

# Convergence in the EU

The EU has long viewed economic and institutional convergence as important goals, but the results thus far have been decidedly mixed, and there remain several open questions: How exactly should convergence be defined? How much convergence is necessary? What steps can be taken to improve convergence in the EU, and how can success be defined? Finally, how much convergence can be achieved by improving the economic performance in underperforming regions, and how can convergence in the form of harmonisation towards lower welfare levels be avoided?

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## Forging Sustainable Growth: The Issue of Convergence of Preferences and Institutions in EMU

Convergence has been a recurrent theme in the process of European economic integration. One of the major attractions of EU membership to potential candidates has always been the perspective of catching up with EU living standards. For real convergence, a member state needs to grow faster in a sustainable way so as to catch up with the EU average. The deepening of economic integration over time (implementing a customs union, completing the internal market, economic and monetary union) has at different times made the EU more attractive for outsiders than alternative forms of preferential trade. The fact that its force of inclusion vis-à-vis third countries is conditioned by the scale of its common market and by internal market results is illustrated by the past knock-on effects on outsiders when the EU moved up to higher levels of economic integration.<sup>1</sup>

The convergence issue has surfaced at various occasions since the EU took a further step up the economic integration ladder to an Economic and Monetary Union (EMU) at Maastricht in 1992. In the run-up to EMU, the issue was framed in terms of nominal versus real convergence of poorer member states. However, with the sovereign debt crisis, it gained a more complex dimension, raising the question of how to grow under the constraint of designing an economic union capable of sustaining monetary

union. EMU was left incomplete in its economic part at Maastricht, and the crisis brought the issue of a sufficient convergence of objectives, preferences and institutions to the forefront.

Adherence to the EU club provides access to a larger market but also presupposes some institutional convergence as a precondition for membership through implementation of the *acquis communautaire*. However, EU and EMU membership have left questions unanswered for which there was no consensus at Maastricht. These issues are subject to preferences and trade-offs and do not necessarily result in further institutional convergence. The possibility of improving economic governance in what had been an open-ended economic union design is conditioned by countries' views on whether nominal convergence (on rules) and real convergence are mutually reinforcing or whether, on the contrary, there is a trade-off between the two. The same applies to a possible trade-off between sustainability and real convergence. Common tighter rules (nominal convergence) or higher environmental standards (sustainability) may be seen to slow down growth or, on the contrary, to promote environmentally sustainable and (self-reinforcing) long-run quality growth and thereby real convergence. Rather than the convergence objective per se,<sup>2</sup> this suggests that it is

1 On the knock-on (domino) effects of more profound EU economic integration and for a discussion of the efficiency properties of the internal market (BE-COMP model), see R. Baldwin, C. Wyplosz: *The Economics of European Integration*, 4th ed., New York 2012, McGraw-Hill.

2 The simplistic presumption of equating economic growth and higher levels of GDP per capita with more well-being/happiness is of course open to criticism and subject to further research. See for instance D. Coyle: *The Economics of Enough: How to Run the Economy as if the Future Matters*, New Jersey 2011, Princeton University Press.

the preferences which are underlying the trade-offs and institutional convergence that are at stake with respect to reinforcing the economic union.

### National preferences and (the lack of) convergence in the mixed economy context

At earlier stages of EU economic integration, differences in preferences and in national institutions did not matter as much as they do in a monetary union where interdependencies are larger. The sovereign debt crisis has been illustrative in this respect.

With increasing European economic integration, the question of the role of the state in European mixed economies had started to surface, raising issues from regulation in the internal market to questions of (redefining) the economic order. With monetary union, its very functioning (sustainability) makes additional demands on the concept of economic union with respect to macroeconomic stabilisation. The EU concept of economic union as set out in the Maastricht treaty does imply some coordination of economic policies but was left incomplete in regard to the requirements of monetary union.<sup>3</sup> Later attempts were made at reinforcing economic coordination at the European level, which comprise notably increased fiscal coordination through the Stability and Growth Pact (SGP) and the coordination of economic and structural reforms under the Lisbon Strategy (replaced by the Europe 2020 strategy). Both depended on member state commitment, with weak enforcement mechanisms.

3 See J. Pelkmans: *European Integration: Methods and Economic Analysis*, Essex 2006, Prentice Hall, 3rd ed., for a discussion.

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The SGP provided an operational clarification of the Maastricht treaty's budgetary rules and defined the procedures for multilateral budgetary surveillance, its preventive arm (soft law), as well as the conditions under which to apply the excessive deficit procedure, its corrective arm. The SGP's enforcement provisions remained weak in practice, in spite of its corrective arm being based on "hard coordination" through legally binding obligations.<sup>4</sup>

In light of the incomplete Maastricht EMU blueprint in the economic sphere, member states committed to common EU objectives and indicators under the heading of the Lisbon Strategy (2000-2010) to make the internal market deliver and adopted a (relatively novel) method for coordination at the EU level, the Open Method of Coordination (OMC). The Lisbon Strategy represents a consensus on the need for a common EU-level response of EU mixed economies in terms of structural reform and institutional modernisation, in order to ensure the EU's competitiveness in a world characterised by new realities and challenges, such as globalisation, the information society, demographic ageing and climate change. Given differences in preferences regarding the equilibrium between the state and the market and the different traditions and path-dependency of national institutions, the member states adopted the OMC rather than the Community method. As a consequence, instruments remained a national competence and the convergence of preferences was to be achieved through best practice and benchmarking, meant to be reinforced by public and peer pressure.<sup>5</sup>

The choice of the OMC, which allows for consensus-seeking on values and institutions, and the ten-year time frame of the Lisbon process reflect a perceived need for ownership of reforms (as a process of the slow-moving convergence of preferences for institutions) and the notion of convergence as a gradual learning process.<sup>6</sup> The fact that (smaller) positive spillovers were given as the rationale for Lisbon reforms may have contributed to a lack of urgency and to the absence of sanctions as an enforcement mechanism for non-compliance. The same ap-

4 See L. Schuknecht, P. Moutot, P. Rother, J. Stark: *The Stability and Growth Pact – Crisis and Reform*, European Central Bank Occasional Paper 129, September 2011.

5 See A. Bongardt, F. Torres: *The Lisbon Strategy*, in: E. Jones, A. Menon, S. Weatherill (eds.): *The Handbook on the European Union*, Oxford 2012, Oxford University Press, pp. 469-483.

6 It is interesting to note that the EU's approach – explicitly aimed at creating bottom-up support for reforms of the mixed economy so as to raise competitiveness and driven by values (efficiency, but also fairness and sustainability) – contrasts with the US relative neglect of considering the complementary role of the state in the economy in areas such as education, research, environmental regulation or financial regulation. See J. Sachs: *The Price of Civilization*, London 2012, Vintage Books, Random House Group Ltd.

plies, with minor differences, to the Europe 2020 strategy for the 2011-2020 period – built on the Lisbon Strategy’s objectives and governance framework – which had been conceived before the outbreak of the sovereign debt crisis.<sup>7</sup> At the time the danger of negative spillovers, to be prevented by the Lisbon economic reform agenda and the SGP, was not perceived. It is only under the impact of the sovereign debt crisis, which gave rise to market and peer pressure, that EU cumulative economic governance developments have started to address the urgency of reforms and that convergence has begun to be debated in the public sphere.

The sovereign debt crisis has put the lack of convergence (once more) at the top of the European agenda. The former cohesion countries – Greece, Ireland, Portugal and Spain (but also Italy) – began to diverge (or, in the case of Italy and Portugal, continued to diverge) with respect to the eurozone core countries in terms of real GDP growth. Their low growth became an important factor in their negative risk assessment by financial markets, putting at risk the sustainability of EMU. EMU had been expected to provide for more macroeconomic stability in cohesion countries but also to intensify economic competition and to further affect patterns of specialisation. Economic results would very much depend on domestic policies, as convergence seemed to be responsive to policies.<sup>8</sup>

Member state progress on the Lisbon Strategy goals, which were to create the bases for competitiveness and sustainable growth, can be seen as an indicator of convergence. A member state scoring poorly will be less competitive and have lower growth or a lower growth potential. In an analysis of member state and EU progress in each policy area and overall,<sup>9</sup> what stands out, besides the large remaining differences among member states, is the low ranking of the cohesion countries.<sup>10</sup> The findings suggest that those member states that failed to achieve good results on the Lisbon goals are the ones that started or continued to diverge.

7 See for instance A. Bongardt, F. Torres: The Competitiveness Rationale, Sustainable Growth and the Need for Enhanced Economic Coordination, Forum: Europe 2020 – A Promising Strategy?, in: *Inter-economics*, Vol. 45, No. 3, 2010, pp. 136-141.

8 See B. Ardy, I. Begg, W. Scheikle, F. Torres: How will EMU affect Cohesion?, in: *Inter-economics*, Vol. 37, No. 6, 2002, pp. 300-314.

9 S. Tilford, P. Whyte: The Lisbon Scorecard X, Centre for Economic Reform, Brussels 2010.

10 Another interesting finding is the EU’s failure to integrate the sustainability objective into the Lisbon Strategy for growth. It is probably fair to say that the more immediate concerns with combatting the crises’ effects and fostering growth have somewhat eclipsed long-term sustainability concerns and their growth potential in the EU policy discussion. See A. Bongardt, F. Torres: Economic governance and sustainability, forthcoming as Chapter 8 in: A. Verdun, A. Toviás (eds): *Mapping European Economic Integration*, Basingstoke 2013, Palgrave Macmillan.

## The nature of spillover effects in EMU and (the need for) convergence

Prior to the eruptions of the global financial and economic crisis in 2008 and the sovereign debt crisis in 2010, most discussions on EMU’s sustainability and its legitimacy considered the impact of (the lack of) European political integration as exogenous to the process of monetary integration and governance. The academic and policy debates during EMU’s first decade of existence focused on the fact that EMU’s functioning – basically limited to a one-size-fits-all monetary policy – triggered spillover effects across various policy areas, potentially affecting cohesion and real convergence in the eurozone.<sup>11</sup> Those spillovers would run from the monetary to the economic side of EMU. Some authors consistently argued that EMU could not survive without a political union since the eurozone had fewer explicit compensation mechanisms than the United States (no automatic fiscal transfers, lower labour mobility and wage flexibility, and less integrated financial markets).<sup>12</sup>

The joint impact of the two crises made it clear that member states had insufficiently accounted for negative (systemic) spillovers from the economic part of the union to its monetary side, thereby illustrating the fact that a monetary union makes additional demands on the economic side of the union in order to be sustainable.

During EMU’s first decade, which was rather successful on many accounts, economic policy coordination, which had been effected through the Lisbon Strategy and the SGP, failed to deliver. The lack of national reforms in some member states and the incapacity of financial markets to distinguish between eurozone sovereigns paved the way for increasing intra-EMU macroeconomic imbalances. The incompleteness of the economic part of EMU meant that its governance institutions were unable to deal with the challenges of increasing policy interdependence, let alone the effects of the crises. The increase in economic integration to a monetary union had brought about a qualitative change, after which different member state conceptions of the mixed economy, when in contradiction with monetary union requirements on the economic side, would no longer be sustainable.

