side. However, since the 1980s this division of labour became increasingly untenable". The launch of the 1992 Single market project raised fears about the destructive social consequences of further steps in the process of European economic integration. To counteract these potential negative effects, in 1986, the approval of the Single European Act (SEA) introduced various novelties: qualified majority voting was allowed to legislate on certain social domains, such as workers' protection at the workplace; the European social dialogue was recognised as a procedure for EEC governance and the promotion of economic and social cohesion became one of the EEC goals (something which was accompanied by a major expansion of EEC cohesion policies from the late 1980s onwards).

The momentum created by the approval of the SEA was continued with the adoption in 1989 of the Community Charter of Fundamental Social Rights of Workers and the adoption of the Maastricht's Social Protocol in 1992 (later incorporated into the Amsterdam Treaty in 1997). Among other things, this Protocol strengthened the role of European social partners allowing them to sign collective agreements that can be given binding legal effect via a decision by the Council.

19. Hemerijck, Anton, *Changing Welfare States*, Oxford: Oxford University Press, 2012, p. 301.

Between the late-1990s and the mid-2000s social and employment concerns remained at the top of the EU agenda. This was partly due to the fears raised by the process of globalisation and the creation of a common currency, but also due to the political context (at the end of the 1990s, 13 out of 15 member states had social democratic or socialist parties in governments and in 1995, three new member states – Austria, Finland and Sweden – with advanced welfare states joined the EU). There was, however, a qualitative change in the mode the EU intervened in the social domain. Since the end of the 1990s, instead of approving new social legislation, the EU has been aiming at promoting policy coordination in areas in which it lacks direct legislative competence, through the so-called Open Method of Coordination. Apart from that, the EU has also taken a more pro-active role as a social policy agenda-setter. EU interventions are no longer aimed at preserving the national "status quo", but at catalysing domestic social reform. The European Employment Strategy, established in the new employment title of the Amsterdam Treaty (1997), and especially the Lisbon Strategy, adopted by the European Council in 2000 (see point 2.2.), are exemplary of the new commitment of the EU to encourage domestic social reform[20].

During the 1990s and 2000s, EU's action in the social field was also enhanced with the creation of new financial instruments aimed at supporting member states' social policies. In addition to the Structural Funds – in particular the European Social Fund – and to the Integrated Mediterranean Programme (adopted in 1985 and aiming at preventing any worsening of possible regional imbalances caused by the Community's enlargement to Spain and Portugal), the EU set up the PROGRESS programme and the European Globalisation Adjustment Fund (see box 1).

20. Hemerijck, Anton, *Changing Welfare States*, *op cit*.

BOX 1 ► Social Europe: financial instruments

EUROPEAN SOCIAL FUND (ESF)	Created in 1957, the ESF aims to promote employment in the EU mainly by funding initiatives to help people improve their skills and job prospects. The ESF is a key part of the Europe 2020 strategy as it supports the EU's goal of increasing employment.
PROGRESS PROGRAMME	Created in 2007, PROGRESS is the EU employment and social solidarity programme established to support the implementation of EU objectives in the fields of employment, social affairs and equality and to contribute to the Europe 2020 Strategy.
EUROPEAN GLOBALISATION ADJUSTMENT FUND (EGF)	Set up in late 2006, the EGF aims to support redundant workers, mainly in regions and sectors which have been disadvantaged by exposure to the globalised economy. It provides financial support to facilitate the reintegration into employment of workers. As part of the EU's response to the crisis, EGF funding was extended to help workers who lost their jobs as a consequence of the crisis.

Source: European Commission, DG Employment, Social Affairs & Inclusion.

Finally, the approval of the Lisbon Treaty in 2009 has further reinforced EU's social policy commitment. Its most important innovation is the Horizontal Social Clause (Art. 9 TFEU), which states that the Union shall take into account social issues (such as the promotion of a high level of employment or the guarantee of an adequate social protection) when defining and implementing all of its policies and activities[21]. In addition, the Treaty introduces new social objectives for the EU: full employment and social progress in a social market economy; combating social exclusion and discrimination; solidarity between generations; promotion of economic, social and territorial cohesion; and solidarity between the member states. The reinforcement of Europe's social dimension is also evident from the incorporation of the Charter of Fundamental Rights into the Treaty, making it legally binding.

21. Article 9 of TFEU states that : "*In defining and implementing its policies and activities, the Union shall take into account requirements linked to the promotion of a high level of employment, the guarantee of adequate social protection, the fight against social exclusion, and a high level of education, training and protection of human health*".

2.2. Europe 2020: an integrated policy agenda for Europe's future

As pointed out above, since the late 1990s the EU intervenes in the social and employment area mostly by promoting the non-binding coordination of national policies. Since 2010, this coordination of employment and social policies is framed by the Europe 2020 Strategy – the successor of the Lisbon strategy – and is based on the adoption of shared European objectives which are then translated into national initiatives and assessed in accordance with common criteria.

Europe 2020 sets an integrated political agenda for Europe's future, which rests on a balance between economic, social and environmental objectives. The strategy is built upon three pillars and five "headline targets" (see box 2) that aim to promote the transition to a greener, smarter and more inclusive economy. The three priorities are expected to be mutually reinforcing: better education propels higher employment, which itself helps tackling poverty; investment in research and innovation increases the resilience of the economic system and is beneficial to employment in the long run. Europe 2020 is thus strongly influenced by the social investment perspective, emphasising the positive complementarities between equity and efficiency by investing in people as well as in active and dynamic welfare states.

BOX 2 ► Europe 2020 Strategy

<table>
<tr><td rowspan="2">EU PRIORITIES</td><td>Smart growth,
i.e. “strengthening knowledge and innovation as drivers of our future growth”;</td><td>Sustainable growth,
i.e. “promoting a more resource efficient, greener and more competitive economy”</td><td>Inclusive growth,
i.e. “fostering a high-employment economy delivering social and territorial cohesion”.</td></tr>
<tr><td colspan="3">* Five headline targets
– Employment rate of 75%
– Spending on R&D amounting to 3% of GDP
– Reduce greenhouse gas emissions by 20%
– Reduce secondary-school drop-out rate by 10% and achieve 40% of graduates from higher education
– Reduce the number of people at risk of poverty by 20 million
* Ten integrated guidelines</td></tr>
<tr><td>EU LEVEL TOOLS</td><td colspan="3">* Monitoring and guidance in the framework of the European semester (Macro, thematic and fiscal surveillance)
* Annual growth survey
* Country specific recommendations
* Seven flagship initiatives
* EU levers for growth and jobs (Single market, Trade and external policies, EU financial support)</td></tr>
<tr><td>NATIONAL LEVEL TOOLS</td><td colspan="3">* National Reform programmes
(with national targets)</td></tr>
</table>

Source: Own elaboration on the basis of EC, governance, tools and policy cycle of Europe 2020, 2010.

Like the Lisbon Strategy, the implementation of Europe 2020 by the member states lies on non-binding instruments. Despite some innovations to improve the governance of the strategy – such as the definition of national targets instead of a single target for all – Europe 2020 still suffers from a weak legitimacy and ownership. In addition, the current sovereign debt crisis in the euro area rendered its implementation even more difficult in the last years, as it is discussed in chapter 4.

3. The impact of the new economic governance on employment and social policies

The launch of the Europe 2020 strategy has coincided in time with the start of the sovereign debt crisis and the subsequent revision of the structures of EMU economic governance. In fact, since 2010, member states have adopted a set of new rules, mechanisms and procedures aimed at strengthening the fiscal and macro-economic surveillance of EU member states: the European Semester, the Six Pack, the Euro Plus Pact, the Treaty on Stability, Coordination and Governance (TSCG), the European Stability Mechanism (ESM) and the Two Pack.

This reform of the European economic governance does not intend to confer additional powers or competences to the EU/EMU level in the employment and social fields. However, it does not mean that the reform has no impact on these policies. On the contrary, the reinforcement of EMU's crisis prevention capacity through reinforced and new surveillance procedures and the setting-up of a crisis resolution mechanism have important consequences for national social policies.

This chapter discusses the impact of the new European economic governance on national employment and social policies. We start by a general assessment of this impact (3.1) and we then differentiate the situation of different member states, according to their fiscal and macro-economic situation (3.2.). We finally discuss in more detail the impact on national social and employment policies of three main elements of the reform: first, the reinforcement of fiscal surveillance (3.3.), second, the new procedure for macroeconomic imbalances surveillance (3.4.); and third, the set-up of a crisis resolution capacity (3.5.).

3.1. The coordination of employment and social policies in the new economic governance framework

Under the new economic governance framework, the conduct of social and employment policies still rests at the national level with the EU acting as a coordinator of national policies. However, Europe 2020 is now included in a new all-encompassing coordination process – the European semester (see box 3) – which consists of the coordination of fiscal, macro-economic and structural policies. By placing together macro-economic, structural and fiscal coordination procedures, the aim of the European Semester is to improve the consistency between national economic decisions and the countries' fiscal constraints.

BOX 3 ► The European Semester

Since 2011, the European Semester establishes a common timetable for the different procedures concerning the three pillars of EU economic governance:

- Fiscal policy coordination, through the Stability and Growth Pact and its reinforcement via the Six Pack and the Two Pack; the TSCG strengthens fiscal policy coordination between 25 EU member states;
- The new macroeconomic surveillance, introduced by two regulations of the Six Pack, which aims at preventing and correcting macroeconomic imbalances;
- The coordination of economic policies via the Europe 2020 strategy and the Integrated Guidelines. This pillar is complemented by the Euro Plus Pact, adopted by 23 out of the 28 EU member states.

The first stage of the European Semester consists of the publication of the Annual Growth Survey (AGS) by the Commission. The AGS presents an analysis of EU economic outlook and sets EU policy priorities for the following year. The priorities must be adopted by the European Council and then guide the member states in the elaboration of their national programmes. The European Semester foresees the joint presentation (in April) and analysis (in June) of the economic priorities included in each country's National Reform Programme (NRP) as well as in the fiscal policies foreseen in the Stability or Convergence Programmes (SCP). The Commission then issues one single set of country-specific recommendations on both programmes.

The Europe 2020 priorities and goals set the framework for economic and social policy coordination, but the latter have been complemented by some provisions of the Euro Plus Pact. Indeed, the Euro Plus Pact has among its objectives to foster competitiveness and employment in the EU. In order to achieve that, the member states having signed the Pact have committed themselves to monitor wage and productivity developments and undertake wage-setting, labour market and tax reforms[22].

There are, however, no binding instruments to guarantee that the signatories of the Pact implement these initiatives. In fact, the provisions of the Pact are based on soft coordination and on the Europe 2020 instruments: the National Reform Programs that are subject to the Commission's country-specific recommendations. No sanctions are foreseen and the enforcement mechanisms rest on peer pressure and naming-and-shaming (although the ex-ante and macro-economic conditionality attached to the future European Structural and Investment Funds 2014-2020 will probably put an additional pressure on member states).

In an analysis of the impact of the new economic governance on the coordination of social policies, Sonja Bekker points out that soft coordination has become more precise with the reforms, in particular through more detailed country-specific recommendations and deadlines to implement them. Nevertheless, she concludes (through the analysis of the first and the second European Semesters) that there is still considerable leeway in response to EU demands: "due to the existence of different sets of goals, countries seem to be able to pick and choose between sets of targets and countries still have flexibility in choosing how to meet the goals"[23].

22. The Euro Plus Pact states that « To assess whether wages are evolving in line with productivity, unit labour costs will be monitored over a period of time, by comparing with developments in other euro area countries (...). Each country will be responsible for the specific policy actions it chooses to foster competitiveness, but the following reforms will be given particular attention: (i) respecting national traditions of social dialogue and industrial relations, measures to ensure costs developments in line with productivity, such as: review the wage setting arrangements, and, where necessary, the degree of centralization in the bargaining process, and the indexation mechanisms, while maintaining the autonomy of the social partners in the collective bargaining process; and ensure that wages settlements in the public sector support the competitiveness efforts in the private sector"; in addition, "Each country will be responsible for the specific policy actions it chooses to foster employment, but the following reforms will be given particular attention: labour market reforms to promote "flexicurity", reduce undeclared work and increase labour participation; lifelong learning; tax reforms, such as lowering taxes on labour to make work pay while preserving overall tax revenues (...)".
23. Bekker, Sonja, "The EU's stricter economic governance: a step towards more binding coordination of social policies?", *Social Science Research Center Berlin*, January 2013.

After this general picture, three observations must be made.

First, some experts outline that the integration of Europe 2020 in the European Semester potentially means its submission to short-term and stabilisation rationales[24]. In October 2012, the EPSCO Council expressed some concerns about the marginalisation of the social dimension in the European Semester[25]. However, even though there is evidence that social and employment priorities have been left behind in the last years, as outlined by Janssen[26], it is unclear that the latter is the result of the changes in EU economic governance. One might argue that this is, above all, due to the impact of the debt crisis and the strategy foreseen to solve it.

Second, in the last four years the priority given to financial stability and fiscal consolidation has led to an increasing predominance of the economic bodies of the Commission and the Council over the social ones. In addition, two other factors might have contributed to the increased role of the DG ECFIN and the Finance Ministers. First, socio-indicators have been introduced in the scoreboard of the Macro-economic Imbalances Procedure (MIP). As pointed out in a resolution by the European Trade Union Confederation, "given the fact that macro-economic imbalances are interconnected with a wide range of policies, this new process is giving finance ministers and DG ECFIN yet another possibility to intervene in areas where they have no competence (including collective bargaining, labour market institutions, public services…)"[27]. Second, the EPSCO Council only meets every three months (while ECOFIN meets at least once per month) and there is no forum for the meeting of the 17 EMU social and employment ministers, while the euro area Finance Ministers meet every month (Eurogroup meetings).

Finally, the reinforcement of the EMU's crisis prevention capacity through reinforced and new surveillance procedures and the setting-up of a crisis resolution mechanism have had important specific consequences for national social policies, as it will be discussed in the following parts of this chapter.

24. Armstrong, Kenneth, "EU Social Policy and the Governance Architecture of Europe 2020", *European Review of Labour and Research*, Vol. 18, No. 3, 2012.
25. Council of the European Union, Employment, Social Policy, Health and Consumer Affairs Council, *Press release 3188th Council meeting*, Luxembourg, 4 October 2012.
26. Janssen, Ronald, "Putting The Social Dimension At The Heart Of European Economic Governance", 25 March 2013.
27. Executive Committee of the European Trade Union Confederation (ETUC), *Resolution on Economic and Social Governance*, Brussels, 13-14 October 2010.

3.2. A differentiated impact depending on the situation of each member state

The real impact of the reform of economic governance on national employment and social policies largely depends on the position of EU countries as regards the different European surveillance mechanisms: it goes without saying that the impact of the EU interventions is as minimal for the countries complying with the European macroeconomic and fiscal rules as it is substantial for the countries under financial assistance.

For this reason, the analysis of the impact of the new economic governance on employment and social policies must be based on a distinction between four categories of countries:

- **Non euro area countries** (currently Bulgaria, Croatia, Czech Republic, Denmark, Latvia, Lithuania, Hungary, Poland, Romania, Sweden, United Kingdom): these countries are not concerned by the new sanctions foreseen by the preventive and corrective arms of the SGP nor by the corrective arm of the macroeconomic surveillance procedure;
- **EMU countries which are not under an Excessive Deficit Procedure (EDP) nor subject to an in-depth analysis on the framework of the MIP** (currently Germany, Estonia and Luxembourg): for these countries the reinforcement of the surveillance rules/procedures currently does not lead to additional constraints in regard to their policy choices;
- **EMU countries under EDP and/or subject to in-depth reports concerning the risk of macro-economic imbalances** (currently Austria, Belgium, Finland, France, Italy, Malta, The Netherlands, Slovenia, Slovakia, Spain): sanctions can be applied to these countries if they do not correct their fiscal or macro-economic imbalances; however, even if they have the obligation to correct these problems, they are free to choose how to attain the goals (the Country specific recommendations are indeed just recommendations and not obligations);
- **EMU countries under financial assistance and implementing an adjustment programme agreed with the Troika** (Greece, Ireland, Portugal and Cyprus at this stage): these member states need to implement the measures jointly agreed with the Troïka and are subject to quarterly reviews of the implementation of their adjustment programme. The

disbursement of the successive tranches of the financial aid depends on the compliance with the commitments taken.

TABLE 3 ► Situation of EU countries concerning fiscal and macro-economic surveillance (2013)

	ADJUSTMENT PROGRAMME	EXCESSIVE DEFICIT PROCEDURE	REINFORCED SURVEILLANCE UNDER THE MACRO-ECONOMIC IMBALANCE PROCEDURE
Austria		X	
Belgium		X	X
Bulgaria			X
Croatia			
Cyprus	X	X	X
Czech Republic		X	
Germany			
Denmark		X	X
Estonia			
Greece	X	X	
Finland			X
France		X	X
Hungary			X
Ireland	X	X	
Italy			X
Lithuania			
Luxembourg			
Latvia			
Malta		X	X
Netherlands		X	X
Poland		X	
Portugal	X	X	
Romania	X		
Spain		X	X
Sweden			X
Slovenia		X	X
Slovakia		X	
United Kingdom		X	X

Source: Own elaboration based on the information available on the European Commission website (www.ec.europa.eu)

In short, the constraints on employment and social policies imposed by the reinforcement of fiscal surveillance and the new MIP are particularly felt by euro area countries under an EDP or an in-depth report for macro-economic imbalances. However, if these member states are confronted to an "obligation of results" they can choose how to meet the goals. For the member states under an adjustment programme the situation is considerably different. The conditionality attached to the granted financial assistance implies an "obligation of means", as the Memorandum of Understanding they have signed with the Troika includes specific measures to be adopted, not least in the employment and social fields.

3.3. The impact of reinforced fiscal surveillance on national social expenditure

The reinforcement of the framework for fiscal surveillance – through the Six Pack, the Two Pack, the TSCG and the Euro Plus Pact – has entailed three main novelties.

Firstly, the revised Stability and Growth Pact (SGP) better takes into account the long term sustainability of public finances as it puts an emphasis on public debt reduction and not only, as prior to the crisis, on the public deficit target. The Treaty states that public debt should not exceed 60% of GDP, unless the debt ratio is "sufficiently diminishing" (Art. 126(2)b TFEU). The new rule – introduced by the Six Pack and confirmed by the TSCG - states that each country will have to reduce the difference between its debt level and the 60% debt target by 1/20 per year on average[28]. The non-respect of this rule will lead to an Excessive Deficit Procedure (EDP), even if the member state respects the public deficit target.

Secondly, the Six Pack, the Two Pack and the TSCG reinforce the implementation of the SGP via (i) additional and more automatic sanctions in the case of non-compliance with the rules and (ii) the introduction of a common budgetary timeline and common budgetary rules for euro area countries. In this context, new sanctions are foreseen at an earlier stage, in the preventive arm of the

28. To take into account yearly fluctuations, debt reduction will be measured on a three-year-basis.

SGP, complementing the existing sanctions of the SGP corrective arm. In addition, the sanctions are now quasi-automatic[29] to make it more difficult for member states that exceed the permitted deficit/debt levels to avoid correction. In what concerns the common budgetary timeline, euro area countries must present their draft budgets for the following year in October and the Commission will examine and give an opinion on each draft budget by the end of November. This exercise will allow the Commission to confirm that the Member states comply with their public deficit target as well as with the country-specific recommendations adopted in June. The budgets must then be adopted by the national parliaments before the end of the year.

Finally, the reform aims at reinforcing member states' ownership of the fiscal rules. To that purpose, in the TSCG member states have committed to introduce a debt brake in their national legislation[30]. They must also set-up an automatic correction mechanism triggered in the event of deviation. The Six Pack includes measures for stronger national fiscal planning, through establishing multi-annual budgetary frameworks under specific rules on accounting, reporting, statistics and numerical targets.

The stricter fiscal rules in a context of over indebtedness of the large majority of EU countries and of low or negative growth rate puts national social budgets under pressure. The real impact of the reform of EMU governance at the national level largely depends on the scope and weight of the social expenditure in the countries that are struggling and are under surveillance: social spending will be all the more affected by the EU interventions if it constitutes the main area of adjustment at the national level.

Member states are not supposed to converge on the same level or model of spending in what concerns social security, pensions or healthcare as there is no "ideal" one-size-fits-all system design. However, the strengthening of fiscal

29. In order to strengthen the preventive part of the SGP, an interest-bearing deposit should sanction significant deviations from prudent fiscal policy making. As to the corrective part of the SGP, a non-interest bearing deposit amounting to 0.2% of GDP would apply upon a decision to place a country in excessive deficit which would be converted into a fine in the event of non-compliance with the initial recommendation to correct the deficit. The sanctions are proposed by the Commission and adopted by the Council through a reverse majority principle, which means that they can only be prevented by a qualified majority of the ECOFIN voting against them.
30. Preferably in the Constitution but in any case in legislation with a permanent and binding nature.

rules (in particular via the adoption of a debt brake in national legislation), presents two main challenges to the financing of national welfare states:

- First, the impact of fiscal stringency on current social spending, in particular for member states with excessive deficit and/or debt.

- Second, the surveillance of the long-term viability of pension and healthcare systems, as they are a source of potential fiscal imbalance in the future taking into account population ageing.

3.3.1. Short-term impact on social spending

For the member states under an EDP, the need to reduce the public deficit (which requires reducing public spending at least partly) is likely to have a different impact on national welfare states depending on the level of social protection expenditure of each country. For instance, France has a higher probability to be led to reduce its social protection expenditure, which amounts to 42.6% of total public expenditure, than Cyprus that only spends 26.1% of its budget on social protection (Cf Figure 1).

In addition, the fiscal rules of the Stability and Growth Pact do not distinguish between current and investment spending. As Hemerijck states, "while all the available evidence suggests that investments in childcare and education will, in the long-run, pay for themselves, existing public finance practices consider any form of social policy spending only as pure consumption"[31]. This might entail cuts in social investment, despite the growth enhancing nature of this spending.

3.3.2. Long-term viability of social protection systems

As the impact of public social security, pension and healthcare expenditure on public finances in one member state may have serious repercussions for others, it is fundamental to guarantee the long-term viability of social security, pensions and healthcare systems across the EMU. Due to the scale of fiscal

31. Hemerijck, Anton, "The social investment imperative beyond the financial crisis", in Andor László et al., *Challenge Europe*, "Growth, well being, and social policy in Europe: trade off or synergy?" EPC, issue 21, May 2011, p. 18.

deterioration following the crisis and the decrease in economic growth rates, fiscal constraints are likely to be very strong in the next decade for the EMU. In addition, most of the euro area member states are facing serious challenges of ageing population. Consequently, in the medium term they could find themselves in difficult budgetary positions related to increased pension and healthcare spending. The aim of fiscal surveillance in this field is to guarantee the viability of social protection systems.

In this context, even if some guidance is provided at the EU/EMU level through the definition of priorities (e.g. linking the retirement age with life expectancy) and the exchange of good practices, each country remains sovereign in defining the good policy for its welfare state. Member states have different starting points, and different demographic trends, all of which must be taken into account. Each member state can define how generous it wants to be concerning the retirement age or the indemnities. The only requirement is that each member state ensures the viability of national social security systems, including pension systems.

The SGP provides the framework for monitoring the sustainability of public finances, including pension systems. Indeed, the fiscal surveillance procedure under the new SGP takes account of implicit liabilities associated with the expected deterioration of fiscal balances due to rising age-related expenditure (i.e. the cost of ageing). Apart from that, there is another, more indirect way through which the SGP might influence political choices concerning pension reforms. The code of conduct for the implementation of the SGP allows for a temporary deviation from the adjustment path to the Medium-Term Objective if a country decides to reform its pension system by partly switching from a PAYGO to a mandatory fully funded pillar system[32] (a reform which entails positive long-term budgetary effect, but has a short-term direct negative impact on the government deficit)[33]. It is clear that whether a country decides to switch from PAYGO to a fully funded system will depend on other factors, but the fact that SGP facilitates this move (by allowing a temporary deviation from the deficit objective) might encourage some countries to follow this path.

