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A SOCIAL DIMENSION FOR THE EMU: WHY AND HOW?

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SUMMARY

The debate on a social dimension for the Economic and Monetary Union (EMU) is not a new one, yet social considerations have been put on the top of the European political agenda again in the context of deep economic recession and of the reform of EMU's architecture. As citizens across many member states perceive that the European project is suffering from a real "social deficit", the Heads of State and Government are expected to define the elements of this new "social dimension of the EMU" at the European Councils of next October and December.

The purpose of this policy paper is to shed some light on how a social dimension for the common currency area could and should look like today. In a general manner, the paper argues that social considerations must be placed at the core of European integration and mainstreamed into all EU policies and initiatives. However, European action in the field of social policy should be pursued only when it is necessary and justifiable.

The first part of the policy paper addresses an important question of whether a reinforced social dimension is needed at the EMU17 or at the EU28 level. The policy paper argues that undoubtedly it is desirable to reinforce the social dimension of the EU as a whole, mainly for three reasons: (i) the ongoing deepening of the single market and the risks of "race to the bottom" often associated with it; (ii) the declining citizen support for the European project and thus its overall legitimacy; and (iii) the need to deal with social consequences of the current economic crisis in the short run.

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

The second part of the policy paper suggests a non-exhaustive list of initiatives that could be placed under the umbrella of EMU's social dimension. These initiatives are grouped in three pillars according to their different purpose, namely increasing the smooth functioning of the EMU, avoiding the negative consequences of the common currency on the national welfare states and adapting the EMU institutional framework in order to place social and economic issues on the same footing.

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INTRODUCTION

In recent debates on Economic and Monetary Union (EMU) reform, the idea of adding a "social dimension" to the four often mentioned "unions" (economic, fiscal, banking and political) is gaining force as social consequences of the current crisis are deteriorating rapidly in many member states. EMU is thus called to develop its own set of initiatives in the social field, which would go further than the social initiatives of the EU28 today. These calls come from the highest political circles. For example, a "social union" or social pact has been recently requested by the Commissioner for Employment and Social Affairs, Lázsló Andor[1], by the European Parliament[2], and by a group of Socialist Ministers for Social Affairs and Employment[3], among others. Herman Van Rompuy has also been asked by the Heads of State and Government at the European Council of December 2012 to present a report on the EMU's social dimension in 2013. Decisions on how this "social dimension" will look like will be taken at the European Councils of October and December 2013.

> "EMU IS CALLED TO DEVELOP ITS OWN SET OF INITIATIVES IN THE SOCIAL FIELD"

However, it should be remembered that the debate on the social dimension of the EMU is by no means a new one. Already before the euro came into being, various scholars have discussed the links between national welfare states and a common currency regime[4]. For instance, as the establishment of EMU was complemented with well-defined rules regarding public spending in the framework of the Stability and Growth Pact, there were fears that such fiscal discipline might eventually undermine social spending and, as a consequence, alter national welfare states. In addition, it was expected that the introduction of the common currency would imply more labour market and wage bargaining flexibility in the member states, eventually leading to the EMU-wide "race-to-the bottom". Finally, there were general fears that in the absence of exchange rate flexibility, social standards would be used as factors of adjustment in a case of asymmetric macroeconomic shock.

Despite all the existing literature and debates in the public sphere, some clarifications seem to be needed in order to better define an EMU's social dimension. Why do we need to have a reinforced social dimension in the euro area instead of reinforcing Social Europe at the EU28 level? Why should euro area member states accept a stronger cooperation in the social field? Which elements should be part of this new EMU social dimension? How to connect it with EU28 Social Europe? The present policy paper sets out to shed some light on the aforementioned questions. We start by analyzing the rationale of having a social dimension at the EMU level (chapter 1). We then present a set of initiatives which should be part of this EMU's social dimension (chapter 2)[5].