11 See H. Enderlein: The Euro and Political Union: Do Economic Spillovers from Monetary Integration Affect the Legitimacy of EMU?, in: *Journal of European Public Policy*, Vol. 13, No. 7, 2006, pp. 1133-1146.

12 See P. De Grauwe: Some Thoughts on Monetary and Political Union, in: S. Talani (ed.): *The Future of EMU*, Basingstoke, 2009, Palgrave Macmillan, pp. 9-28.

## Towards completing the economic side of EMU

In contrast to monetary union, neither the concept of an economic union nor its meaning in the EU is well defined. An economic union could be a stand-alone construct or designed to fulfil the requirements for the functioning of the monetary union, in line with optimum currency area theory.<sup>13</sup> EU member states are to become members of the monetary union after fulfilling the entry requirements, with the exception of those countries that negotiated an opt-out clause (i.e. the UK and Denmark). Under pressure from financial markets and in recognition of the growing interdependencies in EMU, eurozone member states (as well as a few non-members) have come to better define the economic side of the union, which has involved growing EU coordination and increased centralisation at the EU level so as to ensure the sustainability of EMU.

The global financial crisis and the subsequent sovereign debt crisis have come to affect the way monetary policy is implemented and perceived. Judging from the responses (albeit hesitant and taken under the constant pressure of events), it appears that the crises have been leading to converging preferences among member states on the need to tackle some of the issues that had either remained unresolved at Maastricht and/or been perceived as clearly beyond the scope of monetary policy and institutions.

In fact, a variety of steps that have been taken towards enhanced governance and reinforced cooperation in economic and even in social policies reflect the recognition that the interplay of monetary policy with broader EU governance and coordinated action is essential for a successful response to the crisis.<sup>14</sup> This enhanced governance includes the European semester, the “six-pack” reform package on economic governance, the “two-pack”, the Fiscal Compact, the Europe 2020 strategy and further structural reforms as envisaged in the Euro Plus Pact and the new EU financial institutional architecture, notably the Single Supervisor Mechanism (SSM). In fact, this is already happening both in terms of institutions (Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) and bailout programmes.

<sup>13</sup> See J. PeIkman, 2006, op. cit.

<sup>14</sup> With the crisis, economic (labour mobility, wage flexibility, financial market integration) and political/institutional adjustment mechanisms (public insurance mechanisms) as well as the coordination of a number of policies, such as social policy, have been evolving in the direction of more integration.

Most, if not all, member states have come to accept stronger fiscal coordination anchored to Germany, just as monetary policy was in the asymmetric phase of the European Monetary System (EMS). There is also general agreement to address competitiveness issues (structural reform) given the built-up macroeconomic imbalances. There has been a relatively wide consensus among a large part of the European polity (as evidenced by the activism of various EU institutions and national governments, European Parliament resolutions, and national parliaments’ ratifications) with respect to the policy implementation (Macroeconomic Imbalance Procedure), mechanisms (such as the various bailout funds, e.g. the European Stability Mechanism) and institutions which have been put into practice as the crisis continued to unfold.

## The role of multi-level governance

The strategic role that the ECB has come to play in the multi-level governance context has been particularly relevant for promoting the completion of the economic side of EMU in correspondence with the sustainability requirements of monetary union. The ECB has been acting strategically because of the perceived threat to its independence from an (economically) incomplete EMU.<sup>15</sup> It has sought to derive its legitimacy not only from delivering price and financial stability but also from acting as a guardian of EMU objectives by doing “whatever it takes to preserve the euro”.<sup>16</sup> In that sense, it has aimed at guaranteeing what may be termed its foremost objective: the sustainability of EMU as such. This implicit objective has led the ECB to engage in exceptional policies beyond standard monetary tools<sup>17</sup> and in wider economic policy debates, pushing for “a gradual and structured effort to complete EMU”.<sup>18</sup>

Notwithstanding the speed with which new institutions and mechanisms were created and policies implemented, significant divergences are displayed within countries and their respective governments, as well as within their political establishments, interest groups and networks. Beyond the attained consensus, approaches have remained divergent, and old divisions, which had impeded a more complete economic union than EMU, came to the surface (even within the European System

<sup>15</sup> F. Torres: The Strategic role of the ECB: independence and accountability in the context of the euro crisis, in: *Journal of European Integration*, Vol. 35, No. 3, 2013, forthcoming.

<sup>16</sup> Speech by Mario Draghi, President of the European Central Bank at the Global Investment Conference, London, 26 July 2012, <http://www.ecb.int/press/key/date/2012/html/sp120726.en.html>.

<sup>17</sup> Namely, the ECB’s Securities Markets Programme, Longer-Term Refinancing Operations and Outright Monetary Transactions.

<sup>18</sup> M. Draghi: The future of the euro: stability through change, Contribution from the President of the ECB, *Die Zeit*, 29 August 2012.

of Central Banks and the ECB), giving the idea of apparently insurmountable divergences.

Yet, multi-level governance is progressing, and incremental institutional change is taking place. In this sense, the steps that have been taken or are envisaged in favour of enhanced economic governance are an open-ended process associated with a new equilibrium between EU institutions and member states. While institutional reforms have a built-in bias towards incremental change,<sup>19</sup> the current experience of having reached the limits of the institutional framework with respect to dealing with the level of policy interdependence also exerts pressure for more complete reforms towards substantially increased economic and political integration. As in the case of the previous EMS learning experience, in turbulent periods, immaterial structures such as codes of conduct and institutional commitment remain in place.<sup>20</sup>

### The internalisation of EMU constraints at the national level

The negative externalities rooted in the insufficient coordination of fiscal and economic policies as well as the lack of domestic reforms that led to the sovereign debt crisis are now also being dealt with by means of adjustment programmes for certain member states, subject to formal or informal conditionality. The conditionality attached to those adjustment programmes reflects, on the one hand, supply side preoccupations, that is, the appropriate and legitimate incentives to induce reforms that sustain EMU and member states' access to financial markets. On the other hand, it features a demand issue of the problem, as citizens increasingly call for ownership of reforms that condition their everyday lives. Those supply and demand side aspects are associated with different timeframes for fast (political) institutional change and for slow (cultural) change respectively.<sup>21</sup>

Most EU countries had failed to internalise the previously agreed upon common objectives of fiscal (SGP) and

economic and social (Lisbon and Europe 2020 Strategies) governance. The absence of market pressure (financial markets failed to differentiate between the sustainability of public debt and external imbalances among participants) and of binding and enforceable rules (in the Lisbon Strategy and in the SGP), however, contributed to procrastination with regard to some of those economic and institutional reforms.<sup>22</sup> The same is true for the announced objectives (voted for in national and European elections various times) to which various governments and political parties had subscribed and which were poorly implemented.

Those common objectives have, with the sovereign debt crisis, come to encompass increasingly salient political and distributional issues. This fact has led to a much higher degree of politicisation of EU constraints.<sup>23</sup>

In the medium to longer run, increased politicisation may well contribute to the sustainability of EMU, to the extent that a wider and more inclusive debate develops among domestic electorates that are better informed of the challenges in question. It may in turn lead to better internalisation of nationally compatible objectives and better implementation of domestic reforms, the implementation of which has been hindered by national political systems and cultures. In fact, since the beginning of the crisis, fast institutional change in the EU – the completion of EMU's economic pillar with new governance mechanisms – has played a role in shaping new common rules.

The discussions about the type of economic union that is necessary to sustain EMU – involving the increased coordination and/or centralisation of fiscal, financial and other economic and social policies in the eurozone – tend to raise the political relevance of the EU-wide debate, given the perceived negative effects of the lack of domestic reforms and the lack of EU policy coordination in those areas.

19 M. Salines, G. Glöckler, Z. Truchlewski, P. del Favero: Beyond the Economics of the Euro – Analysing the Institutional Evolution of EMU: 1999-2010, in: ECB Occasional Paper 127, September 2011.

20 J. Macedo, D. Cohen, H. Reisen: Monetary Integration for Sustained Convergence: Earning Rather than Importing Credibility in: J. Macedo, D. Cohen and H. Reisen (eds.), Don't fix don't float, Paris: OECD Development Centre, 2001, pp. 11-53; and E. Jones: The Economic Mythology of European Integration, in: Journal of Common Market Studies, Vol. 48, No. 1, 2010, pp. 89-109.

21 See G. Roland: Understanding institutional change: Fast-moving and slow-moving institutions, in: Studies in Comparative International Development, Vol. 38, No. 4, 2004, pp. 109-131, according to whom "culture", which includes values, beliefs, and social norms, like technology, evolves slowly and continuously and is certainly a determinant of economic growth.

22 See M. Arghyrou, A. Kontonikas: The EMU Sovereign-Debt Crisis: Fundamentals, Expectations and Contagion, in: European Economy Economic Papers, No. 436, February 2011. One should add that the lack of market pressure also relaxed the pressure for enacting better institutional EU governance frameworks of economic monitoring and new coordination mechanisms, thereby further aggravating real divergence within the eurozone.

23 For F. Torres, 2013, op. cit., there is an optimal degree of politicisation, which parallels the optimal degree of commitment as a means of dealing with credibility constraints – see K. Rogoff: The Optimal Degree of Commitment to an Intermediate Monetary Target, in: The Quarterly Journal of Economics, Vol. 100, No. 4, 1985, pp. 1169-1189. As suggested by A. Follesdal, S. Hix: Why There is a Democratic Deficit in the EU: A Response to Majone and Moravcsik, in: Journal of Common Market Studies, Vol. 44, No. 3, 2006, pp. 533-62, increased politicisation may enhance legitimacy, since a democratic polity requires contestation for political leadership and with regard to policies.

The values, beliefs and social norms that form the basis of common rules accepted by a majority of member states might eventually also become shared by a majority of the European population. Increasingly, new common rules have become the continual subject of multi-level political negotiation, which allows for greater participation of many different actors (a fact especially potentiated by the European Parliament's role as co-legislator in the ordinary legislative procedure and in the monetary and economic dialogues).<sup>24</sup> This multi-level debate opens up the possibility of increased ownership of structural reforms and new institutions by the public. It also contributes to solving the problem of sequential decision-making stressed by Collignon, as multi-level governance may help structure the politicisation of national debates towards common-interest European public goods.<sup>25</sup>

### The crisis and political integration in the eurozone

The sovereign debt crisis highlighted the fact that some domestic policies were not only inconsistent with the stated objectives of the respective governments but that they were also unsustainable. It made it evident that unsustainability was calling into question the very functioning of EMU and the respective welfare states as well as the quality of life of current and future generations.