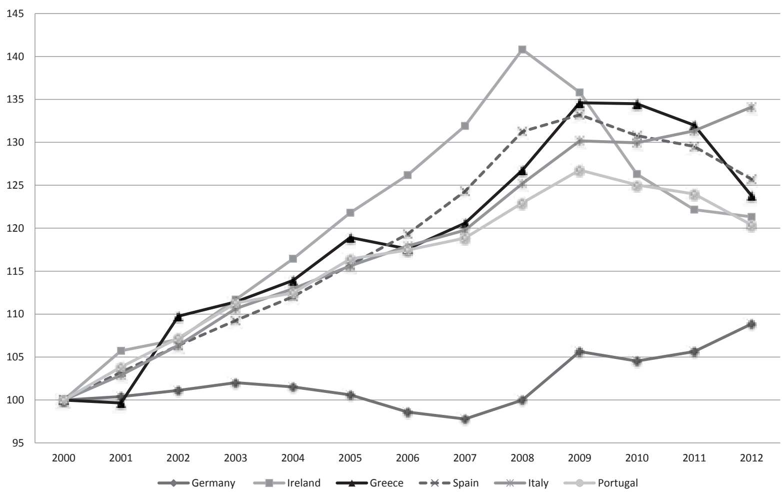
32. See European Commission, DG Ecfin, *Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes*, 3 September 2012, p. 7.

33. This is because the government, during a certain period, will have to divert some revenue to provide initial capital to the new funded system while continue to pay the pensions under the PAYGO system.

3.4. Socio-indicators in the scoreboard of the Macroeconomic Imbalances Procedure

During the first ten years of EMU, euro area countries have developed huge macroeconomic imbalances that went unchecked by the European policy process. This is especially true for the evolution of the measures of competitiveness: unit labour costs (ULC) and real exchange rates. Since the introduction of the euro, the competitiveness gap between the Northern and the Southern euro area members has soared dramatically (Figure 5).

FIGURE 5 ► Trends in unit labour costs among 'non-convergent' countries (Index 2000=100)



Source: Eurostat, Unit Labour Cost – Annual data.

The Six-Pack has introduced a new surveillance and enforcement mechanism, the Macroeconomic Imbalances Procedure. Like the SGP, this new procedure includes a preventive and a corrective arm.

In the framework of the preventive arm, an early warning system has been established, based on a scoreboard of eleven indicators covering the major sources of macro-economic imbalances (see Box 4). Whenever the indicators are breached, it triggers in-depth reports to determine whether the potential imbalances identified in the early-warning system are benign or problematic.

When the macroeconomic imbalances are considered to be harmful to EU stability, the member state has to submit a corrective plan with specific measures and implementation deadlines that are under surveillance by the Commission on the basis of regular progress reports. An enforcement regime with the possibility to impose sanctions – only in the corrective arm – is introduced for euro area member states[34].

BOX 4 ➤ Macroeconomic Imbalances Procedure Scoreboard

	EXTERNAL IMBALANCES AND COMPETITIVENESS
1	3 year average of the current account balance as a percentage of GDP, with a threshold of +6% of GDP and - 4% of GDP
2	net international investment position as a percentage of GDP, with a threshold of -35% of GDP
3	5 years percentage change of export market shares measured in values, with a threshold of -6%
4	3 years percentage change in nominal unit labour cost, with thresholds of +9% for EA countries and +12% for non-EA countries.
5	3 years percentage change of the real effective exchange rates based on HICP deflators, relative to 35 other industrial countries, with thresholds of -/+5% for euro area countries and -/+11% for non-euro-area countries
	INTERNAL IMBALANCES
6	private sector debt as a percentage of GDP with a threshold of 160%
7	private sector credit flow as a percentage of GDP with a threshold of 15%
8	year-on-year percentage change in deflated house prices, with a threshold of 6%
9	general government sector debt in % of GDP with a threshold of 60%
10	3 year average of unemployment rate, with the threshold of 10%
11	year-on-year percentage change in total financial liabilities of the financial sector, with an indicative threshold of 16.5%

Source: European Commission, MEMO-12-912, 28 November 2012

34. Like in the fiscal field, enforcement procedures are also foreseen to support the Excessive Imbalance Procedure. If a Eurozone MS fails to act on Council EIP recommendations or to present a sufficient corrective action plan to address excessive imbalances, an interest-bearing deposit can be imposed; after a second compliance failure, this interest-bearing deposit can be converted into a fine (up to 0.1% of GDP of the member state concerned).

Taking into account that labour market participation, unemployment and labour costs play a key role in macroeconomic stability, as the crisis put in evidence, these indicators have been included into the scoreboard for the surveillance of macro-economic imbalances.

The fact that "labour costs" are now monitored in the new macroeconomic procedure might have some implications for national social protection and employment systems. In particular, one country experiencing an excessive increase in labour costs can be summoned by the Commission to take "remedial action", under the menace of sanctions. As rapid increases in labour costs are often based on increases in wages (rather than increases on the employment's tax wedge), the Commission is likely to encourage this country to introduce changes in its labour market regulation so as to favour a reduction of private wages (i.e. to flexibilize its labour markets). In this respect, those countries more likely to be affected by the introduction of this "labour cost" indicator are those EMU countries having the highest levels of both employment protection and most serious problems of competitiveness (Spain, Greece, Portugal and France according to figure 3 in section 1.1).

3.5. The new crisis resolution instruments

The debt crisis led EMU member states to set-up several crisis resolution mechanisms to grant financial assistance to the member states facing severe difficulties as regards their financial stability. After two temporary mechanisms, the European Financial Stability Mechanism (community instrument) and the European Financial Stability Facility (intergovernmental instrument), the euro area member states agreed on a permanent crisis resolution mechanism, the European Stability Mechanism (see Box 5).

BOX 5 ➤ The instruments of EMU's crisis resolution capacity since 2010

Since May 2010 the EU and EMU countries have created three financial stability instruments which are worthwhile distinguishing:

- The **European Financial Stability Facility** (EFSF): a temporary intergovernmental instrument set up in 2010 for a period of three years. It borrows money on the capital markets on the basis of guarantees issued by the 17 euro area member countries. It has an effective lending capacity of 440 billion euro;
- The **European Financial Stability Mechanism** (EFSM): an instrument set up at the same time as the EFSF in 2010. It allows the European Commission to borrow money on the capital markets using the EU budget as guarantee. It has a borrowing capacity of 60 billion euro;
- The **European Stability Mechanism** (ESM): a permanent intergovernmental instrument which came into force in July 2012. It can borrow money on the basis of its own capital comprised of payments from the 17 euro area member countries (80 billion) and of a callable capital of 620 billion euro. It will have an effective lending capacity of 500 billion euro.

While the member states suffering from fiscal or macroeconomic imbalances could be affected by an indirect impact of the corrective measures on their employment and social policies, the situation is much more serious for the member states that benefited from EMU's crisis resolution mechanism (Greece, Ireland, Portugal and Cyprus so far).

Member states that receive financial assistance from the ESM (or previously from the EFSM and the EFSF) need to adopt a macroeconomic and fiscal adjustment programme. In this context, they are subject to tighter monitoring ("enhanced surveillance"), by the Commission in liaison with the ECB, which goes further than the requirements for member states under an EDP. The monitoring is based on an obligation to communicate information to the Commission and allow assessments to be made about the content and direction of fiscal policy at any point. Against this background, and as presented in table 4 (chapter 4), these countries have to adopt several concrete measures agreed with the Troïka to reduce their public spending, including in the social field. For those member states, the impact is much more direct than the "soft" coordination of employment and social policies.

Initially, this "enhanced surveillance" was applied on an "ad hoc" basis, but since May 2013 the monitoring and surveillance procedures for member states receiving financial assistance are enshrined in EU secondary law through one of the regulations of the Two Pack. This regulation foresees that the strength and intrusiveness of the provisions of the adjustment programmes will depend on the severity of the situation. Moreover, it sets out a new system of post-programme surveillance: until they have paid back a minimum of 75% of the assistance received, member states will remain subject to a number of the new enhanced surveillance provisions.

4. The impact of the global economic crisis on EU welfare states

As seen in the precedent chapter, the recent reform of the EU economic governance will undoubtedly have direct or indirect impact on national social and employment policies. It is, however, important to take into account that during the recent years these policies have been also strongly affected by the consequences of the global economic and financial crisis. The latter has not only entailed a significant deterioration of the social situation of large groups of people, but it has put the financing of welfare policies under considerable strain.

In this chapter, we offer a general overview of the social consequences of the crisis on EU member states. The first section analyses how the crisis has led to growing divergences between the member states in terms of economic performance and social outcomes (4.1.). The second section explores in more detail the impact of the crisis in EMU periphery countries, and in particular on their welfare and labour market structures (4.2.). Finally, we briefly review the main reforms catalysed by the crisis in pension systems, labour market regulations and wage-setting structures (4.3).

4.1. Growing divergences between member states

Since the beginning of the crisis in 2008, virtually all of the EU member states have been touched by its negative consequences, both economic and social. The targets of Europe 2020 have been brushed away as many member states have not reached any progress on their national targets[35]. For example, the majority of member states have not only failed to achieve their yearly national poverty and social exclusion targets, but have also witnessed an increasing number of people at risk.

35. European Commission, Directorate-General for Employment, Social Affairs and Inclusion, *Employment and social development in Europe 2012*, Luxembourg: Publications Office of the European Union, November 2012.

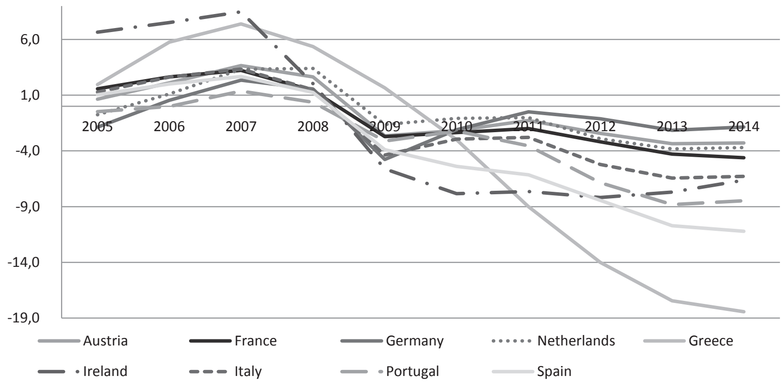
The latest statistical data suggests that euro area countries come off a little worse than the EU average. In 2012, the GDP of the euro area contracted by the average rate of 0.6% whereas in the whole of the EU the loss was half as large (-0.3% vs. -0.6%). The forecasts for the year 2013 suggest that the EU economy will return to slight growth (0.1%) whereas the euro area will stay in recession (-0.3%)[36]. The same pattern is valid for unemployment rates. In August 2013, the unemployment rates reached 10.9% in the EU and soared to 12% in the euro area[37]. These differences are rather small, yet they do suggest that, on average, euro area member states are struggling more to overcome the crisis.

What is striking about the evolution of the crisis is the fact that the general picture of the euro area member states has been changing too. Marked divergences between the ability of EU welfare state types to deal with shocks are particularly dangerous for the euro area because the common monetary policy can only address "average euro area-wide developments". Yet, the divergences in terms of economic performance and resulting social outcomes between euro area member states have been increasing. Indeed, the crisis has divided the EMU into two blocks, the "core" and the "periphery", which has de facto regrouped the welfare state types into two clusters. EMU member states of Mediterranean and Anglo-Saxon type (and to some extent the new member states) have become commonly referred to as "periphery", whereas the "core" of the euro area has been clearly confined to the Continental states and Finland.

The divergence in economic performance between the two blocs is illustrated in Figure 6. The figure shows that in 2008-2009 both "core" and "periphery" countries have experienced negative shocks as measured by output gap. Yet, while the core countries have bounced back, the actual output of the periphery has been deviating even further from the economy's productive potential.

36. European Commission, *European Economic Forecast - Winter 2013*, 2013.
37. Eurostat Database, 2013.

FIGURE 6 ► **Divergence in economic performance (measured by output gap in selected countries)**

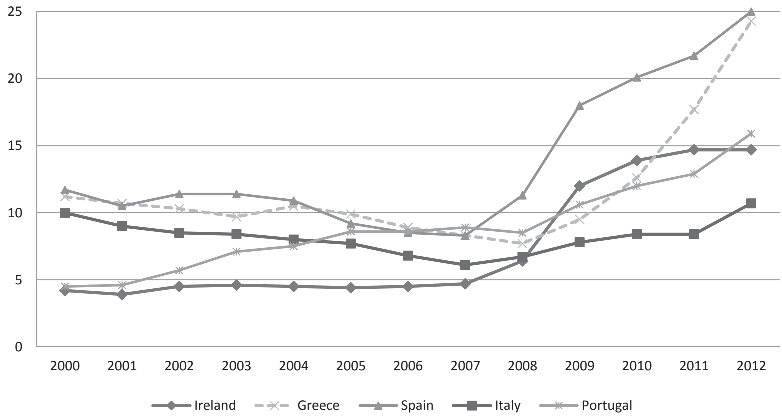


(Projections for 2013, 2014)
Source: OECD Economic Outlook, Volume 2012 Issue 2 - No. 92.

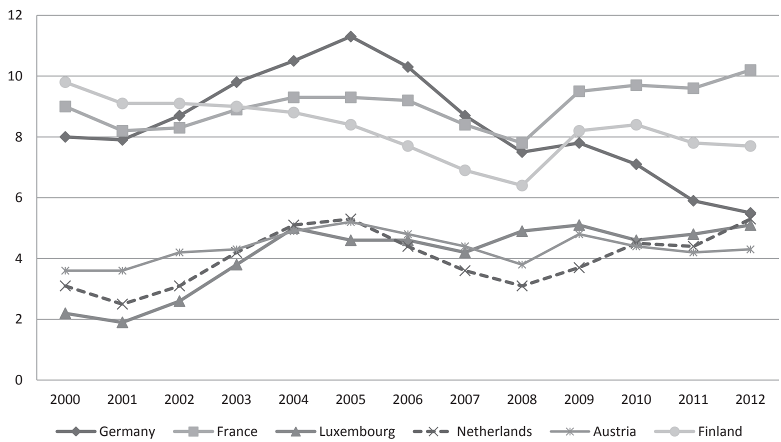
The divergences in economic performance have been matched by marked differences as regards the social consequences of the crisis. A widening social gap between the euro area periphery and the rest of the euro area countries has been emerging during the past few years. Figure 7 clearly shows the extent of these divergences in terms of unemployment rates. In the core countries (figure 7b), unemployment rate has slightly increased in 2009, but has remained stable or decreasing in the subsequent years. In addition, the unemployment rate has been contained under the 10% threshold. In the peripheral countries (figure 7a), the situation has been quite similar to the core in the years preceding the crisis. However, from 2008, the unemployment rate has been continuously rising reaching the 25% threshold in Spain and in Greece. The persistence in the upward trend in the periphery is alarming as well.

FIGURE 7 ► Unemployment Rate (for age groups 15-74, annual average)

a) Unemployment rate in EMU "periphery"



b) Unemployment rate in EMU "core"

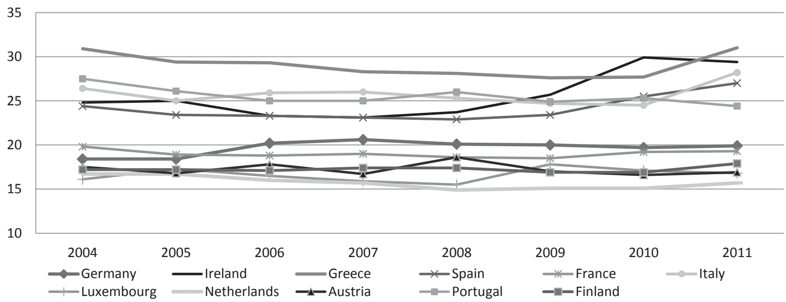


Sources: Eurostat

Other indicators are also pointing towards growing EMU divergences in the social domain. Figure 8 shows that the proportion of people at risk of poverty or social exclusion has been higher in the peripheral countries than in the core even before the crisis. Yet, during the crisis, the rates in the core countries have largely remained stable. In contrast, the poverty rates have been increasing in all of the peripheral countries, except Portugal. Figure 9 further suggests that final household consumption has been suffering particularly strongly in the peripheral countries (figure 9a). This is especially true for the year 2012 when Italian, Portuguese and Greek households lost approximately 5 to 10% of their consumption (data for Ireland and Spain is not yet available for this year). In most of the core countries (figure 9b), except for the Netherlands, the household consumption has jumped back to pre-crisis levels already.

All in all, the crisis has had a negative social impact in the majority of the EMU member states. Yet, the core member states have managed to adjust relatively quickly and limit the consequences of the economic downturn on national populations. The situation in the peripheral member states is much more worrying as the social indicators have been deteriorating ever since the crisis began. These unequal developments contribute to the widening gap between the two groups of member states, a gap that might not be sustainable in a common currency area.

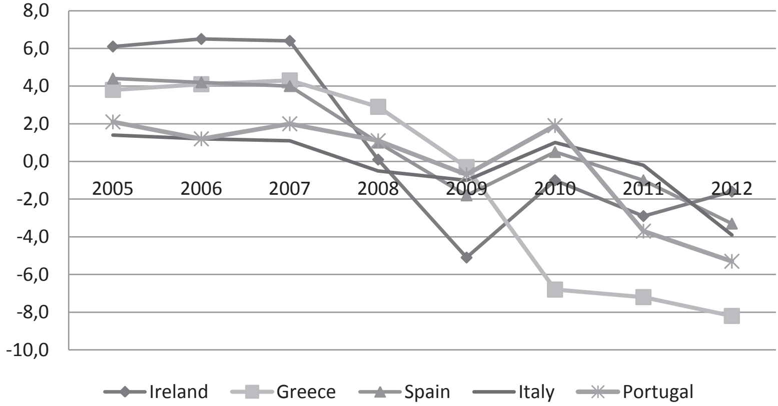
FIGURE 8 ► People at risk of poverty or social exclusion (% of total population)



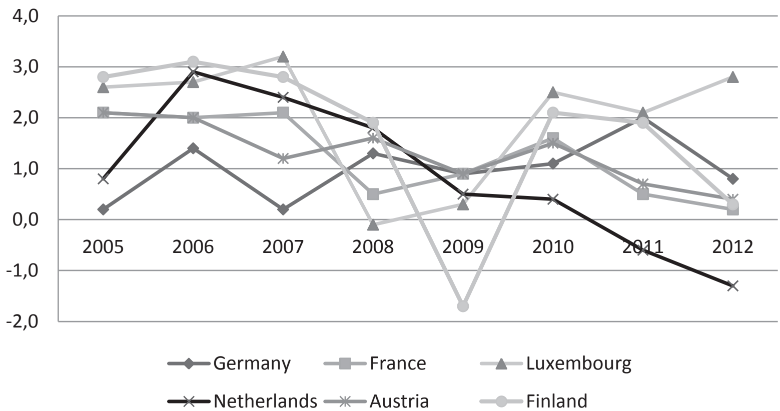
Source: Eurostat

FIGURE 9 ► Final expenditure of households

a) Final expenditure of households in EMU "periphery" (% change)



b) Final expenditure of households in EMU "core" (% change)



Sources: Eurostat

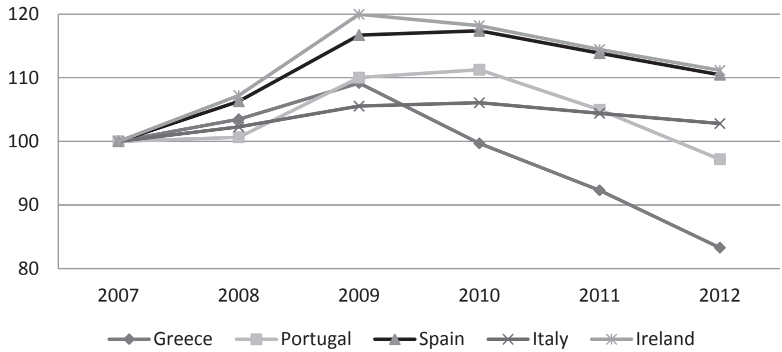
4.2. Social policies as the adjustment variable in the euro area periphery

The social impact of the crisis has been uneven for three reasons. Firstly, as discussed in previous section, the recession in various member states has not hit with the same strength. As a direct consequence, the levels of unemployment have soared to record levels only in those countries where the economic activity has contracted the most. Secondly, and more importantly, automatic stabilisers have not been functioning in a similar manner in all of the member states. Differences in social models and generosity of welfare benefits imply that, *ceteris paribus*, member states hit by the same shock will have unequal capacity of "cushioning" it. Thirdly, a group of EMU member states have been forced by the markets to apply major fiscal consolidation strategies, which have constrained the normal functioning of these automatic stabilizers even where they were in place.

Data on public social spending illustrates these proposals. According to the estimates of the OECD[38], in the whole of the EU, aggregate real public social spending has neither increased nor diminished during the crisis years of 2011 and 2012. However, the aggregate trend hides important disparities between the member states. Figures 10 and 11 reveal that core and peripheral EMU countries have displayed contrasted trends in social spending. Whereas in the core countries real social spending has slightly increased or was maintained at the same levels over the past four years, the peripheral EMU countries have experienced a real decline in social spending since 2009. The decline has been particularly marked in Greece (where social spending is now 16% lower than in 2007) and in Portugal (3% lower than in 2007). In the other three peripheral EMU countries, welfare cuts have been partly offset by increases in entitlement-based social programs (unemployment, pensions) and it remains still slightly higher than in 2007.

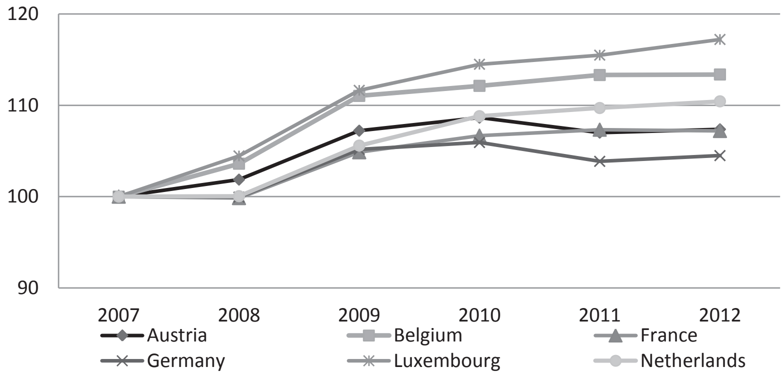
38. OECD social expenditure database (SOCX).

FIGURE 10 ► Changes in real public social spending in core EMU countries (Index 2007=100)



Source: OECD social expenditure database (SOCX). Public social expenditures calculated for 2010 and 2011 and estimated for 2012, on the basis of the European Union Annual Macro-Economic database (AMECO) as at May 2012.

FIGURE 11 ► Changes in real public social spending in peripheral EMU countries (Index 2007=100)



Source: idem

The peculiarity of many peripheral member states is that they have been forced to implement harsh austerity programmes. Some measures taken such as the reduction of cash benefits and pensions were explicitly aimed at improving the state of public finances while others such as the reduction of minimum wages have been aimed at boosting national cost competitiveness. Table 4 compares the austerity packages adopted by the four peripheral EMU countries most hit by the crisis (Greece, Ireland, Portugal and Spain). The aim of this table is to illustrate the extent to which social policies have been used as an adjustment variable in the euro area periphery, yet the list is by no means exhaustive.

First of all, the table suggests that minimum wages and public wages have not been spared in any of the four countries. Minimum wages have been slashed significantly in Greece (by 20%) and in Ireland (by 1euro/hour) and frozen in Portugal and Spain. As minimum wages often concern the most vulnerable part of the labour force, these measures have been undoubtedly related to the growing levels of poverty as discussed in the previous section. Similarly, public sector wages have been cut in all of the member states. In Ireland the cuts ranged between 5 and 15% whereas in Greece, Spain and Portugal the public servants earning above a certain threshold have lost additional months of payment (at least temporarily).

Pensions, other social transfers and healthcare expenditure have also suffered in all of the member states. Pensions have been frozen and/or cut in all countries except Ireland. This is not surprising, as Ireland has one of the least expensive and least generous public pension systems in the EU[39]. In Greece, however, pensions have been significantly reduced in order to correct the lingering inefficiencies of the Greek pension system, which represents the first budget line of total general government expenditure on social protection in 2011 (14.7%). In terms of other social benefits, cuts have been introduced in all of the four countries and access conditions have been tightened. Healthcare services have become more expensive in all of the member states as the co-payments have been increased.

All in all, various social entitlements have been reduced or lost altogether in the peripheral member states in the pursuit of austerity and adjustment. The social cost of "internal adjustment" has, therefore, been extremely high for the countries already suffering from a negative economic shock.

