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New EMU governance: Not (yet) ready for social investment?

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Abstract

Half a decade after the Euro crisis, the European Union (EU) is in dire need of a growth strategy that is – all at once – economically viable, politically legitimate and seen as socially fair. Without a strategic focus on an inclusive labour market, helping to ease the employment transitions for working families, undergirded by a comprehensive safety net and strongly supported by human capital investments from early childhood on, Europe risks becoming entrapped in economic stagnation and political discord. This was the central message of the 'Social Investment Package' (SIP), launched by the European Commission in February 2013. The SIP is best read as a strategic vision for welfare state modernization for post-crisis Europe, based on forward-looking social policies to 'prepare' individuals and families to respond to the changing nature of social risks in the competitive knowledge economy. The SIP was published in the wake of a major overhaul in EU fiscal surveillance – the Six Pack, Two Pack, and the Fiscal Compact – enacted after the Euro zone sovereign debt crisis of 2010.

The central question of this paper is whether and to what extent Europe's new macro-economic governance regime is supportive of the social investment imperative? The short answer to this question is 'no'. Reinforced fiscal austerity, underwritten by heterodox Outright Monetary Transactions and quantitative easing interventions by the European Central Bank (ECB) to counter deflation, continues to be based on the widespread belief that generous social provision inescapably 'crowds out' economic growth, private entrepreneurship, employment participation and labour productivity. The 'long' rejoinder to the central question in this contribution is more positive. With the publication of the non-binding SIP communication, the intellectual genie of the social investment policy paradigm is out of the bottle, with fairly strong evidence of 'capacitating' welfare provision enhancing dual-earner employment and skills levels, while mitigating the reproduction of inter-generational poverty. The current schizophrenic posture of the European Commission as the 'social investment cheerleader', on the one hand, and the 'fiscal austerity headmaster', on the other, informed by contradictory policy theories, is difficult to sustain. The Eurozone has entered a period of transition. Policy attention is shifting to accumulating evidence, brought forth most notably by recent OECD studies, that well-calibrated *social investment policies 'crowd in' inclusive growth and social progress in tandem. At the same time, a fragile recovery, competitive divergences and the social imbalances of mass (youth) unemployment, rising poverty and a deepening intergenerational divide, are increasingly met with rising anti-EU populism. In conjunction, negative anti-EU political feedback and more positive social investment policy feedback may open up a vista, contingent on effective political mobilization and adequate EU support, for anchoring an assertive social investment commitment in future EMU economic governance.*

Contents

1. Europe's 'double commitment' in jeopardy

Since its inception in 1957 with the Treaty of Rome, the core idea behind European integration was based on the political *Leitmotif* of achieving *both* economic prosperity *and* social progress in upward convergence in an 'ever closer union' of the peoples of Europe. In defining the European project to this end today, the 2009 Lisbon Treaty explicitly commits the European Union to work towards a competitive 'social market economy', aiming for full employment with high levels of social protection and cohesion, gender equality and inter-generational solidarity, across all of its current 28 Member States, founded on the common values of 'respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities' (Article 2, TFEU, 2009). The fallout of the Eurozone crisis tragically unveils a serious infringement on the EU's 'double commitment' of economic prosperity and social progress.

Where and when stagnation prevails, widening economic imbalances, high unemployment and rising poverty and inequality become breeding grounds for xenophobic anti-EU populism. The inability to deliver on economic prosperity *and* social progress puts national governments under enormous pressure, as electorates continue to hold national leaders responsible for socio-economic (mis-)fortune. With political accountability bound up with popular national welfare states, it is difficult to renege on established social contracts in hard economic times. Harsh austerity reforms, reinforcing economic insecurity, employment instability and income inequality, alongside the failures to resolve the Euro crisis at the supranational level, are increasingly met by rising EU-sceptic domestic pressures to water down ruling governments' commitments to European solutions. Betwixt rising the EU's inquisitive austerity reform imposition and anti-establishment populism, unsurprisingly, a 'political-institutional vacuum' has emerged at the heart of the European integration project.

The EU, lacking a strong normative basis of 'input-legitimacy' (Scharpf, 2002), is in dire need of a growth strategy that is – all at once – economically viable, politically legitimate and seen as socially fair. Without a strategic focus on an inclusive labor markets, helping to ease the 'flow' of employment transitions for working families, undergirded by comprehensive safety net 'buffers' and strongly supported by human capital 'stock' investments from early childhood on, Europe risks becoming entrapped in economic stagnation and political discord. This was the central message of the communication *Towards Social Investment for Growth and Social Cohesion – including implementing the European Social Fund 2014-2020* published by the European Commission on February 20th in 2013, initiated by then Employment and Social Affairs Commissioner Laszlo Andor (EC, 2013a). The so-called *Social Investment Package* (hereafter *SIP*) advocated forward-looking welfare policies to 'prepare' individuals and families to respond to the social risks of the competitive knowledge society, by investing in human capital stock from their early childhood on, rather than to simply 'repair' damage after economic misfortune strikes. The *SIP* is a remarkable document by making a coherent case for the economic returns on social investment and thereby challenges the conventional view that generous welfare provision impedes economic competitiveness. The Staff Documentation Paper (SWD) of the Directorate-General for Employment and Social Affairs (DG EMPL) attached to the *SIP* unearthed strong empirical evidence of positive returns on economic growth, employment creation, and (child) poverty mitigation through social investment provisions of high quality childcare, generous parental leave, assertive activation and active labour market services, training and education, alongside adequate (universal) minimum income protection, consistent with long-term budget consolidation (EC, 2013b).

The publication of the non-binding *SIP* communication and SWD of the Commission, guiding rather than prescribing countries to develop social investment reforms, took centre stage in the wake of a major overhaul in the architecture of EU economic policy coordination, with more prescriptive portent. As the aftermath of the global liquidity crunch of 2008, exposing major flaws in the design the Economic and Monetary Union (EMU), the EU set up new institutional structures, such as the European Financial Stability Facility (EFSF), later transformed into the ESM (European Stability Mechanism) to assist countries unable to service debt in open capital markets. In the area of fiscal policy, the rules-based SGP was fortified by the so-called Six Pack (December 2011), the Treaty on Stability, Coordination and Governance in Europe (January 2013) and the Two Pack (May 2013), including more intrusive surveillance of annual budgets in the European semester exercise, including the option of sanctions (Verdun, 2015). To wit, the Macroeconomic Imbalances Procedure (MIP), written into the new legislation, stipulates a wholly new role for the European Commission to review current account surpluses and deficits and unit labour cost developments. Furthermore, a contested 'Banking Union' with a single supervisor and a common restructuring mechanism was agreed to. In the summer of 2012 the European Central Bank rose to the occasion with unconventional interventions to do 'whatever it takes' to keep besieged euro currency afloat, through 'Outright Monetary Transactions' assisting European banks and then in the spring of 2015 quantitative easing, five years later than the US, so as to rein in deflation.

The central question of this paper is whether and to what extent Europe's new macro-economic governance regime is truly supportive of the social investment imperative as advocated by the SIP? The short answer to this question is 'no'. Reinforced fiscal austerity, accommodated by heterodox ECB monetary policy, continues to be based on a policy belief that generous social provision inescapably reduces efficiency, labour productivity and economic growth by 'crowding out' private initiative and entrepreneurship, reflecting the experience of stagflation of the 1970s and 1980s. Sadly, the assertion of an inescapable 'trade-off' between equity and efficiency continues to inform the €300 billion Juncker Investment Plan (JIP), privileging, as it does, private investment over public investments in the social infrastructures of Europe's advanced knowledge-based economies.

The 'long' rejoinder to the central question of this contribution is however more positive. With the non-binding SIP communication and Staff Working Document (SWD), the intellectual genie of social investments 'crowding in' employment and growth is out of bottle, with fairly strong evidence of enhancing dual earner families while countering inter-generational poverty and skill depletion. The false schizophrenia of the European Commission as a 'social investment cheerleader', on the one hand, and 'fiscal austerity headmaster', on the other, is increasingly difficult to sustain. The E(M)U has entered a period of transition. On a positive note, policy attention is starting to shift to accumulating evidence, brought forth by the OECD and the World Bank studies on 'inclusive growth' and country-specific reforms that social investment reforms 'crowding in' positive employment, productivity, equality, and work-life balance returns. At the same time, lackluster growth, competitive divergences and social imbalances across the Eurozone, mass (youth) unemployment, rising poverty and a widening intergenerational divide, are increasingly met with rising anti-EU populism in the political arena, inspired also by the influx of migrants and asylum seekers. In tandem, negative anti-EU political feedback and positive social investment evidence, may open up a vista, contingent on political domestic mobilization and EU administrative support, for explicitly anchoring a social investment commitment in EMU economic governance.

This contribution traces the dynamic trials and tribulations in the co-evolution of EU macroeconomic policy and European welfare states since the 1980s. At the outset, it is important to underline that institutional configurations, connecting macroeconomic governance and domestic social policy repertoires, never add up to truly integrated and coherent policy systems. In recent years, scholars studying the dynamics of policy change, from Marie-Laure Djelic and Sigrid Quack (2003) to Colin Crouch (2005), and Wolfgang Streeck and Kathy Thelen (2005), have revealed how different layers of social and economic governance, often embodying contradictory logics, can coexist under different historical circumstances, whilst giving rise to a range of unintended consequences and unforeseen developments. The dynamic relationship between national welfare states and EMU governance is no different. National welfare states moreover are made up of variegated provisions, ranging from social insurance and public assistance, employment policy and labour regulation, gender equality legislation and family and long-term care provision, etc., run by various social partners, local authorities and (semi-)private providers. The governance structure of EMU and the single market is also policy-centric, with single market and competition policy steered by the Commission and enforced by the Luxembourg-based Court of Justice, monetary policy falling under the independent jurisdiction of the ECB, while budgetary policy prerogatives squarely residing within the remit of the sovereign member states, subject to the SGP as a public finance disciplining device (Hemerijck, 2013). It should thus come as no surprise that, over the past half-century, the multi-level institutional order produced by the dynamic co-evolution of national welfare states and the deepening and widening of EU economic integration from six to twenty-eight member states, raised the propensity of inter-institutional friction between domestic welfare provision and supranational market-making on various occasions.