With market pressure, the domestic political and policy process has gained transparency. The vague references to European restrictions in national political debates transformed into rather concrete and binding constraints. Still, in the face of economic and political uncertainty and amidst gradual but hesitant and/or insufficiently coordinated EU intergovernmental action, namely the building up of new mechanisms and institutions through multi-level political negotiation, it is difficult to say whether such a process will result in a national and European consensus for reform (both at the domestic and EU levels) or if it will lead to political and social disaggregation.

By making it clear that national political systems are unable to deal with the inherent coordination and reform

24 Besides the monetary dialogue with the ECB, with the adoption of the "six-pack", the European Parliament has engaged in an economic dialogue with the Council of the European Union, the European Council, the Eurogroup and the European Commission. It has also significantly influenced the "six-pack" and the SSM. For a discussion see P. de Schoutheete and S. Micossi: On political union in Europe: The changing landscape of decision-making and political accountability, CEPS Essay, No. 4, February 2013.

25 S. Collignon: Democratic Surveillance or Bureaucratic Suppression of National Sovereignty in the European Union? Ideas on the Multilateral Surveillance Regulation, Briefing Paper for the Economic and Monetary Affairs Committee of the European Parliament, September 2010.

challenges without sharing sovereignty, the crisis may also promote the debate on the democratic quality of EU governance at various levels, starting at the national level. It follows that national parliaments, the European Parliament and European citizens in general will become more aware of the need for more democratic control. This need applies to new European institutions (like the different rescue funds and intergovernmental treaties) but also to the need for regaining democratic control over national governments and institutions (including supranational and intergovernmental institutions, as illustrated by the innovative process of the economic dialogue), which have become more unaccountable through the process of globalisation and, in some but not in all instances, the process of European integration.<sup>26</sup>

Furthermore, access to all those new common mechanisms and institutions goes along with the (albeit at times hesitant) pursuit of institutional reform and of the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union, namely sustainable development based on balanced economic growth and price stability, a competitive social market economy aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. From this perspective, the frictions created by the need for member states to finally internalise previously (at the inception of EMU) accepted objectives and a higher degree of politicisation of EU constraints are an opportunity for the EU to collectively address some of the main problems that are also unresolved in other parts of the world.<sup>27</sup>

What presently stands most in the way of European political integration, at least in the eurozone, is the question of potential large-scale redistribution, which explains why redistributive issues were in the end avoided in the Maastricht blueprint. The redistribution question, however, is endogenous to the process of domestic internalisation of EMU objectives and to the capacity of the Union and of member states to enact enduring political and economic reforms. This is because, on the one hand, for net-beneficiary member states it may only be politically feasible to undertake painful reforms if there is some visible and more immediate reward and, on the other hand, for net-contributor member states it may only be acceptable if the causes of the problem are addressed.

26 In regard to the centralisation of monetary policy in the eurozone, and with the exception of Germany, there has been an increase of accountability or at least in responsiveness and in any case of transparency. The same is true for various policies under the ordinary legislative procedure.

27 See J. Sachs, 2012, op. cit., for a diagnosis of the US.

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## Is the European Integration Machine Broken?

From the end of the Second World War up to the financial and euro area crisis, Europe was a remarkable integration machine. In fact, convergence between the “core” and the “periphery” had become more or less taken for granted. However, this stylised fact, like many others, is now being questioned as countries like Greece, Portugal, Spain and Italy experience prolonged recessions. Are we at risk of losing the South? To put it differently, are the difficulties currently experienced by some European countries of a temporary nature or should we fear a more profound and lasting economic divergence in the euro area? This obviously matters for its own sake to the countries concerned. But it also matters for monetary policy purposes, as the absence of convergence would imply that the euro area is moving further away from an optimal currency area. Finally, it matters politically to the extent that the European project and many European policies are at least implicitly based on the idea of ever deeper integration, which itself probably depends on the presence of some degree of convergence.

In late 2011, Wolf wrote: “True, if creditworthy members were to transfer resources to the uncreditworthy on a large enough scale, the eurozone might be kept together. But even if such a policy could be sustained (which is unlikely), it would turn southern Europe into a greater Mezzogiorno”.<sup>1</sup> Even though the tensions within the euro area have since abated, the statement raises two issues that remain relevant: First, what is the role of transfers in the convergence process? Second, what can we learn from the fact that the convergence process *between* countries in the EU was generally not accompanied by the same convergence at the regional level *within* countries in a single (national) currency setting?

In this short paper, we first summarise the stylised facts about European convergence before the crisis, with a particular focus on the difference between inter-country and intra-country convergence. We then address the question why some poorer *regions* within relatively rich countries tend not to converge while *countries* with similar characteristics generally do tend to do so. This leads us to the build-up to the crisis and the adjustment process between the core and the periphery in the euro area. Some first lessons learned from the implementation of real devaluations are

also drawn. Finally, we provide some tentative comments on what is to be expected in terms of convergence going forward.

### European convergence before the crisis: a success story with some caveats

Since its inception, the EU has experienced robust convergence in terms of GDP per capita between the “core” and the “periphery”. Whether this process was the result of EU enlargement or whether the latter was a mere facilitator is open to discussion, as countries outside the Union also participated in the convergence. What is clear, though, is that EU membership has not stopped the process. My guess is that it has made convergence more robust and, in a way, more predictable, as success from one enlargement phase led to positive expectations about the next.

Interestingly, the process has largely been driven by convergence at the *country level*. Convergence at the *regional level* has been weaker, with some countries exhibiting regional divergence or sustained North-South or West-East divides. Also, the correlation between unemployment and GDP per capita has been strong and persistent within some EU countries, while much weaker across countries. Finally, and contrary to the US, intra-EU migration has played a negligible role in the EU dynamics.

### Convergence at the country level

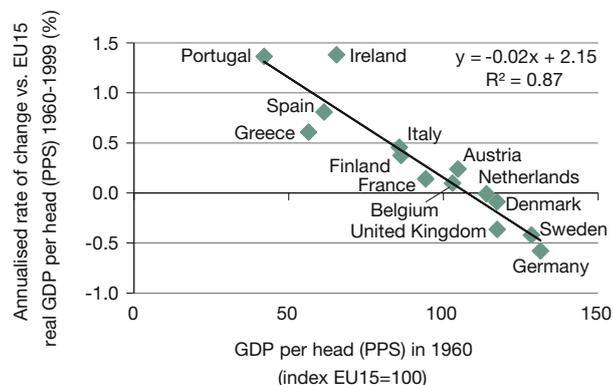
One can broadly distinguish three phases in the EU convergence at the country level: 1) 1950-1973: convergence of Western Europe to US living standards; 2) 1974-1993: convergence of Northern and Southern Europe to Continental Europe; 3) 1994-2010: convergence of Eastern Europe towards Western Europe.<sup>2</sup> This convergence process has been broad-based and robust, with only Italy starting to diverge in the third period due to lower GDP growth. Quantitatively, one needs to distinguish between beta- and sigma-convergence. Beta-convergence refers to a process in which poor countries or regions grow faster than rich ones and therefore catch up with them. Sigma-convergence refers to a reduction of disparities among regions in time. Beta-convergence is necessary but not sufficient for sigma-convergence.

\* Research assistance from S. Cheliout and J. Mont is gratefully acknowledged. The views expressed in this paper are those of the author and do not necessarily represent the views of, and should not be attributed to, the National Bank of Belgium.

1 M. Wolf: There is no sunlit future for the euro, Financial Times, 18 October 2011.

2 See B. Quillin: Europe – convergence machine, in I.S. Gill and M. Raiser (eds.): Golden growth: Restoring the lustre of the European economic model, World Bank publications, 2012.

**Figure 1**  
**Strong beta-convergence from 1960 to 1999**



Source: own calculations based on Eurostat.

Note: Luxembourg has been excluded from EU15 data due to its specific role as a financial center. A negative number on the y-axis implies a relative decline in the GDP per head of the country compared to the EU15 average.

Over the long run, beta-convergence has been very strong at the EU15 level, as illustrated in Figure 1. Countries that were poorer in 1960 grew faster than their richer neighbours over the next four decades. The significance of the relationship between initial GDP per capita and subsequent growth rates has decreased over time, however. In the 1990s and 2000s, the  $R^2$  dropped to around 0.2 from its level of nearly 0.9 from 1960 to 1999. Also worth mentioning is the fact that new member states did not converge towards EU15 countries in the 1990s but did so strongly afterwards. Sigma-convergence took place mainly at the country level prior to the 1980s.<sup>3</sup> This confirms the observation that convergence has lost steam as differences among countries have become smaller and smaller, which is actually not very surprising.

#### Convergence at the regional level<sup>4</sup>

Overall, sigma-convergence was strong at the NUTS 2 regional level from 1980 to 1995 for EU15 countries but has since stopped. Regional disparities also decreased rapidly between 1996 and 2005 at the EU27 level, but they increased within the EU12 subgroup. This divergence seems to be driven by increasing disparities *within* most new member states, with “core regions” driving the catching up to the rest of the EU.

<sup>3</sup> See for instance Quillin, *ibid.*, p. 77.

<sup>4</sup> Based on P. Monfort: Regional Convergence, Growth and Interpersonal Inequalities across EU, Mimeo, EU, 2009; and P. Monfort: Convergence of EU regions, measures and evolution, Working papers, EU, Regional Policy, 2008.

Beta-convergence is also observed at the regional level, as poor regions tend to grow faster than rich regions. However, the catching-up process is weak and driven by the countries’ dynamics. When measured relative to member state averages instead of the EU average, one observes a weak intra-country *divergence* process. All in all, disparities between countries diminished, but they slightly increased within countries. In 1995, 70% of regional disparities in the EU reflected disparities between member states. This share had dropped to 56% in 2005. In the EU15, the share actually went down from 55% in 1980 to just 14% in 2005. These results are confirmed by Bouvet using data from 1977 to 2003. She notes that “[t]he breakdown of inequality into between-country and within-country components suggests that most of interregional inequality occurs within countries rather than between countries. Moreover, the importance of the within component has increased over time, notably since the mid-1990s.”<sup>5</sup>

#### Why do countries converge and regions do not?

Why do we typically expect Slovakia, Slovenia and the Baltic countries to converge towards core EU countries in terms of GDP per capita while we have got used to the fact that the Mezzogiorno is not converging towards Northern Italy? Part of the explanation may have to do with agglomeration economies:

The increase in economic disparities between regions belonging to the same country is the consequence of polarisation processes. Interestingly, the increase in regional disparities is deemed to be due more to the high performance of some regions, for instance capital and metropolitan ones, than to the sluggish performance of lagging regions.<sup>6</sup>