1. Andor, Lázsló, "What does more Europe mean?", speech at the Friends of Europe 9th Annual VIP round table "State of Europe: Escaping the doldrums", Brussels, SPEECH 12/721, 11 October 2012: "My conclusion is, therefore, that greater coordination of the European and national levels on employment and social matters has become necessary if we want to further integrate financial, budgetary and monetary union. We need a stronger social union if we want to have a genuine Economic and Monetary Union".
2. European Parliament, "Resolution: Towards a genuine Economic and Monetary Union", 2012/2151, 20 November 2012.
3. Party of European Socialists, "Towards a Social Union", Declaration of the PES Ministers for Social Affairs and Employment, Brussels, 27 February 2013.
4. Begg, I, "The social consequences of Economic and Monetary Union", Final Report, Brussels: European Parliament DG for Research, 1994.
Teague, P, "Monetary Union and Social Europe", Journal of European Social Policy 8:117, 1998.
Pochet, P, Vanhercke, B, "The Challenges of Economic and Monetary Union to Social Protection", in J Saari (ed) *Financing Social Protection in Europe*, He lsinki: Ministry of Social Affairs and Health, publications, n 21, 1999.
Martin, A, "The EMU Macroeconomic Policy Regime and the European Social Model", in Martin, A and Ross G (ed) *Euros and Europeans: Monetary Integration and the European Model of Society*, New York: Cambridge University Press, 2004.
5. The authors are grateful to Yves Bertoncini, Maria João Rodrigues and Eulalia Rubio for their valuable comments and ideas, which helped to improve the quality of this Policy paper.

1. Why must the EMU have a social dimension?

The first question that needs to be adressed in the debate about a reinforced European social dimension is whether it is needed at the EMU17 or at the EU28 level. Indeed, there are three main arguments in favour of reinforcing EU's social dimension for at least three reasons. First, Social Europe is needed to balance the effects of the completion of the single market in order to avoid social competition between the member states. Second, in the context of the current crisis, there is a case for counteracting the negative effects of the crisis and of national austerity policies by a more resolute action on the level of the EU. Finally, developing the European Union (EU) social dimension would allow strengthening public support for the European integration.

"ACTION ON THE LEVEL OF THE EMU IN THE SOCIAL FIELD MIGHT NOT ONLY BE DESIRABLE, BUT ALSO NECESSARY"

Nevertheless, all of the aforementioned arguments are reinforced in the context of the common currency area; therefore, action on the level of the EMU in the social field might not only be desirable, but also necessary. First of all, a common currency implies that interdependencies between the member states increase beyond those created by the single market. Secondly, as shown by the current crisis, the question of legitimacy and popular support is much more acute within EMU countries, as the member states of the euro area are forced to engage in unprecedented integration, solidarity and control initiatives. Finally, in the case of EMU, deeper cooperation in social and employment policies might also help to ensure the smooth functioning of the euro area.

The following sub-sections provide a more elaborate analysis on the reasons for reinforced social dimension at the EU28 (1.1) and EMU17 level (1.2). We finish this section by suggesting how the EU and EMU social dimensions could work together (1.3).

1.1. A case for a reinforced EU28's social dimension

As mentioned above, there are three main arguments in favour of reinforcing EU28's social dimension.

First of all, Social Europe is needed to balance the effects of the completion of the single market. With its four freedoms of movement of goods, services, and capital, the single market might trigger social and fiscal competition as well as "welfare shopping" between the member states. Intensified intra-EU competition creates the risk of a "race to the bottom", whereby the member states with lowest social standards become the most competitive in terms of production costs. Such developments go against the founding principle of ensuring social progress in the EU; therefore, one might argue that the social consequences of the single market should be better taken into account. As a result, current efforts to deepen the single market[6] should be complemented with actions aimed at ensuring that further economic integration does not undermine the foundations of national social protection systems. For these reasons, in its 2010 report already Mario Monti pointed out that in order to relaunch the single market, member states needed a compromise, which should rest on an "appropriate reconciliation" of Europe's economic and social policies[7].

Secondly, developing the social dimension for EU28 is needed for sustaining public support and democratic legitimacy of the European integration. According to Jürgen Habermas, "the only remaining project for which political mobilisation is possible consists in protecting a "European way of life" against the pressures of globalisation"[8]. However, today citizens in many countries feel that "the EU's (primarily economic) project has not been beneficial to them and that indeed it may be endangering the social standards they aspire to".[9] This is

6. See the Single Market Acts I and II by the European Commission.
7. Monti, Mario, Report to the President of the European Commission José Manuel Barroso, "A new strategy for the single market, at the service of europe's economy and society", 9 May 2010.
8. Jürgen Habermas quoted in Vandenbroucke, Frank, "Europe: The Social Challenge Defining the Union's social objective is a necessity rather than a luxury", European Social Observatory, Opinion Paper No. 11, July 2012.
9. Marlier, Eric and Natali, David, *Europe 2020: Towards a More Social EU*, Peter Lang, 2010, p. 34.

even more relevant in the context of today's declining prosperity today and decreasing support for European integration in many member states[10].