The rest of this contribution is built up over six sections. Section 2 theoretically surveys the intimate relationship between macroeconomic policy paradigms and the welfare state in the governance of the mixed economy of the EU, from the Keynesian-Beveridgean welfare state of the post-war decades to the neoliberal critique of the welfare state, advocating intrusive social retrenchment, privatization and labour market deregulation, of the 1980s and 1990s. Section 3 is devoted to the social investment turn after the mid-1990s. In comparison to the Keynesian-Beveridgean welfare state *Gestalt* and the neoliberal edifice of welfare retrenchment, Section 3 highlights the extent to which social investment perspective conjures up a distinctively novel social policy paradigm, departing both for neoliberal critique of the post-war welfare and the remaining vestiges of the passive male-breadwinner welfare provision. Next, the empirical Sections 4, 5, and 6 examines how EU currency integration has come to shape – but not determine – social reform agendas across Europe's welfare states over the past quarter century. As will be argued below, the co-evolution of EMU and welfare reform played out quite differently *before* the onslaught of global financial crisis, *during* the crisis when the US subprime crisis spilled over to Europe and by 2010 posed an existential threat to the single currency, and then again *after* the depth of the Euro crisis when the ECB came to the rescue of the besieged euro in the summer of 2012. Each of these short episodes, respectively surveyed in the Sections 4, 5, and 6, unleashed, in a cumulative fashion, a wide variety of positive and more adverse, both intended and unintended, effects to the surface for the different EU welfare states partaking in the Eurozone. Before the onslaught of the global financial crisis, disparate growth dynamics camouflaged the macroeconomic, fiscal and financial risks of EMU, and he need for social reform in some of the more insider- and pension-biased European welfare states. Next, the eurocrisis amplified recessionary dynamics, also because truncated crisis-management responses at the EU-level and in domestic politics, with a strong bias towards overnight welfare austerity. After the euro was saved by the ECB – 'whatever it took' – unbalanced fiscal and monetary continue to impede a viable recovery across the Eurozone. To understand the interactive effects between intensified European economic integration and domestic welfare reform, and the spillover effects from one episode to the next, under more normal and truly abnormal economic conditions, is prerequisite for making an adequate diagnosis of these trying times. Moreover, such a historical-institutional assessment, I believe, is also crucial for articulating a more effective and legitimate post-crisis EMU governance resolution that would allow future EMU governance to act as a 'holding environment' for active welfare state to prosper'. Section 7, in conclusion, returns to the current recent 'transitional' phase of Euro-crisis management, which – inevitably – continues to display unresolved ambiguities, but I try my best to suggest light at the end of the tunnel.

2. Macroeconomic regimes and welfare policy paradigms

Every macroeconomic policy regime harbours a theory of the state. When social spending on average hovers between 16 to more than 30% per cent of GDP, as in many EU member states, by implication, macroeconomic policy is critically informed by a theory of the *welfare* state. Under these conditions, it is practically impossible to overlook the importance of the economic beliefs that policy makers hold and cherish, also for political reasons, on the benefits and perversities of generous welfare provision. In her speech at the 2013 World Economic Forum in Davos, German Chancellor Angela Merkel dramatized the European crisis predicament by underscoring that the European continent "represents 7% of the world's population, 25% of the world's GDP and 50% of the world's social spending", intimating that such ratios are unsustainable in an era of intensified global competition (Merkel, 2013). On closer inspection, the EU's share of world welfare spending is less than 40% and per capita spending on public social protection is not that much higher than in the US and Japan. In the future, the EU's share of global social spending is bound to fall simply because developing economies in East Asia and Latin America will catch up (Begg et al., 2015). Perhaps more problematic for Merkel's diagnosis of Europe's competitiveness failure, as caused by overgenerous welfare provision, is that it does not seem to stand up to empirical scrutiny. Four out of the ten most successful economies in the world in the Global Competitiveness

Index of the World Economic Forum (2014) are among the most generous of EU welfare states, including Germany, with levels of social spending edging around 30% of GDP. Does the causal arrow run in reverse, with proactive and generous welfare provision adding to the long-run economic success of Germany, the Netherlands, Sweden and Finland? The empirics seem to suggest that much matters on how and the extent to which social spending is allocated in a 'productivist' fashion for raising human capital, improving labour market transitions, while at the same time serving to stabilize the economy in times of recession.

Unfortunately, in the imperfect world of policy and politics, proof of effective welfare performance, beyond plausible aggregate statistical corroboration, remains modest and thus politically contentious. This is related to the multifaceted character of the welfare state, involving a broad range of differentiated social insurance provisions, social services and labour market regulation, and the multiplicity of policy effects in terms of growth, employment and wellbeing for varying groups. Under such conditions of 'bounded rationality', policy makers and politicians inevitably rely on policy beliefs, whereby they afford priority to one reading of available data at the expense of others. To the extent that Angela Merkel overestimates the budgetary burden of welfare provision on competitiveness, and by implication underestimating the productive potential and stabilizing import of the welfare state, there is the potential policy risk of underinvestment in raising and protecting human and social capital in the competitive knowledge-based economy in the medium- and long-term.

Unsurprisingly, therefore, both the post-1945 expansion of the welfare state and post-1970's oil crises concerns with welfare states 'growing to limits', are strongly associated with alternative policy paradigms of economic management. Taking heed from the seminal writings of Peter Hall on the political power of economic ideas, I employ the notion of a policy paradigm as an overarching set of ideas that brings the *cognitive understanding* of causal relations between policy efforts and outcomes and the *political mobilization* behind social and economic priorities together with the *institutional structure* within economic making is conducted in a coherent and internally consistent fashion (Hall, 1989; 1993). A policy paradigm hereby specifies in union how salient problems facing (policymakers) are to be perceived, what objectives are being privileged and what sort of policy *instruments* have to be put to use to reach politically selected objectives, and the kind of *institutions* to help enact, implement, administer and monitor such privileged policies. The ideational content of a policy paradigm, the *policy theory*, centres around programmatic statements of cause and effect concerning the nature and magnitude of policy problems and the identification of potentially effective solutions. A policy paradigm should not be mistaken for a scientific paradigm in the realm of science, referring to epistemic beliefs and causal understanding in particular scientific communities (Kuhn, 1970). A *policy* paradigm has *practical* portent in the sense that it predefines instruments and institutional modes of procedure, including a delineation of privileged actors participating in the exercise of decision-making and administration, based on a salient hierarchy political goals and operational objectives to be pursued through policy.

Once a policy paradigm is taken for granted, naturally, intellectual inertia prevails, reinforced by status quo biased political and economic interests. Here lies the family resemblance with epistemic beliefs in the realm of science. Any relatively stable 'goodness of fit' between salient political premises and causal understandings of socioeconomic reality inevitably imply blind spots for alternative causalities and anomalies and competing political preferences. When prevailing policies go off track from securing political objectives, accepted cognitive doctrines, rules of procedure, and mental maps, continue to enjoy a considerable comparative advantage over untried policy proposals, based on alternative sets of ideas and preferences. With the passing of time, faltering policies may spark the search for alternative policy solutions and alternative political objectives, and alternative policy paradigms may gain credibility. Empirical backing and growing support in academic circle is, however, never a sufficient condition for paradigm shift. As we know from Peter Hall, alternative policy theories only become relevant when they provide solutions to impending political problems. Changing social and economic conditions, as they alter the functioning of existing policies and institutions, can modify economic and political power positions of relevant stakeholders, and this in turn may ignite political search processes of causal reorientation on how to steer policy in new (and old) directions.

The Keynesian-Beveridgean welfare compromise

Both the post-war recasting of Europe's battered nation-states as modern welfare states and proactive European cooperation are the products of the economic, social and political catastrophes of the Second World War and the Great Depression. The defining innovation of the modern welfare state was that social protection came to be firmly anchored on the explicit commitment to grant 'social rights' as positive freedoms to citizens in areas of human need and wellbeing (Marshall, 1950). By contributing to economic growth, European market integration, in turn, allowed national welfare states to expand and prosper from the 1950s on. In the process, a benign equilibrium materialized whereby the technocratic 'low politics' of free trade and market integration was relegated to the supranational institutions of the European Union (EU), while the 'high politics' of jobs and social security became core prerogatives of national democracies. In the process, the EU became a union of welfare states, reconciling modern capitalism with liberal democracy (Hemerijck, 2013).

Intellectually, the dual shift of welfare state expansion and progressive European economic cooperation was firmly supported by the broad endorsement of the Keynesian macroeconomic policy paradigm after 1945. The Keynesian revolution in economic theory, based on an understanding of volatile financial markets, not merely provided a new technique for managing the post-war mixed market economy (Hall, 1989; 1993). By showing how the political objective of (male) full employment and universal social security in cases of unemployment, sickness, disability, and old age poverty, can be supported by countercyclical demand management, fiscal reflation and fine tuning, Keynesian economics changed the very interest perceptions of post-war political elites and organized capital and labour, by altering the basic categories through which policy makers understood economic conditions, diagnose social problems, and select policy solutions. In the event of recession, according to Keynesian economic theory, comprehensive social insurance, for which the 1942 and 1944 Beveridge reports (1942; 1944) gave the necessary ideational ammunition, would operate as reactive stabilizers, protecting families from demand deficient mass unemployment and economic hardship through dampening the business cycle, as a temporary intervention until economic and employment growth picked up. Market failures, inherent to industrial capitalism, could thus be countered by macroeconomic 'fine tuning', with national systems of social security playing leading roles as automatic 'shock absorbers', thereby buffering effective demand in times of business cycle downturns. In the governance of the modern welfare state, national social insurance systems and employment services developed as clearly demarcated policy silos with hierarchically organized, administrative structures.

The so-called post-war peace settlement between capital and labour, supported by the Keynesian economic policy paradigm, subsequently allowed the modern welfare state to expand unabatedly over the era of the *trente glorieuses* and *Wirtschaftswunder* from 1950s to the 1970s with high growth, rising wages and better living standards, equitably distributed across social classes. Organized labour together with business interests helped the state in many countries to agree on tripartite income policy concertation geared towards full employment with subdued inflation. Part and parcel of the Keynesian-Beveridgean welfare compromise, it should also be emphasized, that industrial male breadwinner full employment and social protection was supported by mothers as unpaid housewives doing domestic work while looking after children and caring for the frail elderly (Orloff, 2010; Ferragina and Seeleib-Kaiser, 2014). Each advanced West European political economy developed its own country-specific brand of welfare capitalism (Esping-Andersen, 1990; Scharpf and Schmidt, 2000).