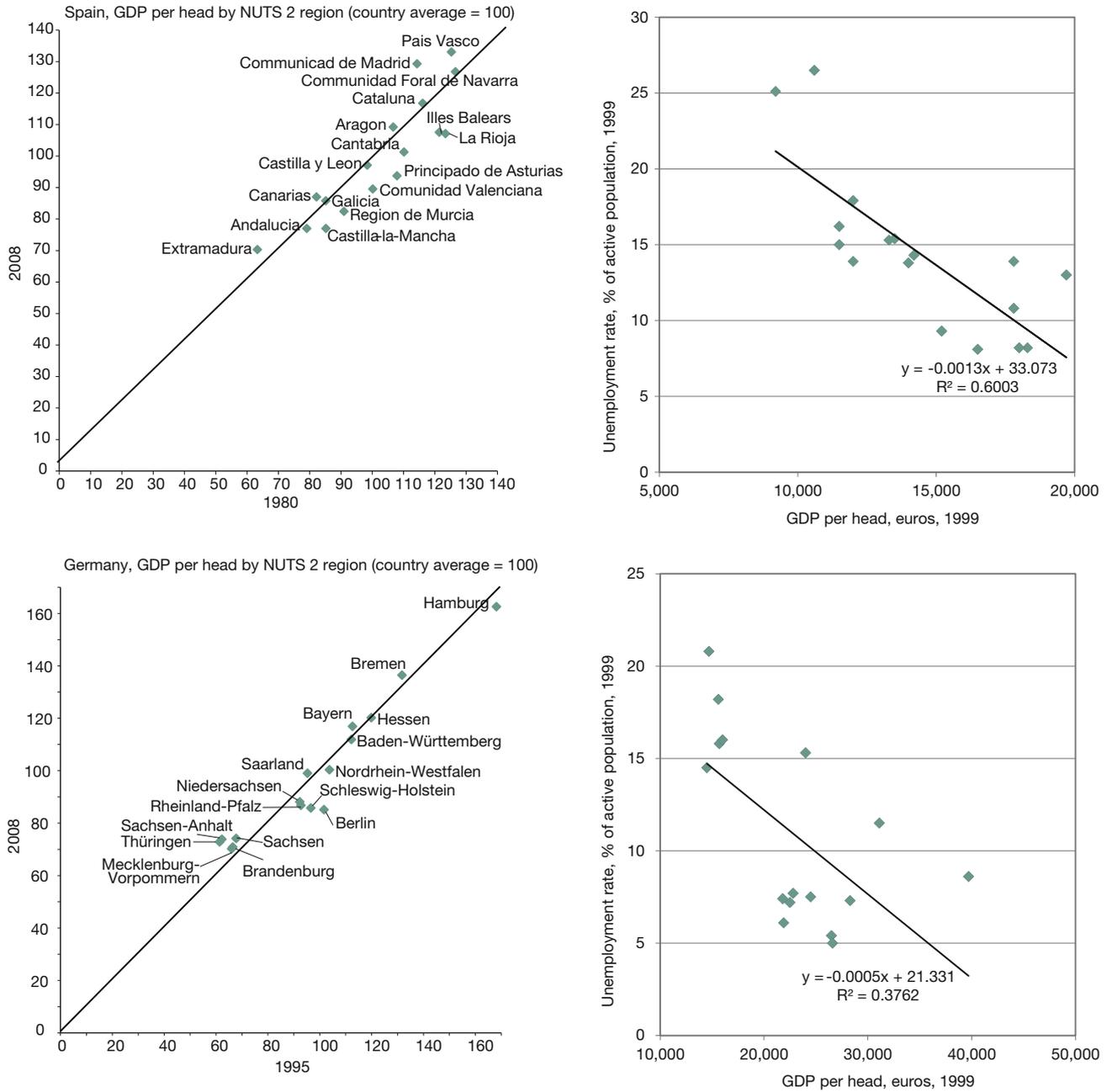
This observation is probably correct as far as developments in Eastern Europe are concerned, with economic growth typically concentrated around capital regions. The same is also true in more advanced countries, e.g. the increasing GDP per capita of the Inner London region. But this new economic geography argument hardly explains the persistent “dualities” in some economies where low regional GDP per capita is strongly correlated with high unemployment rates. This is illustrated in Figure 2 for Spain and Germany.

So, why do we tend to associate high unemployment and low GDP per capita at the regional level *within* countries, although the correlation between unemployment rates and

<sup>5</sup> F. Bouvet: Dynamics of Regional Income Inequality in Europe and Impact of EU Regional Policy and EMU, Annual North American Meeting of the Regional Science Association International, Savannah, GA, 2007.

<sup>6</sup> EU Parliament: Regional Disparities and Cohesion: What strategies for the future, IP/B/REGI/IC/2006-201, p. iv, 2007.

**Figure 2**  
**Relationship between regional per capita GDP and unemployment rates**



Source: own calculation based on Eurostat regional data.

Note: In Germany, the correlation between GDP and unemployment is entirely driven by East-West disparities. The correlation is positive within the former East and West Germany.

GDP levels is much weaker – and non-existent over the long run – at the country level?

Our tentative explanation goes as follows. The success of the European integration machine at the country level rested on a combination of price and wage flexibility across

economies – if need be through exchange rate adjustments – combined with access to the single market. The latter feature brought competition in product markets and a common set of rules, which provided some degree of predictability and security to economic agents. Finally, (limited) transfers resulting from EU regional policy, focused mainly

on infrastructure and economic development (instead of income redistribution), provided some additional support.<sup>7</sup>

The same conditions were not met at the regional level within countries. Regional price and wage flexibility is generally constrained by national schemes, preventing timely adaptation to economic fundamentals and/or adverse economic shocks. Also, intra-national transfers are much higher than intra-EU transfers and typically more focused on reducing income inequalities than on fostering endogenous growth. Altogether, this points to more constraints imposed on the convergence process inside countries and probably fewer incentives for reforms in the regions lagging behind.

This raises the question of a possible trade-off between convergence and solidarity. The issue is both complex and sensitive. To put it cautiously, non-targeted and persistent inter-regional transfers are clearly not a sufficient condition for convergence. In this regard, the German reunification provides a unique natural experiment. After an initial period of fast convergence between 1992 and 1994, the East-West catching-up process has stalled.<sup>8</sup> Much like in Spain before the financial crisis, the construction sector was the main contributor to growth in the first half of the 1990s. Real wages in the East have increased from 49% of the Western level in 1991 to 77% in 2000, but unit labour costs in Eastern Germany failed to reach competitive levels and unemployment increased sharply. This took place despite huge transfers from the West that accounted for roughly one-third of Eastern Germany's GDP in 1999.

The example of Spain (as well as other countries such as Italy and Belgium) also suggests that while transfers may reduce inequalities from a *static* perspective, they do not seem to foster convergence in income levels from a *dynamic* perspective. Some imbalances observed at the regional level would also be unsustainable at the national level. No country can live for decades with high structural current account deficits and very low employment rates, but such imbalances can be observed in some poor regions of relatively rich countries.

### Imbalances lead to the crisis and adjustment process

The origin of the balance sheet recession that we have been experiencing since late 2008 is well known by now. Interest rate convergence had contributed to unsustainable debt

7 Admittedly, the efficiency of cohesion funds is hard to prove due to selection biases, but improving transport infrastructure can hardly create perverse incentives.

8 See for instance OECD Economic Survey, 2001. Note that in subsequent years, differences between East and West were not systematically reported anymore.

accumulation in various peripheral countries of the euro area (as well as in the UK and the US). A combination of higher growth in domestic demand and diverging price developments – both at the inflation and unit labour cost levels – led to significant current account imbalances. In Portugal and Italy, the loss in competitiveness was compounded by the so-called China shock.<sup>9</sup> Still, altogether, imbalances were driven more by endogenous than exogenous factors, while the literature on optimal currency areas used to focus on exogenous shocks. Krugman puts it rather bluntly: “What’s interesting is that the euro itself created the asymmetric shocks that are now destroying it [via the capital flows it engendered]. Not only have they created something incapable of dealing with shocks but the creation engendered the shocks that are destroying it.”<sup>10</sup>

Retrospectively, what was initially perceived as a classical convergence process was not based on sound fundamentals. The increasing decoupling of savings and investments within the EMU did not lead to more efficient capital allocation. Too much investment went to real estate and other projects with low returns in terms of potential GDP growth. Imbalances had reached unsustainable levels when the financial crisis struck in 2008. Peripheral countries’ real exchange rates had diverged by between 20% and 40% versus Germany’s, and current account deficits had reached levels around 10% of GDP.

This led to a hidden sudden stop as the ECB had to step in to intermediate North-South capital flows, with imbalances moving from private financial institutions to Target II balances and other EU programmes. The ECB intervention prevented a meltdown of the euro area and gave countries more time to implement needed structural reforms. Still, the sharp increase in the savings rate of the private sector led to deep recessions and large cumulative output losses in Greece, Portugal, Ireland and Spain, with Italy also suffering, though for somewhat different reasons.

While the South has diverged from the North since the crisis, Central and Eastern European countries are still catching up as a group. Interestingly, the higher growth rates among the new member states are found both in euro area and non-euro area countries (e.g. Slovakia and Estonia as well as Poland and Latvia). One possible explanation for this is that the high catching-up potential of these economies in terms of productivity makes nominal rigidities less of an issue than in older member states. The adjustment process has also been much sharper in the Baltics (and in

9 See A. Ahearne, J. Pisani-Ferry: The Euro: only for the agile, Bruegel policy brief, No. 1, 2006, p.2.

10 M. Wolf: Lunch with the FT: Paul Krugman, Financial Times, 26 May 2012.

Ireland) than in Southern Europe, at least during the first years of the crisis.

Had EMU not been in place, the first variable for countries to adjust would have been their exchange rates, which would have brought about fast and probably sharp variations in relative prices and balance sheet values. This would have been followed by increases in inflation, but the impact of the crisis on unemployment would have been partly mitigated by higher net exports. In a fixed exchange rate regime, the sequence of the adjustment process is quite different. The “Minsky moment” hits economic agents asymmetrically, and the impact of the crisis is not felt directly by all. During the first years of the crisis, adjustments in relative prices were low in the euro area, sometimes even going in the wrong direction. It is only when unemployment rates had reached very high levels that wage moderation kicked in across the board. Unit labour costs and current accounts adjusted more rapidly but largely through the attrition of less competitive firms and workers. In a way – thanks to insufficient structural reforms of labour markets in the euro’s first years – unemployment has assumed the role usually played by exchange rates as the main common shock absorber driving the adjustment process. Of course, the result has been huge social and economic costs.

Real devaluations thus appear to be only imperfect substitutes for nominal ones. This is partly a question of price stickiness and therefore time. But it is also a question of nature. Nominal devaluations impact (nearly) all economic agents symmetrically and reduce external debts denominated in the national currency. Real devaluations imply a much more complex and demanding adjustment process involving heterogeneous economic agents as well as the public authorities. Even in Ireland, wage reductions seem to have been first concentrated in the non-tradable sector, with the adjustment in the tradable sector taking place through productivity gains.<sup>11</sup> This difference between nominal and real devaluations makes labour reforms all the more important but also all the more likely to be resisted by insiders who will try to keep their pre-crisis purchasing power in the common currency.