39. Ireland spent 5,1 % of its GDP in public pensions in 2007, the lowest percentage in the EU. For more details on the Irish pension system see OECD, *Pensions at a glance. Retirement Income systems in OECD countries and G-20 countries*, Paris: OECD, 2011.

TABLE 4 ► Main measures to reduce social spending adopted in Greece, Ireland, Portugal, and Spain during 2009-2013 (April 2013)

	GREECE	IRELAND
Minimum wages	– approx. 20% cut in all minimum wages;	– reduction by €1 per hour of national minimum wage; – abolition of several sector-specific minimum wage;
Public sector salaries	– freeze of all public sector salaries; – cut of 13th and 14th monthly salary (for gross salaries above €3000/month) ; – reduced allowances; – further elimination of seasonal bonuses.	– cut of public sector wages between 5% and 15%; – substantial reduction of civil servants.
Pensions	– all pensions frozen during 2010-2013; – increased general retirement age to 67; – reduction of overall monthly pension incomes and introduction of a special contribution tax on pensions; – elimination of all seasonal bonuses.	– pension-related deduction with rates ranging from 0% to 10.5%; – progressive increase in state pension age from 65 to 68 by 2028; – raise of number of pension contribution years; – future calculation of pensions on average lifetime income.
Social transfers	– cuts in social transfers such as unemployment benefits; – eligibility conditions for social assistance benefits tightened; – family benefits subject to means-testing.	– cuts in social transfers such as unemployment, sickness, universal child benefits, and working age payments; – penalty measures for beneficiaries not in compliance with job-search.
Healthcare expenditure	– reduction of operational cost for hospitals; – increased co-payments; – reduction of administrative and physicians staff.	– increased co-payments; – tightening of eligibility criteria; – provisions to charge all private patients in public hospitals.

Sources: For Greece, Ireland and Portugal: Economic adjustment programs and Reviews of the economic adjustment programs (ECFIN Occasional Papers). For Spain: Spanish Stability Programmes 2011-2014 and 2012-2015, press releases provided by the Spanish government.

4.3. The crisis as a catalyst of pension and labour market reforms

The crisis has not only affected spending trends, but it has also acted as a catalyst for major structural reforms in pension systems and labour markets. The aim of this section is to illustrate the extent of such reforms without making any normative judgements.

In the area of pensions, fiscal consolidation concerns have prompted the introduction of reforms aimed at ensuring the long-term fiscal sustainability of public pension schemes. Table 5 summarises the changes introduced into EU pension systems between 2008 and 2012. As can be observed, most EU governments (22 out of 27) have extended the legal or minimum retirement ages over the last years, or have announced the intention to do so. Many have tightened the conditions for early retirement, and/or have introduced different parametric changes in their public PAYGO pension schemes to better align contributions and pension benefits (for example: extension of the contributory period, increase of contributory rates, and changes in the indexation rules).

Three points should be highlighted concerning table 5. First, only three EU countries (Sweden, Slovakia and Slovenia) have not reformed their pension systems over the last years. All three countries have pension systems grounded to a great extent on (quasi) mandatory private funded schemes[40]. Second, in EMU countries under an adjustment programme, the reform of the pension system has been part of the conditions imposed by the Memorandum of Understanding signed with the IMF and the EU. This is particularly the case in Greece, which had one of the most expensive, inequitable and inefficient pension system in the EU before the crisis, and which has been obliged by the Troika to undertake a major overhaul of its pension system. Finally, to a great extent the crisis has accelerated a path of reform that was already in place. In effect, during the 1990s and 2000s, most EU countries had already introduced parametric changes to ensure the long-term fiscal sustainability of PAYGO pension systems. In this respect, the crisis has just put more urgency to these reforms, prompting EU governments to advance the implementation of already approved reforms or to complement the steps already taken.

40. OECD, *Pensions at a glance. Retirement Income systems in OECD countries and G-20 countries*, Paris: OECD,2011.

In the labour market area since 2010 virtually all EU member states have introduced structural measures to flexibilise their labour markets. Four main trends can be identified (Table 6). First, many EU countries have decentralized wage-setting structures or have introduced other changes in the industrial relations' structures in order to give firms more flexibility to adjust wages and other labour market conditions. Second, there has been a general trend towards reforming individual and collective redundancy rules, so as to give firms greater autonomy in dismissing workers and/or reducing the costs of lay-offs. Third, many EU countries have also introduced reforms in their working time legislation, with the aim of facilitating overtime or on the contrary, allowing companies in financial difficulty to reduce working time on a temporary basis. Finally, practically all EU countries have eased the rules governing the use of atypical contracts (mostly fixed-term contracts) or have created new types of contracts offering less protection than normal contracts, in particular for young people.

As for pensions, labour market reforms have been sometimes imposed by the Memorandum of Understanding signed with the IMF and the EU. In this respect, it is not surprising to find that four of the EU countries having received financial assistance (Hungary, Romania, Greece and Portugal) are among those having approved more labour market reforms over the past years.

TABLE 5 ► Reforms introduced in EU pension systems, 2008-2012

	INCREASE LEGAL AND/OR MINIMUM RETIREMENT AGE	TIGHTEN CONDITIONS FOR EARLY RETIREMENT	INTRODUCTION OF MECHANISM TO INDEX THE RETIREMENT AGE TO LIFE EXPECTANCY
Austria		X	
Belgium	X	X	
Bulgaria	X		
Cyprus			
Czech Republic	X	X	
Germany[42]	X		
Denmark	X		X
Estonia	X		
Greece	X	X	X
Spain	X	X	
Finland	X		
France	X		
Hungary	X	X	
Ireland	X		
Italy	X	X	X
Lithuania	X		
Luxembourg	(X)		
Latvia	(X)		
Malta2	X		(X)
Netherlands	X		X
Poland	(X)		
Portugal2	X	X	
Romania	X	X	
Sweden			
Slovenia			
Slovakia			
United Kingdom	X		

41. Clause establishing an automatic link between the generosity of the pension system and the financial balance of the pension scheme.
42. Reforms introduced in 2007 (Germany and Portugal) and 2006 (Malta); (x) = measures which have been announced but not yet approved, or which are under discussion in the parliament.

Source: European Commission, An Agenda for Adequate, Safe and Sustainable Pensions/White Paper, COM (2012) 55 final, 16 February 2012.

TABLE 6 ► **Approved and/or adopted reforms in industrial relations/collective bargaining systems and certain aspects of labour law, 2010-2012**

	REFORM OF INDUSTRIAL RELATIONS AND COLLECTIVE BARGAINING SYSTEMS	CHANGES TO INDIVIDUAL/ COLLECTIVE DISMISSAL RULES	CHANGES TO WORKING TIME LEGISLATION	CHANGES TO RULES ON ATYPICAL CONTRACTS -	CREATION OF NEW TYPES OF CONTRACTS, IN PARTICULAR FOR YOUNG PEOPLE (X2)
Austria					
Belgium		X	X		X2
Bulgaria	X				X2
Cyprus		X			
Czech Republic		X	X		X
Germany			X	X	
Denmark					
Estonia					
Greece	X	X	X		X2
Spain	X	X	X	X	X2
Finland					
France					X2
Hungary	X	X	X		X2
Ireland	X				
Italy	X	X			X2
Lithuania		X	X	X	
Luxembourg			X		X2
Latvia		X		X	
Malta					
Netherlands	X			X	
Poland	X		X		X
Portugal	X	X	X	X	
Romania	X	X	X	X	X2
Sweden			X		X2
Slovenia			X		X
Slovakia	X	X	X		X
United Kingdom		X	X	X	

Source: Clauwaert, Stefan and Schömann, Isabelle, *"The Crisis and National Law Reforms: A Mapping Exercise"*, ETUI working paper, Brussels, No 04, 2012.

PART II
THE SOCIAL DIMENSION OF A GENUINE ECONOMIC AND MONETARY UNION

1. Why must the EMU have a social dimension?

The first part of the study has given an overview of the state of Social Europe today and proved that fundamental changes in terms of social policies and increasing social gaps are under way. Building on this analysis, the second part of the study suggests a prospective outlook for the future of the euro area. It is devoted to construct likely future scenarios for the EMU based on credible assumptions.

In this chapter, we start by analysing whether the EU's or the EMU's social dimension should be reinforced (1.1); we then go on to the theoretical (functional and political) reasons for a reinforced EMU's social dimension (1.2) and we finally present some considerations on the relationship between Social Europe and EMU's social dimension (1.3.).

1.1. A case for a reinforced social dimension for the EU28

There are three main arguments in favour of reinforcing EU's social dimension.

First of all, Social Europe is needed to balance the effects of the completion of the single market. With its four freedoms of movement of goods, services, and capital, the single market might trigger social and fiscal competition as well as "welfare shopping" between the member states. Intensified intra-EU competition creates the risk of a "race to the bottom", whereby the member states with lowest social standards become the most competitive in terms of production costs. Such developments go against the founding principle of ensuring social progress in the EU; therefore, one might argue that the social consequences of the single market should be better taken into account. As a result, current efforts to deepen the single market should be complemented with actions aimed at ensuring that further economic integration does not undermine the foundations of national social protection systems. For these reasons, in its 2010 report already Mario Monti pointed out that in order to relaunch the single market, member states needed a compromise, which should rest on an "appropriate reconciliation" of Europe's economic and social policies[43].

Secondly, developing the social dimension for EU28 is needed for sustaining public support and democratic legitimacy of the European integration. According to Jürgen Habermas, "the only remaining project for which political mobilisation is possible consists in protecting a "European way of life" against the pressures of globalisation"[44]. However, today citizens in many countries feel that "the EU's (primarily economic) project has not been beneficial to them and that indeed it may be endangering the social standards they aspire to"[45].9 This is even more relevant in the context of today's declining prosperity today and decreasing support for European integration in many member states[46].

Finally, against the backdrop of the current financial, economic and social crisis, there is a need to counteract the effects of the crisis and of national austerity policies by a more resolute EU-level action to promote sustainable growth, employment and social investment. After all, the respect of the values associated with the European Social Model, which include – as mentioned in the White Paper of the European Commission from 1994 - "democracy and individual rights, free collective bargaining, the market economy, equality of opportunity for all and social welfare and solidarity"[47], should be ensured both in good times and in times of economic downturn.

For all these reasons, the case for reinforcing EU's social dimension seems to be strong. The immediate question that needs to be answered then is whether reinforcing EMU's social dimension on the top of what is (or should be) under-

taken at the EU level is desirable, necessary and feasible.

43. Monti, Mario, Report to the President of the European Commission José Manuel Barroso, "A new strategy for the single market, at the service of europe's economy and society", 9 May 2010.
44. Jürgen Habermas quoted in Vandenbroucke, Frank, "Europe: The Social Challenge Defining the Union's social objective is a necessity rather than a luxury," *Obervatoire Social Européen*, Opinion Paper No. 11, July 2012, p.21.
45. Marlier, Eric and Natali, David, *Europe 2020: Towards a More Social EU*, Brussels: Peter Lang, 2010, p. 34.
46. Debomy, Daniel, "EU no, Euro yes? European public opinions facing the crisis (2007-2012)", Policy paper n°90, *Notre Europe – Jacques Delors Institute*, March 2013.
47. European Commission, "European Social Policy – A Way Forward for the Union" White Paper, 1994, p.2.

1.2. Reasons for a new EMU's social dimension

While it is true that the challenges mentioned above apply to EMU as much as they do to the EU as a whole, they might be much more amplified in a common currency area in which further challenges might emerge.

We can distinguish two sets of arguments why the economic, fiscal, banking and political union in the euro area should be completed with a social dimension: a functional one, related to EMU's long term sustainability; and a political one, concerning EMU's legitimacy. These two sets of arguments are the two sides of the same coin, as reinforcing EMU's legitimacy and citizens' support is also a matter of sustainability for the EMU.

Indeed, if the common currency is perceived by European citizens as a threat to national welfare states tradition, the political support for the Euro will fade away, thus putting at risk the long-term sustainability of the project.

1.2.1. Functional arguments: a social dimension for a more sustainable EMU

The theory of Optimal currency area (OCA) is useful for understanding how a social dimension could help improve the functioning of the EMU. According to this theory, good functioning of a common currency zone requires a certain degree of symmetry between the economies pertaining to the union. If the level of symmetry is not very high, the latter can be compensated by either the existence of adjustment mechanisms (flexibility) or a sufficient centralized fiscal capacity[48].

The criterion of symmetry means that national or regional business cycles should be strongly correlated between the members of the common currency area, so as to reduce the risk of asymmetric shocks (be they exogenous – resulting from external factors, or endogenous – resulting from the asymmetric impact of the common monetary policy)[49]. When there are major structural differences within a currency area, just like in the EMU, these can still be

48. De Grauwe, Paul, *The Economics of Monetary Union*, Seventh Edition, Oxford: Oxford University Press, 2007.
49. For an explanation of the distinction between exogenous and endogenous asymmetric schoks, see Enderlein, Henrik, et al., "Completing the Euro: A road map towards fiscal union in Europe", Report of the Tommaso Padoa-Schioppa Group, Study n° 92, Paris: *Notre Europe - Jacques Delors Institute*, June 2012, p. 26.

reduced through the surveillance and coordination of macro-economic policies, including those concerning the labour market. In addition, some believe that symmetry could also be enhanced by stronger a social policy convergence in areas such as education or life-long learning, all of which have a significant impact on member states' competitiveness[50].

Yet, even by putting into place effective mechanisms of surveillance and policy coordination, the cyclical divergences within the EMU are unlikely to disappear. As member states have different industrial structures and specializations (which is positive as these constitute the source of welfare gains within the union), asymmetric shocks are bound to occur. That is why the EMU needs to be equipped with certain mechanisms to deal with them whenever they occur. According to OCA theory, there are basically two types of instruments that could address these cyclical divergences in a currency area: market-based instruments, such as labour mobility as well as price and wage flexibility; and institutional instruments, via a fiscal stabilization mechanism.

Flexibility relates to wage and price flexibility as well as labour mobility, all of which determine the "internal" adjustment capacity of euro area member states in case of cyclical divergences. Wage and price flexibility are important mechanisms of adjustment. Whenever a major asymmetric shock occurs, a rapid change in wages and prices might be necessary to adjust competitiveness. Yet, as noted by Vandenbroucke, the choice for flexibility is not socially neutral[51]. Normally, "wage flexibility" refers to adjustment processes that are rather painful and difficult, including direct nominal pay cuts or relaxing dismissal procedures. Thus, while necessary in case of a major shock, from a social perspective, it is preferable to make use of alternative mechanisms of internal adjustment.

In particular, labour mobility within a currency area can play a crucial role in enhancing the functioning of the single currency, by allowing workers from a country hit by a negative shock to relocate to the countries experiencing a positive shock. Nevertheless, despite the right of free movement of people in the EU, today only 3% of working-age EU citizens live in a different EU country.

50. Vandenbroucke, Frank, "Europe: The Social Challenge Defining the Union's social objective is a necessity rather than a luxury", *op. cit.*
51. *Ibid*, p. 14

This points to an uncomfortable fact that even though labor mobility needs to be reinforced in the euro area, it is hard to expect that it can be a sufficient instrument to address cyclical divergences in the common currency area.

Finally, the lack of symmetry and/or of flexibility in a common currency area can be compensated by settingup a centralised fiscal capacity which would give a possibility to absorb asymmetric shocks through budgetary transfers across the members of the currency area. This solution seems to be particularly appropriate in the EMU, given that low levels of cross-country labour mobility and structural impediments to price flexibility make market-based adjustment mechanisms less effective than in other monetary unions.

All these arguments are relevant if we want to construct an EMU's social dimension that is not only politically profitable, but also functionally meaningful. As it will be discussed in section 2, social policies, or social dimension, can contribute significantly to making the euro area a more optimal currency union as defined by the OCA theory.

1.2.2. Political arguments: a social dimension for a more legitimate EMU

A social dimension of the EMU also lies on political arguments. Even if some initiatives on employment and social fields are not fundamental for the good functioning of the EMU stricto sensu, they might be judged appropriate in order to avoid certain politically "undesirable" consequences of the EMU on national welfare systems. Indeed, the common currency has two main potentially negative effects on national social policies.

First, the risk of social dumping is higher in the EMU than it is in the EU because EMU member states can no longer compensate for a loss in competitiveness by bringing down their exchange rate and are forced to compete in direct labour costs[52]. In addition, the reformed EMU as it is being constructed today will become even more economically open with increased movement of labour, goods, services and capital within the euro area. The risk of social competition between the member states will thus be greater. Naturally, some

52. Thillaye, Renaud, "Gearing EU Governance towards Future Growth. The side-lining of Europe 2020 and its worrying consequences", *Policy Network paper*, March 2013.

competition between the governments is welcome if it leads to the improvement of functioning of the public sector (competition in “quality”). However, competition in social standards aiming at reducing the cost of production may lead to the bad equilibrium of the “race to the bottom” between the member states.

Second, there is an increased risk of drastic “social dismantlement” in any EMU country affected by an asymmetric shock as the EMU today is still lacking adjustment mechanisms to mitigate these shocks. Consequently, social standards might be used as factors of adjustment. With no control over exchange rates and increasingly limited scope for fiscal policies, the number of macroeconomic policy tools available to the national governments is reduced. In the absence of agreed common rules, the temptation and the necessity to sacrifice social standards for economic adjustment might thus become more evident. As Commissioner Andor puts it, EMU needs to establish certain social policy benchmarks, which “would represent a safeguard that employment and social outcomes are not simply treated as residual variables in the process of macroeconomic adjustment”[53].

Avoiding these two risks is fundamental for guaranteeing the EMU’s legitimacy. EMU citizens will only support the EMU if it can ensure rather than threaten the principles of social justice and social progress. In this context, the construction of the EMU must prevent social dumping and promote common shared values in the euro area.

1.3. Connecting Social Europe to EMU’s social dimension

The arguments presented above point to a fact that the first-best scenario for reinforcing the social dimension in Europe would consist of a comprehensive agreement at the EU28 level. For the purposes of legitimacy, social issues should be placed at the heart of European integration with all member states doing their utmost to preserve the European social values. In addition, an agreement on the EU28 level would prevent the emergence of social

53. Andor, László, “Looking Forward: Social Investment as a way out of the crisis”, speech at the Eurofound forum, Dublin, 15 February 2013.

competition between EMU and non-EMU countries. However, a far-reaching agreement will certainly be hard to achieve, given the differences between national welfare states and the reluctance of some member states to cede more power and competences to the EU level in this field.

If reinforcing the social dimension at the EU28 level is desirable, but less feasible, more social integration on the EMU level is necessary and should be more feasible. The euro area represents a smaller group of countries than the EU as a whole and reinforcing the EMU's social dimension is a much more urgent task (as argued in section 5.2). In addition, because some problems are particular to the countries sharing the same currency (such as the risk of "social dismantlement" due to the lack of adjustment mechanisms to asymmetric shocks), additional initiatives in the social field at the EMU level would still be necessary even if all EU28 member states agreed to move towards more integration in the social field.

Euro area countries should, therefore, take the driving seat in reinforcing Social Europe. Of course, voluntary participation of non-EMU countries should be allowed, if not encouraged, in all new initiatives. To illustrate this proposal, a parallel with the banking union could be drawn: even though it would be desirable to build a banking union at the EU level, but as this is "too high an ambition to be practical, at least for the foreseeable future" and as it is "urgently needed" at the EMU level[54], EMU countries are taking the front lead, but their initiative is open to the participation of all EU countries. The same logic could be adopted for the reinforcement of "Social Europe".

One can argue that such developments could potentially lead to a two-tier Europe as the EMU countries engage in more surveillance and coordination in the social field and develop new instruments to promote social justice and social progress. In this way, the risk of social competition between euro area and non-euro area countries could be aggravated.

However, one should also keep in mind that even if this risk is present, the current situation of a weak overall social dimension, both on EMU and on EU

54. Pisani-Ferry Jean., Sapir André., Véron Nicolas and Wolff Guntram B., "What kind of European banking union?", *Bruegel*, Issue 2012/12, June 2012.

levels, is the least optimal one. Social fragmentation enables social competition between individual member states and many national welfare states are under pressure while social policies are treated as adjustment mechanisms to the negative economic shocks. A similar logic of avoiding the worst-case scenario already applies to other new European initiatives, such as the creation of the Financial Transaction Tax, despite the fact that they might lead to increased competition between the “ins” and the “outs”.

Finally, we cannot forget that the common currency is part of the “acquis communautaire”. As a consequence, all EU countries are expected to join in, except for the UK and Denmark which benefited from an opt-out when the single currency was established. Therefore, in a longer term, improving EMU’s social dimension directly concerns 26 out of 28 member states and not only 17.

2. EMU's reinforcement: where are we heading?

Member states have taken important action in the last four years to avoid the euro area break-up and make the EMU more resilient to future crises. As presented in part 1 of this study, the EMU developed a permanent crisis resolution capacity, the European Stability Mechanism, and improved its crisis prevention capacity via the reinforcement of fiscal and macroeconomic surveillance.

However, the action undertaken so far is not sufficient to ensure the long-term sustainability of the EMU and its prosperity.

In this chapter, we start by outlining the main challenges that the EMU is facing today (2.1.) and present the structure and rationale of three stylized scenarios that we will develop in the last three chapters of this study (2.2).

2.1. Main challenges for the EMU today

The EMU today faces numerous short term and medium/long term challenges. Some of these challenges are specific to the EMU, but certain of them are common to the EU as a whole. Clear understanding of these challenges is crucial for plausible construction of future scenarios for the EMU.

In the **short-term**, the euro area member states face two main challenges.

The first challenge is to ensure **growth, employment and social welfare** across the euro area. To that purpose, member states need to review their policy agenda in order to get to a better balance between the three variables for economic recovery: growth, fiscal adjustment and structural reforms[55]. So far, austerity measures have taken precedence over measures to stimulate growth whereas social and employment policies have been treated as "adjustment variables" in the national adjustment programmes. As a consequence,

55. Diamantopoulou, Anna, " A new path of growth and solidarity ," *Notre Europe-Jacques Delors Institute*, *tribune*, December 2012.

most EMU member states were unable to relaunch growth and are facing high levels of unemployment. The challenge thus is to make a sustainable path of public debt reduction compatible with the return to growth and job creation in all EMU countries. Structural reforms are of central importance in order to address the differences of competitiveness across the euro area and as such they should be encouraged; however, as outlined by Pisani-Ferry et al, rebalancing should involve Northern Europe as well as Southern Europe[56].

The second challenge concerns the **financial sector**. The crisis led to a tightening of bank financing conditions for SMEs and households in the peripheral EMU countries. It is fundamental to ensure that in the short term credit supply meets the real economy's needs at affordable interest rates all over the euro area. This is a pre-requisite for economic recovery and job creation. Member states then must adopt the necessary measures in terms of banking regulation, supervision and crisis resolution in order to ensure financial stability all over the euro area. In this context, the link between sovereign and banking crisis, which is one of the root causes of the current crisis, needs to be broken.

In the **medium/long term**, four additional challenges remain.

First, in addition to the urgent need for economic recovery, member states also have to ensure the transition to **a new more knowledge-intensive and less carbon-intensive growth model**, adapting structures to and preparing people for new jobs. This transition requires an important amount of new investments and of structural reforms – in business framework conditions, labour markets, social protection, education, as well as innovation systems - which should be better coordinated at the European level, because they have many spill-over effects. The issue is of utmost importance bearing in mind that one of the probable legacies of the current crisis will be widening EMU divergences. As a consequence, the co-existence of "low cost" and "high cost" EMU economies will translate into greater risk of social and fiscal dumping.

56. Pisani-Ferry, Jean, "Europe's banks need to be recapitalised – now", Financial Times, April 15th 2013 : "Consistent with the ECB mandate, average inflation in the eurozone should be close to the 2 per cent target yet inflation expectations have fallen to well below that. Northern Europe should refrain from domestic policy action that would prevent domestic inflation from rising above 2 per cent, as long as eurozone price stability remains ensured".

Second, member states need to reform their **national welfare states** in order to guarantee their long-term sustainability. The main challenges to be addressed are population ageing, new family and life-cycle patterns, tax evasion and fraud, the labour market consequences of globalization as well as technological change[57].