Far from being polar opposites, European economic integration and national welfare states prospered together in a mutually beneficial manner in the Golden Age of the 1950s and 1960s. The painful memories of the Great Depression and the Second World War remained ever present in the minds of post-war policymakers. In this respect, the impetus for the path-breaking establishment of the male-breadwinner welfare state, protected by the international regime of embedded liberalism after 1945, was as much progressive in design, based on organized labour support and class compromise, as it was conservative in intent. As Charles

Maier (1987) notes, post-war reconstruction reflected, above all, a quest for normalcy and a search for stability. The gradual deepening of European integration gave a formidable boost to national welfare state expansion. Market integration did not constrain the welfare state; on the contrary, growth stemming from market expansion allowed for the unencumbered maturation of national welfare states. A benign division of labour of mutual 'non-interference' between national social policy and supranational market opening evolved.

The neoliberal critique of the post-war welfare state

The 'goodness of fit' between post-war welfare state expansion and European market opening was put to the test by the breakdown of the Bretton Woods monetary system in 1971 and by the two oil price shocks that followed. In the process, the Keynesian welfare state proved increasingly less effective in managing a full employment economy (Hall, 1993). If Keynesian macroeconomics was the brainchild of the 'market failures' of the Great Depression, the neoclassical 'supply side' revolution in economic theory in various guises was the intellectual product of the crisis of stagflation, the malignant combination of high cost-push price inflation, stagnant growth, and rising unemployment (Scharpf, 1991). After the oil prices hikes of 1973 and 1979-80, the problem of stagflation was increasingly associated with the failure Keynesian 'demand' management.

From the perspective of the new 'supply-side' economics, mass unemployment was no longer diagnosed as a macro problem of deficient demand, but rather as a microeconomic problem of supply-side 'hysteresis', and in particular low search intensity and poor motivation, because of deficient incentives produced by generous welfare provision and job protection legislation. From this perspective, economic cycles are best understood as outcomes of exogenous shocks—the oil shocks of the 1970s being a case in point—combined with slow transmission through the real economy as the result of labour market rigidities and generous welfare benefits (OECD, 1981). Keynesian efforts of fine-tuning to achieve full employment are ineffective as expansionary interventions, according to rational expectations theory, are often already calculated into wage- and price-setting, evoking inflationary spirals. At the micro-level, Olivier Blanchard and Larry Summers (1987) offered the paradigmatic explanation of 'hysteresis' to explain why wages did not fall and unemployment remained high in Europe in the 1980s: structural rigidities of job preservation for employed workers was achieved at the expense of labour market outsiders and this prevented real wages from falling enough to restore full employment. High minimum wages, generous unemployment insurance and employment protection, in combination with progressive taxation create negative 'moral hazard' and 'adverse selection' externalities, incurring lower labour supply, higher unemployment, less investment in training and education, and, as a result, a brake on growth and competitiveness. Coordinated wage bargaining and social dialogue are, from this perspective, also understood to raise the costs of labour above market clearing levels (Bertola *et al.,* 2000).

Closely associated with the 'market-distorting' view of the welfare state and corporatist bargaining, there is the conjecture of low (public) service productivity, often associated with so-called 'Baumol cost disease', named after the US economist William J. Baumol (1967). At its core, the Baumol cost disease conjectures that productivity improvements in labour-intensive welfare services – health, education and family care services – consistently lag behind productivity gains in competitive industry. Especially when public service pay increases follow wage developments in the more dynamic capital-intensive private sector, low productivity services become more expensive in relative terms (see also: Iversen and Wren, 1998). In this respect, the ongoing externalization and professionalization of care provision, from the family to the public sector, conjures up a significant handicap for competitive adjustment, a dynamic which may be a critical to an export-led economy, such as Germany. Angela Merkel's 2013 speech at the WEF can be understood in this light.

By trying to reduce inequality through a politics of income redistribution, an overly ambitious welfare state ultimately deepens and cements existing labour market distortions, leading to lower labour supply, net wage compression, and higher unemployment among the old, the young, and the low-skilled. In other words, welfare states in rich OECD democracies are ultimately faced with an inescapable 'big trade-off' between 'equality' and 'efficiency', a dilemma coined by the American economist Arthur Okun (1975).

On the intellectual wing of the neoclassical economic doctrines of monetarism, rational expectation macroeconomics, efficient capital market hypothesis, inefficient labour markets, rent-seeking collective action models, public choice and principal-agent New Public Management theory, were swiftly endorsed by international organizations, the IMF, the World Bank, and the OECD. In the early 1990s, the OECD received a mandate to examine the labour market performance of its Member Countries. The OECD Jobs Study, published in 1994, launched a critical attack on the 'dark side' of double-digit unemployment of many European OECD members (OECD, 1997; 2006). In a span of a decade the post-war settlement of 'embedded liberalism' and Keynesian full employment with comprehensive Beveridgean social security was replaced by the so-called 'Washington Consensus' (Williamson, 1989) of giving free reign to efficient markets through hard currencies, balanced budgets, capital market liberalization, labour market deregulation, low taxes, benefit retrenchment, and the privatization of public services, weakening, in the process, the national state as the guardian of employment and social rights (Jenson, 2010).

The stagflation conundrum was ultimately broken by the drastic interest rate hikes by the US Federal Reserve and the German *Bundesbank*. Inspired by the laissez-faire ideologues Friedrich von Hayek and Milton Friedman, the election of Margaret Thatcher and Ronald Reagan, in 1979 and 1980 respectively, brought the belief in the primacy of self-regulating markets and a minimal state back into the limelight. A related important political background factor behind the political success of neoliberalism and neo-conservatism in the 1980s was the weakening of organized labour, as a consequence of deindustrialization, rapid technological advance, the expansion of the service sector, and the feminization of the labour market related to the shift to services. With heavy industry no longer accounting for the bulk of economic growth, the effectiveness of social conflict and the need for class compromise gradually waned.

Beginning in the 1980s and gathering momentum in the 1990s, neoliberal doctrines of fiscal discipline, low inflation, financial liberalisation, labour market deregulation, and the marketization of pension provision, gained precedence in the management of advanced market economies, followed by incisive labour market deregulation and welfare retrenchment. Policy-making shifted from a pro-welfare *'politics against markets'* in the 1950s and 1960s to anti-welfare *'politics for markets'* after the 1970s crisis of stagflation.

3. The social investment policy paradigm

The rise of neoliberalism and the 'politics for markets' did not spell the demise of the welfare state. In spite of the weakening of left-winged power resources, increased social security coverage, higher benefits, old age security, universal health care and free access to education, had meanwhile produced a new political context of popular social entitlements, making welfare retrenchment a particularly problematic ticket for electoral competition, confronting policy-makers with the daunting challenge of 'blame avoidance' of dispersing, obfuscating, and hiding the costs of unpopular social reform (Pierson, 1994; 2001).

In the shadow of the political risks of welfare retrenchment, almost by stealth, the notion of 'social investment' gradually emerged as a metaphor to underscore some of the productive qualities of the welfare state from the mid-1990s on. And rather surprisingly, it was the OECD in 1996, at the time still wedded to the neoliberal Washington Consensus, who organized a conference focused on social policy's positive economic impact in times of adverse demography. The European Union (EU) followed suit, and under the Dutch presidency in 1997, the term 'social policy as a productive factor' was coined. This idea was anchored in the EU's Lisbon Agenda of 2000 for welfare policy guidance in the knowledge-based economy and the creation of better jobs and greater social cohesion. The book *Why We Need a New Welfare State* of Gosta Esping-Andersen, Duncan Gallie, Anton Hemerijck and John Myles, commissioned by the Belgian Presidency of 2001, very much codified the intellectual groundwork of the social investment agenda (Esping-Andersen et al, 2002). This study echoed the notion that generous social security does not hamper economic efficiency, but it also critiqued the staying power of selective male bread-winner employment-based social insurance for excluding large groups, especially youngsters and women, whose activation was deemed crucial to sustain economic growth in sync with generous social protection for all (Esping-Andersen et al., 2002). The title *Why We Need a New Welfare State* evoked a paradigmatic imperative for rethinking social risk management in an era of intensified economic internationalization, the shift to services, rapid technological change, demographic ageing, gender and family change, and labour market transformation.

The paradigm shift in the social investment perspective is evoked by a new combination of a *causal understanding* of the changing nature of social risks, the *political objectives* best pursued in light of social risk change, but perhaps most striking is the temporal shift from *ex post* palliation and compensation for economic hardship to an orientation in policy analysis and action towards early identification and *ex ante* prevention. To extent that the welfare state remained popular, the overarching objective became to raise employment and employability. In terms of causality, adverse demography and the changing nature of social risks in the knowledge economy require advanced welfare states to raise the *quantity* and *quality* of *capacitating* social services (family services, care provision and rehabilitation) *alongside* inclusive social security, so as to assist people to surmount the increasingly hazardous labour markets and life course transitions to achieve better aggregate economic output.

In terms of *policy theory*, the chapter by John Myles (2002) in *Why We Need a New Welfare State* introduced a simple equation for the sustainability of long-term pension provision, one that can easily be extended to the welfare state as a whole. This equation proposes that the cost of welfare provision equals:

$$\frac{number\ of\ welfare\ recipients}{number\ of\ paid\ workers} \times \frac{average\ consumption\ of\ welfare\ recepients}{average\ productivity\ of\ workers}$$

Whereas the neoliberal policy advocacy was largely focused on limiting the numerator of the above equation here and now, through reducing the number of welfare recipients and/or lowering benefits, *Why We Need a New Welfare State* shifted attention to the denominator side of the welfare equation. By maximizing employment and the productivity of those in employment, an improved 'carrying capacity' of inclusive welfare provision, with a strong focus on social services for male and female workers, families with children, preschool education, remedial teaching, and vocational training, the welfare state would no longer compromise economic efficiency. Since the mid-2000s, the ideas of Esping-Andersen et al. (2002) gained considerable traction through academic efforts to elaborate and empirically assess social investment oriented policy interventions. An impressive series of OECD studies on family policy, gender-friendly employment relations, education, and rising inequality (2008, 2011, 2012, 2015a, 2015b, 2015c) enlarged the evidence base for social investment. The 2013 *SIP* marks the most explicit endorsement of the social investment paradigm in Europe thus far, advocating policies aiming to *'prepare'* individuals, families and societies to respond to novel risks, rather than simply *'repair'* damages after moments of economic or personal crisis.

Stocks, flows and buffers in institutional complementarity

In recent publications I have tried to operationalize social investment in terms of a classification of three complementary social investment policy functions: (1) improving the 'stock' of human capital; (2) easing the 'flow' of labour market and life transitions; and (3) maintaining strong universal safety nets and economic 'buffers' in support of the political prerogative of raising labour force participation in ageing societies (Hemerijck, 2014; 2105).