### Will the South become the new Mezzogiorno of Europe?

Is the introduction of the euro thus likely to lead to a lasting divide between the North and the South of Europe? The situation is clearly challenging, but the base scenario remains one of a return to long-term convergence. Prices and wages, although sticky, are not set or harmonised at the euro

area level, and real devaluations are still more likely to occur between euro area countries than between regions of the same country. In the absence of recurrent income transfers at the euro area level, countries are faced with strong market pressure to reduce imbalances (at least after they have become unsustainable). While the increase in Target II positions has played a role in alleviating the balance of payments crisis, it is not, as such, equivalent to paying for current account deficits.

In a “world à la Solow”, convergence should not be indefinitely impacted by the financial crisis. In fact, all that has been lost since 2008 should ultimately be recovered. Moreover, to the extent that market pressure leads to structural reforms in adjustment countries, the net long-run impact of the crisis could even be positive. Still, other scenarios cannot be excluded. The financial crisis had a lasting impact on GDP levels in most countries, which is not easily explained by a Solow-type model. There may also be a difference between global convergence and convergence between higher income countries. Since 1995, EU15 countries have diverged from the US after four decades of catching up. The fact that current account deficits in peripheral countries are being closed faster than wage differentials may also point to multiple equilibria compatible with a balanced external position. Some countries may have moved back to a current account equilibrium at a higher relative wage level than was initially the case through labour shedding and demand contraction. Also, a combination of unemployment hysteresis, lower capital accumulation and restrained access to capital markets could reduce the growth potential of these countries for a relatively long period, even though the steady state is (almost by definition) not impacted.

Endogenous growth models allow for the capture of broader sets of dynamics, but they are quite sensitive to model specifications. Some models illustrate cases of adverse specialisation in tradable sectors with poor growth dynamics.<sup>12</sup> Freely extrapolating from them, one could imagine a scenario in which the South would be stuck in a low growth/high wage (relative to pre-euro levels) “equilibrium”, with revenues from tourism and possibly remittances from workers who have emigrated to the North closing the current account deficit.

### Conclusion

Europe was a quite remarkable integration machine when Solow-type convergence was not very widespread. It would be quite a paradox if the continent were to now experience prolonged divergence when Solow is making a comeback

<sup>11</sup> See Z. Darvas: A tale of three countries: recovery after bank crises, Bruegel policy contribution, No. 19, 2011.

<sup>12</sup> See for instance R. Lucas: On the mechanics of economic development, Journal of Monetary Economics, Vol. 22, pp. 3-42, North Holland, 1988.

at the global level. Based on evidence gathered in assessing the lack of inter-regional convergence within countries, attempts to harmonise wages and social benefits at the euro area level should be resisted, as should structural income transfers that would slow down the necessary adjustment process.

Support for countries in recession should be focused on debt sustainability through lower interest rates, for example the conditional support provided through the EFSF and the ESM. Transfers, if any, should be targeted at (useful) infrastructure projects and other policy areas that contribute to enhancing the growth potential of countries lagging behind. This calls for a reform of European regional policy in order to make it more focused and efficient, which is

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## The Limits of Economic Policy Convergence in Europe

“When you come to a fork in the road...Take it!”

Yogi Berra

The current discussion about Britain’s future in the European Union highlights a fundamental problem with the integration process in Europe. With Croatia joining the EU later this year and Latvia aiming at membership in EMU for next year, an ever expanding European Union does not really discuss where its borders are. There is certainly some discussion about the EU’s geographical extension and whether Turkey or Ukraine can become members one day, but there is very little about if and how an ever larger union can be combined with ever deeper union. While some countries, in particular Germany, see an eventual political union as desirable, others oppose it or, like France, wish to push forward in terms of economic policy convergence but are unwilling to give up political sovereignty. Thus, not even in the monetary union does there seem to be a consensus on where this all should end. At the same time, monetary union and the financial crisis have generated integration momentum over which European institutions seem to no longer have full control.

### The crisis and policy harmonisation

The financial crisis has given a big boost to European integration and harmonisation. It is quite possible that later generations will see the crisis as a defining moment in the history of European integration. While EMU is widely considered a landmark decision for giving up autonomy in monetary matters, the extent to which the crisis has yielded similar or even greater levels of broad policy convergence is probably underestimated. The creation of monetary union was ac-

admittedly easier said than done. Money simply thrown at countries or regions with uncompetitive wage levels would most probably be lost. Ultimately, it is essential that wage corrections take place in adjustment countries to levels compatible with full(er) employment and international competitiveness.

Finally, this discussion suggests that our understanding of regional growth dynamics, especially inside currency unions, remains poor and should be improved. We tend to come back to Solow because it is a simple model with no path dependency. But the sad truth is that we just do not understand the complex interactions between the impact of financial crises, real devaluations with price stickiness and medium to long-run growth dynamics.

accompanied by a promise that it would need fiscal discipline and that a little loss of autonomy of fiscal policy was therefore a necessary component of it. However, the rules were loose and widely ignored. Now there are extensive common fiscal liabilities and talk about Eurobonds and a full fiscal union. Without any real discussion, Europe has indeed come a long way on fiscal integration in only five years.

The consequence of the debt crisis in Europe is a strong increase in the control and coordination of economic policy. Because more coordination and stricter rules have been identified as necessary for escaping the crisis, the Commission has made wide-ranging proposals for more harmonisation in fiscal policies and beyond. Currently, there are three main pillars of coordination.<sup>1</sup> The first pillar is composed of the Integrated Guidelines and “Europe 2020”, the successor to the largely failed Lisbon strategy of 2000 that sought to make Europe the most competitive region in the world. Both of these components deal with general economic policy for the 27 member states, setting aims for increasing employment and investment into R&D, reducing poverty and creating a “greener” economy. While no sanctions are foreseen for missing targets, there is an extensive consultation process as well as reporting obligations in the form of Broad Economic Policy Guidelines and Employment Guidelines, which are part of the National Reform Programmes. Together they form part of the “European semester” with extensive plans, coordination and reports by the Commission about countries’ economic development.

<sup>1</sup> The taxonomy follows Deutsche Bank: Research Briefing: European Economic Policy, 2 May 2012.

The second pillar is formed by the Stability and Growth Pact with rules on public debt and deficits. The Pact has two “arms”: the preventive arm comprises extensive surveillance and reporting with the purpose of *ex ante* coordination, while the corrective arm supplies the possibility of imposing fines on countries not complying with the rules. Countries which enter the Excessive Deficit Procedure are subject to the close scrutiny of the Commission, which has to agree to national plans of how deficits should be corrected. Given the largely unsuccessful experience with the initial version of the Pact, recent reforms foresee a quasi-automatic imposition of fines. The Ecofin ministers have at least vowed to follow Commission recommendations to sanction violating countries in the future.

The third pillar is a new agreement on macroeconomic surveillance. Based on a defined macroeconomic scoreboard, the Commission is to prepare annual Alert Mechanism Reports that compare national developments to these previously defined thresholds. If the Commission notices excessive imbalances, it has to inform the European Parliament, Ecofin and the Eurogroup. Similar to the role played by the Excessive Deficit Procedure for fiscal policy, recommendations will be developed and can be made public, and fines of up to 0.1% of GDP can be imposed if countries do not implement corrective measures in a given time frame.

Coordination and joint control extend further for those countries that are in programmes related to the EFSF and ESM, the fiscal support mechanisms created for countries in debt crises. The financial support is conditioned on an extensive surveillance programme by the so-called troika of the European Commission, the International Monetary Fund and the European Central Bank. Apart from controlling policy plans, the troika sets clear targets for countries’ deficits and makes very detailed prescriptions for increasing taxes, improving tax administration, reducing public employment and fostering privatisation in order to achieve those goals. This is certainly understandable from the point of view of those bankrolling the funds, but it also implies a significant loss of policy autonomy in crisis countries.

But the EU is going even beyond imposing conditions on debtor countries. In its attempt to identify and punish those who are responsible for the crisis, member states have singled out banks and financial markets as the main culprits. It has been decided to impose a general financial transaction tax on capital transactions and to cap the maximum performance-based bonuses that bank managers are allowed to earn.<sup>2</sup> Both measures interfere strongly with do-

mestic policy decisions and parliamentary prerogatives in member states. Until now, fiscal policy has been in the hands of national parliaments, and it had previously been unimaginable that compensation would be regulated at the European level. Common bonus caps are likely to open demands for common minimum wages in the next round.

The problem with this is that it leads to clashes within the EU. In the case of financial market activity regulation, the conflict is between the UK and almost everybody else. In fighting the financial and debt crises, the strong interference in domestic economic policies by the troika creates strong resentments between contributing countries, like Germany and the Netherlands, and those receiving conditional help, like Greece and Portugal.

Apart from these conflicts between governments, recent polls demonstrate wide gaps in public opinion among member states on the integration and harmonisation process at a more fundamental level.<sup>3</sup> Strikingly, the overall share of European citizens who have trust in governments (national and EU) has fallen from around half in 2004 to just a third today, indicating a growing gap between government policy and citizens’ expectations. A similar development is observable concerning the share of people who have a positive image of the EU as such. At the same time, more than 80% believe that the EU member states will have to work together more closely as a consequence of the crisis, whereas only a quarter believe that the EU will be able to solve the crisis. These somewhat inconsistent aggregate data mask huge divergences across member states. Trust in the EU is low in the UK (a mere 20%), Sweden (33%) and Greece (18%) but much higher among Belgians (60%). Interestingly, despite the crisis, support for the common currency is quite strong among members of the eurozone (as high as 70% in Belgium and Germany) and predictably low in Sweden and the UK. Equally high is the support for a common external and security policy. Most EU citizens are also in favour of more integration, and even UK polls indicate strong minority or even majority support for common policies in these fields. While citizens tend to favour more integration in some areas, they equally strongly reject an enlargement of the EU. Still, the UK is the only country in which a (small) majority believes they would be better off outside the EU.

Hence, despite a remarkable extension of power to the different European bodies and the far-reaching harmonisation of economic policies, there seems to be little agreement on what the justification for this is. Neither is there consensus among countries or citizens on whether, how and in what areas the EU should further integrate.

<sup>2</sup> After agreeing in late February on the bonus cap for bankers, EU parliamentarians have recently proposed to extend the caps to hedge fund and private equity managers.

<sup>3</sup> See Eurobarometer 78, Autumn 2012.

### When is harmonisation justified?

Theoretical prescriptions concerning the allocation of decision-making power in federations or unions are, in principle, quite simple.<sup>4</sup> From an economic point of view, more centralisation is called for when there are externalities that result from policy decisions. Coordinated policies or the allocation of decision-making power to a higher level can take those externalities into account and “internalise” them. Standard examples include cross-border environmental pollution and crime control. Border protection and environmental policy should be coordinated, because individual states do not sufficiently take into account the extent to which other regions are positively or negatively affected by their policies.