"THE RESPECT OF THE VALUES ASSOCIATED WITH THE EUROPEAN SOCIAL MODEL SHOULD BE ENSURED BOTH IN GOOD TIMES AND IN TIMES OF ECONOMIC DOWNTURN"

Finally, against the backdrop of the current financial, economic and social crisis, there is a need to counteract the effects of the crisis and of national austerity policies by a more resolute EU-level action to promote sustainable growth, employment and social investment. After all, the respect of the values associated with the European Social Model, which include – as mentioned in the White Paper of the European Commission from 1994 - "democracy and individual rights, free collective bargaining, the market economy, equality of opportunity for all and social welfare and solidarity"[11], should be ensured both in good times and in times of economic downturn.

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

1.2. Reasons for a new EMU's social dimension

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

We can distinguish two sets of arguments why the economic, fiscal, banking and political union in the euro area should be completed with a social dimension: a functional one, related to EMU's long term sustainability; and a political one, concerning EMU's legitimacy. These two sets of arguments are the two sides of the same coin, as reinforcing EMU's legitimacy and citizens' support is also a matter of sustainability for the EMU. Indeed, if the common currency is perceived by European citizens as a threat to national welfare states tradition, the political support for the Euro will fade away, thus putting at risk the long-term sustainability of the project.

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

The theory of Optimal currency area (OCA) is useful for understanding how a social dimension could help improve the functioning of the EMU. According to this theory, good functioning of a common currency zone requires a certain degree of symmetry between the economies pertaining to the union. If the level of symmetry is not very high, the latter can be compensated by either the existence of adjustment mechanisms (flexibility) or a sufficient centralized fiscal capacity[12].

The criterion of symmetry means that national or regional business cycles should be strongly correlated between the members of the common currency area, so as to reduce the risk of asymmetric shocks (be they exogenous – resulting from external factors, or endogenous – resulting from the asymmetric impact of the common monetary policy)[13]. When there are major structural differences within a currency area, just like in the EMU, these can still be reduced through the surveillance and coordination of macro-economic policies, including those concerning the labour market. In addition, some believe that symmetry could also be enhanced by stronger a social policy convergence in areas such as education or life-long learning, all of which have a significant impact on member states' competitiveness.[14]

10. Debomy, Daniel, "EU no, Euro yes? European public opinions facing the crisis (2007-2012)", *Policy paper n°90, Notre Europe – Jacques Delors Institute,* March 2013.
11. European Commission, "European Social Policy – A Way Forward for the Union" White Paper, p.2, 1994
12 De Grauwe, Paul, *The Economics of Monetary Union*, Seventh Edition, Oxford University Press, 2007.
13. For an explanation of the distinction between exogenous and endogenous asymmetric schoks, see Enderlein, Henrik, coord., "Completing the Euro: A road map towards fiscal union in Europe", *Study n° 92, Notre Europe-Jacques Delors Institute*, p.26, June 2012.
14. Vandenbroucke, Frank, op. cit.

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

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

"THERE ARE TWO TYPES OF INSTRUMENTS TO ADDRESS CYCLICAL DIVERGENCES IN A CURRENCY AREA: MARKET-BASED AND INSTITUTIONAL INSTRUMENTS"

In particular, labour mobility within a currency area can play a crucial role in enhancing the functioning of the single currency, by allowing workers from a country hit by a negative shock to relocate to the countries experiencing a positive shock. Nevertheless, despite the right of free movement of people in the EU, today only 3% of working-age EU citizens live in a different EU country. This points to an uncomfortable fact that even though labor mobility needs to be reinforced in the euro area, it is hard to expect that it can be a sufficient instrument to address cyclical divergences in the common currency area.

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

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

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

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

First, the risk of social dumping is higher in the EMU than it is in the EU because EMU member states can no longer compensate for a loss in competitiveness by bringing down their exchange rate and are forced to compete in direct labour costs.[15] In addition, the reformed EMU as it is being constructed today will become even more economically open with increased movement of labour, goods, services and capital within the euro area. The risk of social competition between the member states will thus be greater. Naturally, some competition between the governments is welcome if it leads to the improvement of functioning of the public sector

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

(competition in "quality"). However, competition in social standards aiming at reducing the cost of production may lead to the bad equilibrium of the "race to the bottom" between the member states.