The 'buffer' function is the easiest to explain, as it basically alludes to 'Keynesianism through the back door'. This policy function aims at securing adequate minimum income protection, more equal distribution of income, and stabilizing the business cycle and buffering economic shocks – a policy function that harks back to the prime function post-war Keynesian-Beveridgean welfare state. Next, the 'stock' function has to do with productivity and is focused on developing and maintaining human capital from early childhood all the way to lifelong learning. Upgrading and upkeeping human capital is crucial in times of rapid skill erosion, job mismatches and changing labour opportunities (Nelson and Stephens, 2012). The 'flow' function, finally, bears on easing labour market in order to achieve a more efficient and optimal allocation of labour over the lifespan. These transitions do not only include periods of unemployment, but also integrating disadvantaged groups into the labour market, timely passages to more prosperous sectors, and from parenthood to employment (Schmidt, 2008).

In actual policy practice there is significant functional overlap and interconnection, but also of institutional friction, between the policy functions of ‘stocks’, ‘flows’ and ‘buffers’ (De Deken, 2014). For example, poverty alleviation is primarily a ‘buffering’ policy, but its associated financial security facilitates smoother ‘flowing’ transitions because of its mitigated pressure on immediate job acquisition, which in turn is associated with fewer mismatches and reduces skill depletion of human capital ‘stock’. This point of ‘institutional complementarity’ is perhaps most persuasively brought to the fore by the recent OECD (2015) report *In It Together. Why Less Inequality Benefits All.* According to the OECD one of the main transmission mechanisms between inequality and growth concern human capital development. While there is always a gap in education outcomes across individuals with different socioeconomic backgrounds, this gap is particularly wide in high inequality countries with disadvantaged households struggle disproportionately to gain access quality education for their offspring. Any reduction of inequality between the rich and poor citizens, thus requires the mobilization of a whole range of policy instruments of fostering female employment promotion into good quality careers (‘flow’), proactive early childhood development and youth and adult training policies (‘stock’), and effective and efficient tax-and-transfer systems (‘buffers’). The work-family policy nexus is very much the ‘lynchpin’ of social investment perspective. Formal childcare and early childhood education contribute to the cognitive development of children, in terms of ‘stock’, while countering risks of social exclusion early in life. At the same time, increased female labour market participation, supported by childcare and parental leave, optimizes labour market ‘flow’, generating higher return on education as well as secure household income and fiscal revenue ‘buffers’, which again mitigate the risk of child poverty. However, there is no such thing as an optimal social investment policy mix. Individual welfare states with varied policy legacies and institutional capabilities preside over different policy mixes and governance arrangements. Each welfare state requires different combinations of policies to foster social investment progress, depending on country-specific social, economic and institutional conditions.

The definitive social investment policy conjecture is that effective institutional complementarities in a life course perspective ‘crowd in’ employment, productivity and economic growth with improved work-life balance for working families. With more disadvantaged children having access to early education, overall levels of skill attainment improve, resulting higher employment and labour productivity and more upward social mobility. Quality childcare and preschool programs, alongside effective parental leave arrangements and other family benefits and services, supported by appropriate tax and benefit incentives and active labour market policies and vocational rehabilitation programs, enable more parents to engage in gainful employment without long career interruptions. The more parents, especially mothers, work, the broader the tax base, most likely also resulting in higher birth rate. Over the mature phases of the life course, lifelong learning and healthy ageing policies help secure older worker's employment participation, resulting in an overall high exit age, and by implication lower outlays for early retirement, pensions and health care (Hemerijck, 2015).

The paradigmatic portent of the social investment turn

In a span of a mere decade, the notion of social investment matured from an intuitively appealing metaphor of 'social policy as productive factor' to nothing less than a paradigmatic rethink of an active welfare state for the 21st century knowledge economy, based on mutually reinforcing policies of raising human capital 'stock', easing labour market 'flow', critically undergirded by inclusive safety net 'buffers'. To underscore the paradigmatic portent of the social investment turn, a comparison with the Keynesian-Beveridgean welfare state and the neoliberal attack on the welfare state is in order. With its strategic concern with work-life balance and reconciliation, the social investment paradigm radically transcends the 'maternalist' bias in the Keynesian breadwinner welfare state and the 'gender-blind' anti-welfare neoliberal paradigm. Although the social investment perspective underscores the need for strong social security 'buffers', it deviates from the passive male-breadwinner social security portfolio of the mid-twentieth century Keynesian-Beveridgean welfare state, singularly focused on *ex post* income compensation 'buffers' as important for aggregate demand stabilization, by underscoring the importance of 'stocks' and 'flows' in the gendered knowledge based economy. With neoliberalism, the social investment paradigm shares a concern with the 'supply side', based on the more gendered understanding of labour market 'flow' and a more positive theory of state, especially when it comes to human capital 'stock'. The neoliberal paradigm is based on a conscripted gender-blind conception of optimal labour market 'flow' in terms of the absence of regulatory barrier. A perfectly deregulated labour market, unburdened with social protection 'buffers' is believed to set the right incentives for private economic actors to invest in their human capital 'stock'. The social investment paradigm, in recognition of the importance of public policy, based on a richer understanding of labour market transitions, gives ample credence to public authorities and professionals cross-cutting and aligning the social investment policy jurisdictions of 'stock', 'flow' and 'buffer' provision. The positive theory of the social investment state also places the Baumol cost predicament in a different light. Tony Atkinson gives the example of public health care. Even if surgery is publicly financed, timely intervention allows an incapacitated worker to go back to work sooner, thereby creating extra private output at less public cost (Atkinson, 2015: 121). The same indirect logic from public investments to private returns applies to parenting services, education, active labour market policy interventions, long-term care and disability policy.

With its re-appreciation of social protection as a stabilizing 'buffer' on the 'demand side', together its more contextualized understanding of 'stock' and 'flow' interventions on the 'supply side', the social investment policy paradigm is more synthetic in quality. As both the mid-twentieth century Keynesian-Beveridgean welfare state and the social retrenchment neoliberal critique of the modern welfare state were closely associated with hegemonic macro- and micro-economic theories of the economy, this finally begs the question of what kind of macroeconomic policy is best suited to support social investment progress. Under both Keynesian 'demand management' and neoclassical 'supply-side' economics, social policy interventions remained subservient to private economic production as the prime engine of prosperity. In the social investment paradigm, *ex ante* preventive and proactive 'stock', 'flow' and 'buffer' policies are conclusively drawn into the 'productive function' of the knowledge-based economy. By pulling different theoretical insights and empirical findings, produced by diverse array of social science disciplines, the social investment perspective is more agnostic and lacks the parsimony of Keynesian macroeconomic demand management and neoclassical supply-side analysis and rational expectation macroeconomics, but potentially it does a better job in delineating critically important meso-level institutional prerequisites for achieving high returns from social investment by guiding policy makers towards fairly concrete but diversified policy mixes of complementary 'stock', 'flow' and 'buffer' provisions in an integrated fashion.

The political support structure of social investment remains something of an enigma, which is perhaps why Nathalie Morel, Bruno Palier and Joakim Palme refer to social investment as an 'emerging' policy paradigm (Morel, Palier and Palme 2012). Whereas the post-war welfare state of the industrial era was supported by a clearly demarcated class compromise between organized labour and capital in parliamentary and societal arenas, the cleavage structure of social investment is more elusive. A fair number of political scientists are therefore sceptical about the political power of social investment ideas to take root (Hausermann, 2010; Streeck and Mertens, 2011). Allegedly 'new social risk' groups of children, part-time working women, jobless youths, the low-skilled and the frail elderly, do not add up to a coherent cleavage for effective political mobilization (Taylor-Gooby, 2004). As long as existing welfare programs are bound up with strong insider-interest constellations, social investment reforms are easily sacrificed in favour of more constrained status quo biased welfare reforms (Palier and Thelen, 2010).

Notwithstanding such political barriers, social investment reform can just as likely create political space for what Giuliano Bonoli has coined 'affordable credit-claiming' (2013). A fair number of immediate gains in the area of early childhood development, female employment, improved work-life balance, and reduced levels of early school leaving, couched in a non-partisan normative discourse of 'capacitating' and family-friendly welfare provision, may actually place fairly manageable demands on forward-looking political leadership to build broad support for social investment welfare provision and thereby re-legitimising the role of public policy and the state in the aftermath of global financial crisis (Sabel, 2012). Surely, a political discourse of social investment 'capacitation' is more appealing than the 'there-is-no-alternative' (TINA) pronouncement that 'the European social model is already gone', ventured by Mario Draghi in 2012 at the height of the Eurocrisis (Wall Street Journal, 2012). The introduction of EMU in 1999 fundamentally reshaped the political incentive structure of domestic social policy making over the past half century, but as will be revealed below not merely in a regressive fashion as will be revealed over the next three empirical sections.

4. Monetary integration and changing European welfare states

The Single European Act (SEA) of 1986 and the Economic and Monetary Union (EMU) of 1999 were negotiated at a time when the Washington Consensus, rooted in neoclassical 'supply side' micro- and macro-economic theory, was riding high. Descending from the stagflation crisis of the 1970s and early 1980s, the EMU, as a natural complement to the single market freedoms of goods, services, capital and people, was firmly grounded in a rejection of Keynesian demand-management and the use of deficit social spending to counter economic recessions and mitigate social hardship.

Erik Jones (2013) has aptly described the EMU policy framework in terms of an interlocking triptych of three basic supply-side ingredients: price stability, fiscal conservatism, and local- or domestic-factor market liberalisation, which together were believed to best guarantee Eurozone productivity and employment growth. An independent European Central Bank, modelled after the German *Bundesbank*, with a singular mandate for price stability and no concern for (un)employment, was agreed to at the Maastricht Summit of the European Council in December 1991. The aim was to eliminate high inflation risks in member-country economies for good (Dyson and Featherstone, 1999; Dyson, 2000). In passing, it was decided not to develop a EU-wide fiscal policy, but rather to enforce to strict fiscal rules through Stability and Growth Pact (SGP) with respect to public debt and budgetary deficits, with threshold criteria, respectively, set at 60 and 3 per cent of GDP (Heipertz and Verdun, 2010).
The economic benefits of EMU, as a natural complement to the Single Market, seemed plentiful to its architects, ranging from greater market transparency to improvements in terms of trade, without exchange rate unpredictability and financial market integration without the risk of competitive devaluations, and all this at low inflation levels. Even if the initial

conditions stipulated by the theory of an optimal currency area were not fulfilled for all participating countries initially, it was benignly anticipated that the institutional design of EMU, with the independent ECB strictly mandated to pursue price stability without a 'lender-of-last resort' facility, together with the 'no-bailout clause' (now Article 125, TFEU) in the Maastricht Treaty, underwritten by the fiscal rules of the SGP, would foster a strong endogenous impetus towards greater economic and social convergence in the longer term inspired by TINA imperative of 'structural reform'. The omissions of a Eurozone fiscal capacity and a 'lender-of-last resort' facility, and also the absence of a banking union, were deliberate and consistent with monetarist economics of keeping money supply growing steadily at a rate equal to the growth of aggregate supply plus a low target rate of inflation. Under European monetarism and liberalized capital markets, financial markets were expected to assume the critical role of disciplining profligate and indebted member state by raising interest rates and progressive risk-premiums on public debt and deficits.