Third, EMU countries need to **reduce the occurrence and the impact of cyclical divergences in the EMU.** These cyclical divergences can be exogenous, if they are the consequence of asymmetric shocks, or endogenous, if they result from the asymmetric impact of the common monetary policy on countries with large national inflation differentials[58]. Even if they can be reduced, cyclical divergences cannot be completely avoided due to a natural - and desirable - variety of productive specializations. In other monetary zones, these divergences can be reduced by federal fiscal instruments for macro-economic stabilization as well as by well-functioning market-based adjustment mechanisms (labor mobility or price flexibility). However, the EMU member states do not have a common fiscal capacity and their national margin of manoeuvre in terms of budgetary policies is reduced due to excessive indebtedness. In addition, labor mobility remains very low in the euro area. This means that if one of the euro area countries is hit by an asymmetric shock, there are few means to avoid the social impact in terms of wage and social spending cuts and job losses. In order to protect their welfare states, euro area countries then need to reinforce EMU's cyclical adjustment capacity.

Fourth, the crisis demonstrated **EMU's vulnerability to self-fulfilling solvency crises**, and this issue is still not addressed in the new economic

57. Esping-Andersen, Gøsta, "A Welfare State for the 21st Century. Ageing societies, knowledge-based economies, and the sustainability of European welfare states", Report to the Portuguese presidency of the European Union, prepared for the Lisbon Summit, 2000.
58. The report of the Tommaso Padoa-Schioppa group explains this second type of cyclical divergences: "As the ECB does not base its interest rate decisions on the economic trends of individual Member states, but rather on the euro area as an aggregated whole, its monetary policy will be at the same time too restrictive and too loose for individual countries. In the Member states with higher inflation rates than the euro area average, the common nominal interest rate was translated into low real interest rates, which triggered higher rates of investment and consumption. This, in turn, accelerated the growth over the production potential and had an inflationary effect, in particular in asset prices, such as the real estate market. In countries with lower inflation rates than the euro area average, the opposite was the case: real interest rates were too high, investment and consumption rates were too low. The single monetary policy fosters rather than prevents such divergences. Rather than being "one size fits all", the ECB's monetary policy was "one size fits none". The ECB's monetary policy had adverse and even self-enforcing pro-cyclical effects in those Member states whose economic fundamentals were not in line with the euro area average. And this, although the ECB did exactly what was required of it: the ECB ran the right monetary policy for a country that did not exist".

governance framework. As explained by de Grauwe[59], the euro area is a fragile construction because a member state can become insolvent if investors fear default. As long as the euro area continues to be vulnerable to these crises, the risk that member states experience a sudden loss of investors' confidence in the future remains with all the catastrophic consequences (economic and social) the latter entails.

Exactly how these challenges will materialize, i.e., their magnitude and specific implications for different EMU countries and for the euro area as a whole depends partly on how the overall EMU reform evolves. As outlined by the Van Rompuy report and the Blueprint of the European Commission on the future of the economic and monetary union[60], the economic governance reform started in 2010 needs to be pursued in order to strengthen EMU's economic, fiscal, banking and political pillars.

2.2. Policy choices for the future of the EMU

Based on the challenges outlined above, the study proceeds by presenting three possible scenarios for the future development of the EMU. The scenarios, which represent only three out of many of possible future developments, share a certain number of common assumptions. Firstly, all of the scenarios assume that keeping the EMU together remains a shared objective for all of the member states; as a consequence, the scenario of a euro area break-up is excluded from the analysis. Secondly, the scenarios are based on the logic that there should be as much European integration as necessary to achieve common goals, but as little as possible[61]. The euro area should remain a "federation of nation states" whereby member states remain as free as possible in making their policy choices.

Nonetheless, each of the three scenarios follows a different driving logic and represents varying levels of European integration needed to sustain the euro

59. De Grauwe, Paul, "The Governance of a Fragile Eurozone", *CEPS Working Document*, No. 346, May 2011.
60. European Council, Report by President of the European Council Herman Von Rompuy, *Towards a genuine and monetary union*, Brussels, 26 June 2012; European Commission, *A blueprint for a deep and genuine economic and monetary union Launching a European Debate*, COM/2012/0777, 28 November 2012.
61. Enderlein Henrick et al., "*Completing the Euro. A road map towards fiscal union in Europe*", *Notre Europe-Institut Jacques Delors*, june 2012.

area intact. Conditions triggering the choice of each scenario consist of economic, political and social developments in various member states individually and in the euro area as a whole. Therefore, the proposed scenarios are not mutually exclusive in time or in contents. Indeed, they could be built up one on the other in a sequential manner and form a single continuous scenario. They could also be reshuffled to form intermediary proposals as the choice of limiting the set of future outcomes to three is imperfect by definition.

The main starting assumptions of the three scenarios are as follows:

- **Scenario A.** Up until now the member states have been acting in response to the market pressure in order to prevent the break-up of the euro area. This scenario supposes that such "negative purpose" for the euro area continues to drive the process of "muddling through". Limited policy responses are triggered by market pressure exerted on over-indebted sovereigns. The measures adopted are just enough to keep the euro area intact, but do not prevent further shocks and low growth prospects in the majority of EMU countries. There is no political will to engage in deeper integration and transfer additional power to the EMU level.
- **Scenario B.** This scenario assumes that the debt crisis in the euro area gets much worse. For example, one of the big economies such as Spain or Italy is forced to ask for a full-blown financial assistance from the ESM. As a result, the member states are obliged to find additional solutions in order to guarantee the survival of the EMU, even though the political will for deeper integration is still lacking. As a consequence, the priority of this scenario is to restore financial stability.
- **Scenario C.** This scenario is different from scenarios A and B because it supposes that the action of the member states is no longer guided by the purpose of crisis management. Member states move from a "sense of survival" to a "sense of common purpose". Such a paradigm shift could be prompted by the fact that euro area countries are caught in a "Japanese scenario" with low growth or stagnation. In addition, the economic and political weight of Europe keeps decreasing in the changing global context. This scenario is then based on a "positive" purpose for the euro area: there is a political will for common action to ensure the transition towards a new model of growth and to reinforce the role of the EU/EMU in the world.

For each scenario, we present the set of initiatives that member states are likely to undertake. These initiatives are organized on four building blocks: economic and fiscal union, banking union, political union and social dimension. It has to be outlined beforehand that our approach does not consist of saying that the EMU should have a parallel and separate social pillar adding to the four identified in Van Rompuy's report. The social dimension should be mainstreamed in all EMU's initiatives. As Janssen puts it: "What needs to be done is to strike at the very heart of European Economic Governance. Social limits and principles need to be placed inside its processes and procedures. In that way, the social dimension can be safeguarded from the very start"[62].

Building on the assumptions and the initiatives of each scenario we discuss first, the general pros and cons of the scenario for the EMU as a whole; and second its impact on national welfare states. This second analysis rests on a differentiation between peripheral EMU countries, which are currently under market's pressure; and the core member states, which suffer from indirect consequences of the crisis.

62. Janssen, Ronald, "A Social Dimension For A Genuine Economic Union", 22 March 2013.

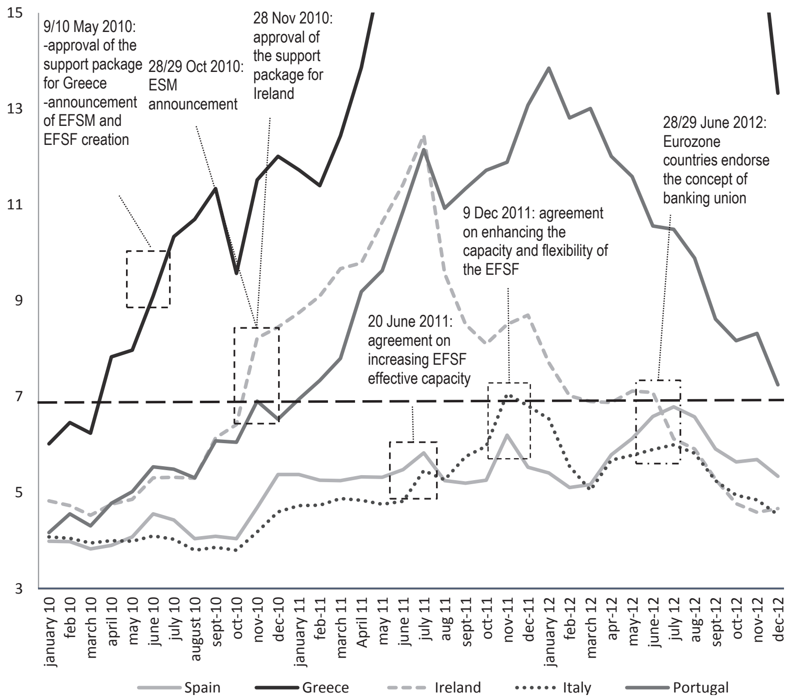
3. Scenario A

3.1. Assumptions

Since the beginning of the debt crisis, the member states have taken significant action to restore financial stability and avoid the euro area break-up. Even though European policy makers have been criticised for doing "too little too late", the reach of the new instruments and the speed with which they have been introduced could not have been imagined just before the crisis.

Common action of the member states has mostly been a response to the pressure of financial markets. Indeed, during the recent years and for the first time since the introduction of the single currency, markets have started differentiating between the quality of government bonds of various member states. While the "core" has been enjoying particularly favourable conditions for market access, the interest rates have increased to unsustainable levels in many of the peripheral member states. Whenever the bond yield of a member state crossed or got close to the critical 7% threshold, it provided an impetus for more integration. The adoption of the EFSF and the EMS are straightforward examples illustrating this tendency. More recently, the project of the Banking Union has also been pushed through at a time when the Spanish 10-year bond yield approached the 7% limit (see figure 12).

FIGURE 12 ► **10-year government bond yields and adoption of new initiatives in the euro area**



Source: own elaboration based on European Central Bank data

In short, today member states "muddle through" short term emergencies to avoid the fragmentation of the EMU because the costs of break-up are considered too high. For example, one of the members of the German Council of Economic Experts has estimated that a euro break-up could cost up to 10% of German GDP[63] and it could be an underestimation still. The fear of the unknown is a strong force pushing the governments to do what it takes to avoid the collapse.

63. Suoninen, Sakari and Kuehnen, Eva, "Euro breakup would cost Germany 10 percent of GDP-wise man", *Reuters*, August 30 2012.

In scenario A, we assume that member states continue to follow the same course of action as it has been observed up until today; they keep on "muddling through" in a step-by-step approach. Member states' action is driven by a sense of survival; there is no sense of common purpose and no consensus on how the EMU could be transformed to meet the future challenges. As Tommaso Padoa-Schioppa puts it, member states are stuck on a "short view" and are unable to rise above short-term challenges and contemplate the long-term future[64].

The new initiatives foreseen in this scenario continue to rest, as it is the case since the beginning of the crisis, on a balance between solidarity and responsibility: steps towards more solidarity are combined with more control and economic discipline. However, as member states do not share a sense of common purpose, the political will for engaging in new solidarity initiatives or transferring more power to the EMU level is absent. In addition, in this scenario we assume that there is no new significant economic or political shock, which could force member states to engage in new solidarity initiatives. As a consequence, both the political will and an urgent need to adopt ambitious initiatives to strengthen the EMU are lacking.

The prevailing paradigm in this scenario continues to be that of fiscal consolidation, which is considered as an exit strategy from the debt crisis. The main goal is thus to put the public finances of all member states back on a sustainable track in order to diminish market speculation and reestablish financial stability in the euro area. However, given rather low growth prospects, member states adopt some limited initiatives for growth and employment on the European level, all of them in line with the main objective of fiscal consolidation. After this "period of austerity" and once the crisis is over, member states expect to come back to the pre-crisis "business as usual" with reinforced obligations of keeping one's house in order.

By and large, and as Enderlein et al put it, euro area countries continue to look at the EMU as a grouping of economically independent sovereigns that subscribe to a framework of rules, but within this framework act severally, not jointly[65].

64. Padoa-Schioppa, Tommaso and Romano, Beda, *Contre la courte vue, Entretiens sur le Grand Krach*, Paris: Odile Jacob, 2009.
65. Enderlein, Henrick et al., "*Completing the Euro. A road map towards fiscal union in Europe*", *op. cit*.

3.2. EU/EMU policy initiatives

3.2.1. Fiscal and economic union

a) Differentiated budgetary consolidation

In this scenario the mechanisms of the new economic governance including the Six Pack, the Two Pack and the Fiscal Compact, are implemented to reinforce fiscal surveillance in the euro area. Reduction of public deficits and public debts in the short term in order to restore market confidence remains the key priority. Yet, in many cases fiscal consolidation has negative repercussions on economic growth, which in turn worsens the state of public finances. As it can be witnessed today, the consequences of pursuing the numerical objectives are the harshest for the countries where the debt and deficit levels are the highest and the growth levels are stagnating or negative. These countries get trapped in a vicious circle as fiscal discipline leaves little room for supporting growth-enhancing public and private investment, all of which only worsens the fiscal balance.

Consequently, as fiscal consolidation remains difficult in many member states because of the low growth, the Commission continues to soften its stance on nominal targets and concentrates on structurally-adjusted budgetary balances. This does not constitute an infringement to the current EU fiscal surveillance rules because, even though the nominal deficit is taken into account to launch the excessive deficit procedure, the Six Pack and the Fiscal Compact foresee a medium-term budgetary objective defined in structural terms. In addition, the new legislation also foresees that member states can temporarily deviate from their respective medium-term objective in exceptional circumstances.

In this context, whenever the conjuncture turns out to be worse than expected, the Commission takes it into account and allows the automatic stabilizers to operate. Such “softer” approach can be witnessed already. For example, in 2012, Spain and Portugal have been accorded an additional year to bring their deficits below the 3% threshold because their growth prospects have proved to be worse than previously forecasted.

b) Promoting growth

In this scenario the main strategy for growth remains the completion of the European single market based on the two Single Market Acts (SMA) proposed by the European Commission. The key actions include the legislation on energy and transport infrastructures, facilitating the electronic trade and revision of public procurement rules, among others. It has been widely documented that barriers to trade in goods and especially in services are still persistent in the EU. Their elimination could bring significant benefits in terms of growth and welfare. Yet, the actual progress remains slow as shown by the state of play of the first SMA[66]. In this scenario, the member states are deepening the single market step by step, yet as the progress is limited, it is difficult to expect tangible results in terms of growth, at least in the shorter term.

Initiatives on the EMU level for promoting growth, limited in size and in scope, keep being launched as the lack of growth preoccupies European policy makers. One example of such initiatives is the Compact for Growth and Jobs adopted in 2012 with the three components: more effective use of existing structural funds, increase of the lending capacity of the European Investment Bank and creation of the pilot stage of the "project bonds". In this scenario, for example, additional financing could be made available through a larger scale implementation of the "project bonds" or a new capital increase for the EIB aimed at facilitating targeted investment.

c) Economic surveillance and coordination

The crisis has shown that national economic policies may have important negative spill-over effects for the EMU as a whole. Differences in policies relating to wages and productivity levels might result in growing divergences between the member states. For this reason, the Macroeconomic Imbalance Procedure (MIP) remains an important improvement of the economic governance of the euro area. Additional surveillance of a set of economic indicators contributes to identifying important divergences and obliges the member states to correct them.

In addition to ex-post surveillance and the benchmarking foreseen in the framework of the European Semester, we assume that member states also adopt a

66. European Commission, *Single market Act II. Together for new growth*, COM(2012) 573 final, Brussels, 3 October 2012, p5.

procedure of systematic ex-ante coordination of major economic reforms, as foreseen in Art. 11 of TSCG[67]. As recently proposed by the Commission any plans for major economic reform, which could have repercussions for other member states, should be signalled in the National Reform Programmes.[68] The European Commission then provides its opinion and recommendations so that the reforms do not create negative spill-overs for the EMU. Such practice does not only prevent the build-up of economic imbalances, but it also helps the member states to engage in the learning process and exchange of good practices.

d) Combating tax evasion and fraud: towards more cooperation

Today the question of engaging in more fiscal cooperation is back on the political agenda mainly for three reasons. Firstly, the majority of the member states can no longer avoid losing additional tax income in the context of tight budgetary positions. The Commission has estimated that approximately 1 trillion euro per year[69] is missing in the national EU budgets due to tax fraud, let alone the losses accrued from sub-optimal tax competition. Large multinational companies are the ones gaining the most from the single market, yet the current rules enable them to optimise their tax bill at the detriment of all EMU member states. Secondly, scandalous leaks concerning fiscal evasion by individuals in Europe (such as the recent publications of the International Consortium of Investigative Journalists) result in public pressure for the establishment of a clear common fiscal framework. Thirdly, as the recent example of Cyprus has shown, the tolerance of fiscal dumping has decreased significantly in the EMU. The fact that an increase of corporate taxation has been one of the main conditions for obtaining financial assistance via the ESM has sent a strong political signal in this direction.

67. Article 11 of TSCG states that "With a view to benchmarking best practices and working towards a more closely coordinated economic policy, the Contracting Parties ensure that all major economic policy reforms that they plan to undertake will be discussed ex-ante and, where appropriate, coordinated among themselves".
68. European Commission, *Towards a Deep and Genuine Economic and Monetary Union. Ex ante coordination of plans for major economic policy reforms*, Brussels, COM(2013) 166 final, 20 March 2013.
69. European Commission, *Clamping down on tax evasion and avoidance: Commission presents the way forward*, Press release, Brussels, 6 December 2012: European Commission, *Concrete ways to reinforce the fight against tax fraud and tax evasion including in relation to third countries*, COM(2012) 351 final, 27 June 2012.

In addition, in December 2012 the European Commission has proposed an Action Plan to strengthen the fight against fraud and tax evasion[70]. The EU Member states have already adopted several directives relating to automatic exchange of information, namely the Savings Taxation Directive and the Directive on administrative cooperation in the field of taxation[71]. Nevertheless, as highlighted by the European Commission in its Action Plan, the amendments proposed by the Commission in 2008 in order to close the loopholes in the former directive have not been adopted yet and the selective transposition of the latter casts doubts on its final effectiveness.

In this scenario, member states do not address the questions of fiscal competition directly; nevertheless, they concentrate their effort in facilitating automatic exchange of information in the EU28 to increase fiscal transparency. Lately the political will for more cooperation in this area has intensified and the Commissioner Šemeta has claimed that "many of the member states have reviewed where they stand on these issues"[72]. Therefore, it seems fair to assume that in this scenario member states carry out all the necessary measures to increase fiscal transparency and information exchange to limit tax evasion and fraud.

3.2.2. Banking union

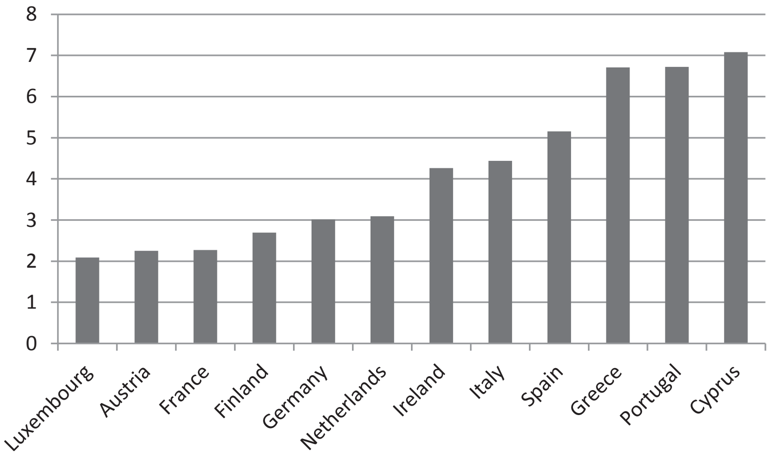
The global financial crisis put in evidence several weaknesses of the EU's financial system, in particular concerning regulation, supervision and crisis resolution. In order to tackle these problems, Member states launched in 2010 a reform of the EU's financial regulation and supervision. However, the crisis showed two additional problems shared by EMU countries: their increased financial interdependency and the vicious circle between banking and sovereign crises.

Moreover, as a consequence of the debt crisis, the euro area financial markets became fragmented. The funding costs of banks have increased significantly

70. European Commission, *An Action Plan to strengthen the fight against tax fraud and tax evasion*, COM(2012) 722 final, Brussels, 6 December 2012.
71. Council directive on savings taxation, Council Directive 2003/48/EC, Council directive on administrative cooperation in the field of taxation, Council Directive 2011/16/EU.
72. European Commission, *Statement by Commissioner Šemeta on fighting tax evasion*, MEMO/13/314, Brussels, 8 April 2013.

in the peripheral economies. The divergence in bank funding conditions at national level in turn gave rise to cross-country differences in lending conditions. As shown in figure 13, some countries face low borrowing costs: the average interest rate of firm loans in Germany, France and The Netherlands is under 3%. In contrast, Greek, Portuguese and Cypriot companies pay well above 6% for the same kind of loans. So even though the ECB sets interest rates for the entire euro area, the effects on private sector borrowing costs are not even. This results in an inefficient allocation of funding across the euro area and hence has a negative impact on growth and employment.

FIGURE 13 ➤ Average interest rate of non-financial corporation loans in March 2013



Source: Eurostat

Taking into account the particular problems of euro area member states and the need to restore confidence in euro area's banks and improve access to credit for households and firms, one of the priorities of this scenario is to establish a banking union in the euro area.

In this scenario, the Single Supervisory Mechanism (SSM), adopted in September 2013, is put in place. The SSM enables a fully rigorous and independent supervision of EMU's banking sector by the ECB (non-EMU member states are free to participate in this mechanism). In addition, as agreed in June 2013, the European Stability Mechanism has the possibility to recapitalise banks directly. This contributes to breaking the vicious circle between banks and sovereigns as the ESM loans do not add to the debt burden of countries facing intense market pressure.

In addition, EU member states adopt the legislation on: (i) bank recovery and resolution (in order to make sure that supervisory authorities have all the tools they need to deal with bank failures), (ii) the harmonization of deposit guarantee schemes and (iii) other crucial areas of financial regulation (capital requirements and credit rating agencies, among others).

These steps towards a banking union in the euro area contribute to increasing confidence between the banks; they are not, however, sufficient to guarantee financial stability in the euro area. However, it should be noted that in this scenario we assume that the banking union remains incomplete as there is no agreement on the establishment of the second (Single Resolution Mechanism) and third (a European Deposit Insurance Scheme) pillars of the banking union.

3.2.3. Political union

In this scenario, as there are no significant additional transfers of powers or resources, no major new institutional innovations are expected.

The European Parliament goes on playing a key role in the adoption of all the directives and regulations aiming at fostering a better functioning of the EMU. It also uses its power of control to hear and question EU decision makers, such as the President of the Commission or the Commissioner for Economic and Monetary Affairs, the President of the European Council and the President of the ECB[73].

The Euro summit meets at least twice per year to provide strategic orientations on the economic and fiscal policies in the euro area, on the basis of the "rules of procedure" adopted in March 2013.

73. Kreilinger, Valentin and Deubner, Christian, "The role and place of parliament in a genuine Economic and Monetary Union", Paris, *Notre Europe-Jacques Delors Institute*, 17 April 2013.

In addition, the EMU inter-Parliamentary conference gathering members of the relevant committees from the national and European Parliaments is established under the basis of Art. 13 of the TSCG, in order to discuss fiscal and economic issues. This "Inter-parliamentary Conference" is not a new "institution", but a place where European parliamentarians meet and debate about euro area issues, so as to reinforce political control and dialogue at the EMU level. It meets at least twice a year, before the euro area summits or on the occasion of the adoption of the "Annual Growth Survey" and the adoption of the "Country Specific Recommendations". The EMU inter-parliamentary conference can also organize hearings with national or euro area decision makers (Heads of state and government, director of the ESM, ministers for finances, etc.).

3.2.4. Social dimension

In this scenario, member states adopt some initiatives to reinforce EMU's social dimension. However, these initiatives are not built on the consensus that protecting and/or upgrading social standards must be one of the main goals for common policy making. Instead, they rest on the need to tackle the social consequences of austerity measures and of the crisis, as the situation deteriorates. The initiatives presented in the social field above are just examples of the measures that could be adopted, yet the list is by no means exhaustive.

a) EU's initiatives to mitigate the social consequences of the crisis
As a response to the social consequences of the debt crisis, several initiatives - including those foreseen in the Youth Opportunities Initiative – are promoted and the resources of the European Social Fund are used to combat targeted social problems. For example, the recently adopted Youth Guarantee is implemented in all of the member states in order to fight excessively high youth unemployment and promote social inclusion of young people. Under the Youth Guarantee, member states put in place measures to ensure that young people up to the age of 25 receive a good quality offer of employment, continued education, an apprenticeship or a traineeship within four months of leaving school or becoming unemployed. The EU allocated 6 billion euro for the period 2014-2020 to support the member states with youth unemployment rates above 25% in the implementation of this initiative[74].