Second, there is an increased risk of drastic "social dismantlement" in any EMU country affected by an asymmetric shock as the EMU today is still lacking adjustment mechanisms to mitigate these shocks. Consequently, social standards might be used as factors of adjustment. With no control over exchange rates and increasingly limited scope for fiscal policies, the number of macroeconomic policy tools available to the national governments is reduced. In the absence of agreed common rules, the temptation and the necessity to sacrifice social standards for economic adjustment might thus become more evident. As Commissioner Andor puts it, EMU needs to establish certain social policy benchmarks, which "would represent a safeguard that employment and social outcomes are not simply treated as residual variables in the process of macroeconomic adjustment" [16].

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

1.3. Connecting Social Europe to the EMU's social dimension

The arguments presented above point to a fact that the first-best scenario for reinforcing the social dimension in Europe would consist of a comprehensive agreement at the EU28 level. For the purposes of legitimacy, social issues should be placed at the heart of European integration with all member states doing their utmost to preserve the European social values. In addition, an agreement on the EU28 level would prevent the emergence of social competition between EMU and non-EMU countries. However, a far-reaching agreement will certainly be hard to achieve, given the differences between national welfare states and the reluctance of some member states to cede more power and competences to the EU level in this field.

If reinforcing the social dimension at the EU28 level is desirable, but less feasible, more social integration on the EMU level is necessary and should be more feasible. The euro area represents a smaller group of countries than the EU as a whole and reinforcing the EMU's social dimension is a much more urgent task (as argued in section 1.2). In addition, because some problems are particular to the countries sharing the same currency (such as the risk of "social dismantlement" due to the lack of adjustment mechanisms to asymmetric shocks), additional initiatives in the social field at the EMU level would still be necessary even if all EU28 member states agreed to move towards more integration in the social field.

> "EMU COUNTRIES ARE TAKING THE FRONT LEAD, BUT THEIR INITIATIVE IS OPEN TO THE PARTICIPATION OF ALL EU COUNTRIES"

Euro area countries should, therefore, take the driving seat in reinforcing Social Europe. Of course, voluntary participation of non-EMU countries should be allowed, if not encouraged, in all new initiatives. To illustrate this proposal, a parallel with the banking union could be drawn: even though it would be desirable to build a banking union at the EU level, but as this is "too high an ambition to be practical, at least for the foreseeable future" and as it is "urgently needed" at the EMU level[17], EMU countries are taking the front lead, but their initiative is open to the participation of all EU countries. The same logic could be adopted for the reinforcement of "Social Europe".

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

16. Andor, László, "Looking Forward: Social Investment as a way out of the crisis", speech at the Eurofound forum, Dublin, 15 February 2013.
17. Pisani-Ferry J., Sapir A., Véron N., Wolff G. B., "What kind of European banking union?", Bruegel, Issue 2012/12, June 2012.

However, one should also keep in mind that even if this risk is present, the current situation of a weak overall social dimension, both on EMU and on EU levels, is the least optimal one. Social fragmentation enables social competition between individual member states and many national welfare states are under pressure while social policies are treated as adjustment mechanisms to the negative economic shocks. A similar logic of avoiding the worst-case scenario already applies to other new European initiatives, such as the creation of the Financial Transaction Tax, despite the fact that they might lead to increased competition between the "ins" and the "outs".

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

2. What social dimension for the EMU?

The definition of the EMU's social dimension must rest on two underlying principles.

First, we need to bear in mind that the responsibility for conducting the employment and social policies lies mainly on the national level and member states are reluctant to give more powers in these fields to the European level. In addition, taking into account the diversity of national social models (see box 1), any sort of social harmonization is hard to achieve. In this context, it would not be realistic to expect an important transfer of competences or powers to the E(M)U[18] level. As a consequence, the deepening of EMU's social dimension should only go as far as it is necessary for the smooth functioning of the common currency area, but not further. EMU level action should be such as to allow the cohabitation of different social models reflecting national preferences.

Second, to our view the EMU should not have a parallel and separate social pillar to be added to the four identified in Van Rompuy's report (the economic, fiscal, banking and political pillars). The social dimension should be mainstreamed in all EMU's initiatives because social policies are very often affected by policies pursued in other areas. As Janssen puts it: "What needs to be done is to strike at the very heart of European Economic Governance. Social limits and principles need to be placed inside its processes and procedures. In that way, the social dimension can be safeguarded from the very start"[19].