The social policy consequences of monetary integration were indirect but highly consequential. Most fundamentally, membership of the single currency meant that national governments could no longer employ discretionary devaluations to address the social consequences of cyclical economic shocks. Tailored again after the experience of the 1970s and 1980s, the architects of EMU generally in effect believed that the single currency, reinforced by the SGP, would push member countries forward to adopt converging market-conforming 'structural' labour market and welfare reform agenda, including breaking down job protection rigidities, retrenching welfare benefits, privatizing pension liabilities, lowering (corporate) taxes, disciplining member states to hold 'wasteful' public sectors in check, while curtailing the influence 'distributive coalitions' in collective bargaining and disengaging tripartite social dialogue concertation, as primary instruments to foster market-conforming economic convergence. The policy mix of monetarism, fiscal conservatism, and supply-side reform thus provided a conspicuously coherent cognitive, distributive, institutional and normative template for restructuring Europe's expensive welfare states in a regressive fashion after EMU was introduced, integrating 11 countries with highly diverse economic structures and welfare arrangements. What happened? Did the progressive deepening of the EU project since the 1980s unleash a full-blown market-making remaking of national welfare states? Far from it! Two important unintended and unanticipated consequences stand out in trajectories of welfare state change over EMU's first decade in operation: one positive, also in terms of social investment welfare recalibration, and a second far more adverse development.

The unforeseen but welcome social investment turn

Since the late 1980s, the majority of European governments have come to enact a wave of social reforms to make their social policy systems more efficient and employment-friendly. Cumulative social reform, shaped by domestic political conditions, reveals that an increasing number of countries shifted to more heterodox social investment portfolios, including Austria, Belgium and Germany as Eurozone members. Alongside retrenchments, there have been deliberate attempts to rebuild social programmes and institutions and thereby accommodate welfare policy repertoires to the new economic and social realities of the knowledge-based economy. With respect to *social insurance* and *assistance,* most countries today preside over universal minimum income protection programmes, coupled with 'demanding' activation and 'enabling' reintegration measures, targeting labour market 'outsiders' such as young, female or low-skilled workers (Clasen and Clegg, 2011). The area of *employment policy* saw a considerable increase, from the 1990s onwards (Bonoli, 2013), alongside social security activation, of spending on active labour market policies, and training and education servicing to improve life course employability. With respect to *labour market regulation*, several European countries have moved towards a greater acceptance of flexible labour markets, with new elements of security introduced for labour market outsiders, governed by more flexible employment relations (Schmid, 2008). For *pensions*, financing problems due to population ageing and lower growth have prompted the reversal of the trend towards early retirement policies, together with initiatives to promote longer and healthier working lives. A key shift has been the growth of (compulsory) occupational and private pensions and the development of multi-pillar systems, combining pay-as-you-go and fully funded methods, with relatively tight (actuarial) links between pension benefits and contributions, with a view to factoring in life-expectancy (Ebbinghaus, 2011). *Family policy*, covering childcare, parental leave and employment regulation, and work and family life reconciliation policies, has experienced a profound upgrade in both scope and substance (Orloff, 2010). Particularly noteworthy is the German experience, which round the turn of the century was deemed the 'sick man of Europe', suffering serious growth and unemployment problems after unification. Difficulties to abide by the SGP ultimately inspired the Agenda 2010, suggesting a neoliberal turn. However, in the wake of the contentious Hartz IV reforms, the archtypical Bismarckian welfare state, decisively moved in the direction of social investment within the span of three years (2005 - 2008), the first Merkel I government adopted a parental leave scheme providing strong incentives for women to return to work and for fathers to also take up care leave, significantly expanded childcare for the under-three year olds, and finally introduced the right to childcare. In the background of German social investment innovation, the ageing predicament played a key role in redefining 'causal beliefs' about stagnant fertility and the 'policy objective' of seeing working parents as the new backbone of economy and society (Fleckenstein, 2011). And, as the Merkel II government constitutionally committed Germany to maintain a balanced budget in 2010, education and research were exempted from budget cuts. Does this progressive reform development suggest that fiscal conservatism and monetarism are supportive of the social investment turn after all? Not quite.

The unintended welfare reform consequences of a one-size-fits-only-some interest rate policy

In the aggregate level, the Eurozone seemed fairly stable, over the first decade in operation, with moderate deficits and public debt and an external account roughly in balance. But underneath the aggregate good health of the Eurozone, imbalances built up after. The EMU entrance exam of the mid-1990s played a powerful role in forging national social pacts over pension and labour market de-segmentation in the hard-currency latecomer countries, such as Italy, Spain, and Portugal, but thereafter the public debt threshold was pretty much ignored (Avdagic *et al.,* 2011). A fair number of prospective members, notably Belgium, Greece and Italy serviced debt levels far above 60 per cent of GDP, were eventually admitted. With respect to inflation a similar story can be told. In the aggregate inflation indeed hovered around the 2 per cent from the launch of the euro to onslaught of the financial crisis, but over time country-specific inflation rates moved away from the ECB-benchmark. At low levels of economic growth, Germany undershot the ECB's inflation target round the turn of the century. By contrast, Mediterranean member countries, and also Ireland, increasingly faced much higher inflation at equally fortuitous levels of catch-up growth. In hindsight it seemed that ECB's one-size nominal interest rate policy meant that real interest rates were (too) high for Germany, while for the peripheral economies real interest rates were perhaps (too) low (Enderlein, 2005). Although Spain and Ireland continued to adhere to fiscal conservatism, lower interest rates and easy availability credit stimulated excessive asset-biased inflation as Spanish and Irish households were persuaded to take on massive private debt to buy property and reconstruct homes, thereby boosting demand and inflation. A further destabilizing factor was that looming asset-price bubbles in the periphery were largely financed by capital inflows from the low-inflation and subdued-growth Northern economies. For Italy and Greece, with their highly indebted public finances, an entirely different scenario unfolded. After these two countries had secured safe entry into EMU, 'structural reform' incentives waned as borrowing became cheap, making it easier to service public debt, with the effect of delaying competitive adjustment and reform. Paradoxically, on entry, EMU reduced rather than reinforced pressures on debt-ridden countries to bring their fiscal house in order through 'structural reforms'. In hindsight, competitive pressures from the single market seemingly did not discipline national price and cost development, while supposed efficient capital markets neither disciplined national fiscal policy to pre-empt emerging imbalances. Mistakenly, financial markets kind of assumed that with the establishment of EMU, all participating member states had joined Germany's 'stability culture' of fiscal prudence and low inflation.

In other words, safe entry into EMU thus acted as a 'reform tranquilizer' for the peripheral economies, while, at the same time, for a country like Germany, EMU, including the SGP, did act as a 'disciplining precursor' and 'reform amplifier' to the Hartz IV reforms of the early 2000s. In effect, the 'one-size-fits-all' interest rate policy of the ECB together with the ineffective enforcement of the SGP set the scene for unforeseen imbalances and missed welfare reform opportunities within the Eurozone far before the onslaught of the global financial crisis. Policy makers in Frankfurt and Brussels, who focused rather singularly on Eurozone aggregate developments in growth, fiscal balance, employment and inflation, were entirely ignorant of emergent imbalances and (non-)reform divergences, unleashed by their cherished policy paradigm of European monetarism, rules-based fiscal policy and structural welfare reform imperatives. In effect, 'structural reforms' came to a halt where they was needed the most, i.e. in the Southern periphery with their rigid insider-biased labour markets and pension-heavy male-breadwinner welfare states (Sacchi, 2015; Perez and Rhodes, 2015; De la Porte and Hein, 2015; Pavolini et al., 2015).

5. The Eurocrisis and the fiscal austerity reflex

After the US sub-prime mortgage crisis broke in 2008, the financial crisis quickly spread to Europe. Because of its fragile governance architecture, after a brief episode of fire brigade Keynesian stimulus with little concern about sovereign debt, the Eurozone swiftly became the main victim of the global financial crisis. It saw the end of a decade of illusory catch-up convergence in the Eurozone periphery. Housing and construction bubbles broke in Ireland, Spain, but also in the Netherlands and the United Kingdom, triggering an array of bank failures. Bank bailouts turned private into public debt. The manner and extent, to which the financial crisis travelled at great pace from the US to the EU, resulted in disparate problems for different member states: private debt in Spain, securing consumer deposits for Ireland, public debt in Italy and Greece. From 2008 to 2009, Europe's fiscal stance was largely countercyclical. By late 2008, the EU commission presented its European Economic Recovery Plan (EERP), allowing member states to temporarily run deficits in excess of the 3 per cent rule, to stimulate infrastructural investment, reinforce automatic stabilization, and direct support employment subsidies and short-time work schemes. Also the ECB responded swiftly and with unanticipated flexibility, by providing essentially unlimited amounts of liquidity to the euro-area financial systems.

After this short-lived Keynesian moment to stabilize the economy to buffer the downturn, by late 2009, the Greek sovereign debt crisis triggered an unreconstructed conservative reflex, consistent with the micro- and macroeconomic theorems upon which EMU was raised. The contagious Eurocrisis brought to bear a much deeper level of economic interdependence between the member economies of the Eurozone than its architects anticipated (Salinas et al., 2012). Capital flows shifted into reverse gear from the periphery back to the Eurozone core, whereby the credit boom transmuted into a credit crunch for countries in dire straits, plunging the Eurozone periphery into the sovereign debt crises. Political procrastination over the Greek bailout operation, on the part of Germany, turned out to be financially costly and dangerously contagious (Jones, 2010). The widening competitiveness divide between the North, paying close to zero interest rates on moderate levels of public debt and deficits at manageable rates of unemployment after 2010, on the one hand, and the uncompetitive South on the other, facing exceedingly high spreads on debt and deficits at two-digit levels of unemployment, ultimately threatened to destabilise the entire Eurozone economy. The Troika of the ECB and the European Commission, together with the IMF, came to the rescue of Ireland, Greece and Portugal, by making financial support conditional of draconian 'structural reform' of dismantling 'automatic stabilizers', again fully consistent with EMU's original ideational profile.