Another argument for the centralisation of policies is when there are cost advantages, or economies of scale, when goods or services are provided jointly. Examples are military protection or diplomatic services. Significant savings could be achieved if countries had joint representation in the form of embassies and if they pooled resources in terms of military equipment.

Arguments in favour of decentralisation, on the other hand, are the higher accountability of the political system and the ability to better reflect differences in policy preferences. When political decisions are made at a level that is close to the population, citizens can better influence decisions and more easily hold politicians accountable who deviate too much from the electorate’s interests. In addition, when people have more direct influence on policy, they are more likely to develop an interest in those policies. Therefore, decentralisation should both be good for the average quality of decisions and should lead to less alienation with politics.

The strongest argument for decentralisation, however, is that people simply have different preferences and that states and regions should conform to those preferences with their policies. Some regions or countries may opt for a larger welfare state while others prefer a smaller one, and some might choose more labour market regulation while others prefer less. Combined with the free movement of people, decentralised policy should make it possible for everyone to move to the region with the policy regime they like best. The larger the electorate’s differences in preferences are, the more supranational unions should abstain from pursuing harmonisation in those areas.

<sup>4</sup> See e.g. W. Oates: An Essay on Fiscal Federalism, in: *Journal of Economic Literature*, Vol. 37, No. 3, 1999, pp. 1120-1149.

A political economic argument against harmonisation is that centralisation not only violates preferences but also has outright negative effects, because coordinated policy could be viewed as a cartel that restricts competition among multiple suppliers.<sup>5</sup> As in a cartel, collusion leads to too few “goods” being provided at too high a price or too low a quality. By restricting competition among different suppliers of policy, the incentive to provide the best policy possible is reduced.

Another argument from the theoretical literature is that coordination could be harmful if policy makers are uncertain about the “true model” of their economies.<sup>6</sup> If the state of the economy or the effects of particular policy measures are uncertain, this may lead not only to “wrong” policies, but harmonisation per se could be bad. If, for instance, the consequences of minimum wages or higher taxes and public expenditures on employment are unclear or if, due to institutional differences, the policies have asymmetric effects on national economies, the harmonisation of policies could result in member states moving further away from their preferred policy outcomes.

In addition to recognising when the significance of externalities or economies of scale outweighs the drawback of diverging preferences, one has to acknowledge that changes in the level of externalities and cost savings – in addition to altered levels of political accountability and divergences in policy preferences – may change the optimal allocation of tasks over time. More integration of markets over time could result in externalities that are stronger than initially expected and thus subsequently warrant more centralisation. An obvious example is the connection between monetary union and banking policy. The integrated financial market creates strong spillovers between banking systems; therefore, common banking supervision and regulation that is stronger than initially foreseen is a logical consequence. Also, the changing nature of military and security conflict coupled with demographic transition in Europe should eventually lead to more integrated military systems across EU member states. The changing nature of military conflict requires more specialised and trained forces, and economies of scale could be exploited by organising them at the European level. Moreover, the demographic transition means that member states will find it increasingly hard to mobilise enough young and

<sup>5</sup> See R. Vaubel: Coordination or Competition among National Macroeconomic Policies?, in: F. Machlup, G. Feis, H. Müller-Groeling (eds.), *Reflections on a Troubled World Economy*, London 1983, pp. 3-28.

<sup>6</sup> J. Frankel, K. Rockett: International Macroeconomic Policy Coordination When Policymakers Do Not Agree on the True Model, in: *American Economic Review*, Vol. 78, 1988, pp. 318-340.

able people for their military forces. Moving towards a European army would be one solution to this problem.

However, the dynamic benefits of experimentation should also be recognised. Theory argues that decentralised policy allows for more responsiveness to differences in preferences, but it also has the benefit of allowing experimentation with different policies in different regions to find what works best.<sup>7</sup> Policy competition could actually be seen as a discovery mechanism for finding the best policy. As market competition generally should help to find which products consumers want and to lower their prices, policy competition should help to identify better policies and make it possible to provide them at the lowest possible costs. Developing this argument further, one should compare centralisation's static gains (e.g. cost savings) with its dynamic costs. A possible one-off gain should be balanced against the long-term costs of giving up the possibility of finding better solutions later due to too much harmonisation.<sup>8</sup>

### Does Europe go too far?

In applying these theoretical considerations to the EU, the strongest case for harmonised policies is usually made for trade. Efficiently integrating Europe into world trade requires a common external policy, and a logical extension of free trade is common market policy. It therefore makes sense to have either common regulation or mutual recognition of rules in product standards or public procurement, and most economists would argue that the allocation of trade and common market policy issues to the European level is broadly adequate.<sup>9</sup> Likewise, a common currency requires a common monetary policy and regulation of the payment system. As the financial crisis has demonstrated, an integrated financial area also requires common banking regulation. The crisis has shown that banks produce strong externalities and that national perspectives on the vulnerability of their financial systems consistently underestimated the European-wide systemic vulnerability.

It is less clear, however, that a common fiscal policy is needed. While one might argue that debts and deficits do indeed have some spillovers among countries, one must at the same time acknowledge that these are mostly political spillovers, because markets have come to expect political pressure to bail out single states. That this impression has taken hold is, of course, to some extent the consequence of previous violations of debt and deficit rules. The United States, on the other hand, shows that federal states can be largely separated and that there need not be common liability among individual regions.<sup>10</sup> But even if one were to acknowledge that binding rules on debt and deficits should exist, there seems to be little justification for common or mandatory taxes, because it is hard to see strong externalities here, whereas it seems that differences in preferences concerning the size and scope of state activities are quite significant.

The EU involvement in education, research and culture should also be rather limited, because externalities are not present, whereas preference differences are likely to be rather large. It remains unclear why the EU's involvement in these areas should further increase with Europe 2020 and the large EU programmes for research support. There also seems to be little justification for EU involvement in health, employment and social protection. Working hours, layoff rules or worker co-determination are hardly areas with large externalities; however, preferences in these areas are likely to diverge significantly.<sup>11</sup> For the same reason, it is also hard to justify the recent regulation of compensation for financial managers.

Reality, of course, is complicated, and it is not always easy to clearly identify those cases where benefits from more centralisation outweigh the costs of harmonisation.<sup>12</sup> In every case, theory would maintain that different bundles of public goods should be provided and people should move to those bundles they like best. Consistent with this, there has always been a more or less subdued discussion about the possibility of having countries opting in and out of certain measures. The United Kingdom and Denmark have fa-

7 See F. von Hayek: *Der Wettbewerb als Entdeckungsverfahren*, Kieler Vorträge 56, Institut für Weltwirtschaft, Kiel 1968. However, K. Strumpf: *Does Government Decentralization Increase Policy Innovation?*, in: *Journal of Public Economic Theory*, Vol. 4, No. 2, 2002, pp. 207-241, points out that finding the best policy has to some extent a public good character and that therefore too little effort will be provided to identify best policies. This would justify subsidisation of policy experimentation.

8 See H. Klodt, O. Lorz: *The Coordinate Plane of Global Governance*, in: *Review of International Organizations*, Vol. 3, No. 1, 2008, pp. 29-40.

9 See A. Alesina, I. Angeloni, L. Schuknecht: *What Does the European Union Do?*, in: *Public Choice*, Vol. 123, No. 3-4, 2005, pp. 275-319.

10 See, for instance, J. Frieden: *Global Economic Governance After the Crisis*, in: *Perspektiven der Wirtschaftspolitik*, Vol. 13, 2012, pp. 1-12.

11 R. Vaubel: *The Political Economy of Labor Market Regulation*, in: *Review of International Organizations*, Vol. 3, No. 4, 2008, pp. 435-465, argues that the harmonisation of social and labour market policies is mainly driven by an attempt to raise rivals' costs. Similar arguments, of course, can be developed for harmonisation of taxation in general.

12 A. Alesina et al., op. cit., develop indices to measure the degree of centralisation already achieved and compare this to evidence based on Eurobarometer polls of what European citizens want. They argue that more centralisation is adequate in trade, military matters, the fight against crime and foreign affairs, whereas social and educational policy are areas in which divergences in preferences are large.

mously negotiated a so-called opt-out clause from Maastricht, allowing them to not introduce the euro, whereas for all other countries it is part of the *acquis communautaire*. Depending on the observers' views, this has been referred to as "variable geometry" and "two-speed Europe" by supporters or, more condescendingly, "Europe à la carte" by advocates of strong centralisation. The simple underlying idea is to allow countries to choose only those aspects which they like.<sup>13</sup>

In general, one would expect that smaller unions are more harmonised than larger ones, as heterogeneities are likely to increase with the size of the union. The enlargement of the EU to soon 28 countries implies that differences between citizens and countries are increasing as well. A larger union will also be a more heterogeneous one in terms of income, religion, culture, tradition, languages and so on. Therefore, a larger union very likely should be one with less centralisation, leaving more room to follow different ways of life.

13 This principle of so-called overlapping jurisdictions is advanced by A. Casella, B. Frey: *Federalism and Clubs*, in: *European Economic Review*, Vol. 36, 1992, pp. 639-646.

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## Structural Adjustment and Neoliberal Convergence: The Impact of the Crisis and Austerity Measures on European Social Models

The tension between the convergence and divergence of countries and national growth models is a recurring theme in international political economy. The most prominent representative of the theory of path-dependency is the Varieties of Capitalism School.<sup>1</sup> Depending on the author, representatives distinguish between two, three or five models of capitalism.<sup>2</sup> European integration certainly had an impact on the economic and social development of the EU member states, but it has not done away with national differences.<sup>3</sup> Sapir, for example, identifies four European social models: the Nordic, Continental, Anglo-Saxon and Mediterranean

1 P. Hall, D. Soskice: *An Introduction to Varieties of Capitalism*, in: P. Hall, D. Soskice (eds.), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*, Oxford 2001, Oxford University Press, pp. 1-70.  
 2 D. Coates: *Models of Capitalism: Growth and Stagnation in the Modern Era*, Cambridge 2000, Polity Press; B. Amable: *The Diversity of Modern Capitalism*, Oxford 2003, Oxford University Press.  
 3 G. Menz: *Varieties of Capitalism and Europeanisation: National Response Strategies to the Single European Market*, Oxford 2009, Oxford University Press.