On the basis of these two assumptions and building on the reasons presented for a social dimension of the EMU, we identify hereafter two sets of initiatives aiming at answering two problems of the common currency area: improving the functioning of the EMU (2.1) and avoiding the negative consequences of the common currency on national social policies (2.2). Finally, we outline how to improve the social governance of the EMU (2.3).

18. Here the "E(M)U" refers both to the EU and the EMU.
19. Janssen Ronald, "A Social Dimension For A Genuine Economic Union", Social Europe Journal, 22 March 2013.

Table 1. Types of Welfare State in Europe

	ANGLO-SAXON	MEDITERRANEAN	CONTINENTAL	NORDIC
Overall purpose of the system	Combating poverty and social exclusion	Protecting workers from adverse labour market or lifecycle risks	Protecting workers from adverse labour market or lifecycle risks	Reducing overall inequality
Main access criteria to welfare benefits	Means-based	Employment	Employment	Citizenship
Generosity of welfare benefits	Low	Low on average but unequal levels of generosity, depending on to whom they benefit (insiders/outsiders of the labour market)	High on average but unequal levels of generosity, depending on to whom they benefit (insiders/outsiders of the labour market)	High
Labour market regulation and policies	Low levels of employment protection, residual labour market policies	High levels of employment protection, strong emphasis on passive labour market policies	High levels of employment protection, strong emphasis on passive labour market policies	Low levels of employment protection, strong emphasis on active labour market policies
Level of social spending	Low	Low	High	High
Degree of social inequality	High	High	Medium	Low
Countries	UK, Ireland	Italy, Spain, Greece, Portugal	Germany, France, Luxembourg, Austria, Belgium, the Netherlands	Denmark, Finland and Sweden

Source: Compilation by Sofia Fernandes and Kristina Maslauskaite

2.1. Initiatives for the smooth functioning of the EMU

In its note for the European Council of June 2013, Herman Van Rompuy outlines: "While social policy remains an exclusive prerogative of member states, lack of coordination can disrupt the functioning and the stability of the EMU"[20]. As mentioned in the previous part, increasing the symmetry between member states' business cycles, reinforcing markets' flexibility and setting-up a centralised fiscal capacity would contribute to a well-functioning EMU. In order to achieve this goal, initiatives in the social field in these three areas are particularly relevant.

2.1.1. A reinforced surveillance and coordination of employment and social policies

Excessive social imbalances have a negative impact on national economic performances - as they are frequently the consequence of underperforming labour markets and education systems – and, therefore, they represent a problem for the long-term sustainability of the monetary union (for an in-depth analysis of excessive social imbalances see Vandenbroucke et al, 2013). Taking this into account, and even if this is not a consensual issue, we can assume that tackling social imbalances in the EMU would contribute to reinforcing the symmetry among EMU countries' business cycle, which is, as outlined, a key condition for the smooth functioning of a common currency area. As Vandenbroucke et al put it: "Although there are no hard proofs in these matters, it is plausible to argue that economic symmetry in the euro area would benefit from upward convergence in the "social fabric" of the euro area members."[21]

To that purpose, member states should supplement the existing macroeconomic surveillance framework by a reinforced surveillance of employment and social policies. This could be achieved through the adoption of a

20. Cabinet of the President of the European Council, "Towards a Genuine Economic and Monetary Union", Summary note prepared for the European Council of June 2013.
21. Vandenbroucke, Frank et al, Excessive social imbalances and the performance of welfare states in the EU, UK Leuven, p. 14, 2013.

scoreboard of employment and social indicators – as proposed namely by PES Social Ministers - in order to detect the key employment and social developments affecting economic performance and the EMU's stability[22]. This surveillance of social imbalances could rest on the same procedures as for the surveillance of macroeconomic imbalance (in-depth assessment is conducted when a risk of social imbalance is identified), but one main difference should apply. Rather than a sanction mecanism, social imbalances have to be tackled with an incentive mechanism.

Various social indicators relating to the labour market (e.g. long-term unemployment rates) or general wellbeing in the society (e.g. poverty levels) might depend on cyclical economic situation and be outside direct government control, at least in the short run. In addition, achievement of certain commonly-set target levels might require expensive immediate reforms, which would bear desired outcomes in the longer term only. Therefore, contrary to the Macroeconomic Imbalance Procedure, which includes a sanction mechanism, in the social field member states should adopt an incentive mechanism instead. This mechanism could rest on the "Convergence and competitiveness instrument" which is currently being debated and which aims at reinforcing the implementation of structural reforms. Nevertheless, the approach for these contracts has to be different from the one provided today. Rather than a bilateral approach in which the Commission tells each government what it has to do, the member states should define a set of social objectives – or retake the ones from the Europe 2020 strategy – and agree on a financial aid addressed to the countries that are launching initiatives and reforms aiming at achieving these objectives as well as reducing their social imbalances[23].