74. The 6 billion euro earmarked for youth employment will be used during the first two years of the next multiannual financial framework.

The EU thus contributes, via this initiative and in addition to the other initiatives financed by the ESF, to promoting social investment across the EU.

These initiatives fall into the scope of the EU-28 and not only the euro area countries. As previously stated, the reinforcement of the social dimension of the whole of the EU should be a priority whenever it is feasible.

b) "Mobility Package" for improving labour mobility

One of the social consequences of the crisis is the increase of the labour force migration from peripheral member states to core EMU countries. Indeed, the mobility of the labour force is one of the market-based adjustment channels in a monetary union. In the current context of youth unemployment rates above 40% in several peripheral member states, higher labour mobility can help avoiding the emergence of a "lost generation". Yet, the overall labour mobility across Europe remains very low. Consequentially, facilitating workers mobility and ensuring that migrant workers enjoy full rights in the euro area Member state is a crucial element for enhancing the functioning of the single currency.

In this scenario member states agree on several initiatives to improve the mobility of workers in the EU because, cultural and linguistic barriers aside, there are many policy-induced factors hampering the mobility of workers in Europe. A recent OECD report[75] cites in particular: (i) the lack of portability of supplementary pension rights; (ii) scarce cross-country information about job vacancies, (iii) the difficult recognition of professional qualifications, (iv) housing market policies that raise the costs of moving, (v) the difficulty in accessing public sector jobs as non-nationals.

Taking into account that single market legislation is generally a topic for EU-28, but that the necessity to integrate is much more significant in the euro area for the functional reasons, EMU member states engage in "enhanced cooperations" to adopt legislation fostering intra-EMU labour mobility (e.g. on the portability of supplementary pension rights[76], or the creation of a closed cooperation agreement between EMU national employment agencies).

75. OECD, "European Union", *OECD Economic Survey, European Union*, Paris: OECD Publishing, March 2012.
76. The Commission proposed a Directive in 2005 to set minimum standards for the acquisition, preservation and transferability of supplementary pension rights. However, it has still not been possible to achieve the unanimity needed in the Council to pass the Directive. The Monti Report also suggests an option to explore the 28th regime for supplementary pension rights, see "A new

In addition, the European Commission continues to develop its initiatives aimed at helping labour mobility across EU borders in order to reduce unemployment levels. Such initiatives include, for example, the development of the fully functional EU job search engine "EURES" to increase job-matching efficiency as well as the deployment of Erasmus programmes on larger scale and wider scope (not only for university students and trainees, but also for young entrepreneurs and volunteers).

c) Strengthening the role of social partners

The role of the social partners in the new Economic Governance, in particular in the European Semester, should be reinforced.

First of all, European social partners should be consulted by the European Commission on drawing up the Annual Growth Survey. In addition, the national social partners should be consulted and given the opportunity to provide a feedback on the recommendations made to member states concerning the Stability or Convergence Programmes (SCPs) and the National Reform Programmes (NRPs) through the Tripartite Summits. Such consultation is necessary because the SCPs have a direct impact on public spending, including on social policy, and the NRPs involve elements of the European Social Model, including social protection, labour market reforms or education.

Finally, European social partners should be given a possibility to provide their own view and analysis on the new instruments that are being created to reinforce EMU's architecture, such as the setting-up of a cyclical adjustment fund in the euro area. Social partners are well placed to bring additional elements regarding the possible consequences of such new instruments on national welfare states; therefore, their opinion should be taken into account by the European policy makers at all stages of the policy process.

strategy for the single market, at the service of europe's economy and society *Report to the President of the European Commission* by Mario Monti, 9 May 2010, p. 58.

3.3. Pros and cons of scenario A for the general functioning of the EMU

This scenario presents some advantages for the euro area countries.

First and foremost, this scenario is the easiest to accept for the majority of EMU member states because the process of "muddling through" acts as a learning curve for both the decision makers and the national populations. Like today, integration continues in an incremental manner whenever the cost of non-integration becomes too high and evident for everyone; consequentially, common action gets more acceptable politically in the context of growing Euro-scepticism.

Second, it implies a very limited additional transfer of competences and restricted pooling of financial resources. In this scenario, the principle of subsidiarity and limited solidarity applies to the largest extent possible for the common currency to stay together.

Third, the "muddling through" is convenient because it does not require a Treaty change right away. Limited policies and instruments are set up within the existing legal framework taking advantage of the possibilities offered by the clause of enhanced cooperation or adoption of additional intergovernmental treaties between the member states. The difficult history of the Lisbon Treaty suggests that any scenario requiring a change in the EU Treaties could pose a real problem for the policy makers.

However, this scenario also implies that the euro area, even if kept together through "muddling through", remains vulnerable in the face of both short and long term challenges (as outlined in section 7.1):

- In the short term, the problem of **weak growth and high unemployment** remains unresolved: EMU countries get caught in the Japanese scenario of the 1990s. The overall economy of the euro area keeps contracting, which lowers aggregate internal demand. Due to economic openness in the EMU, diminishing aggregate demand has negative effects for all of the member states. As a result, continuous effort to balance public budgets is outweighed by the lack of growth.

- In addition, **national divergences** in terms of output, competitiveness and social indicators between the "core" and the "periphery" continue to widen threatening the good functioning of the EMU. As witnessed by current developments, the enforcement of various country-specific recommendations in the context of a deep economic and social crisis has proved to be extremely challenging.

- Even though the banking union is put in place, due to the over-indebtedness of many EMU countries and the risk of additional needs for financial assistance, **financial stability** is not completely restored. As a consequence, access to credit remains difficult, especially in the peripheral countries with prohibitive interest rates for SMEs and households. Future expectations of investors, consumers and businesses are gloomy, adding to the recessive spiral.

- In the longer term, EMU countries' capacity to adapt to **asymmetric shocks** might be reinforced, with the introduction of the "Mobility Package" and the consequent improvement of labour mobility. Even so, it is difficult to expect that better legislation would bring European labour mobility to the levels of the USA, for example due to significant cultural and linguistic barriers. Moreover, the example of the USA illustrates that even if the market-based adjustment mechanism works well, in a monetary union a macroeconomic stabilization mechanism at the central level is needed to counter cyclical divergences. As in this scenario this mechanism is not established in the euro area, EMU member states may still need to engage in internal devaluations to tackle an asymmetric shock.

- Finally, due to constant uncertainty and continuous crisis management, the euro area keeps losing its **attractiveness** as a destination **for global investment**.

In addition, this scenario also entails important political consequences, which are potentially dangerous for the long term sustainability of the EMU. Growing animosities between national populations are intensified in both the "core" and the "periphery". In the "periphery" this is due to the general climate of economic downturn and externally imposed fiscal discipline whereas in the "core" countries it is a result of obligatory additional solidarity efforts and tensions resulting from immigration inflows. The issue of legitimacy of the euro area gains momentum because EMU is no longer seen as a solution for increasing well-being, but a problem on its own. Against this background, various fringe parties continue rising and national sentiment prevails in a majority of the member states.

3.4. Impact on national welfare states

This last part of the analysis describes the potential impact of the adopted instruments and the resulting economic situation on the national welfare states. They could be affected in at least three different ways: in terms of additional constraints on the financing of the welfare states; in terms of increased social competition between EMU countries and in terms of "social dismantlement" because social policies are used as adjustment variables to negative economic shocks. Indeed, these three issues could give rise to potential negative effects of the common currency on national social policies in this scenario.

Of course, member states will be affected differently depending on whether they are in a vulnerable situation (suffering directly from the debt crisis) or if their economic model is functioning rather well. We therefore complement the general analysis with specific analysis for the two groups of member states.

Firstly, in terms of welfare financing, this scenario implies additional constraints in virtually all of the member states. Even before the crisis, the great majority of the member states were facing the need to fundamentally reform their national welfare state. Indeed, it has been a long-term political priority in the last decades as new challenges such as the ageing population puts the European welfare models into question. The crisis has put an additional pressure on national welfare states in the short term. Today all of the member states are suffering from a negative output gap (figure 6) and reduced growth perspectives, even if the magnitudes are different.

Yet, as discussed by Gros[77], the key to ensuring the sustainability of national welfare states is faster growth. In this context, this scenario reduces the

77. Gros, Daniel, « Saving Europe Social's model », *Business Standard*, 29 January 2013.

capacity of member states to modernize their welfare state and to guarantee their sustainability because the prospects of growth remain rather gloomy. On the positive side, increased cooperation on the tax evasion issues might engender additional budgetary resources bringing some much-needed "breathing space" for the national authorities. Yet, it would be naive to claim that increased cooperation in terms of information exchange would be sufficient to compensate for the gaps in public budgets caused by economic stagnation.

Secondly, the risk of social competition is exacerbated by the widening divergences between EMU countries. Social competition is harmful for the EMU as a whole given that it results in lower overall social standards and lower budgetary revenues, which in the end go to the benefit of private companies and to the detriment of European values.

Thirdly, as previously mentioned, the absence of a macroeconomic stabilisation mechanism, which would complement the national automatic stabilisers, means that social policies remain a factor of adjustment to negative shocks. Internal devaluation is the only way for regaining competitiveness for euro area member states suffering from an asymmetric shock. As a consequence, the increased risk of social dumping and desperate labour migration might put the four freedoms of the internal market under pressure.

a) In the peripheral member states

In the more vulnerable countries today, internal devaluation is the only possible strategy for improving their competitiveness and complying with the European rules for fiscal consolidation. Wages in private and public sectors as well as social benefits keep being reduced; as a consequence, aggregate national demand falls further aggravating recession. The impact of such internal devaluation on social indicators can be illustrated by the situation today as discussed in Chapter 4. In particular, deep economic downturn and layoffs in the public sector are translated to increasing job losses as witnessed by the current situation of the record high unemployment levels.

Unemployment has two important negative consequences for the economy. First of all, it implies the rise in poverty levels as it deprives households of constant income. It is especially true for the most vulnerable social groups such as the elderly, the young and the women. Secondly, joblessness combined with low public investment implies depreciation of human capital, which in the longer term hinders job access on the individual level and curbs growth potential on the national level.

High levels of unemployment encourage emigration towards the member states that are better off. It can be seen as a positive development for the vulnerable member states both on national and on individual levels. On the national level, emigration reduces unemployment figures and relieves public spending on unemployment benefits. On the individual level, unemployed citizens of the vulnerable member states can avoid the phenomenon of "unemployment cliff", whereby the long-term unemployed become unemployable in the job market (as shown by recent research)[78]. However, mass emigration can also result in a real "brain drain" whereby the most mobile and the most productive segment of the labour force leaves the country. This could further hinder the chance of sustainable economic recovery in the longer term.

Obviously, the impact of this scenario on national welfare states is even more marked for the countries that are under adjustment programmes and receiving financial assistance from the EMU partners (currently Greece, Ireland, Portugal and Cyprus). Financial assistance from the EU and the IMF comes at a cost of strong conditionality attached to the adjustment programme to be agreed between the Member state and the European Commission. This conditionality leads to a partial loss of sovereignty. As discussed in section 3, the externally imposed reforms and pressure to use social policies as factors of adjustment lead to a substantial impact on the national social models.

b) In the core member states

In the member states that are currently not hit by a negative shock, the welfare states are also under pressure. High trade openness between the EMU member states due to the common currency and the free movement of labour, goods, services and capital imply that all member states are interdependent. The implications of these interdependencies for the welfare policies and spending in the "core" member states can be both direct and indirect.

78. See, for example, Ghayad, Rand, and Dickens, William, "What Can We Learn by Disaggregating the Unemployment-Vacancy Relationship?", Public policy brief, Federal Reserve Bank of Boston, No 12-3, 2013.

In a more direct way, widening divergences between the EMU member states in terms of economic growth and social standards encourage immigration from the more vulnerable countries. This can bring many positive results, especially in the countries that are in need of a labour inflow due to the ageing population. For example, it is forecasted that in Germany there will be "a skilled-labour shortage of about 5.4 million by 2025" and the authorities plan to partly fill this gap by bringing in 800,000 workers through the additional immigration[79]. Yet, mass immigration instead of a targeted one for only skilled workers, may also create significant problems for social cohesion and, in many cases, welfare spending. This is especially true if citizens from the more vulnerable countries get tempted to engage in "welfare regime shopping" in the more generous and well-off welfare states.

In addition, the risk of social dumping exacerbates within the euro area, especially given the co-existence of (peripheral) countries adopting cost competitive strategy and (core) countries adopting high skill/high value competitive strategy. The high (and often expensive) social standards of the core member states are threatened if the "vulnerable" member states engage in the "race to the bottom".

Finally, even though these member states are not suffering from the sovereign debt and competitiveness crisis themselves, they are affected indirectly in at least two ways. First, their growth potential is curbed by the recession in the trading partners and low aggregate demand on the European level. Resulting output gap implies lower fiscal revenues and higher social spending. Second, the "core" member states are required to contribute financially through the crisis management mechanisms such as the ESM even if the funding remains in the form of loans and guarantees.

79. OCDE, *Recruiting Immigrant Workers: Germany 2013*, Éditions OCDE, 2013.

4. Scenario B

4.1. Assumptions

In this scenario we assume that member states pursue the same logic of scenario A, their action being driven by a sense of survival. However, the crisis in the euro area gets much worse obliging the member states to change their paradigm and to agree on more ambitious and far-reaching initiatives.

This change happens if it is acknowledged that the paradigm of austerity does not bear the expected fruit. Discretionary fiscal consolidation is outweighed by the negative repercussions brought by the lack of economic growth. As a consequence, the peripheral member states get caught in a vicious circle of deepening recession and deteriorating public balances. Social unrest intensifies and the lack of consensus among national policy makers threatens political stability.

One possible trigger of this scenario could include raising fears that two of the four largest EMU economies, Italy and Spain, might lose access to financial markets. This would happen if, because of the deterioration of their national fiscal and economic situation or because of the fears of a default of a euro area country - and the consequent risk of contagion -, the interest rates of these member states rise to prohibitive levels. Facing a risk of insolvency, Spain and/or Italy are forced to apply for financial assistance from the ESM.

Yet, the ESM does not have sufficient funds for bailing out such large economies. In fact, as outlined by Giovaninni and Gros, the ESM would run out of funds already if the member states currently under adjustment programmes would not manage to regain market access in the predefined schedule and would require additional financing (as it already happened in Greece)[80]. Indeed, in this scenario of a prolonged recession, the Southern member states are likely to be struggling to meet their commitments.

80. Giovaninni, Alessandro and Gros, Daniel, "How high the firewall? Potential financing needs for the periphery", *Center for European Policy Studies*, Brussels, 2012.

Knowing that the ESM is not a viable option for helping out Spain and/or Italy, the member states are obliged to find additional larger-scale solutions to deal with excessive sovereign debts and market speculation in order to guarantee the survival of the EMU. The political will for deeper integration is lacking, yet the member states are forced by the circumstances to accept a higher degree of solidarity with one another and to transfer more powers to the EMU level in order to keep the euro area together.

In addition, the intensification of the austerity-induced recessive spiral leads to a change of strategy for dealing with excessive deficits. Strict austerity is no longer seen as the best way out because it is destroying the growth potential both in the long and in the short term. Lack of growth is reflected not only in the public accounts of the member states, but also in the decreasing aggregate demand within the EMU and the contraction of the single market. As a consequence, the concern for growth becomes as important as the quest for fiscal consolidation. Growth-friendly fiscal consolidation becomes a real priority. However, because member states are still overwhelmed by short-term concerns and as their action rests on a sense of survival and not on a positive common purpose, the EMU's architecture is not completed and the common currency remains a fragile construction. Member states risk to fail to successfully address their medium/long-term challenges.

Even though some initiatives are adopted to promote growth, the priority of this scenario is to restore financial stability through new policy approaches to the over-indebtedness of EMU countries and via the completion of the banking union.

4.2. EU/EMU Policy initiatives

4.2.1. Fiscal and economic union

a) Reinforcing EMU's crisis resolution capacity

If the debt crisis intensifies as it is assumed in this scenario, member states will have to find new solutions to restore financial stability in the euro area. In this context, we consider that member states are forced to reinforce EMU's crisis resolution capacity as a response to new needs for financial assistance from countries currently under adjustment programmes or those currently under market pressure.

Such mechanisms could, for example, include the reinforcement of the ESM lending capacity and the setting-up of temporary debt mutualisation instruments such as Eurobills and/or a European Debt Redemption Fund (EDRF)(see box 6)[81]. Setting-up Eurobills and/or a EDRF gives some breathing space to the countries in need in exchange for fiscal discipline. However, in order to avoid the problem of moral hazard, strong conditionality is undoubtedly attached to these new solidarity mechanisms.

81. In order to take full advantage of these instruments, the common debt issuances would benefit from joint and several guarantees, implying a corresponding pooling of credit risk. Each guaranteeing Member state becomes liable not only for its own share of common debt issuance but also for the share of any other Member state failing to honour its obligations.

BOX 6 ► Temporary debt mutualisation schemes

TWO TEMPORARY DEBT MUTUALISATION SCHEMES

Eurobills*	European Redemption Fund*
• Issuance of common SHORT-TERM debt; • Maximum maturity of Eurobills, which allows for continued monitoring and due to short term maturity frequent renewal of guarantees; • Eurobills amounting to maximum 10% of GDP • Establishment of an agency or use an already existing entity (ESM?) to issue eurobills; • Participation of all euro area member states without full adjustment programmes and a phasing in of member states that have successfully completed their adjustment programmes; • Member states that do not comply with the rules set-out in the Stability and Growth Pact have to pay a penalty interest rate.	• Set-up a debt redemption fund (EDRF) in order to redeem the transferred debt over a benchmark period of 25 years (temporary, not permanent solution); • Transfer the debt above 60 % of GDP to the EDRF through a roll-in phase of five years; • ERF includes member states with a debt to GDP ratio above the Maastricht threshold AND without a full adjustment programme; • Member state under an adjustment programme would phase in after the successful completion of their programme; • Strong conditionality through the adoption of a debt redemption pact; posting collateral such as gold reserves; and penalties in the case of non-respect of the commitments.
* Proposal by Philippon, Thomas and Hellwig, Christian, Eurobills, not Eurobonds, 2 December 2011, voxeu.org.	* Proposal by Bofinger, Peter et al., A European Redemption Pact, 9 November 2011, voxeu.org.

PROBLEMS OF DEBT MUTUALISATION AND POSSIBLE SOLUTIONS

Problem		Solution
Lower incentives for fiscal discipline and moral hazard Common debt issuance would prevent financial markets from exerting their disciplinary effects through higher interest rates; in addition, they could create a moral hazard problem in that a member state may be tempted to free ride on other members' legal obligations to assume its debt in case of default	→	– Fixing the maximum amount of debt obligations that each member state could have in the form of common debt issuance (financial markets would exert their disciplinary effect on national bonds) – Strong conditionality (posting collateral – such as gold reserves – or foreseeing penalties in the case of non-respect of fiscal discipline rules)
Problem of equitable sharing of the benefits and costs of the program Member states with the highest credit standings might lose from debt mutualisation as they could face higher borrowing costs than with national issuance	→	– Set up a compensation scheme based on the indexation of the interests paid by each member state (as a function of its credit risk premium or fiscal parameters)

b) Fiscal consolidation sustaining growth potential

The reinforced solidarity (via the increase of the ESM lending capacity and/or the setting up of Eurobills or a EDRF) implies a stricter control of member states' economic and fiscal policies. The dialectic of "solidarity-responsibility" was at the heart of EMU's crisis management initiatives in the last years and it is bound to continue this way. This stronger control will be translated into the reinforcement of fiscal surveillance and increased pressure for fiscal consolidation. In this context, the adoption of new measures, such as giving a veto power on national budgets to the European Commission, or the adoption of special tax provisions, which are designed to generate revenue earmarked for servicing the debt (as proposed by the German Council of Economic Experts in their proposal for a EDRF[82]), could be considered.

However, as in this scenario we assume that member states are suffering from low growth, reinforcing fiscal constraints alone would only contribute to worsening the situation. Thus, in order to avoid this scenario, member states change their approach to public deficit and substitute the debt brake foreseen by the SGP and the Fiscal Compact by a "Golden Rule" allowing for public investment such as in education to be subtracted from the structural deficit calculations[83]. Indeed, one major criticism of the current debt brake has concerned its implications for public investment. It has been argued that the rules of the SGP seriously restrict policymakers' willingness and ability to carry out public investment in member countries. Central to these arguments has been the notion that public capital spending is intrinsically different from other types of public spending because it has the capacity to enhance the future output potential of an economy[84].

c) Promoting structural reforms

In order to further strengthen growth in the euro area, public and private investment is necessary, but not sufficient. Member states also need to

82. Bofinger, Peter et al., "A European Redemption Pact", *VoxEU*, November 2011.
83. The European Parliament has already forced the European Council to make a first step in this direction by including in one of the regulations of the Two Pack the obligation for the Commission, when reviewing national budgets, to secure that fiscal cuts do not concern development-oriented public investments.
84. Potential consequences of subjecting public investment to the same fiscal constraints as current spending have also been recognized by the IMF. Having acknowledged the contribution of public capital spending to a country's future public revenues and growth potential, the IMF has proposed new initiatives to promote public investment in countries under IMF supported programs (Hemming, Richard and Terminassian, Teresa, "Making Room for Public Investment. Possible new approaches to fiscal accounting", IMF, 2004).

implement structural reforms, which will enhance the growth potential of member states' economies. However, euro area countries that need to reform the most are usually the ones with the tightest budgets. This is particularly worrying because, as a rule, structural reforms come at a great cost in the short run and bear fruit only in the longer term.

In this scenario, member states agree on a "Convergence and Competitiveness Instrument" (CCI) in order to reinforce the implementation of structural reforms and to overcome the obstacles of financing. As foreseen in the European Commission's proposal[85], member states sign a contractual arrangement with the Commission, in which they commit to undertake structural reforms in exchange for some financial assistance. The definition of the structural reforms to be implemented by each member state is based on the recommendations issued by the European Commission on the National Reform Programmes. The contracted countries are fully liable for the results of the policy implementation and would have to return the grant if they fail to achieve the outlined objectives. The added value of the CCI, as compared to the current Structural Funds, is the possibility to provide "targeted, limited in time and quick support" for countries in need[86].

d) Increasing efficiency in tax systems: towards more coordination

In this scenario more attention is paid to make the design and structure of the tax systems more effective, efficient and fairer. However there is no consensus to move towards the harmonization of tax rates. Instead, member states engage in more tax coordination as the lack of harmonization of rules leads to extra compliance costs, complexity and legal uncertainty. It hinders cross-border activities, particularly for SMEs. Two examples of such increased cooperation are in the fields of corporate taxes and the value added taxation, among others.

The European Commission made a proposal in March 2006 of a Common Consolidated Corporate Tax Base (CCCTB). However, member states have difficulties in achieving a consensus on the issue[87]. In scenario B we can fairly

85. European Commission, *Towards a Deep and Genuine Economic and Monetary Union. The introduction of a Convergence and Competitiveness Instrument*, *op. cit*.
86. European Commission, *Ibid*.
87. A number of countries fear losing tax revenues via tax consolidation or fear that this might actually be a first step towards rates harmonization, even though the European Commission clearly indicated that it was not the case.

assume that member states finally agree on the proposition and that companies experience the full benefit of a single set of rules to calculate their taxable profits. As a result, companies active in more than one EU member state only have to file a single tax return for the whole of their activity in the EU. Eventually the CCCTB makes it possible for companies or groups of companies to consolidate all profits and losses across the EU, thereby recognising their cross-border activity. In this way, the harmful tax competition consisting of shifting book profits (transfer pricing, thin capitalization and other "tax planning" techniques) between the countries is limited.

Similarly, numerous shortcomings in the current VAT system hinder the exploration of the true potential of this tax[88]. Recently, the Commission has adopted a Communication on the future of VAT[89]. The Communication concludes that agreement on a system based on the principle of origin is politically unattainable. Therefore, in scenario B member states agree to work on a properly functioning VAT system based on the principle of destination. They agree on a broader tax base and while not changing the minimum rate of 15%, they restrict the use of reduced rates. Moreover, member states carry out the necessary measures to build a more robust and fraud-proof VAT system. They finally achieve a consensus on mutual access to national data bases and automated access to information.