### Conclusion

Driven by the financial and debt crisis, Europe has been pushed towards more integration in many policy areas. The problem is that there has not been a comprehensive discussion about this. Previous grand changes have been subject to wide-ranging and detailed debate. The European "constitution" and the monetary union were both enacted only after long and sometimes tedious discussions throughout the EU as well as referendums in many member states. Strong fiscal unification and the further harmonisation of taxation in certain areas, however, have been the subject of much less discussion. This is partly justified by external pressure, but it may also be the result of a fear to put up these issues for discussion. The conflict with the United Kingdom shows that not all are willing to go along with this. There is a clear danger that the integration process has stopped and maybe even reversed when no consensus can be found regarding the extent to which policy convergence should ultimately be pursued in a more heterogeneous union. This is an unpleasant discussion that, moreover, will periodically have to be repeated, but it is necessary nonetheless. Europe is at a crossroads, and it should at least discuss which way to take.

models.<sup>4</sup> Essentially, Sapir argues that the Nordic and Anglo-Saxon models display a high degree of flexibility, enabling them to respond to the new challenges created by global capitalism, while the Continental and Mediterranean models are rigid, unresponsive and ultimately unsustainable.<sup>5</sup> In addition, some authors distinguish a Central and Eastern European model, or more precisely, Central and Eastern European (CEE) divergences from a European model.<sup>6</sup> The models not only differ in terms of the role of

4 A. Sapir: *Globalisation and the Reform of European Social Models*, in: *Journal of Common Market Studies*, Vol. 44, No. 2, 2005, pp. 369-90.  
 5 Interestingly, "continental" Germany came out of the crisis as one of the strongest and fastest-growing economies, whereas "liberal" Britain is on the brink of a "triple dip" recession.  
 6 A. Nölke, A. Vliegenthart: *Enlarging the Varieties of Capitalism: The Emergence of Dependent Market Economies in East Central Europe*, in: *World Politics*, Vol. 61, No. 4, 2009, pp. 670-702; B. Hacker: *Hybridization Instead of Clustering: Transformation Processes of Welfare Policies in Central and Eastern Europe*, in: *Social Policy & Administration*, Vol. 43, No. 2, 2009, pp. 152-169.

the state and other cooperative institutions in managing the economy, but also in the design and extent of welfare systems, the regulation of labour markets and the nature of collective bargaining. Southern European countries, for example, combine residual welfare systems with highly segmented labour markets and comprehensive sector-wide collective bargaining.<sup>7</sup> There is a significant body of literature that criticises the Varieties of Capitalism Approach for its overemphasis on continuity and its failure to grasp the commonalities of change that have transformed virtually all member states in the past three decades. Some authors have therefore described the current situation in Europe as a variety of neoliberalism rather than of capitalism.<sup>8</sup>

In the light of the ongoing debate, the current economic and social crisis in Europe presents an interesting test case for exploring the institutional dynamics of capitalist development.<sup>9</sup> Not only does the crisis present a massive shock that continues to hamper economic growth throughout Europe and has caused four straight years of economic contraction in parts of Southern Europe; the dependence on external emergency funds provided by the European Stability Mechanism and the International Monetary Fund (IMF) gave external forces the possibility to interfere in national crisis-solving strategies.<sup>10</sup> In fact the crisis provided Brussels (in coordination with Washington) with an unprecedented opportunity to intervene in member states' social and employment models.<sup>11</sup>

This article looks at measures that were adopted by crisis countries in response to the economic downturn and analyses them in a wider context of institutional change. The focus lies on structural reforms that were negotiated with representatives from the European Commission, the European

**Table 1**  
**Public sector employment**

	Job cuts	Wage cuts	Pay freeze	Extension of working hours
Estonia	-	X	X	-
Greece	X	X	X	X
Hungary	X	X	X	-
Ireland	X	X	X	-
Italy	X	X	X	-
Latvia	X	X	X	-
Lithuania	X	X	-	-
Portugal	X	X	X	-
Romania	X	X	-	-
Spain	X	X	X	X
United Kingdom	X	-	X	-

Source: Own elaboration.

Central Bank and the IMF – the so-called troika – as part of the Memoranda of Understanding, or that were adopted to calm financial markets and avoid public default. More specifically, the article explores changes in the public sector and especially in public sector employment, changes in the regulation of labour markets and collective bargaining, as well as changes in pension systems. The analysis covers eleven EU member states that were particularly strongly affected by the crisis. The evidence stems from a larger study on the financial crisis and the consequences for welfare states and employment relations. After assessing the possibility of a crisis-driven convergence of European social models, the article concludes by discussing some economic and social consequences of the structural adjustment policies.

### Public sector and public employment

The public sector and the level of employment therein is a major target of the structural reforms adopted during the crisis (see Table 1). In Greece and Portugal, large-scale privatisation programmes are part of the Memoranda of Understanding negotiated between the national governments and the troika; the Spanish and Italian governments have also revealed privatisation plans to increase financial revenues to cover the national budget deficits.<sup>12</sup> While privatisation plans are country-specific, ten of the eleven countries included in this analysis have announced public sector job cuts. The Greek government wants to reduce public employment by a third. In companies that are to be

- 7 M. Karamessini: Still a Distinctive Southern European Employment Model?, in: *Industrial Relations Journal*, Vol. 39, No. 6, pp. 510-531; J. Visser: The Quality of Industrial Relations and the Lisbon Strategy, in: *European Commission: Industrial Relations in Europe Report 2008*, pp. 45-72.
- 8 P. Cerny: Mapping Varieties of Neoliberalism, Paper prepared for presentation at the annual convention of the International Studies Association, Montreal, Québec, 17-20 March 2004; G. Albo: Contesting the 'New Capitalism', in: D. Coates (ed.): *Varieties of capitalism, varieties of approaches*, Houndmills 2005, Palgrave Macmillan, pp. 63-82.
- 9 J. Becker, J. Jäger: Integration in Crisis: A Regulationist Perspective on the Interaction of European Varieties of Capitalism, in: *Competition and Change*, Vol. 16, No. 3, 2012, pp. 169-87.
- 10 K. Busch: Is the Euro Failing? Structural Problems and Policy Failures Bringing Europe to the Brink, Friedrich Ebert Foundation Berlin, 2012, <http://library.fes.de/pdf-files/id/ipa/09034.pdf>; G. Feigl: Austeritätspolitiken in Europa – Konsolidierungspakete im Überblick, in: *Kurswechsel*, No. 1, 2012, pp. 36-45.
- 11 E. Klatzer, C. Schlager: Europäische Wirtschaftsregierung: Eine stille neoliberale Revolution, in: *Kurswechsel*, No. 1, 2011, pp. 61-81; C. Hermann, K. Hinrichs: Die Finanzkrise und ihre Auswirkungen auf Sozialstaaten und Arbeitsbeziehungen – ein europäischer Rundblick, Chamber of Labour, Vienna, 2012, [http://www.arbeiterkammer.at/bilder/d184/Forba-Studie\\_Finanzkrise\\_2012\\_neu.pdf](http://www.arbeiterkammer.at/bilder/d184/Forba-Studie_Finanzkrise_2012_neu.pdf).

- 12 K. Busch, C. Hermann, K. Hinrichs, T. Schulten: Euro Crisis, Austerity Policy and the European Social Model, Friedrich Ebert Foundation Berlin, 2013, <http://library.fes.de/pdf-files/id/ipa/09656.pdf>.

**Table 2**  
**Labour market reforms**

Promotion of non-standard employment	
Promotion of fixed-term employment and agency work	ET, LT, GR, RO, PT
Introduction of new employment contracts with less job security	GR, ES
Extension of probation periods	ET, GR, RO
Reduction of job security	
Weakening of employment protection for civil servants	GR
Weakening of employment protection for particular vulnerable groups of employees	ET, HU, RO
Shortening of notice periods	ES, GR
Increasing thresholds and reducing obligations for mass layoffs	ET, ES, GR, RO
Changes in the definition of fair and unfair dismissals	ES, UK, IT
Reduction of severance pay	ES, ET, GR, PT
Restriction of access to court and reduction of fines for unfair dismissals	UK, HU
Elimination or weakening of the right to be reinstated after an unfair dismissal	ES, IT, RO

Source: Own elaboration.

Note: ET=Estonia, LT=Lithuania, GR=Greece, RO=Romania, PT= Portugal, ES=Spain, HU=Hungary, IT=Italy, UK=United Kingdom.

privatised, staff numbers have been cut by 44 per cent within two years. The UK wants to shed almost half a million public sector jobs by 2014. As in other countries, jobs in education and health care are frequently being eliminated there. Yet while the UK simply lays off public sector workers, Southern Europe and CEE countries shrink the workforce primarily through the non-replacement of retirees or voluntary dismissals. After a temporary ban on all new hiring, only every tenth public sector employee is currently replaced in Greece. In Romania this applies to every seventh and in Italy to every fifth worker who leaves the public sector.

Job cuts are frequently combined with wage cuts and pay freezes. Again Greece stands out, as here the public sector workforce will not only shrink about a third, but those who keep their jobs will also earn 33 per cent less. Substantial public sector wage cuts were also introduced in Portugal, Romania, the Baltic states and Hungary. In addition, nine of the eleven countries have enforced public sector pay freezes during the crisis. While thousands of jobs were axed, Greece and Spain increased working time for the remaining workers.

### Labour markets

Even though labour market reforms have hardly any effect on national budgets, labour market flexibilisation has become a frequent target of structural adjustment in Europe (see Table 2). The European Commission and others argue that labour market reforms are important because more flexible labour markets encourage employers to hire more staff and spur economic growth. However, what is pre-

sented as the flexibilisation of labour markets by and large amounts to a weakening of job security and a promotion of atypical and precarious employment. A number of countries have relaxed the regulations on fixed-term employment. In Portugal, for example, the maximum length of fixed-term contracts has been increased from six to 36 months. One of the few exceptions is Spain, which at the beginning of the crisis introduced new restrictions for fixed-term employment. Fixed-term contracts were limited to a maximum of two years. After that, a temporary contract became an unlimited employment relationship. Spain adopted this measure not least because 25 per cent of all employment contracts were already fixed-term at the start of the crisis and this did not prevent unemployment from increasing. However, after a change in government, Spain fell in line with the other countries and suspended any restrictions on fixed-term employment. In some countries, the promotion of fixed-term employment went hand in hand with the elimination of restrictions for temporary agency work. While cutting permanent and temporary jobs, the Greek government, for example, enabled government agencies to hire temporary agency workers.

Greece and Spain also introduced new employment contracts for younger and in the case of Spain unskilled workers. These contracts last for two years and pay only between 75 and 80 per cent of the national minimum wages. Greek workers under these contracts not only earn less; they can also be laid off at any time and they are not eligible for unemployment benefit. Employers, in contrast, profit not only from lower wages but also from a reduction in social security payments. Workers can now also be dismissed

Table 3  
**Reform of collective bargaining**

Decentralising collective bargaining	
Elimination or suspension of national collective agreements	IE, RO
Suspension of the favourability principle	GR, ES
Approval of exceptions and divergences	IT
Weakening of collective bargaining	
Suspension or reduction of extension procedures	GR, HU, PT, RO
Limitation of the “after effect” of expired collective agreements	ET, ES, GR
Limitation of arbitration	GR
Interventions in collective bargaining	
Suspension of existing agreements	GR
Limitation of the duration of agreements	GR, RO
Weakening of trade unions	
Higher thresholds for representativeness of trade union organisations	RO
Promotion of alternative forms of employee representation at the cost of works councils and trade unions	GR, HU, PT

Source: Own elaboration.