Finally, the ex-ante coordination mechanism of major reform plans which is expected to be adopted by the end of the year must also contribute to improving the sharing of best practices in the employment and social fields.

2.1.2. Improving labor mobility as a market-based adjustment mechanism

The mobility of the labour force is one of the market-based adjustment channels in a monetary union. As the overall labour mobility across Europe remains very low, facilitating workers mobility in the euro area is a crucial element for enhancing the functioning of the single currency. Indeed, in the current context of youth unemployment rates above 40% in several peripheral member states, higher labour mobility could help avoiding the emergence of a "lost generation".

Box 1. Policy-induced factors which hamper the mobility of workers in Europe

A recent report from the Organisation for Economic Cooperation and Development (OECD)[i] cites several policy-induced factors which, in addition to cultural and linguistic barriers, hamper the mobility of workers in Europe:

1. the lack of portability of supplementary pension rights;
2. scarce cross-country information about job vacancies;
3. the difficult recognition of professional qualifications;
4. housing market policies that raise the costs of moving;
5. the difficulty in accessing public sector jobs as non-nationals.

i. OECD Economic Survey, *European Union*, Paris: OECD Publishing, March 2012.

Taking into account that single market legislation is generally a topic for the EU-28, but that the necessity to integrate is much more significant in the euro area for the aforementioned functional reasons, EMU member states could engage in "enhanced cooperations" in order to adopt legislation fostering intra-EMU labour mobility more quickly and more efficiently (e.g. on the portability of supplementary pension rights[24], or the adoption of a cooperation agreement between EMU national employment agencies).

22. An alternative proposal to this Employment and Social Scoreboard is to broaden the macroeconomic scoreboard with complementary social indicators instead of having two separate scoreboards. This is proposed by the European Parliament (Thyssen report) and Herman van Rompuy (Note to the European Council of June 2013).
23. See Jean Pisani-Ferry, "Distressed Europe should not be bribed to reform", Bruegel, 6 February 2013
24. The Commission proposed a Directive in 2005 to set minimum standards for the acquisition, preservation and transferability of supplementary pension rights. However, it has still not been possible to achieve the unanimity needed in the Council to pass the Directive. The Monti Report also suggests an option to explore the 28th regime for supplementary pension rights, see "A new strategy for the single market, at the service of europe's economy and society" Report to the President of the European Commission by Mario Monti, 9 May 2010, p.58.

2.1.3. An unemployment insurance scheme for macroeconomic stabilisation

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

This automatic stabilization instrument at the EMU level could take a form of a EMU unemployment insurance scheme, as proposed by several EU decision makers, such as the French Minister for Finance, Pierre Moscovici, or the Commissioner for Employment and Social Affairs Lázlo Andor[25].

Setting-up an unemployment insurance scheme is certainly a challenging goal for the euro area member states as several technical issues would need to be addressed, especially the one relating to its financing. It has to be outlined that even before the crisis this idea was already discussed and some proposals were presented (e.g. Dullien, 2007)[26]. If the design of such a scheme would deserve an in-depth analysis, we can nevertheless outline its main features.

> "A CYCLICAL-ADJUSTMENT FUND WOULD REDUCE THE PRESSURE FOR USING SOCIAL POLICIES AS A VARIABLE OF ADJUSTMENT"

First, this scheme should have a triggering mechanism linked to an economic indicator such as the short-term unemployment rate[27]. The fiscal transfers would be triggered by a certain increase in this economic indicator (regardless of the starting short-term unemployment rate, which means that both a country with a relatively low short-term unemployment rate and one with a high rate are suitable to receive fiscal transfers if they suffer from cyclical unemployment).

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

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

2.2. Avoiding negative consequences of the EMU on national welfare states

An incomplete EMU might have significant negative consequences on national welfare states through primarily two channels. On the one hand, the EMU countries can no longer engage in "beggar-thy-neighbour" currency wars; consequently, the incentives to engage in a "race-to-the-bottom" strategy in terms of labour standards in order to achieve better competitiveness might be higher. On the other hand, as EMU of today is not complemented by a fiscal backstop to deal with asymmetric shocks, social policies and outcomes serve as factors of macroeconomic adjustment via the "internal devaluation" strategies. These two processes might eventually deplete national welfare states and the European Social Model in general, unless some initiatives are adopted to avoid these negative consequences of the common currency such as those presented hereafter.