All these measures contribute to boosting public budgets throughout the EMU, which reinforces the fiscal basis of welfare states.

4.2.2. Banking union

As the debt crisis intensifies in this scenario, the energy of member states is concentrated on restoring financial stability. This includes reinforcing EMU's crisis resolution capacity as well as the completion of the banking union.

Consequently, building on the legislation for bank recovery and resolution foreseen in scenario A, member states adopt a single resolution mechanism

88. The wide and divergent use of reduced rates and exemptions by Member states mean that only part of final consumption is being taxed at the standard rate.
89. European Commission, *Towards a simpler, more robust and efficient VAT system tailored to the single market*, COM (2011) 851, December 2011.

(SRM). The SRM includes a single resolution authority as well as a single resolution fund financed by ex-ante risk-based levies on banks and benefits from a fiscal backstop (see box 7).

BOX 7 ► The Single Resolution Mechanism

EMU's Single Resolution Mechanism will include:

- a single resolution authority with the financial, legal and administrative capability as well as the necessary independence to carry out effective and least cost resolution; it guarantees that failing banks are restructured or closed down swiftly;
- a single resolution fund for the recapitalisation of failing banks; this fund will be financed by ex-ante risk-based levies on all the banks directly participating in the single supervisory mechanism (by ensuring that the private sector bears the primary burden of bank resolution costs, the authority would increase market discipline, and minimise the residual costs for the taxpayers of bank failures). However, this fund needs to be coupled with a fiscal backstop (through an ESM credit line or national contributions to the fund). Any fiscal support to the SRM should be in the form of credit to the European Resolution Fund to be repaid ex post. For this purpose, the European Resolution Fund should have the authority to impose additional levies on the banks under the jurisdiction of the SRM. This should ensure that the mechanism is fiscally neutral over the medium term.

In addition, member states complete the banking union with its third leg, a single deposit guarantee scheme (SDGS), which contributes to reinforcing financial stability in the euro area by preventing bank runs. As a result, depositors no longer have an incentive to shift their funds across the euro area in search of a safe haven, as all banks offer the same insurance coverage.

With the SSM, the SRM and the SDGS, financial confidence is restored and member states protect themselves from the negative consequences of banking problems on their public finances and, therefore, preserve tax payers' money.

4.2.3. Political union

The EMU's fiscal capacity foreseen in this scenario does not require the setting-up of an EMU Treasury.

Indeed, the financial assistance foreseen for the Growth and Competitiveness contracts is part of the EU budget based on article 136.1 of the TFEU[90]. Euro area member states are required to contribute to a special fund in the EU budget (assigned revenues) and national contributions are based on a contribution key depending on the level of GDP. The use of these funds is monitored by the European Parliament.

In what concerns the issuance of Eurobills, this task can be attributed to the ESM. If member states decide to establish a EDRF, they will have to engage in a new intergovernmental Treaty.

The EMU Inter-parliamentary conference foreseen in scenario A is competent to discuss all debt mutualisation aspects and is involved in the definition of the degree of control established over the national budgets, in compensation for such debt mutualization.

In addition, the architecture of EMU's governance is reinforced in order to increase its democratic accountability:

- A first step is the creation of a euro area sub-committee within the European Parliament, at the occasion of the revision of its "Rules of procedure" after the May 2014 elections. Given the importance of euro area issues, it is only natural to establish such a sub-committee, similarly as in other fields such as Human rights or Defence, where the EU does not necessarily have more powers than in the questions of euro area governance. Such subcommittee welcomes MEPs from the "Economic and monetary", "Social Affairs and employment" and "Budget" Committees.
- The second step consists of the nomination of a full time president of the Eurogroup, with the aim of reinforcing the transparency and accountability of this body. This president will be a permanent interlocutor to the European and national parliaments as well as to a larger public. The permanent President of the Eurogroup will be in charge of the euro as a "public good", without being simultaneously in charge of any national ministry.

90. Art. 136.1 TFEU : "In order to ensure the proper functioning of economic and monetary union (…) the Council shall (…) adopt measures specific to those Member states whose currency is the euro (…) to set out economic policy guidelines for them (…)".

4.2.4. Social dimension

a) Promoting public and private social investment

In this scenario, while social protection expenditure is still under pressure due to the reinforced fiscal surveillance, the adoption of a "Golden Rule" allowing public investment to be excluded from the structural deficit target permits member states to spare certain social areas from budgetary cuts. Of course, making a distinction between social investment and consumption spending entails technical difficulties. For instance, Vandenbroucke, Hemerijck and Palier include childcare policies, education and active labor-market policies in social investment[91]. Some common criteria could be agreed between the member states and the Commission, just like it was the case for calculating "structurally adjusted" deficits, for example.

In addition, member states explore the use of new financial instruments in order to complement public sector efforts with innovative financing of social investment with private and third sector resources. Among other initiatives, the Commission invites member states to work on "Social Impact Bonds" which incentivize private investors to finance social programmes by offering returns from the public sector if the programmes achieve positive social outcomes[92].

b) Convergence and competitiveness contracts for social reforms

The CCI (cited above) will inevitably include reforms in the social field. This means that through the contractual arrangements and the financial assistance to which it is coupled, the EU will have binding instruments to intervene in the social field and promote reforms for instance in labour markets and/or pension systems. Even though the idea of granting Member states a financial assistance to implement structural reforms is a welcomed one, there is a risk that this instrument can be wrongly perceived. Indeed, it can be perceived as a mean for the European Commission to oblige member states to engage in reforms on the social and employment fields, while according to the Treaties the definition of employment and social policies is a national competence. If

91. Vandenbroucke, Frank, Hemerijck Anton and Palier Bruno, "The EU Needs a Social Investment Pact", *op.cit.*
92. European Commission, *Towards Social Investment for Growth and Cohesion – including implementing the European Social Fund 2014-2020*, COM(2013) 83 final, 20 February 2013.

applied to the employment and social policies, this convergence and competitiveness instrument must rest on incentives – and not coercion – with the member states remaining free to choose which reforms are to be implemented.

c) Eurogroup at social and employment ministers level

Eurogroup meetings at the finance minister level are complemented by informal meetings of ministers dealing with social and employment affairs (EPSCO). EPSCO ministers meet at least twice per year, before each Euro summit, in order to give their contribution to the meetings of the Heads of State and Government of the euro area. This enlargement of the Eurogroup composition contributes to integrating better social and employment concerns in the discussions and decisions of the euro area authorities.

4.3. Pros and cons of scenario B for the general functioning of the EMU

In this scenario, the main advantages for the functioning of the EMU as a whole accrue from the stabilization of the financial system.

- First of all, the completion of the banking union restores confidence in the financial markets and contributes to tackle the problem of the fragmentation of the financial system. As a consequence, private investment in the EMU is expected to be boosted which will contribute to reversing the downward recessive and unemployment spiral, especially in the EMU periphery.

- Secondly, the good functioning of the banking union also has positive repercussions for public finances. After numerous waves of bank recapitalizations, both in the core and in the periphery, one fourth of the European banking system remains under the state aid controls and dependent on public financing.[93] Such wide-scale nationalization of private debt has significantly worsened the state of public finances in many EMU member states. In this scenario, efficient bank resolution on the EMU level, based on the "polluter pays" principle, would break the vicious

93. Darvas Zsolt., Pisani-Ferry Jean and Wolff Guntram B., "Europe's growth problem (and what to do about it)", *Bruegel*, April 2013, p.5.

circle between the banks and the sovereigns and take into account all cross-border spillover effects.

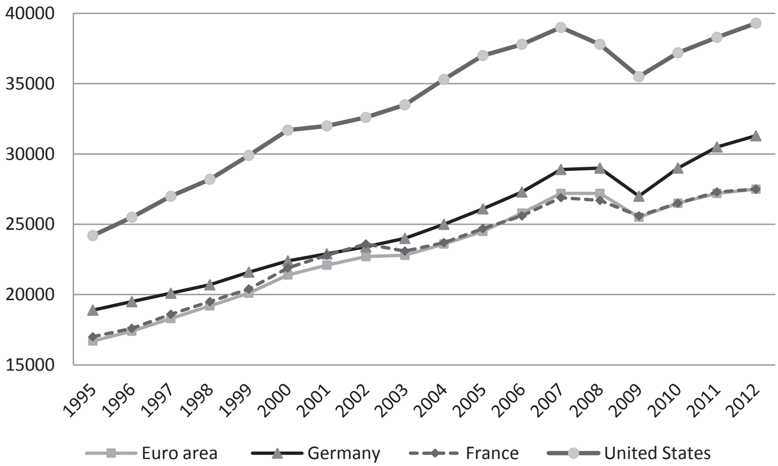
- Finally, the reinforcement of EMU's crisis resolution capacity also contributes to restoring markets confidence in the sustainability of the common currency. This has a positive effect on stopping market speculation on various government bond yields. Of course, the exact effect on the government bond yields will depend on the instruments adopted. If the member states go as far as adopting the EDRF in order to mutualize the excessive public debt, the interest rates would drop significantly in the peripheral countries. Even if the peripheral countries are concerned the most by this issue directly, it also matters for the EMU as a whole, as the policy makers will no longer be forced to act under market pressure.

Other measures adopted in this scenario are expected to have several positive consequences too. For example, a more efficient tax collection ensures that more resources reach public treasuries. They could be channeled for the reduction of public deficits and/or increasing investment.

Despite all these positive developments, the member states still find it difficult to come up with a common vision for the future. The common currency remains to be regarded as a constraint rather than an opportunity for dealing with the long term challenges such as the lack of growth in productivity and innovation or transition to the new sources of greener growth.

Indeed, even before the crisis, the EMU as a whole and the majority of member states were suffering from poor performance in terms of total factor productivity and low growth, especially as compared to the USA. As depicted in figure 14, the EMU member states including Germany have not managed to reach the GDP levels per capita of the USA, a phenomenon often referred to as a European "ceiling of growth". The figure suggests that the potential for growth in Europe is still present, yet the member states have not managed to unlock it on their own.

FIGURE 14 ► **GDP at purchasing power parity per capita (market prices)**



Source: Eurostat

In this scenario, member states continue on the pre-crisis "business as usual" as regards the national strategies for growth. They engage in cost competition with one another instead of commonly building new structures for being able to compete in quality on the global level. Even if some member states manage to individually transform their economies and adopt more knowledge intensive and less carbon intensive models of growth, due to large interdependencies their growth levels will be curved by the lack of positive developments in the rest of the euro area. Consequentially, the EMU is unable to ensure the development of the "highly competitive social market economy" foreseen in the Lisbon Treaty.

In addition, in this scenario just like in scenario A, two of the main challenges for EMU's sustainability are still unaddressed: its vulnerability to self-fulfilling solvency crises and the lack of instruments to tackle asymmetric shocks.

Lastly, the public sentiment of the EMU stays mitigated. While the project of banking union shows the citizens the value-added of the EMU action (by, for example, preventing bank nationalisations), the strengthened logic of control in exchange for solidarity pictures the EMU as a policeman of national action rather than an actor of social progress. The risk of nationalism persists as the sense of hostility towards the European integration is on the rise among citizens in both core and peripheral countries. Radical fringe parties, many of which are gaining ground in Europe already, might use this context for their purpose.

4.4. Impact on national welfare states

As argued above, several initiatives linked to the completion of the banking union and the change of paradigm to a growth-friendly fiscal consolidation allows enhancing the growth prospects in the short/medium term. This, in addition to the reinforcement of tax cooperation, has a positive impact on the future sustainability of national welfare states. However, three observations must be made to this positive outlook.

First, if the measures adopted are supposed to counter the impact of the crisis on EMU's growth potential, this will at the best allow member states to return to their pre-crisis growth levels. However, the growth levels in EU countries before the crisis were already low; as a consequence, it can be admitted that in the long run the growth prospects are insufficient to meet the challenge of the sustainability of national welfare states.

Second, if growth is a necessary condition to ensure the sustainability of national welfare states, it is not a sufficient one. As outlined in part 1, the EMU can have potentially harmful consequences on national welfare states. As Southern countries have to restore their competitiveness and pursue a long debt reduction path, they might be forced to continue their internal devaluation. As a result, the risk of social competition would remain, even though it is lower due to general improvement of economic and social outlook.

Third, like in scenario A, the absence of any common shock absorption capacity makes future adjustment to shocks dependent on market-based mechanisms (labour mobility and wage and price flexibility), forcing member states to engage in an internal devaluation whenever an asymmetric economic shock occurs. Against this background, social policies might still be used as a variable of adjustment in such a situation.

a) In the peripheral member states

Taking into account that the initiatives foreseen in this scenario aim at addressing the short term challenges related to the crisis, the member states who benefit the most from this scenario are those the most affected by the current crisis. Even though an important improvement is not realistic in the short term, their situation stops deteriorating and their economy gives the first signs of recovery.

The vicious circle of the last four years (austerity, shrinking demand, unemployment and low growth lead to less public revenues and more public spending, which in turn lead to more austerity, including cuts in social spending) is progressively replaced by a virtuous circle. Indeed, guaranteeing financial stability via reinforced crisis resolution mechanisms and the completion of the banking union would probably allow easier access to credit for the enterprises, eventually leading to job creation. This, together with the additional measures from the EU to support the most vulnerable countries (up-front payment of structural funds, etc.), is likely to have a positive impact on demand. Taken together, these measures improve EMU's growth prospects, increase public revenues and reduce the need for additional austerity measures.

b) In the core member states

The consequences on national welfare states of the core countries are generally those presented above for the euro area as a whole. These member states remain vulnerable to the two potential undesirable effects of the EMU on their national welfare states:

- Social competition: even if the general economic and social outlook of the EMU improves, the divergence between member states will be one of the main legacy of the current crisis and this trend will take many years to be reversed. As a consequence, the risk of a race to the bottom on social standards is lower than in scenario A but still exists.
- Social dismantlement: in the current crisis it is the peripheral member states who would have needed a cyclical adjustment fund; however, as cyclical divergences are bound to occur in the future, the core member states might also be forced into internal devaluation and need to rely on social policies as adjustment variables in a case of a negative asymmetric shock.

In addition, these countries can also be obliged to engage in reforms on the social and employment fields via the CCI, which goes against the member states right to maintain their own preferences on these fields, at least as long as they respect the fiscal and macroeconomic rules commonly agreed.

5. Scenario C

5.1. Assumptions

Scenario C is different from scenarios A and B because it supposes that the action of the member states is no longer guided by the purpose of crisis management. Moving from a "sense of survival" to a "sense of common purpose" is a basic condition to build a "genuine" EMU as defined in Van Rompuy's report.

It should be highlighted that the need to have this sense of common purpose in a common currency area is not a result of the current crisis. Indeed, back in 2008 already, de Grauwe warned that without a sense of common purpose the monetary union would remain a fragile construction[94]. Yet, undoubtedly, the claims in this direction have gained momentum with the crisis: if some years ago this common purpose was considered desirable for reinforcing the monetary union, it has now become a necessity mainly for two reasons: to guaranty the long-term sustainability of the common currency and to ensure the prosperity of its member states. Such a necessity has been confirmed, among others, by President Barroso ("(...) we need a sense of common purpose not only from the European institutions, but from all our member states")[95] and Pisani-Ferry ("Europe displays a strong sense of survival, but not a strong sense of common purpose"[96]).

This third scenario is built on the assumption that euro area countries are able to agree on this sense of common purpose. Such an assumption raises two main questions: what would make the member states change their paradigm and which features would constitute this common purpose that could guide the common EMU action.

94. De Grauwe, Paul, "The Euro at ten: achievements and challenges", Paper presented as the keynote lecture at the Annual Meeting of the Austrian Economic Association inVienna, May 23 2008.
95. European Commission, *Statement of President Barroso following the European Council on economic governance*, EP plenary debate on EuroCouncil on economic governance, Strasbourg, SPEECH/10/68124, November 2010.
96. Pisani-Ferry, Jean, « Is the euro crisis over ? », *Project syndicate*, 1 February 2013.

There exists a set of reasons which could lead member states to change their attitude and become aware that EU's and EMU's future depends on a transition from action guided by a sense of survival to action guided by a sense of common purpose.

First, the EU fails to ensure sufficient growth and prosperity for its citizens. All EMU countries are still enduring sluggish growth, stagnation or are caught in recession. Europe lacks new sources of growth and competitiveness, while unemployment remains the main issue on the political agenda. In the context of various structural difficulties, the member states realize that only common action can bring sustainable long-term solutions.

Second, Euroscepticism is gaining momentum in the EU - and in particular in the euro area - endangering the long-term viability of the European project. Citizens from peripheral countries blame the EU for the strong adjustments they are suffering; and the citizens from the core countries criticize the EU for using "their" money to support the periphery.

Third, the crisis compromises EU's economic and political weight on the global arena. Member states realize the implications of the ongoing shift of powers on the global level. As illustrated in table 7, the estimations show that by 2050 none of the EU member states will be part of the G8 of global largest economies. As the new competitors are growing and getting stronger, European single market is contracting and loses its attractiveness as a destination for external investors. In addition to the loss of influence, intensified competition with the emerging economies has repercussions on the national welfare states. Today, Europeans constitute only 7% of global population, produce 25% of global output and have to finance 50% of social expenditure[97], a level which might no longer be affordable in case of EMU economic decline.

97. Interview of Angela Merkel by Quentin Peel, "Merkel warns on cost of welfare", *Financial Times*, 16 December 2012.

TABLE 7 ► Actual and projected top 10 economies ranked based on GDP in PPP terms

	2011		2030		2050	
PPP rank	Country	GDP at PPP (2011 US$bn)	Country	Projected GDP at PPP (2011 US$bn)	Country	Projected GDP at PPP (2011 US$bn)
1	US	15.094	China	30.634	China	53.856
2	China	11.347	US	23.376	US	37.998
3	India	4.531	India	13.716	India	34.704
4	Japan	4.381	Japan	5.842	Brazil	8.825
5	**Germany**	3.221	Russia	5.308	Japan	8.065
6	Russia	3.031	Brazil	4.685	Russia	8.013
7	Brazil	2.305	**Germany**	4.118	Mexico	7.409
8	**France**	2.303	Mexico	3.662	Indonesia	6.346
9	**UK**	2.287	**UK**	3.499	**Germany**	5.822
10	**Italy**	1.979	**France**	3.427	**France**	5.714

Source: PwC, World in 2050 - The BRICs and beyond: prospects, challenges and opportunities, January 2013.

However, even though the member states become well aware of all these realities, there is a need for a triggering effect that incites the member states to move forward. 2014 represents a window of opportunity in this context. Indeed, the appointment of the new German government at the end of 2013 as well as the nomination/election of new key decision-makers at the EU level next year (new Presidents for the Commission, the European Council/euro area summits and the European Parliament; and new Commissioners and members of the EP) could contribute to creating a favourable political context for this transition.

The remaining question concerns the nature and the features of this sense of common purpose. Historical detour may give some hints what constituted a basis for advancing European integration in the past. As Heirse and Lierse remind us, former President of the European Commission Jacques Delors was successful in overcoming the euroscepticism of the 1980s ("Eurosclerosis") and the economic challenges to which European countries were confronted through a compromise between economic and social integration and a mobilizing project - the completion of the single market[98].

Similarly, in this scenario, we assume that almost 30 years later, EMU countries – and ideally the EU 28 - engage in a new compromise and new mobilizing projects. The sense of common purpose is based on the relaunch of growth and the transition to a new growth model. However, growth is not an end in itself, but a prerequisite for being able to maintain and increase Europe's prosperity and thus for preserving and enhancing national welfare states. At the end, the common purpose is about preserving the "European way of life"[99].

This brings us back to the Lisbon and the Europe 2020 strategies. Indeed, the aim of these two successive growth strategies is to ensure a balance between the economic, social and environmental dimensions. If the EU's growth strategy did not deliver the expected results, it was not because it defined the wrong objectives, but because of its weak instruments and the lack of ownership.

The consensus is thus based on the priorities of Europe 2020: a quest for a smarter, greener and more inclusive growth. As such, the new positive agenda should be defined for the EU as a whole, even though some initiatives are undertaken at the EMU level where i) they concern only the countries sharing the same currency, such as addressing EMU's fragilities; or ii) they are unattainable at the EU28 level.

It should be emphasized that all of the joint action in this scenario does not imply the creation of a European "superstate". In line with the principle of subsidiarity, the instruments leading to deeper integration should be limited to what is strictly necessary for a well-functioning and prosperous EU/EMU. The challenge is to act jointly upfront in order to avoid collective problems which ask for common solutions.

98. Heise, Arne and Lierse, Hanna, "Budget Consolidation and the European Social Model. The Effects of European Austerity Programmes on Social Security Systems", *Friedrich Ebert Stiftung*, March 2011.
99. Vandenbroucke, Frank, "Europe: The Social Challenge Defining the Union's social objective is a necessity rather than a luxury," *op cit*.

5.2. EU/EMU policy initiatives

5.2.1. Fiscal and economic union

a) The EU/EMU as an actor for growth and competitiveness
In this scenario, member states agree to allow the EU to become an actor in its own right and not just a coordinator of national policies. To that purpose, several initiatives are undertaken.

First, the EU develops positive stimulant actions, and those actions involve developing policies for which the treaty assigns "shared responsibility" to the EU (in accordance with Article 4 of TFEU). The policies in question concern in particular the fields of energy, transports, research and the environment. The EU mobilizes resources for its action and puts in place a program of European investment or public spending.

Second, the EU and its member states engage on a social investment pact, the aim of which is twofold: to increase EU economies' growth potential and to modernize national welfare states[100].

Third, in order to develop these initiatives, member states agree on new own resources for the EU budget and confer it a borrowing capacity as proposed by Tommaso Padoa-Schioppa[101]. For Padoa-Schioppa, the justification for reinforcing EU financial means lies on the "greater effectiveness of European public spending over national public spending. It is easy to demonstrate that, without altering the overall amount of (national and European) public expenditure, if we were to cut back on the national part and to raise the European part by the same amount, that would allow us to achieve better results, or to achieve the same results while spending less"[102].

100. European Parliament, Committee on Employment and Social Affairs, *Report on Social Investment Pact – as a response to the crisis*, 2012/2003(INI), 25 july 2012. Vandenbroucke, Frank, Hemerijck Anton and Palier Bruno, "The EU Needs a Social Investment Pact", *op cit*.
101. Padoa-Schioppa, Tommaso, *From the Crisis to a European Economic Strategy: A Conversation with Tommaso Padoa-Schioppa on the Eve of the June 2010 European Council*, *Notre Europe-Jacques Delors Institute*, 15 June 2010.
102. The idea of greater effectiveness of European public spending over national public spending is developed in: Haug, Jutta, Lamassoure Alain and Verhofstadt Guy, *Europe for growth: for a radical change in financing the EU*, 2011.

Fourth, member states agree on a new approach for the "Convergence and competitiveness contracts" foreseen in scenario B. As proposed by Pisani-Ferry[103], the contracts should, in this third scenario, concern European policies rather than member states. The EU/EMU should define its clear long-term growth objectives and strategies and propose financial assistance for their implementation to the countries that are willing to follow suit. For example, if the EU wants to increase the number of senior workers, it could establish a national grant scheme for their training. However, the grants could only be available to the member states that do not hinder senior employment in any other way (by, for example, favouring early retirement). The definition of the EU objectives should be based on the Europe 2020 strategy.

b) Adjustment to cyclical divergences: a shock absorption capacity at EMU level

As we previously argued, EMU countries do not have sufficient instruments for tackling asymmetric shocks. Additionally, there is evidence that in integrated economies, dealing with asymmetric shocks is most effective on the aggregate, not on the regional/national level[104]. However, the EMU has no cyclical adjustment mechanism and the market-based adjustment mechanisms are less effective than in other monetary unions because of low levels of cross-country labour mobility and structural impediments to price flexibility. The currency union thus lacks mechanisms that could dampen the effects of asymmetric shocks and/or the pro-cyclicality of ECB's monetary policy and prevent spill-overs resulting from deeper economic interdependencies. As a consequence, social policies often become variables of adjustment as the current crisis put in evidence.

In order to address this problem and improve the synchronization of member states' business cycles, in this scenario member states commit to the setting-up of a macroeconomic stabilization fund (see box 8).

103. Pisani-Ferry, Jean, "Distressed Europe should not be bribed to reform", *Bruegel*, 6 February 2013.
104. Enderlein, Henrik et al., "Making one size fit all: designing a cyclical adjustment insurance fund for the Eurozone", *Notre Europe – Jacques Delors Institute*, Policy paper, January 2013.