Overnight, the financial crisis for Europe was re-brandished as a crisis of profligate public spending, requiring intrusive fiscal austerity, welfare retrenchment, labour market deregulation and more economic liberalization. In swift succession, fiscal surveillance, spearheaded by Germany, was strengthened through the 'Six-Pack' (December 2011), later complemented by the 'Two-pack' (May 2013), and further consolidated by the 'Fiscal Compact', later anchored in the Treaty on Stability, Coordination and Governance, for the entire Eurozone (January 2013). By stipulating a binding timetable for EU surveillance of national budgets, the Two-Pack legislation marks a fundamental change in the relationship between the European Commission and its member states, by bringing budgetary oversight to the level of the EU with sanctions as an *ultimum remedium*. Based on the belief that for any return to growth, indiscriminate fiscal austerity, rigorous retrenchment and export-led internal devaluations are imperative to recover international capital market confidence, irrespective of the economic cycle, in line with the notion of 'expansive consolidation' of the Harvard economist Alberto Alesina (2013; 2015), influential with Directorate-General Economic and Financial Affairs (DG ECFIN) and the Ecofin Council, thus reignited the call for 'structural' welfare and labour market reform, along the neoliberal lines of the mid-1990s *OECD Jobs Study*. Meanwhile, ironically, the Paris think-tank itself had bode farewell to the Washington Consensus in favour of a social investment-oriented reform agenda of 'inclusive growth', informed by a novel understanding of the functioning of the labour market, gender and family demography, and the importance skill enhancement, maintenance and rehabilitation in the knowledge-economy (OECD, 2006; 2014). Just as generals are often to fight the last war rather than immediate danger, the sovereign debt crisis was badly handled, rooted as it was in an overreaction based on an out-dated policy theory. The moral narrative that prevailed in the political debate petted the virtue of the frugal industriousness of Germans against lazy and profligate Greeks, thereby laying the blame of rising spreads on sovereign bonds on fiscal irresponsibility, requiring fiscal austerity and structural labour market and welfare reform (Jabko, 2013). By 2012, it was generally believed that funding through the European Stability ESM, the successor of the EFSF), would not be sufficient to support Spain and Italy (Lane, 2012). Barring the option of currency devaluation, pro-cyclical 'internal devaluations', prescribed by the Troika, was the only strategy left on the menu of macro-economic adjustment for Ireland, Greece, Portugal, and more indirectly Spain and Italy (Sacchi, 2015). Pro-cyclical retrenchment offered little relief for the Troika countries as public debt levels grew between 2011 and 2013 in Greece from 136% to 160%, in Spain from 73% to 88%, in Portugal from 112% to 127% and in Italy from 123% to 130%, from 2011 to 2013 2014. Widespread fiscal retrenchment triggered a second hike in unemployment after 2011, accompanied by a stark deepening of economic divergences and social imbalance between the competitive North and the Mediterranean periphery in the Eurozone. With unemployment peaked at 27 million in 2013, about 9,5%, varying from 4,7% in Germany to 23% in Spain (ESDE, 2014) of the EU's working age population. Considerable EU job growth achieved over the previous decade has been wiped out. European youth has been hardest hit by the crisis. Most worrisome is the surge in youth unemployment to 23% on average, but in the most troubled economies the figure has reached catastrophic levels of 52,4% in Greece, 53,2% in Spain, and 42,7% in Italy, conjuring up an image of a 'lost generation' in the making (ESDE, 2015). In comparison, elderly unemployed rose to 7,4% for the EU as a whole. Of the 12 million long-term unemployed in the EU, 10,9% of the labour force, one in five has never worked, and three quarters of them are below 35 years of age. A cohort of 7,5 million youngsters between 15 and 24 years of age, 18,6% in 2013, are Not in Education, Employment or Training (NEET). Most dramatically the NEET rate peaked at 30% in Greece and Italy; by contrast in Germany the NEET rate fell from 13,9% in 2007 to 9,5% in 2013. On the whole youngsters suffered more from the crisis than the elderly. Whereas the number of severely materially deprived children rose from 10,1% to 11,7% between 2007 and 2012, the rate of severely deprived elderly fell from 8,6% to 7.5% over the same years. Close to 15% of the EU population is living at-risk-of-poverty (after social transfers) today, with Greece dramatically leading the pack at 23,1% in 2013, followed Romania second at 22,4%. The best performers in terms of low rates of poverty are the Czech Republic and the Netherlands, at respectively 8,6% and 10,4% risk of poverty in 2013. Countries under the Excessive Deficit Procedure (EDP) were forced to make extensive cuts in public expenditures. To wit, public spending on education was cut by 17% in Greece, 13% in Portugal, 10% in Ireland, 8% in Spain and 6% in Italy. The Greek economy contracted by more than a quarter. To the extent that the objective of the Troika of the EU, ECB and IMF was to make Greek debt sustainable, the austerity drive has surely failed as Hellenic debt grew from 130% of Gross Domestic Product (GDP) in 2009 to 177% in 2014 (2014, Eurostat). As the European economy has in all likelihood a protracted period of low growth and weak job creation, the 'scarring effects' of economic disparities, social inequities and 'lost generations' will linger for decades. The ambitious Europe 2020 goal of lifting at least 20 million people out of poverty moved out of reach. The overall depth of economic divergences and social imbalances cast significant doubts about the return of upward socioeconomic convergence for which the EMU was originally designed.

6. Central bank normalization and the socialization of the European Semester

As fiscal policy became more orthodox, the ECB initially followed suit. In July 2008 and in April and July of 2011, the ECB raised interest rates. Quasi-secret were letters sent by Jean-Claude Trichet and Mario Draghi to the Prime Ministers of Ireland, Italy and Spain, advocating benefit retrenchment, public sector pay cuts, pension privatization and labour market deregulation 'whatever the circumstances' (De la Porte and Hein, 2015). By the summer of 2012 Mario Draghi's pledged to 'do whatever it takes to preserve the euro', making ways for unconventional Emergency Liquidity Assistance (ELA) loans and Outright Monetary Transactions of buying unlimited amounts of distressed bonds the secondary markets. Hereby the ECB became a 'lender of last resort' (De Grauwe 2013). In an attempt to stave off the threat of a deflation, by 2015 the ECB turned to the even more aggressive unorthodox strategy of 'quantitative easing' of 1.2 trillion euros monetary financing. Recent monetary policy interventions reveal a belated recognition on the part of the ECB of the need to pursue a broader objective of sustaining real economic activity cum financial stability, rather than merely securing low inflation behind fiscal consolidation. Within a span of just a few years, the ECB started to perform a variety of new functions, including liquidity and credit enhancing measures, becoming a lender of last resort, and maintaining general financial stability. Now being able to pursue flexible inflation target and backstop financial markets in government bonds, the ECB swiftly became a normal central bank after the depth of the Eurocrisis.

European central bank normalization was in significant measure the product of the conservative fiscal reflex of the European Council. As the fiscal policy stance turned more austere, the more aggressive the quantitative easing operations of ECB had to become to pre-empt deflation. During informal discussions in the Council, ECB-president Draghi called on government leaders to pursue more expansionary fiscal policies, especially for the surplus countries, in order to underwrite the ECB's fight against deflation (Draghi, 2014). In the face of lackluster growth, the absence of strategic coordination between the ECB and fiscal authorities is becoming ever more problematic. The ECB's belated re-conversion to some sort of Keynesian monetarism, still opposed to by most North-European central bank presidents, is not without the risk of asset inflation and new financial bubbles. Fiscal Europe ultimately has to play its part, but a deeply engrained collective action problem in the European Council seems to pre-empt a more growth-friendly European fiscal policy resolution.

As the aftershocks of the Eurozone sovereign debt crisis unfolded, the European Commission tried hard to picture 'light at the end of the tunnel' with a more human face with initiatives like the Employment Package (April 2012), the Youth Employment Package (December 2012), the SIP and the Youth Guarantee (February 2013). In 2012, the President of the European Council, Herman van Rompuy, re-launched the debate on the 'social dimension of a genuine EMU', reminiscent of earlier attempts under the helm of Jacques Delors in the late 1980s. In October of 2013, the European Council agreed to a 'scoreboard' of social indicators for systematic social benchmarking of levels unemployment and changes thereof; the proportion of youngsters not in education, employment or training (so-called NEETs); real disposable income of households; at-risk-of-poverty rates and income inequality, similar to the ones now used in the Macro Imbalances Procedure (MIP), with a view of alerting policy makers of the serious dangers of 'social imbalances' undermining the integrity and viability of EMU. After taking office in November 2014, Commission President Jean-Claude Juncker launched an 'ambitious program of jobs, growth and investment' (European Commission, 2014: 3). Although the new Commissioner of Employment, Social Affairs and Inclusion, Marianne Thyssen, does vindicate the economic returns to social investment, it is revealing that the flagship Juncker Investment Plan (JIP) (2015), designed to mobilize up to over €300 billion for public and private investment in the area of infrastructure, energy, transport and the digital economy, does not even mention the concept of social investment. Later, the Juncker Commission came round to pledge that 'investment priorities must go beyond traditional infrastructure and extend to human capital and related social investment', that 'labour markets need to balance flexibility and security', with a particular focus on 'tackling youth and long-term unemployment' and modernizing social protection to 'effectively respond to risks throughout the lifecycle while remaining fiscally sustainable in view of the upcoming demographic challenges' (European Commission 2015). By 2015, the Commission has come to endorse a more forward-looking strategy with an enhanced focus on employment and social performance in the MIP, whereby employment indicators have moved up in the hierarchy from auxiliary to headline indicators.