25. László Andor pointed out in a recent speech: "A fiscal capacity would be able to strengthen the sustainability as well as the legitimacy of the EMU, by addressing asymmetric shocks and mitigating the social consequences of adverse economic developments. (...) For example, in the form of EMU level unemployment insurance, this would constitute direct expression of EU support to citizens in need" in Andor, László, "Europeans want and deserve a monetary union with a human face", Speech at ETUC conference, Madrid, 28 January 2013.
26. Dullien, Sebastian, "Improving Economic Stability in Europe : what the Euro Area can learn from the United States' unemployment insurance", Working paper FG1, SWP Berlin, 2007/11, July 2007.
27. Using the short-term unemployment rate would have two main advantages: on the one hand, it is highly sensitive to cyclical developments and, on the other, it is easily measurable (as opposed to the output gap) and there are robust data across Europe on the basis of a common Eurostat/ILO definition.

2.2.1. Adopting social standards to limit social competition

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

> "ONE WAY FOR PREVENTING SOCIAL COMPETITION OR SOCIAL DUMPING IS THE CREATION OF EMU-LEVEL MINIMUM SOCIAL STANDARDS"

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

Various proposals relating to the minimum social standards are circulating around. They include, for example, setting a common minimum "health package" for each citizen as well as introducing common minimum pensions, minimum wages[28] or, more generally, minimum European income levels[29]. Such policy standards would eliminate the incentive to engage in social dumping and would protect national welfare states from negative effects of the EMU. In addition, correctly set minimum incomes and wages could help to eliminate such phenomena as the "working poor" (today 8% of European workers live below the poverty line[30]) as well as reducing the income gap between the groups of vulnerable (younger, older, disabled and female) and more advantaged workers. These are important effects for the social cohesion that European project is aspiring to and, more precisely, for the achievement of the Europe 2020 targets.

2.2.2. Preventing social policies from being an adjustment variable

As witnessed by the current crisis, social policies and social standards have been widely used as factors of adjustment by the EMU member states experiencing negative economic shocks. Such "internal devaluations" have had drastic social consequences for national welfare states and their citizens resulting in a "socially explosive" situation in many peripheral countries[31]. A two-stage approach could be used to protect existing social standards from a negative impact of asymmetric shocks in a common currency area.

In the short term, the horizontal social clause (Article 9, TFEU) should be put in practice, not least when designing macroeconomic adjustment programmes for the countries facing financial difficulties. Currently, the Treaty requirement of taking into account "the promotion of a high level of employment, the guarantee of adequate social protection, the fight against social exclusion, and a high level of education, training and protection of human health" in all EU action seems to have been largely ignored, especially in what concerns the euro area's periphery. In addition, the introduction of aforementioned minimum social standards would ensure that the most important social rights are ensured even in times of recession.

In the longer term, however, the only way to ensure social standards in the EMU is to create and reinforce other mechanisms for dealing with asymmetric shocks. As discussed in section 1.2, there are two ways of achieving smoother functioning of the EMU in times of differing economic shocks between the member states.

28. Most notably proposed by France and Germany in their joint statement: "Together for a stronger Europe of Stability and Growth", 29 May 2013.
29. See European Parliament, "The role of minimum income in combating poverty and promoting an inclusive society in Europe", Resolution of 20 October 2010 or ETUC, Position on the social dimension of the European Union, 23 April 2013.
30. European Commission, Towards a job-rich recovery, COM (2012) 173 final, p.9.
31. Reuters, "Standard & Poor warns of socially explosive situation in euro zone", 18 March 2013.

One is to increase worker mobility across borders and the other relates to the creation of a shock absorption capacity (cyclical adjustment fund). These, combined with increased surveillance of macroeconomic imbalances, would significantly reduce the pressure to go through socially painful process of internal devaluation and therefore *de facto* preserve national social standards.