BOX 8 ➤ A cyclical adjustment capacity for the EMU

Although the need for some form of stabilization at the EMU level was featured in both the Delors report and the "One Money, One Market" report by the Commission that led up to the creation of the euro, the EMU started without any such scheme in place. The debt crisis brought the question of macroeconomic stabilization back into the discussion and both the Commission's Blueprint for the EMU and Van Rompuy's report on the future of EMU call for the implementation in the medium/long term of a shock absorption capacity in the EMU.

According to Van Rompuy's report on the future of EMU such **a euro area shock absorption mechanism should be in accordance with five criteria**: (i) it should not lead to unidirectional or permanent transfers; (ii) it should not undermine incentives for structural reforms; (iii) it should be implementable within the framework and the institutions of the EU; (iv) it should not be an additional crisis resolution mechanism, but rather complement the ESM; and (v) it should not lead to an overall increase in tax and expenditure levels.

c) A permanent debt mutualisation scheme in order to avoid self-fulfilling solvency crises and reinforce the Euro on international financial markets

We cannot exclude that in this scenario member states might also need to reinforce their crisis resolution capacity as foreseen in scenario B as a consequence of deteriorating situation in some EMU countries.

However, in this scenario, member states go beyond the crisis management and consider setting up a permanent debt mutualisation scheme for the euro area as one of the last stages of EMU's reinforcement. In this context, Eurobonds have two main purposes: acting as a crisis prevention instrument, protecting member states from self-fulfilling solvency crises; and enhancing the Euro's role in the global financial markets (see box 9). Just like the temporary instruments presented in scenario B, this permanent scheme must be coupled with a strong conditionality in order to avoid moral hazard.

BOX 9 ➤ Advantages of a permanent debt mutualization scheme in the euro area

This new instrument has several advantages, inter alia:

- It makes the euro area financial system more resilient to future adverse shocks; member states are provided with more secure access to refinancing, preventing a sudden loss of market access due to unwarranted risk aversion and/or herd behaviour among investors. Accordingly, Eurobonds would help smoothing market volatility and reducing or eliminating the need for costly support and rescue measures for member states temporarily excluded from market financing.
- It offers the possibility of a large and highly liquid market; the liquidity and high credit quality of the Eurobond market delivers low benchmark yields, reflecting correspondingly low credit risk and liquidity premiums.
- It enhances the role of the euro in the global financial market. The US Treasury market and the total euro-area sovereign bond market are comparable in size, but fragmentation in Euro-denominated issuance means that much larger volumes of Treasury bonds are available than for any of the individual national issuers in the euro area. High liquidity is one of the factors contributing to the prominent and privileged role of US Treasury Bonds in the global financial system (backed by the US dollar as the sole international reserve currency), thereby attracting institutional investors. Accordingly, the larger issuance volumes and more liquid secondary markets implied by Stability Bond issuance would strengthen the position of the euro as an international reserve currency.

d) A double mandate for the ECB: low inflation and low unemployment

Today the ECB follows a mandate of ensuring price stability in the euro area (Art. 127, TFEU). Only when the goal of price stability is reached, the ECB is also required to contribute to the general economic policies of the EU, including the balanced economic growth, full employment and economic, social and territorial cohesion as well as solidarity among member states (Art. 3 TEU). In the words of Jean Claude Trichet, the ECB has "only one needle in its compass"[105] (price stability) to guide its actions. Such a mandate contrasts sharply with, for example, a dual mandate of the Federal Reserve of the US consisting of both ensuring price stability and full employment.

Several member states, in particular France and Spain, have already expressed their position that the change in ECB's mandate would be a way forward for

105. Trichet, Jean-Claude and Papademos, Lucas, European Central Bank, "Press conference, Introductory statement with Questions and Answers", Frankfurt am Main, 7 August 2008.

ensuring the prosperity of euro area countries[106], while other member states are resisting (notably Germany). Yet, the ECB's mandate is enshrined in the EU Treaties and only an agreement among the 28 member states could modify it.

As in this scenario a Treaty change is envisaged, it is assumed that the ECB could be given a double mandate ensuring price stability as well as full employment. It would permit the ECB to pursue a more expansionary monetary policy, without prejudicing its inflationary target. As argued by Whelan, the double mandate of the Fed has not resulted in higher inflation in the US; however, a single mandate in the EU has resulted in less expansionary monetary policy[107]. Today, the Fed is continuing its zero interest rate policy and has pledged to do so until the unemployment rate falls back to 6.5% in order to boost market confidence. The ECB is currently sticking to the 0.5% interest rate but with the probability of increasing it in case of any increase in inflation. If the hierarchy of the ECB mandate would be abandoned, a more balanced approach could be adopted for the EMU monetary policy.

This is not to say, however, that the ECB would also become a "lender of last resort" for the member states with the aim of ensuring financial stability. As discussed by Pisani-Ferry, such a change of ECB's mandate is "the least feasible option" because the ECB is "not in a position to make such a commitment"[108]. Even if a Treaty change could be introduced in this scenario (thus eliminating the legal obstacles), direct purchase of government bonds by the ECB would make it a "vehicle for a transfer in favour of the countries benefiting from the purchases"[109] creating a problem of strong moral hazard. On the one hand, the ECB has no power to exercise any strong conditionality and rightly so as its credibility rests on its independence from various political considerations. On the other hand, the ECB's governance structure consisting of "one country-one vote" in the governing council is not adapted for direct sovereign bond purchases: a coalition of weaker member states could potentially "trigger intervention in favour of their countries at the expense of the larger countries which would contribute the bulk of recapitalization"[110].

106. "Spain joins French calls to rewrite ECB mandate", *EurActiv*, 9 April 2013.
107. Whelan, Karl, "A broader mandate: Why inflation targeting is inadequate" in Lucrezia Reichlin and Richard Baldwin (eds) *Is Inflation Targeting Dead? Central Banking After the Crisis*, London: Center for Economic Policy Research, 2013.
108. Pisani-Ferry, Jean, "The Euro Crisis and the New Impossible Trinity", *Bruegel*, ISSUE 2012/01, January 2012, p. 1.
109. *Ibid*. p.10
110. *Ibid*. p.10

e) Rebalancing: sharing the burden of adjustment

Peripheral member states will certainly need to pursue their debt reduction path and to implement structural reforms to regain their competitiveness. However, in this scenario, core member states accept that they need to contribute to the rebalancing of the euro area. Indeed, adjustment in the surplus countries could contribute to the rebalancing of external positions in the euro area, and provide some easing of the adjustment pressure in the deficit countries. Moreover, as stated in a recent study of the European Commission, "surpluses are detrimental to the welfare of the population to the extent they are driven by structural weaknesses affecting demand (…). Addressing these issues through structural reforms, while letting wages and prices respond flexibly to market signals, would be welfare-enhancing for the surplus countries".[111]

In this context, core EMU countries accept to share the burden of adjustment in particular via the two following initiatives, as proposed by Pisani-Ferry.[112]

First, they limit fiscal adjustment to what is needed for a gradual reduction of excessive public indebtedness and avoid the temptation of budgetary overkill.

Second, they accept temporarily higher inflation as long as price stability is maintained in the euro area as a whole. As explained by Pisani-Ferry, "governments should accept that to the extent Southern Europe does adjust, the monetary policy of the ECB is likely to be too loose in the years ahead to maintain price stability in their countries and they should accept wage settlements significantly above those observed in the first decade of EMU"[113].

In addition, the European Commission undertakes a more symmetric approach on the surveillance of macroeconomic imbalances. This includes two main changes in the MIP scoreboard: adding a lower threshold for the change in nominal unit labour cost, in order to prevent excessive wage restriction; and considering current account surpluses with the same urgency as current account deficits.

111. Hobza, Alexandr and Zeugner, Stefan, "Current-account surpluses in the Eurozone: Should they be reduced?", Vox, 26 April 2013.
112. Pisani-Ferry, Jean, "The euro-area rebalancing challenge ", *Bruegel*, 22 May 2012.
113. *Ibid.*

f) Limiting tax competition: towards more harmonization

In this scenario, member states go much further and introduce some harmonization of tax rates on the top of the initiatives foreseen in scenarios A and B. As discussed in the Monti Report, fiscal competition is present in the EU as "almost all member states decreased their statutory corporate tax rates, competing for internationally mobile capital".[114] In fact, the average rates for the EU15 has gone down by 20 percentage points (from 50% to 30%) in the last two decades and the rates in the new member states are lower still.[115]

At the moment, the idea of tax rate harmonization is not on the table; indeed, the Commission makes it very clear that this question is not being discussed[116]. Yet, the Thyssen report for the European Parliament states that once the current CCCTB directive is in place, "the Commission should consider whether [...] harmonisation is appropriate when reviewing the application of this Directive."[117] In this scenario, member states want to go a step further to limit tax competition and optimize fiscal revenues for the EU as a whole. The Commission takes the initiative to investigate the appropriateness of some tax harmonization. If the Commission finds that common tax rate would bring more benefits for the EU, member states would be ready to consider the proposals for some tax harmonization.

Of course, any kind of tax harmonization should be done in a differentiated manner. Much of the real variation in the corporate tax policy can be explained by intrinsic national market characteristics (such as the size of the country or its remoteness to the "core" of Europe) as well as social preferences of national societies. In this sense, a certain level of tax differences is optimal for each member state and for the Union as a whole. Yet, the new system could establish either a minimum tax floor or a mechanism based on rule-led tax harmonization. Theoretically speaking, such rules would be beneficial to both larger and richer "core" member states and the small peripheral ones: the bigger

114. Monti, Mario, *op cit*.
115. *Ibid.*
116. After the adoption of Thyssen Report for the EP, the Commissioner Semeta has said that "*the Commission has consistently made it clear that the CCCTB proposal is only meant to deal with the rules for computing the corporate tax base and should not touch upon minimum tax rates.*"
117. European Parliament, Committee on Economic and Monetary Affairs, *Report on the proposal for a Council directive on a Common Consolidated Corporate Tax Base* (CCCTB), A7-0080/2012, 28 March 2012.

countries would be free to strategically choose a higher rate whereas the smaller ones would converge to the agreed minimum.[118]

5.2.2. Banking union

The three pillars of the banking union, as presented in scenario A and B, are implemented.

5.2.3. Political union

The new shock absorption capacity requires the setting-up of an EMU budgetary authority to manage joint resources and/or common borrowing.

This EMU Treasury can i) be established within the Commission and be headed by the Vice President responsible for Economic and Monetary Affairs and the euro or ii) be an independent institution headed by the President of the Eurogroup, who would fulfil the tasks of a kind of "minister for finances of the euro area". The merger of these two functions can also be made, following the model used for the High Representative of the Common Foreign and Security Policy, so as to identify clearly a Mr/Mrs euro area.

Concerning the reinforcement of the democratic legitimacy of the EMU, and as Bertoncini proposes[119], the EMU Inter-Parliamentary conference gathering members of national and European Parliaments and the euro area sub-committee (both foreseen in scenarios A and B) share the following tasks:

- The EMU Interparliamentary conference debates all the aspects related to debt mutualisation, as to define the level of debts that it is legitimate to mutualize as well as the degree of control established over the national budgets, in compensation for such mutualization. The EP euro area sub-committee is involved in such discussion if this debt mutualization is decided on the basis of an enhanced cooperation or if Eurobonds are

118. Kanbur, Ravi and Keen, Michael, "Tax competition and tax coordination : when countries differ in size, *Policy Research Working Paper Series* , n°738, World Bank, 1991.
119. Bertoncini, Yves, "The parliaments of the EU and the EMU governance. What parliamentary dimension for the "political union ?", *Notre Europe-Jacques Delors Institute*, Tribune, 11 April 2013.

issued to finance EU expenditures (for example dedicated to investments for Trans-European networks).

- The monitoring of the "Cyclical adjustment fund" is also defined in connection with its way of funding. If this stabilisation fund is based on an insurance type philosophy (meaning the contribution of member states), the EMU Inter-parliamentary conference deals with its organisation and use. If the funding is made on a European basis, thanks to the use of new own resources, the European Parliament - via its euro area sub-committee - is naturally more directly mobilised.

5.2.4. Social dimension

a) A social investment pact

Reinforcing the "social investment" component of national welfare states is a key condition to ensure their long-term sustainability. As explained by Hemerijck et al., "central to the social investment perspective is the attempt to reconcile social and economic goals. In policy terms, the focus is on public policies that "prepare" individuals, families and societies to adapt to various transformations, such as changing career patterns and working conditions, the emergence of new social risks, population ageing and climate change, rather than on simply generating responses aimed at "repairing" any damage caused by market failure, social misfortune, poor health or prevailing policy inadequacies".[120] This means re-building national welfare systems on two twin pillars: social protection and social investment.

In the first place this social investment pact should include actions to be undertaken at the national level by national governments. However, the EU should contribute to national action via its existing instruments and some new or reinforced initiatives.

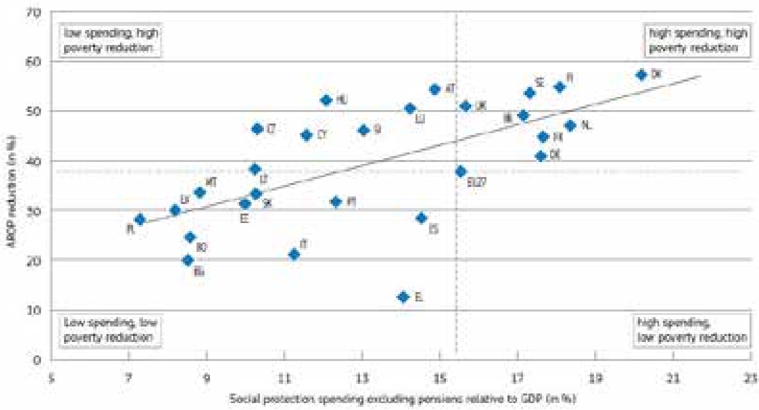
First, the EU/EMU can become a real actor in terms of social investment through the new objective-based contracts for convergence and competitiveness. EMU develops and pursues its goals in the fields of education, life-long learning and labour market policies among others. Member states are free to

120. Vandenbroucke, Frank, Hemerijck Anton and Palier Bruno, *op cit*, p. 5.

choose if they want to adhere to these policies and receive financial support for their implementation.

Second, the EU/EMU focuses more on "spending better" instead on "spending less" in the social field. "Spending better" is particularly relevant for social spending because, as shown in the graph below, the member states with comparable budgets often have very divergent social outcomes; consequently, there is room for efficiency gains in many countries.

FIGURE 15 ► Relationship between social protection spending (excluding pensions, relative to GDP) and relative reduction in the share of population (aged 0-64) at risk of poverty (2010)



Source: European Commission, Towards Social Investment for Growth and Cohesion – including implementing the European Social Fund 2014-2020, Communication COM(2013) 83 final, 20.02.2013.

b) An unemployment insurance scheme

The setting-up of a cyclical-adjustment fund has first of all a major advantage for the reinforcement of the EMU's social dimension: it reduces the pressure for using social policies as a variable of adjustment in the case of an asymmetric shock.

This short-term automatic stabilization at the EMU level can be achieved through an EMU unemployment benefit scheme. This scheme would have a triggering mechanism linked to an economic indicator such as the output gap or the short-term unemployment rate. Using the short-term unemployment rate would have two main advantages: on the one hand, it is highly sensitive to cyclical developments and, on the other, it is easily measurable (as opposed to the output gap, for example) and there are robust data across Europe on the basis of a common Eurostat/ILO definition. If we consider the short-term unemployment rate, the fiscal transfers would be triggered by a certain increase in this economic indicator (regardless of the starting short-term unemployment rate, which means that both a country with a relatively low short-term unemployment rate and one with a high rate are suitable to receive fiscal transfers if they suffer from cyclical unemployment).

The transfers to the member states would be earmarked for unemployment benefit expenditure on the basis of harmonized provisions, conditionality and minimum standards, e.g. of social protection and labour activation. Earmarking the transfers for unemployment benefit schemes is justified by the fact that these schemes have significant counter-cyclical stabilizing effects not only because unemployment rapidly responds to the economic cycle, but also because recipients of unemployment benefits have a higher propensity to support aggregate demand in the real economy (through consumption or entrepreneurial investment).

The mechanism should be conceived in such a way as to avoid two problems: (i) large transfers in one direction, e.g. from the North to the South, as a system with one-way flows would not be sustainable and would create strong disintegrating pressures; and (ii) moral hazard, with EMU automatic stabilizers replacing the need for fiscal consolidation of structural nature and structural reforms. It is then important that the transfers would be attached to a strong conditionality, linked to strong active labour policies and employability elements and the implementation of structural reforms.

The scheme could be financed from one or more of the following sources: transfers from national budgets; new own revenue at the EMU level (e.g. the financial transaction tax); or workers' contributions (payroll taxes), in which case the scheme would be an unemployment insurance system based on individual entitlements.

As pointed out by Commissioner Laszló Andor: "A fiscal capacity would be able to strengthen the sustainability as well as the legitimacy of the EMU, by addressing asymmetric shocks and mitigating the social consequences of adverse economic developments. (…) For example, in the form of EMU level unemployment insurance, this would constitute direct expression of EU support to citizens in need"[121].

c) EMU-wide common social standards

The discussion on minimum social standards on the EU/EMU level dates back to at least two decades as the introduction of single market and single currency was expected to intensify competition between the member states. Such competition might not always be "fair" and welfare-enhancing if member states compete on various labour cost factors instead of adopting a more difficult and time-consuming strategy of improving labour productivity. This temptation is extremely high for the euro area countries, which can no longer use their currency exchange rates to boost their competitiveness by making their exports cheaper.

One way for preventing such social competition, or social dumping, is the creation of well-defined EMU-level minimum social standards. The ultimate aim of these social standards should not necessarily be the upward social convergence between the member states; instead they should prevent the downward social spiral beyond the agreed levels (the so called "nonregression" clauses in European labour law today). This would protect the social rights already acquired without putting pressure on complete upward harmonization, which is impossible bearing in mind the large diversity of EMU national welfare states.

One of the most obvious common social standards that could be agreed on is a EMU-wide minimum wage standard. Minimum wages are important because they represent both an economic variable and a clear social standard. In a current state of play minimum wages could potentially suffer from unfair competition between countries trying to bring down their cost of labour at the expense of the poorest workers. A common minimum wage standard, which

121. Andor, László, "Europeans want and deserve a monetary union with a human face", Speech at ETUC conference, Madrid, 28 January 2013.

would obviously take into account the price and productivity levels in the member states, could thus be introduced in the EMU to eliminate the destructive "race to the bottom" and reduce in-work poverty.

Minimum wages constitute an important policy variable because they have important economic and social consequences. On the economic side of the issue, minimum wages might provide an efficient stabilization instrument in a case of cyclical shock as they help to sustain aggregate demand. However, according to the classical view, minimum wages can also increase the cost of (low-skilled) labour and subsequently destroy the jobs available. This view is often contested though as a number of studies show that the effects of introducing or raising minimum wage in a country do not significant negative effects on unemployment.[122] In addition, in a case of a negative economic shock in a common currency area, minimum wages might be used as a factor of "internal devaluation". Indeed, as discussed in chapter 4 of this study, during the crisis minimum wages have been reduced in several countries hoping to improve their real exchange rate.

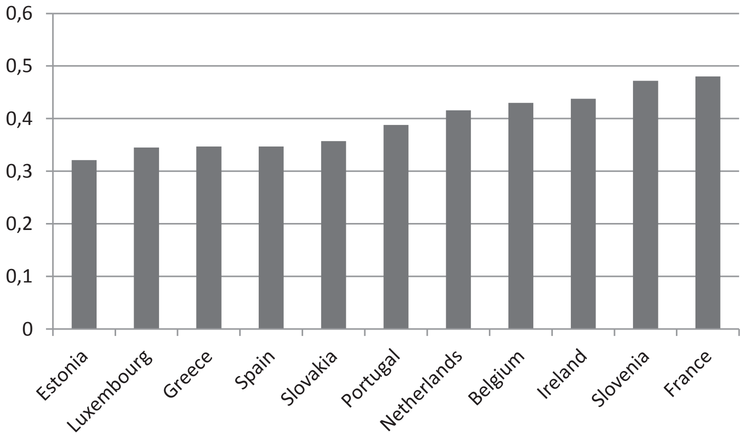
On the social side, rightly set minimum wages can add to eliminating the phenomenon of the "working poor" as well as reducing the pay gap between the groups of vulnerable (younger, older, disabled and female) and more advantaged workers. These are important effects for the social cohesion that EU is aspiring to and, more precisely, for the achievement of Europe 2020 targets. Yet, the minimum wages today do not provide a guarantee that having a job allows avoiding poverty as 8% of European workers today live below the poverty line.[123] Recent study shows that a more clearly defined minimum wage could be advantageous even in the Nordic context.[124]

In this scenario, member states go beyond the logic of cost competition and adopt a EU/EMU minimum wage standard by gradually converging to a certain threshold of minimum wage as a proportion of average or median national salary[125]. In order to respect the very different traditions of labour relations in

122. For an analysis of recent research see the Low Pay Commission Report 2011: "National Minimum Wage" by the British Secretary of State for Business, Innovation & Skills of April 2011.
123. European Commission, *Towards a job-rich recovery*, COM(2012) 173 final, p. 9.
124. Eldring, Line and Alsos, Kristin, *European minimum wage : A nordic Outlook*, Oslo: FAFO, report 2012:16, 2012.
125. Schulten, Thortsen et al., "Theses for a European Minimum wage policy", in Schulten et al, *Minimum Wages in Europe*, Brussels: ETUI, 2006.

the EU, the member states would be free to choose the method of achieving this target (for example, either through adjustment of statutory wages or via collective bargaining). One famous proposal of a group of researchers foresees convergence up to 50% of national average wage in the shorter term and an eventual increase up to 60% in the longer term. Yet, the Figure 16 suggests such a proposal might be too ambitious as some member states are very far off the 50% threshold. In any case, in order to provide meaningful improvements, the target should be higher than the current rates of Estonia and Luxembourg.

FIGURE 16 ► Minimum wage as proportion of national average wage, 2011



Source: OECD

Various proposals relating to the minimum social standards – in addition to a minimal minimum wage – are circulating around. They include, for example, setting a common minimum "health package" for each citizen as well as introducing common minimum pensions or, more generally, minimum European income levels[126].

126. See European Parliament, "The role of minimum income in combating poverty and promoting an inclusive society in Europe", Resolution of 20 October 2010 or ETUC, Position on the social dimension of the European Union, 23 April 2013.

In a few words, defining common social standards would eliminate the incentive to engage in social dumping and would protect national welfare states from negative effects of the common currency.

5.3. Pros and cons of scenario C for the general functioning of the EMU

The main advantages of this scenario stem from the fact that EMU member states pledge themselves to a coherent long-term strategy for growth, employment and transition to a more sustainable economic model. In this scenario it is assumed that the banking union as presented in scenario B is already completed, which helps to tame the current crisis. Nevertheless, significant changes in the European growth strategy are needed if Europe wants to sustain its prosperous way of life in the changing global context.

For many years before the crisis Europe lagged in terms of prosperity from the US (see figure 14, scenario B) and its GDP growth, was based on intensive use of natural resources rather than on productivity growth. Indeed, labour productivity in Europe has been declining for most of the 2000s whereas the growth of total factor productivity has remained close to zero. In 2012, total factor productivity in Europe has contracted further pointing to a weakening capacity for innovation and a failure to strengthen competitiveness.

In this scenario, common vision is translated in real policy action with the aim of making the EU/EMU a "highly performing social market economy". The new growth strategy is mobilized for achieving the Europe 2020 targets, reducing dependence on fuel energy by pursuing common energy policy, improving European competitiveness in the world by investing in human capital and creating new infrastructures (physical, cyber and intellectual). Additional European funding pooled together facilitates the implementation of all these expensive reforms and ensures the achievement of the Europe 2020 targets, many of which have been abandoned in the current period of crisis.

In addition, it could be expected that the shift to the new model of growth via the common strategy would generate a new type of competition both between the member states and globally. Member states would be forced to compete for investment by improving the quality of infrastructure, productivity of the labour force or business-friendly administrative systems rather than by simply cutting their production costs. Such competition in "quality" rather than in "price" could result in the "race to the top" and would have important positive effects in terms of structural convergence within the EMU and general advantages in terms of competitiveness and economic efficiency.