Social Europe observers Bart Vanhercke and Jonathan Zeitlin discern in recent developments what they call a progressive 'socialization' of the European Semester exercise in recent years (Zeitlin and Vanhercke, 2014; Vanhercke, Zeitlin, with Zwinkels, 2015). While the first 2011 Annual Growth Survey (AGS), published in November 2010, was dominated by setting 'budgetary policies on a sound footing through rigorous fiscal consolidation' through 'corrective measures' in welfare state and labour markets, by 2015, the latest AGS 2016 embraces a renewed commitment to social investment, including education and training services, but also healthcare, childcare, and rehabilitation services, consistent with a timely survey on recent social investment reforms across Europe, compiled by European Social Policy Network (ESPN). Empirical evidence collected by the ESPN underscores that countries investing more in early childhood, while proactively facilitating labour market 'flow' through the expansion of gender-equitable leave arrangements, continue to reach the highest levels of male and female employment participation, without compromising fiscal consolidation and negatively affecting relative poverty, as high levels of employment contributes to greater fiscal revenue. In the report, the ESPN identifies important social investment progress across a broad range of countries, including Austria, Belgium, Germany, France, the Netherlands, Slovenia, and the Scandinavian countries, and catching-up processes in the United Kingdom, Spain, Portugal, Ireland, Hungary, Poland and Slovakia, is catching up. More worrying is that Greece, Italy, Romania, Bulgaria and the Baltic states, are falling behind, not least because of the reinforced austerity-retrenchment drive since 2010 (Bouget et al., 2015). The Brussels based think-tank Bruegel confirms that countries confronted with fiscal austerity record a noticeable generational shift in public expenditures, away from spending on families with children towards older cohorts, with the result of higher levels of youth unemployment, child poverty and lower enrolment in preschool education and care (Hütti, Wilson and Wolff, 2015). This finding is also consistent with spending evolutions on public education across Europe, analysed by Frank Vandenbroucke and David Rinaldi, recording dramatic cuts in education spending in countries falling Troika, Mou, and Excessive Deficit surveillance, with only a handful of EU member states having up-kept pre-crisis education spending levels (Vandenbroucke and Rinaldi, 2015). The upshot of these trends is that the economic and social aftershocks of the Eurocrisis are creating new cleavages both between and within countries. Generous and inclusive European welfare states, in good fiscal shape, have found the road to social investment as the means to compete in the global knowledge based economy. On the other hand, to Eurozone countries, whose welfare state require a 'capacitating' impulse the most, the social investment message is immediately lost. The peripheral economies with crippled public finances are essentially coerced onto a 'race to the bottom' scenario of price competition, low wages and welfare standards, un(der)employment and widening inequities between the old and the young. Slashing active labour market and lifelong education and social services, we know from the *SIP* documentation and recent OECD reports, in the long run, critically erodes job opportunities for men and women and thereby thwarts the capacity of their economies to shoulder the impending ageing burden. In the aggregate, equally worrisome, is that such deviating socioeconomic policy strategies are likely to further deepen economic divergences within the Eurozone, which may once again undermine the viability of European economic integration. In other words, the progressive socialization of the European Semester, together with ECB central bank normalization, conjures up a sensible process of policy rethinking. But without real corrective significance for the prevailing fiscal policy regime of front-loading austerity, central bank normalization and European semester socialization, remain drops in the ocean.

7. Discounting social investments to bolster EMU

The success and *raison d'etre* of European economic integration since the Rome Treaty (1957) have been the promise and output deliverance of upward socioeconomic convergence. In the aftermath of the global financial crisis, convergence was put into reverse gear, bringing the single currency close to the brink of extinction. The social repercussions of austerity – lackluster growth, mass (youth) unemployment, plummeting household incomes, rising inequality and deprivation – have brought the EU integration project and its member-welfare-states to a new crossroads. The Eurocrisis, an amalgam of unwelcome spillover effects from the global credit crunch of 2008, preceded by unanticipated welfare reform divergences over the single currency's first decade in operation, together with policy errors and delayed interventions made in its aftermath, exposed major weaknesses in the governance of EMU.

The naïve policy mix of hard currencies, tight budgets, and structural reform imperatives, unleashed an array of inter-institutional friction, unforeseen and adverse consequences for individual member-welfare-state and the functioning of the currency union. The 'one size fits all' ECB interest rate policy together with the inflexible and restrictive public finance thresholds of the SGP set the scene for the growing economic and social imbalances in the Eurozone far before the global financial crisis struck. Instead of engineering an inflation-free growth for the Eurozone, the ECB's uniform interest rate policy and the SGP, indiscriminately accounting all government expenditures as potential burdens on the competitiveness of the single market, amplified rather than mitigated already existing divergences.

Before the Great Recession, the Spanish economy, together with Ireland, was the poster-child of EMU, swiftly catching-up with the Continental Eurozone economies. Spanish housing and banking bubbles did not appear on the radar-screen of the ECB and the Commission, reductively merely taking note of inflation and public debt and deficit. Germany struggled with a protracted recession, making it the 'sick man of Europe', a condition that intensified the need for intrusive reform. In hindsight, the uniform fiscal rules together with the one-size nominal interest rate worked out as a 'reform accelerator' in Germany and as a 'reform tranquilizer' in Greece and Italy.

After the crisis, diverging dynamics further deepened as the wheels of fortune turned. In reasonably good fiscal shape, the Northern economies, blessed already with high human capital stock, continued their upward social investment turn, making way for even higher levels of productivity and female employment growth by enlarging and streamlining the policy mix of 'stocks', 'flows', and 'buffers'. Germany experienced an unprecedented expected growth spurt, helped by low interest rates and an undervalued euro, triggering a swift reduction in unemployment, while Spain was plunged into a deep recession with record high (youth) unemployment. Also for Italy and Greece no other alternative remained than pro-cyclical retrenchment, including cuts in 'capacitating' services in the areas of education, childcare, parental leaving, and active labour market policy, raising the spectre of a 'lost generation' at the heart of the EMU, potentially putting the long-term viability of the single currency at risk. In theory, where national governments can no longer affect monetary policy, counter-cyclical fiscal policy becomes imperative to complement and correct monetary policy. Thus far, the reinforced SGP has been wholly ineffective.

Now that the Euro is on safer ground, European policy makers should face up to the truly existential – economic, political and social – challenge of mitigating social imbalances and asymmetries by forging a viable reform consensus that does justice to the political self-image of the EU, laid down in the 2009 Lisbon Treaty, as an inclusive 'social market economy'. Post-Eurocrisis management, however, continues to be riddled with ambiguities. The launch of the SIP in early 2013, exemplifying important economic returns from 'capacitating' social investment policies, shortly after the Fiscal Compact came into force, prescribing pro-cyclical austerity-biased welfare retrenchment 'whatever the circumstances', leaving little room for social investment reform for Eurozone members that need such an impulse the most, aptly captures the contradictory signs of the times.

It is high time to correct past mistakes by taking the SIP very seriously indeed by incentivizing real rather than illusory and self-defeating convergence of the previous two decades. Europe will only prosper politically and economically if it improves on its own social model, proud as it should be on the historical feats of inclusive welfare states and progressive regional economic integration, which are both unparalleled in the world. To the extent that EMU was designed to dismantle the welfare state by stealth, it was an utter failure that should immediately be thrown back into the dustbin of history. What new kind of policy mix of macroeconomic governance and welfare reform is required to allow for more symmetry in Europe's competitive market economy, aiming at full employment and social progress? Will the self-acclaimed 'last chance' European Commission, under the helm of Jean-Claude Juncker, be able to cross the Rubicon of creating a safe institutional haven at the EU-level for its members that does justice to the social investment package as an important ingredient to regain upward socioeconomic convergence in the aftermath of the Great Recession? Can 21st century welfare provision still play a constructive role in support of short-term macroeconomic demand while at the same time strengthening long-term human capital supply in the knowledge-based economy? Or is there really no alternative for pro-cyclical austerity-biased welfare retrenchment, labour market deregulation and social risk privatization in Europe's ageing societies? Answers to these questions require, as I have argued in this contribution, an in-depth understanding of the interaction of macroeconomic policy and welfare reform over the past quarter century.

Five biggish lessons loom large from the cautionary historical-institutionalist tale presented above. These are: (1) the lesson of intellectual inertia and cognitive capture; (2) the deep EMU economic interdependency lesson; (3) the domestic policy (still) matters lesson; (4) the EMU crisis management lesson; and, finally, (5) the danger of not-biting-the-bullet political lesson.

(1) The 'boundedly rational' world of policy and politics is by definition prone to *cognitive inertia* and intellectual and political capture. The established manual of hard money, tight budgets and 'structural reform', even when it fails to foster convergence, is not easily traded for an assertive social investment agenda, based on a more appropriate understanding of 21st century labour markets, family demography, and life course dynamics, for which mounting evidence can be tabled in support. By 2016, it is fair to say that we have reached a halfway policy paradigm shift, with a more generalized recognition, appreciation and support of the 'capacitating' economic advantages of social investment in ageing societies, together with the incipient but progressive 'socialization' of the European Semester. By contrast, the more accommodating monetary policy stance of the ECB is essentially meant to underwrite the retrenchment-deregulation 'structural reform' agenda of the old EMU policy paradigm, a strategy that is not without risks of asset inflation and new financial bubbles. As neo-classically trained economists, working at the ECB and DG ECFIN and DG Competition, gained authority over the neoliberal era, these bastions of EMU policy-making tend to hold onto the background neoclassical belief that comprehensive welfare provision hurts competitiveness, especially in uncertain times. In spite of intellectual inertia, the seeds of reorientation are admittedly also apparent. The deeper significance of the *SIP* is that the intellectual genie of the social investment paradigm, officially endorsed by the Commission, is out of the bottle with strong evidence, suggesting that social investments in early childhood education, family income protection, active labour market policies and parental leave

arrangements 'crowd in' inclusive growth through high long-term employment and productivity returns, informed by new insights into the causes of inequality, the intergenerational poverty transmission, gender change and family demography, and the workings of post-industrial knowledge-based economies and their more 'transitional' labour markets. For the moment, we need to acknowledge that the *SIP*, courageously put on the policy agenda by DG Employment, Social Affairs and Inclusion, is no more than non-binding communication, but an extremely important one with potentially long-term reverberation. As such, policy recommendations that follow from the SIP remain subject to the fiscal rectitude of the Six-Pack, Two-Pack, the Fiscal-Compact, the Excessive Deficit Procedure, and Troika bailout programs. In other words there is an imminent danger that the social investment message will be side-lined in the drive to front-load (pro-cyclical) austerity in times of public and private debt deleveraging, against mounting empirical evidence, because of deep seated cognitive capture and intellectual inertia of out-dated micro- and macro-economic policy prescriptions.