2.3. An improved social governance in the EMU

> "A BETTER ADAPTED INSTITUTIONAL FRAMEWORK IS NEEDED TO PLACE SOCIAL AND ECONOMIC ISSUES ON EQUAL FOOTING"

EMU's economic governance has undergone many important changes in the recent years, including the emergence of new institutional arrangements such as the establishment of the euro summits. Nevertheless, a better adapted institutional framework is needed to place social and economic issues on equal footing. For this reason, new economic governance should be complemented with additional platforms meant for discussing social issues at the EMU level.

2.3.1. Eurogroup at the Employment and Social Affairs Ministers level

In order to better integrate social and employment concerns in the discussions and decisions of the euro area authorities, the Eurogroup meetings should also be held at the level of the Employment and Social Affairs Ministers. The Ministers for Employment and Social Affairs of the euro area should thus meet before each Euro summit (which are supposed to take place at least twice per year), in order to give their contribution to the meetings of the Heads of State and Government of the euro area. The French-German statement of 29 May 2013 goes in this direction as it states that: "(…) the Eurosummit [should have the possibility] to task other euro area Ministers, for example employment and social affairs, research or economics ministers, to take work forward on specific matters"[32].

2.3.2. A strengthened social dialogue

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

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

Finally, European social partners should be given a possibility to provide their own view and analysis on the new instruments that are being created to reinforce EMU's architecture, such as the setting-up of a cyclical adjustment fund in the euro area[33]. Social partners are well placed to bring additional elements regarding the possible consequences of such new instruments on national welfare states; therefore, their opinion should be taken into account by the European policy makers at all stages of the policy process.

32. France and Germany, "Together for a stronger Europe of Stability and Growth", 29 May 2013.
33. ETUC, "Position on the social dimension of the European Union", 23 April 2013.

CONCLUSION

The recent economic and financial crisis is threatening national welfare states in many EU member states. The negative developments over the past five years lead many to question whether current EU instruments are sufficient for safeguarding social progress, one of the main goals of European integration. More than that, some view the EU as a cause rather than a solution of degrading social situation in European periphery. For these reasons, public debate and political action concerning the reinforcement of European social dimension should be mobilized on the highest level and with utmost urgency.

> "IT SHOULD BE ENSURED THAT THE EUROPEAN CITIZENS NOTICE THAT THEIR UNION IS CAPABLE OF PROMOTING SOCIAL PROGRESS"

This policy paper argues that, whenever possible, more elaborate social policy instruments should be adopted by all 28 member states of the EU. As these countries share a borderless single market and a common project based on certain European values, it should be ensured that the European citizens notice that their union is capable of promoting social progress, rather than social dismantlement and competition. Of course, whenever possible, social policies should largely remain a national competence as the preferences of European peoples are diverse, yet the European social dimension should be sufficiently developed to counteract the negative social effects of economic integration.

Certainly, history shows that reaching a common agreement on various social issues on the EU level might be a long and difficult task; yet one group of EU member states might not have any more time to lose. Indeed, this paper argues that what seems only desirable for the EU28 member states is absolutely necessary for the euro area countries.

Broadly speaking, there are two sets of reasons why the euro area can no longer afford neglecting its social dimension. First, new initiatives in the social field would help to ensure the smooth functioning of the euro area and contribute to EMU's long term sustainability (functional argument). Second, the common currency can have negative effects on national welfare states (political argument). If European citizens perceive the common currency as a threat to national welfare states, the political support for the Euro will fade away, thus putting at risk the legitimacy of the project. Yet, as shown by the current crisis, the question of legitimacy and popular support is much more acute within EMU countries, as the member states of the euro area are forced to engage in unprecedented integration, solidarity and control initiatives.

To respond to these challenges the new social dimension of the EMU should be based on three pillars.

- The first pillar, aimed at continuing to make EMU a more optimal currency area, should include: a new procedure for the surveillance and for addressing excessive social imbalances (which would contribute to limit the risk of asymmetric shocks in the euro area); more labour mobility under better conditions (which would reinforce euro area countries' capacity to adapt to an asymmetric shock); and the setting-up of an unemployment insurance scheme (which would be a macroeconomic stabilization instrument for the euro area).
- The second pillar should deal with the negative consequences of the EMU on national welfare states. For example, common social standards such as a minimum incomes and wages should be adopted in the EMU to limit social competition. In addition, the proposed instruments for the EMU to deal with asymmetric developments (labour mobility under better conditions and an unemployment insurance scheme) would also have the advantage of avoiding that social policies are used as an adjustment variable in the case of an asymmetric shock.
- The third pillar should consist of adapting institutional setting to put economic and social issues on equal footing in the EMU decision making process.

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