Note: IE=Ireland, RO=Romania, ET=Estonia, GR=Greece, LT=Lithuania, ES=Spain, IT=Italy, HU=Hungary, PT= Portugal.

without reason during probation periods. Several countries have extended these periods in response to the crisis. In Greece the probation period now lasts for 12 instead of two months, and in Romania for 90 instead of 30 days (120 instead of 90 days for employees with managerial tasks).

As part of the flexibilisation agenda, changes have also made it easier to lay off workers. In Greece the government ended the special employment protection for civil servants. In Estonia employers no longer need the consent of the labour inspectorate to lay off pregnant women, while in Hungary employees can now be dismissed while they are on sick leave. In addition to weakening special protection for particularly vulnerable employees, the reforms also included a shortening of dismissal periods. In Greece workers have to be given just three months' notice instead of five; in Spain the period was reduced from 30 to 15 days. Dismissals have also become more attractive to employers through the reduction of severance pay. In both Greece and Spain, severance pay has been halved (although in Spain, companies have to prove that they are in economic difficulties, i.e. they have to document two consecutive quarters of falling revenues). In Estonia severance pay has been reduced from three to two monthly wages – with one of the two monthly salaries being paid by the labour market service.

While job security has been weakened, it has become more difficult for employees to fight unfair dismissals. In the UK a worker must now be employed for two instead of one year to be able to challenge a dismissal in court. In Spain the def-

inition of fair dismissals has been expanded. It is now sufficient for companies to refer to technological or economic reasons to justify a fair dismissal. Even if an employee can prove an unfair dismissal, the right to be reinstated has been restricted. In Italy a planned labour market reform will still grant victims of unfair dismissals financial compensation, but they will no longer be able to return to their former job. The Hungarian government refrained from altering the definition of unfair dismissals, but it reduced the maximum fine for infringing companies from 36 to 12 monthly wages.

Mass layoffs have also been made easier. In Estonia the dismissal period for mass layoffs has been halved. In addition Estonian and Spanish companies no longer need government approval for mass dismissals. Estonian employers, furthermore, are no longer required to reinstate workers if new employees are hired after a mass layoff. In Romania dismissed workers still have a right to be re-hired – but the period for which this rule applies was cut from nine months to 45 days. Since mass layoffs are associated with additional obligations, the Greek government has increased the minimum number of workers that need to lose their jobs simultaneously to qualify as a mass layoff.

Additional reforms concern the regulation of wages and working hours. Greece and Ireland cut national minimum wages in response to the crisis – by 22 and 12 per cent respectively. Ireland has reinstated the initial rate after the government responsible for the cut lost the elections. While cuts in minimum wages are an exception, several

countries have introduced minimum wage freezes during the crisis. Hence between 2008 and 2011, minimum wages in real terms decreased by almost 15 per cent in Estonia and almost four per cent in Britain. In terms of working hours, the Portuguese government contemplated an increase in the working week but ended up reducing the number of vacation days and cutting overtime supplements. More frequent was the introduction of measures that made working time more flexible, including the extension of averaging periods, the introduction of working time accounts and the expansion of overtime limits.

### Collective bargaining

Particular dramatic are the changes in collective bargaining (see Table 3). A series of measures that were introduced as part of the austerity packages amount to a profound decentralisation and erosion of collective bargaining systems. As with labour markets, the idea is that decentralisation improves wage flexibility and wage flexibility enhances growth. Decentralisation is imposed in three different ways. Firstly, in countries with nationwide collective agreements, these agreements have been abandoned. While in Romania the government suspended the national collective agreement through legislative reform, in Ireland the social partnership on which the national agreement was based collapsed after the government opened an existing agreement and unilaterally cut public sector wages. Secondly, countries discard the favourability principle which stipulated that in the case of multiple collective agreements, those regulations prevail that impose the most favourable conditions for workers. As a result, company agreements only had an effect when they contained better conditions for workers than multi-employer agreements. With the changes in Greece and Spain, company agreements apply even if they provide for poorer employment conditions than sector or regional agreements. Thirdly, countries promote decentralisation through the granting of exceptions and the acceptance of derogation from sector-wide standards. Italy, among others, adopted a reform that allows for a wide range of derogations in essential bargaining matters.

Decentralisation is complemented by a weakening of bargaining institutions. Greece has suspended extension procedures through which agreements concluded between one or more employer organisations and trade unions were made binding for an entire sector or region. Now the regulations only apply for members of the interest organisations who signed the agreement. In Portugal extension procedures were initially also suspended. Meanwhile, the government has introduced a reform of the process which includes more restrictive extension criteria. The signing parties must now represent at least 50 per

**Table 4**  
**Pension reforms**

Increase of retirement age	GR, IT, ES, IR, HU, RO, LV, UK
Reduction of pension payments	GR, PT, HU
Temporary pension freeze	GR, IT, PT, IE, LV
Extension of contribution periods	IT, ES, RO, LV
Extension of the periods on which pension payments are calculated	GR, ES
Increase of employee contributions for public sector workers	IE
Limitation of access to early and invalidity pensions	IT, PT, HU
Introduction of minimum pensions	GR, RO

Source: Own elaboration.

Note: GR=Greece, IT=Italy, RO=Romania, IE=Ireland, HU=Hungary, ES=Spain, LV=Latvia, PT=Portugal, UK=United Kingdom.

cent of the workers in the sector. Similar changes were introduced in Romania and Hungary. Collective bargaining systems also suffer from the elimination or shortening of the “after effect”, which means that regulations continue to apply after an agreement has expired. By doing so, they encourage employers to negotiate a new contract. In Estonia the “after effect” was entirely abandoned; in Greece it was reduced from six to three months. In Spain the effect still lasts for two years – but this is a significant deterioration from the previous situation in which agreements continued to apply until a new contract was reached.

The crisis even encouraged governments to interfere in collective bargaining. In Greece the government suspended an existing agreement between the social partners and cut the national minimum wage by 22 per cent. In Greece and Romania new legislation limits the duration of collective agreements to three and two years respectively. In both cases, the International Labour Organisation has criticised the changes as violations of the principle of free bargaining. The erosion of the bargaining systems was complemented by a weakening of trade union representation. In Greece, for example, company agreements can be signed by non-trade union and works council-related staff representatives. Romania has introduced tougher criteria for trade unions to be qualified as representative organisations that can sign collective agreements.

### Pensions

Since pensions typically account for a large part of welfare expenditures, it does not come as a surprise that

pension reforms are high on the austerity agenda (see Table 4). However, the changes in pension systems were not so much a break with previous developments than an acceleration of existing reform plans. The main purpose of the reforms is to cut costs and to reduce government contributions to pension systems. A widespread measure is the increase of the retirement age. Apart from Portugal, all countries included in this survey have introduced higher retirement thresholds. Women are particularly affected because their retirement age has not only been increased as a result of the crisis, but has at the same time been adjusted to the higher male retirement age. Usually these changes are introduced gradually over a period of several years. In Italy, however, the retirement age for women employed in the public sector was raised from 61 to 65 between 2010 and 2011 and then to 66 in the following year. In the long term, the retirement age in the crisis countries is expected to increase to between 67 and 70 years. Some reforms include “automatic stabilisers” which increase the retirement age in line with growing life expectancies. While the postponement of the retirement age in the public system is meant to limit the growing gap between those in employment and those in retirement, in the private system it gives pensions funds more time to make up for the losses incurred during the financial crisis.

While the regular retirement age is increasing, access to early retirement and invalidity pensions has been restricted. Several countries have also extended the period of contributions which makes retirees eligible for a minimum or full pension. In Latvia the minimum period of contributions for a state pension has been increased from ten to 20 years, while in Greece the period that grants access to a full pension without deductions has been raised from 35 to 40 years. Greece and Spain have also extended the contribution periods upon which their pension payments are calculated. In the Spanish case, a worker’s last 25 rather than 15 years are now taken into account. The likely result is lower pension payments.

In addition to long-term changes, pension reforms have also included short-term measures to limit costs. Five countries introduced temporary pension freezes, while three countries cut pension payments. In Portugal the 13<sup>th</sup> and 14<sup>th</sup> pension payments were eliminated for pensions that are higher than 1100 euros a month; Hungary abandoned the 13<sup>th</sup> payment for all pensioners, while in Greece pensions have been cut repeatedly during the crisis – by up to 25 per cent in the latest austerity package adopted in fall 2012. In Ireland the government has increased the pension contributions of public sector workers, amounting to an additional pay cut for public sector staff. Greece and Romania mitigated some of the worst effects of the cuts by introducing minimum pensions.

## Conclusion

The current crisis, no doubt, put tremendous pressure on European social models – especially in Southern and Central and Eastern Europe, where the effects are most dramatic. Despite national specific reasons for the crisis, the counter-measures adopted in the various countries look quite familiar and include, among other features, the shrinking of the public sector and in particular public sector employment, the weakening of job protection and the precarisation of employment, the decentralisation of collective bargaining and the weakening of trade unions, as well as the increase of the retirement age.<sup>13</sup> This does not mean that the various responses adopted during the crisis necessarily break with the previous development model. In some areas, including pension reforms, path-dependency continues to play an important role; in others, such as collective bargaining, some of the changes amount to a fundamental departure from the traditional system. Furthermore, some of the measures merely bring the respective countries in line with what happened elsewhere in Europe years ago. Hence the reduction of job security for core workers may be new for Greece, Italy, Spain and Portugal, but is quite familiar in Continental and Anglo-Saxon Europe. Other measures, however, go beyond familiar reform terrain. The elimination of the favourability principle in Greece and Spain, for example, is a new phenomenon and poses a veritable threat for traditional Northern and Continental European industrial relations systems. In addition, Southern European countries were not alone in adopting structural reforms during the crisis, as liberal forerunners such as the United Kingdom, Ireland and the Baltic states also pushed ahead with such reforms. Regardless of the background and impact of the changes, the reforms follow the same broad trajectory: they amount to a further (neo-)liberalisation of the economy and society in Europe.

Based on a study of ten EU member states and their responses to the crisis, Steffen Lehndorff calls the response to the crisis a “triumph of failed ideas” and comes to a similar conclusion: “In most of the countries ... the outcomes of the 2008/2009 crisis are being tackled in practice on the basis of core guidelines of neoliberalism. Free-market fundamentalism is being called into question rhetorically, but neoliberalism is being resurrected”.<sup>14</sup> The result of structural adjustment and neoliberal convergence in Europe has so far been disastrous. Economic growth has hardly come back in the crisis countries, while unemployment has reached record numbers and large parts of the population are suffering from deprivation.<sup>15</sup>

13 C. Hermann, K. Hinrichs, op. cit.

14 S. Lehndorff: Introduction – The Triumph of Failed Ideas, in: S. Lehndorff (ed.): *The Triumph of Failed Ideas. European Models of Capitalism in Crisis*, Brussels 2012, ETUI, pp. 7-26, here p. 16.

15 K. Busch et al., op. cit.