(2) The days of inadequate self-sufficient fiscal sovereignty are over! This I call the *recognition of deep EU interdependency lesson*. With the benefit of hindsight, it can be argued that country-specific and perverse welfare reform divergences, with Northern member-countries making a (halfway) social investment turn, and Southern welfare states continuing to protect the vestiges of insider-biased male breadwinner social provision, in time of deep structural change, was in part caused by important design flaws in the architecture of EMU. It turned out to be an illusion to think that a one-size-fits-all interest rate policy and the (ineffective) SGP enforcement would automatically inspire fiscal sovereigns to swiftly correction of looming imbalances before they fester and grow. Moreover, capital markets made some big mistakes since the introduction of EMU, but even if they would have aptly signalled emerging imbalances, policy correction, bearing on public budgets, pension provision, employment policy and health care, are not readily forthcoming as long as they remain political decisions of self-acclaimed sovereign member-states. The challenge therefore is to design a governance structure, containing supranational discipline elements consistent with the growing interdependence of the semi-sovereign welfare states of the Eurozone. More detailed

surveillance of member states' fiscal policy has since 2010 been introduced and this indeed is a *sine qua non* for the proper functioning of the single currency, together with the establishment of a banking union.

(3) The growing importance of the EU, however, does not undermine the importance of national politics and policy-making. Reform ownership is crucial. While levels of social spending have on average been relatively stable over the past decades, with a slight increase since the onslaught of the Great Recession, national social policy repertoires have transfigured in significant ways in a long process of gradual but transformative reforms across different areas of socioeconomic regulation far before the crisis. National policy-makers and stakeholders have however not been the blind followers of policy fashion. Two contrasting experiences stand out. The *positive* lesson is that assertive and active, non-segmented and family-friendly welfare states do better on practically all counts. The richer democracies have not fallen prey to unreconstructed retrenchment as this would lead to political suicide. Instead, they have incrementally, through trial and error, stumbled on social investment as a pro-active reform strategy, in the shadow of high real interest rates, that holds a promise of sustaining an inclusive welfare state in times intensified economic competition, demographic ageing and family change. By contrast, as a *negative* lesson, the problematic policy legacies of labour market dualization and pension biased social insurance have been exposed as unsustainable by the crisis. Paradoxically, low real interest rates and the ineffective enforcement of the SGP acted as perverse 'reform tranquilizers' in the EMU periphery. Then, in the aftermath of the Eurocrisis, socioeconomic fate transfigured once again. The prosperous economies up North, in particular those accumulating large current account surpluses, such as Germany and the Netherlands, are in the context of the Europe 2020 strategy advised to step up social investment reform and quality competition, while the fiscally distressed economies of Greece, Italy, Spain and Portugal are told to pursue an alternative strategy of internal devaluation and price competition.

(4) The *EMU crisis management lesson* is that indiscriminate austerity undermines long-term economic consolidation and growth. The chief economists of the IMF and OECD and leading

economists, such as Olivier Blanchard, Paul de Grauwe, Jean Pisani-Ferry, and Paul Krugman, all agree that Europe's austerity turn after 2010, inspired by the 'expansionary consolidation' teachings of Alberto Alesina, has unnecessarily prolonged the crisis. Resultant longer spells of youth unemployment discourage labour market participation with the likely effect of massive skill erosion, which corrodes the long-term growth potential of ageing economies, and deepen rather than mitigate unfolding disparities within the Eurozone, which may in due course once more undermine the sustainability of the currency union.

(5) In hard economic times politics and economics become inseparably linked. Where economic stagnation prevails, high unemployment and rising poverty and inequality become the breeding grounds for xenophobic anti-EU populism. This is the *political lesson* of the crisis, brought home by the results of the elections to the European Parliament in 2014 and also by the 2015 national elections in Greece and the United Kingdom. The landslide victory of the radical left Syriza party, under the charismatic leadership of Alexis Tsipras in crisis-struck Greece, raised the prospects of a 'Grexit', but this was ultimately pre-empted on the promise of a yet-to-be-decided debt write-off. For the more affluent United Kingdom, the victory of the Conservative party under David Cameron set the stage for a 'Brexit'-referendum in June 2016. As political accountability continues to be bound up with widely cherished national welfare states, it is little wonder that harsh austerity reform, reinforcing economic insecurity, employment instability and income inequality, double-digit unemployment, alongside additional failures to resolve the Euro crisis, and the refugee and immigration crisis and the Jihadist terrorist threat, is increasingly met with anti-establishment political mobilization and rising EU-sceptic domestic pressures to water down ruling governments' commitments to European solutions.

The Eurocrisis has called into question a wide range of once taken-for-granted policy ideas and expectations. Meanwhile many reform proposals have been tabled to correct what is today called the 'incomplete design' of EMU. Unsurprisingly, the majority of such policy recommendations, ranging from the banking union to the capital markets union, improved (countercyclical) macroeconomic coordination, enlarged fiscal policy space, risk- and burdensharing for smoothing economic cycles and mitigating asymmetric shocks, under the jurisdiction of a prospective fully-fledged Eurozone Finance Minister, focus on monetary, financial and fiscal policy (Marzinotto et al., 2011; Pisani-Ferri, 2014; Bofinger, 2011; Enderlein et al., 2014; De Grauwe, 2011; 2012; 2013; Dreze and Durre, 2013). Likewise, the June 2015 'Five Presidents' Report' also recognizes that Eurozone socioeconomic convergence requires fiscal stabilization and some sort of shock-absorption capacity (Juncker et al. 2015: 7-7, 22). Very few proposals address the interconnected nature of macroeconomic governance and national welfare states and social reform agendas, except perhaps for the idea of a common unemployment insurance benefit to cope with asymmetric shocks, already proposed by former Social Affairs Commissioner Andor (2013; Dullien, 2014; Bertelsmann Stiftung, 2014). Although I question the political and administrative feasibility of an Eurozone unemployment benefit scheme, such an insurance policy does little to stop fiscal austerity from falling onto youngsters and families with children, who are the backbones of future social insurance and pension provision. Tragically, this is happening.

The post-crisis challenge of gradually reducing government debt remains, but it is questionable whether permanent austerity, reinforced by prolonged unemployment and thereby progressive human capital erosion, will be sufficient to stabilize public debt. Under the current austerity regime, a fair number of countries, continuing to face high interest premia on their debt, will have to be run by governments committed to impose spending cuts and tax increases without much prospect for growth and fiscal relaxation in the short to medium term. It remains questionable whether mainstream national political parties and social partners can muster the required domestic 'reform ownership' for structural reform without much light at the end of the tunnel? Short-sighted austerity, under conditions of financial and human capital flight, is putting the cart before the horse. Everyone does seem to agree, including Wolfgang Schauble, that a deflationary vicious spiral should be avoided, as it could wreck the single currency. In this respect austerity thinking is powerful but not entirely hegemonic. How to reassure creditors on (partial) debt repayment? I believe that social investment can have a role in stabilizing EMU.

While front-loading fiscal austerity may perhaps have been justified to restore the immediate credibility of EMU vis-à-vis capital markets after 2009, now that the single currency is on safer grounds, it is in my view imperative to anchor the social investment progress more thoroughly in the Eurozone economic governance framework and the European Semester exercise. Because social investment reform is principally a 'supply side' alternative to the neoliberal retrenchment-deregulation agenda, the Commission's recommitment to social investment cannot substitute for effective macro-economic management, especially not in times of depressed demand (Hemerijck and Vandenbroucke, 2012). But I also agree with Fabian Zuleeg (2015), that for the foreseeable future E(M)U macroeconomic governance will have to settle on a far-from-perfect methodology of rule-based EU fiscal policy (Zuleeg and Schneider, 2015). This raises the question whether fiscal rules can be amended in to encourage countries to step up national social investment strategies, while maintaining the overall integrity of a rules-based budgetary framework, including the SGP 3% deficit and the 60% debt limits. The task at hand is to formulate a coordinated two-level reform agenda of making long-term social investments and medium-term fiscal consolidation mutually supportive by incentivizing all governments to pursue credible budgetary discipline and social investment reform and to be effectively supported therein (Vandenbroucke et al. 2011, Hemerijck and Vandenbroucke 2012).

As empirical research increasingly shows that the gains from improving educational standards across the life course are associated with significant productivity and wage increases together with employment and GDP growth, my preferred solution is to discount social investments from the deficit rules in the reinforced SGP, in the areas of life long education. Exempting human capital 'stock' investments from SGP deficit requirements would render greater fiscal space to member states that genuinely opt for social investment reform. As a paradigmatic legacy of the stagflation era, today standard public accounting procedures continue to report education and active labour market policy spending as current expenditures; in other words: like pensions as 'unproductive; or at 'consumption-smoothing' costs with no medium- or long-term positive economic and social significance. Discounting social investments allows both for adherence to Eurozone fiscal rules and domestic policy discretion, necessary for domestic 'reform ownership' (Truger, 2014). Granting more fiscal room of manoeuver within bounds to countries that experience excessive social and macroeconomic imbalances, thereby securing long-time financing for education from early childhood to life-long learning, would help incentivize that national reform programs are in line with the SIP. Moreover, this would also allow peripheral and core economies to jointly pursue a social investment strategy. The added advantage at the macro EU-level would be a more synchronized business cycle. Finally, government spending would privilege younger generations and families and thereby mitigate intergenerational imbalances.

Although social investment exemptions from Stability Pact rules could be enacted without a major overhaul of the EMU governance framework, it is of utmost political importance to give the EMU social investment turn greater credibility and legitimacy. To this effect, I suggest to more visibly anchor the strategy under a 'Social Investment Protocol' in the Lisbon Treaty, as a complement to rule-based budgetary supervision, fully consistent also with the Europe 2020 policy strategy of 'smart, inclusive and sustainable growth' and the more recent endorsement of a 'Triple A social Europe' of the Juncker Commission.

Ultimately, as we know from the seminal writing of Peter Hall on the political power of economic ideas, novel policy paradigms only gain institutional importance if they provide answers to salient political problems. Two such political problems loom large. First, there is the overarching challenge to keep the single currency afloat. Economic divergences and social imbalances can still undermine the sustainability of EMU. The second conundrum concerns the populist temptation of national welfare chauvinist closure. An honest recognition of the economic, social and political limits of austerity reform, on the one hand, and the full recognition of the positive track record of social investment innovation, on the other hand, are sine qua non for constructing an overlapping political consensus in the political centre of a currency union based on an employment-friendly macroeconomic 'holding environment' that allows EMU and active European welfare states to prosper in tandem.

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