The common shock absorption capacity at EMU level would also have a positive effect on reinforcing the EMU. In case of future negative asymmetric shocks, the insurance mechanism would prevent the member states from resorting to wage and social dumping as an alternative to national currency devaluation. This is, of course, not to say that the EMU would become a permanent fiscal transfer union from the core to the periphery; on the contrary, all member states would have access to the insurance payment in a case of a country-specific shock. For example, as shown by recent calculations[127], had such a shock absorption capacity be in place in 1999, almost all EMU founding members would have been close to a net-zero financial position in 2013.

All these positive structural developments and policy initiatives would have positive repercussions for the legitimacy and public support of the EMU project for two reasons. On the one hand, a well-functioning EMU could then ensure economic prosperity. In the long term, economic growth based on new technologies and sustainable development creates new jobs and better living standards for the populations of the member states. On the other hand, whenever a cyclical divergence occurs in one of the euro area countries, its citizens are reassured that the EMU mechanisms will act in the spirit of solidarity rather than as means of punishment.

Finally, the role of the EU/EMU in the world could be strengthened substantially to meet the challenges of the changing geo-political context. As the common currency area becomes capable of creating sustainable growth and is more robust to economic shocks, global investors will find it more attractive as an investment destination. In addition, the creation of highly liquid European bond market, which would be comparable in size to that of the US, would

127. Enderlein, Henrik et al., "Making one size fit all: designing a cyclical adjustment insurance fund for the Eurozone", *Notre Europe – Jacques Delors Institute*, Policy paper, January 2013.

reinforce the role of the euro as a global reserve currency. Lastly, the will of acting more jointly on various issues would ensure that European voice is heard even if no EU member state belongs to the club of G8 largest global economies in the long run (see table 7).

However, this scenario also implies several difficulties. First and foremost, even if it is assumed that the new European leadership concentrates more on the long term growth agenda and is willing to engage in more European action, in all likelihood it will still be hard to achieve a consensus on a "sense of common purpose". Member states might have very different ideas about the future model of growth as well as the reform of national welfare states. It is not obvious for the member states to agree on the common finality of deeper integration and the consensus will probably be based on a set of common denominators instead of a coherent fully-fledged common strategy.

Secondly, this scenario assumes the revisison of the Treaty, which in itself might prove to be a difficult challenge in the current context of growing euroscepticism. Historically, any EU Treaty negotiation has been a rather long and laborious task, taking several years of European debate, including the organisation of a European Convention, and national referenda. These necessary and very welcome processes ensuring the legitimacy of further integration might, nevertheless, become an obstacle for moving forward with the European project. For one thing, today it might be extremely challenging to ensure the necessary level of public support needed for the ratification of the new Treaty. For another, long negotiations might delay the effectiveness of the new growth strategy, as the global economies are incessantly moving forward making the catch-up process more difficult with time.

Thirdly, this scenario might also reinforce the division of a "two-speed" Europe. The integration between the EMU member states will get much deeper than within the remaining EU member states through additional EMU level instruments and reinforced cooperation. These developments might endanger the functioning of the single market and hurt the member states outside the EMU. This is especially valid vis-à-vis the member states which have no legal obligation and intention of joining the EMU and could thus decide to stay out of the new European initiatives altogether (United Kingdom and Denmark).

5.4. Impact on national welfare states

Taking into account that in this scenario we assume that the common purpose which drives member states' action is enhancing growth in order to sustain the "European Social Model", it is fair to conclude that this scenario is the one which gives member states the best chances to i) counter the potential negative impact of the EMU on national welfare states and ii) ensure their overall sustainability.

However, it has to be highlighted that this scenario does not imply the setting up of common social and employment policies with the aim of replacing national competences. Indeed, these policies are bound to remain in the hands of member states. Gros highlights that more European integration is irrelevant for addressing the common challenges national welfare states are confronted to[128]. Indeed, if we are talking about ageing population, changing family and life cycle patterns, it is true that even though coordinated responses at the EU level might have a positive impact, the main issues concern national governments and their national policy choices and strategies. However, in this scenario more European integration has a strong positive impact on the sustainability of national welfare states for other reasons, already put forward in this study.

First, common action is needed to promote the transition to a new growth model and thus enhance growth perspectives, which, as discussed beforehand, is the main condition for welfare states' sustainability.

Second, more integration via the reinforcement of the EMU allows to reduce the potential harmful effects of the EMU on national welfare states. On the one hand, initiatives aiming at upward social convergence such as the definition of minimum social standards (eg. a common minimum wage) reduce the scope for social competition. The EMU project becomes rather a promoter of rather than a threat to the shared values. The European identity is thus reinforced and citizens find it easier to relate to the deeper integration process. On the other hand, the common shock absorption capacity at EMU level will keep member states from resorting to wage and social dumping as an alternative to national currency devaluation.

128. Gros, Daniel, « Saving Europe Social's model », *Business Standard*, 29 January 2013.

In short, in the long term, as the national economies catch up on new growth, continuously reduce their debt levels and deal with asymmetric shocks in a coordinated manner, each member state regains its de facto sovereignty of choosing the social policies that reflect its society the best. Member states are only obliged to respect EMU's fiscal rules: (i) avoiding excessive debt and/or deficit levels, which implies to ensure the fiscal viability of social security, pension and health systems and (ii) avoiding macroeconomic imbalances, which justifies the mutual surveillance of unit labour costs and productivity increases.

a) In the peripheral member states

Coming back to the two previous scenarios: while in scenario A social dismantlement continues to be one of the consequences of the debt crisis and in scenario B the economic outlook improves and thus social dismantlement can be stopped, in this last scenario member states can expect to have some room for manoeuvre to modernize their welfare states in order to increase their efficiency and sustainability in the long term.

In this context, this scenario may actually have a positive impact in terms of social welfare in these member states. The member states would be forced to compete for investment in other ways such as improving the quality of infrastructure, productivity of the labour force or business-friendly administrative systems. Such competition in "quality" rather than in "price" could result in the "race to the top" and has many positive spill-over effects for social policies and economic efficiency.

As it was discussed before, the purpose of deeper EMU integration is not to harmonize welfare state models between the member states. It would be neither realistic nor desirable as the welfare state models are the outcomes of national preferences and historical developments. However, reducing the possibility of social and fiscal dumping by establishing clear European rules would lead to higher overall social standards in EMU.

b) In the core member states

Building on the general consequences for national welfare states presented above, we can outline two particular positive consequences for the core member states.

First, the majority of the most robust member states today (Finland, France, Germany, Luxembourg and Austria) are also the ones which have the highest social standards and the highest levels of social spending. However, these welfare state choices could be threatened in a situation of low growth and stagnation. As a result, the core member states are in need to ensure sufficient levels of growth in order to maintain the generosity of their welfare systems. Consequentially, this scenario particularly benefits the welfare systems of the core countries as it boosts their prospects of growth in the long term.

Second, generally speaking, these member states are also the most vulnerable to fiscal and social competition because they have higher social standards and higher levels of taxation. This scenario limits the risks on both fronts: the core member states are shielded from intra-EMU social competition thanks to the strengthening of common social standards and they are protected from a "race to the bottom" in the levels of taxation, which helps to maintain the fiscal basis of the welfare state financing.

CONCLUSION

Social progress has been one of the founding principles of European integration since the very creation of the European Union. With the establishment of the single market and the monetary union, Jacques Delors has proposed several EU initiatives with a social purpose in order to ensure that deeper economic integration does not threaten various social values, treasured by all of the member states. Nowadays, the **European Social Model and EU-level social policies** might not only be a matter of preserving shared European values, but also **a necessity for a well-functioning EU** in the context of deeper integration and increasing globalization.

Nonetheless, in the past decades the **European welfare states have been under strain** coming from ageing population, increasing globalization, tax evasion and fraud and changing family life patterns, among other factors. Recently, this pressure has been exacerbated further by both significant reforms of EU economic governance as well as the unprecedented economic and financial crisis.

First of all, the **reinforcement of European economic governance is bound to have various consequences for the national social policies** even though the reform does not directly confer additional powers or competences to the EU/EMU level in the employment and social fields. Various new policy initiatives aimed at improving the functioning of the EU/EMU such as stricter fiscal and macroeconomic surveillance procedures as well as the setting-up of a crisis resolution mechanism might have considerable effects on national employment and social policies.

Of course, these **consequences will primarily depend on the specific situation of each member state** in each moment of time. On the one hand, countries, which will comply perfectly with the European rules and targets, will be free to exercise their sovereignty in all policy fields, including the social one.

On the other hand, member states in need of financial support via the new crisis resolution mechanism will have to follow adjustment programmes spelled-out at the EU level. The countries "in between", i.e. not complying with all of the rules, but not in need of financial assistance either, will have to follow more or less strict European recommendations, depending on whether they belong to the common currency area. On top of that, the impact of the new reform on social policies might also depend on the welfare structure (e.g. the level of social expenditure) and the long-term sustainability of welfare spending in each member state.

Secondly, **social policies** have been also **strongly affected by the consequences of the global economic and financial crisis.** Indeed, the great majority of EU member states have been hurt by the recession since 2008 and the prospects of recovery remain gloomy. One consequence of the crisis was that numerous labour market and pension reforms have been accelerated in many of the member states, particularly in the "programme" countries. Another, more striking consequence stemming from this recession, is the emergence of significant divergences between member states, both in economic and social terms. Recent developments have **divided the euro area into a club of economic "core"**, which managed to shield itself from the crisis, and **a grouping of "peripheral" countries**, which are falling ever deeper in economic and social decline.

Clearly, many factors have influenced the emergence of this growing economic and social gap between the member states. However, importantly, all of the peripheral member states had to go through harsh austerity programmes due to the market pressure and as a part of their Memorandum of Understanding signed with the international lenders. Consequently, various social rights and acquis were sacrificed with the aim of achieving fiscal adjustment. **De facto, social policies have, therefore, become a factor of adjustment to economic shocks in the euro area.**

All these developments have been transforming the national welfare states and, possibly, the European Social Model in the recent years. Yet, the **emerging "social deficit" in parts of the EU is threatening the legitimacy and the sustainability of the European project.** It is, thus, essential to add the considerations regarding the European social dimension to any debate about deepening of the EU/EMU, as it has been finally acknowledged in the European Council of December 2012.

The first question to raise about this new **"social dimension"** is whether it is needed **on the EMU rather than on the EU level.** This study argues that undoubtedly it is desirable to reinforce the social dimension of the EU as a whole, mainly for three reasons: (i) the ongoing deepening of the single market and the risks of "race to the bottom" often associated with it; (ii) the declining citizen support for the European project and thus its overall legitimacy; and (iii) the need to deal with social consequences of the current economic crisis in the short run.

Nevertheless, in the case of the euro area, the arguments for a better developed social dimension are much stronger. Indeed, in a common currency area, **a social dimension could improve the functioning of the EMU as well as boost its declining legitimacy.** On the functional side, common initiatives with social purpose could help reduce the risk of asymmetric shocks (or improve the symmetry in member states' business cycle) and improve the adjustment capacity in a socially acceptable manner (via an improved labor mobility and a common shock absorption fiscal capacity). On the political side, even if some initiatives on employment and social fields are not fundamental for the good functioning of the EMU stricto sensu, they might be judged appropriate in order to avoid certain politically "undesirable" consequences of EMU on national welfare systems (such as the use of social policies as factors of adjustment to economic shocks and social competition). For all these reasons, **EMU countries should take a driving seat in reinforcing common initiatives with social purpose**, even if their initiatives are open to the participation of all EU countries.

What should constitute a social dimension in the context of EMU? Two approaches are possible: constructing a "social union", which would complement the emerging banking, fiscal, economic and political unions, or establishing a "horizontal" approach, whereby **social concerns are mainstreamed in all of the EMU initiatives.** This study essentially builds on the latter idea for two reasons. First, social concerns are very often affected by policies pursued in other areas. As such they should be accounted for and become an integral part of "social dimension" for the EMU. Secondly, the setting up of this social dimension of EMU should go only as far as it is necessary for a smooth functioning of a common currency area, but not further. EMU level action should be such as to allow the cohabitation of different social models reflecting national preferences.

The mainstreaming of the **social dimension should be integrated** in the national and EMU level **response to various short and long term challenges.** The short term challenges that the EMU is facing today consist of counteracting the negative impact of the crisis on growth, employment and social welfare as well as restoring financial stability. The longer term challenges have been present even before the current crisis has broke out. However, they have become much more evident nowadays. Three main challenges remain of particular importance: ensuring a transition to a new more knowledge intensive model of growth, engaging in the reform of national welfare states and improving the construction of the EMU to avoid dangerous cyclical divergences as well as self-fulfilling solvency crises.

The study proposes **three different scenarios for the future development of the EMU** in the light of the aforementioned short and long term challenges. Even though these scenarios are simplified representations of reality, they facilitate the analysis of the implications of various initiatives adopted for both the general functioning of the EMU and the national welfare states. On the basis of the three scenarios we elaborated for EMU's future, we suggest the following main conclusions.

Since the beginning of the crisis, several EMU level initiatives were adopted to assist the member states under financial markets pressure and to reinforce the EMU's architecture. However, this deepening of the EMU was not guided by a "sense of common purpose" but rather by a "sense of survival".

According to the first scenario, **member states stick to the current course of action and if the crisis does not deteriorate, it can be expected that EMU member states will not adopt new ambitious initiatives to address the EMU's short and long term challenges.** In addition, social concerns will most likely remain outside the EMU policy making and will not be genuinely mainstreamed in all of the EMU action. Neither a positive agenda for the EMU nor a roadmap to strengthen it will be defined. Hence, member states will most probably not be able to counteract the negative consequences of the crisis on their national welfare states:

- The **problem of weak growth and high unemployment** will remain unresolved: EMU countries can be expected to be caught in the Japanese scenario of the 1990s. Weak growth undermines public and private deleveraging, fuels banking fragility and high unemployment. Stagnation reduces the attractiveness of Europe for investment. As a result, Europe's social models are bound to prove unsustainable because faster growth is one of the key conditions to ensure the long term sustainability of national welfare states.

- In addition, **national divergences** in terms of output, competitiveness and social indicators between the "core" and the "periphery" will continue to widen thus threatening the good functioning of the EMU. The peripheral countries will see their social standards decline because the implementation of the national adjustment programmes pushes the governments concerned to use social policies as simple adjustment variables.

- As a consequence, the **risk of social dumping** exacerbates within the euro area, given the co-existence of peripheral countries adopting cost competitive strategies and core countries adopting high skill/high value competitive strategies in the same currency area. The high and often expensive social standards of the core member states will thus be threatened if the "vulnerable" member states engage in the "race to the bottom".

- Moreover, in the future, as the EMU will still lack sufficient mechanisms for dealing with asymmetric shocks, **social policies** are bound to be used **as adjustment variables.**

- Important **political consequences** might stem from this course of action as EMU loses its legitimacy. Growing animosity among national populations, rising fringe parties in numerous EMU countries and eroding legitimacy of EU's action – all of these consequences are potentially dangerous for the future of the European project itself.

In such a context, we can conclude that both short and long term challenges that are threatening the national welfare states at the moment remain unresolved. In short and generally speaking, this first scenario entails that the social dimension is not developed enough to have a positive effect on improving the functioning and the legitimacy of the EMU.

However, even if the **political will for deepening the EMU is absent in the current context, member states might be forced to do so if the crisis intensifies.** For example, if one of the larger economies, such as Spain or Italy, is in need of full-blown financial assistance, new significant policy reforms might be adopted. We suppose that in such a situation, the main priority of the member states will consist of addressing EMU's short term challenges: restoring financial stability and stopping the recession. Consequently, member states adopt all necessary instruments for achieving these goals (as outlined in table 8).

According to this second scenario, thanks to the new initiatives/instruments that will be adopted, we can expect an improvement of EMU's economic and social outlook with improved growth prospects and no additional increases of the divergences between the member states. It can seem paradoxical that **the aggravation of the crisis leads to an overall improvement of the situation in the EMU.** However, since the beginning of the EU integration, member states tend to adopt the most ambitious long-sighted initiatives when the crisis intensifies. In the words of Jean Monnet, **"Europe will be forged in crises**, and will be the sum of the solutions adopted for those crises".

However, even though an improvement of growth prospects is expected in this scenario, it is likely that these prospects will not supersede their pre-crisis level as no long-term growth strategy is adopted following the intensification of the crisis. In addition, the legacy of the current recession, including the widening of economic and social divergences between member states, will take some time to rectify. As a result, some risks for national welfare states will remain:

- First, the transition to a new growth model, which could help overcoming the European "ceiling of growth" (as witnessed in the pre-crisis years) and boost the EMU's growth prospect in the long-term is not a priority in this crisis management scenario. Consequentially, the **long term sustainability of national welfare states remains uncertain.**

- Second, the two potential undesirable consequences of the EMU on national welfare states might be limited in scope, but not completely excluded. Indeed, member states might need to continue to use **social policies as adjustment variables** in a case of asymmetric shocks and **social competition** between member states is still likely to occur.

In essence, this second scenario would allow counteracting the negative consequences of the crisis for the sustainability of national welfare states in the short term. However, the modernization of the national welfare states in order to ensure their sustainability and in the medium/long term is not addressed. In addition, the streamlined EMU social dimension contributes to a better functioning and improved legitimacy of EMU level action to some extent. Yet, it is not developed to its full potential.

Finally, there is a third possibility for the future EMU's development. Growing threats to the EMU economies and to the European project as a whole arising from low growth, social unrest, growing euroscepticism as well as a declining role of the EU on the global stage convince the member states of the need to define a positive agenda for the EU/EMU's future. This **agenda is built on a "sense of common purpose"** instead of a previously prevailing "sense of survival". **The year 2014**, with the European elections and the nomination of new European leaders, **presents a window of opportunity** for this change of paradigm.

The sense of common purpose is based on the transition to a new model of growth and is inspired by the Europe 2020 strategy. However, growth is not seen as an end in itself; instead, it is treated as a prerequisite for maintaining and increasing the EU/EMU's prosperity and, by extension, a mean to **preserve and enhance national welfare states**, which symbolize the "European way of life".

Such a consensus represents the starting point for successfully addressing the EMU's short and long term challenges and to reconcile European citizens with the European project. It has several potential benefits for national welfare states:

- The new growth strategy is mobilized to achieve the Europe 2020 targets and to improve the European competitiveness in the world by investing in human capital and creating new infrastructures (physical, cyber and intellectual). New sources of growth should provide the necessary potential needed to reform and modernize the national welfare states in a least painful manner.

- Faster growth and more tax cooperation is expected to **reinforce the fiscal basis** for social spending and thus contribute to the long-term fiscal sustainability of the national welfare states.

- A strengthened EU action in favour of fast recovery of the peripheral EMU countries and a coordinated answer to the need of rebalancing in the EMU would contribute to **lowering the social and economic divergences between the core and the periphery.**

- The adoption of a cyclical adjustment fund would **protect the EMU countries from the negative consequences of asymmetric shocks** and reduce the need to engage in internal devaluations using social policies as adjustment variables.

- The definition of common social standards acts as a **protective barrier against social competition** between EMU countries.

This last possible scenario for the EMU appears to be the most desirable, as it would maximize the chances of the member states to tackle their short and long term challenges related to their welfare states. However, this scenario is extremely **difficult to implement**. In the current context of increasing distrust between the member states and growing animosities among national populations, the consensus on a “common purpose” might be difficult to achieve. In addition, this scenario implies a revision of the Lisbon Treaty with difficult questions to be addressed, such as the new own resources for the EU budget, the revision of the mandate of the ECB or the setting-up of new institutions, such as an EMU Treasury.

For all the above-mentioned reasons, the first two scenarios characterized by the "muddling through" approach, are more likely to happen as they are easier to implement. However, this study tries to convey a message that in any possible future scenario for the EMU, the reinforcement of the social dimension is not a matter of luxury or just a political catch-phrase, but indeed **a burning necessity**. The European project is only as good as it allows sustaining the "European way of life" and national welfare choices. Unfortunately, today the European integration is often seen as a threat in itself and not as a shield from growing internal and external pressures on the welfare states. European policy makers are therefore called to treat social concerns and to develop the **EMU's social dimension with the same urgency** as the four other pillars of the genuine economic and monetary union.

TABLE 8 ► Summary of policy initiatives adopted / to be adopted according to the three scenarios

	SCENARIO A	SCENARIO B	SCENARIO C
Fiscal and Economic union	Budgetary surveillance (Six Pack, Two Pack, and TSCG); Growth promotion (Completion of the Single Market Act I and II, Compact for Growth and Jobs); Economic surveillance and coordination (Euro+ Pact, MIP, European Semester, Ex-ante coordination of structural reforms based on Art. 11 TSCG); Combating tax evasion and fraud.	Reinforcing EMU's crisis resolution capacity (increasing ESM lending capacity and/or temporary debt mutualisation schemes such as Eurobills or a European Debt Redemption Fund); Golden rule for investment; Contractual arrangements for structural reforms between each member state and the Commission (Convergence and competitiveness instrument), based on the country-specific recommendations; Reinforcing tax coordination (Common Consolidated Corporate Tax Base, VAT).	Program of European investment with new mobilizing projects in areas where the EU has shared competences, such as energy, transports, research and/or environment; Social investment pact New own resources for the EU budget; Convergence and competitiveness contracts based on EU priorities defined in the Europe 2020 strategy; Cyclical adjustment fund; Double mandate for the ECB; Coordinated action for rebalancing in the euro area; Permanent debt mutualisation scheme; Reinforcing tax cooperation (corporate taxes, VAT).

Banking union	Single Supervisory Mechanism; ESM direct bank recapitalization; Common legal framework for bank recovery and resolution and for deposit guarantee schemes.	Same as in Scenario A; Single Resolution Mechanism (with a single resolution authority and a common resolution fund); Single deposit guarantee scheme.	Same as in Scenarios A and B.
Political union	No major institutional reforms; EMU inter-Parliamentary conference gathering members from the national and European Parliaments (Art. 13 TSCG).	Euro area sub-committee within the European parliament; Permanent President of the Eurogroup.	Same as in Scenarios A and B; EMU Treasury; Revision of the Treaty.
Mainstreamed social dimension	One-off EU-level initiatives to mitigate the consequences of the crisis (such as the Youth Guarantee); Labour Mobility Package; Strengthening the role of social partners.	Social Impact Bonds; CCI; Eurogroup meetings for Employment and Social Affairs Ministers.	Social Investment Pact; EMU unemployment benefit scheme (cyclical adjustment fund); EMU-wide common social standards.

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Original version

Sofia Fernandes and
Kristina Maslauskaite

DEEPENING THE EMU: HOW TO MAINTAIN AND DEVELOP THE EUROPEAN SOCIAL MODEL?

The global economic crisis is putting EU welfare states under strain and the voices arguing that the EU suffers from a real "social deficit" are getting louder. In the countries most hit by the crisis, the economic downturn has translated into a significant rise of unemployment and poverty levels, whereas growing pressure to consolidate national budgets is forcing significant cuts in welfare programs. At the same time, the crisis has led to a major overhaul of the EU framework of economic governance, with special implications for the euro area countries, and the current debate suggests deepening the process of integration within the euro area with the creation of a "fiscal union", an "economic union", a "banking union" and a "political union". While there is still uncertainty on the profoundness and specific content of this completion of the EMU, certain actors fear these reforms will translate into stronger pressures to slim down social budgets and into further constraints regarding domestic social and labour market policy choices.

As Jacques Delors underlines in the foreword, the Austrian Federal Chancellery is to be commended for taking a serious interest in this issue as it has commissioned a report from *Notre Europe – Jacques Delors Institute* on the impact of the reforms either currently being implemented or being mooted in the EMU on national welfare states. This study was finished at the very moment the heads of state and government placed the discussion on "EMU's social dimension" at the heart of the European agenda.

The study is divided in two parts. The first one presents an overview of the state of "Social Europe" today with an emphasis on the constraints of the new Economic governance on national employment and social policies and the impact of the current crisis on national welfare states. In the second part of the study, Sofia Fernandes and Kristina Maslauskaite present three possible scenarios for EMU's future. These scenarios are built on different assumptions and they include a set of initiatives in the fields of the fiscal, economic, banking and political union as well as EMU's social dimension. The authors assess each scenario on the basis of their main consequences for the euro area economy and for national welfare states from core and peripheral member states.

This report was written for the Federal Chancellery of Austria

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