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Social and Employment Policy in the EU and in the Great Recession

Abstract

This paper briefly reviews "systems competition" tensions when markets are integrated in the absence of a suitably harmonized policy framework, notes that harmonization of social and employment policy across EU member countries is hampered by historical and economic heterogeneity, and discusses recent institutional and empirical developments with particular attention to the politico-economic implications of the recent financial and economic crisis. Before the crisis, employment rates grew along with income inequality in many member countries, plausibly as a result of competitive deregulation pressures in the absence of effective policy coordination tools, rather than of the "activation" measures envisioned by the 2000 Lisbon Strategy. Easier financial market access could allow workers and households to cope with more volatile labour incomes, but the 2008-09 financial and economic crisis had particularly severe employment and welfare implications for newly flexible labour markets. This may yet trigger a reversal of previous deregulation and economic integration trends. Only a coherent approach to the integration of markets and market-correcting policies may in the future prevent uncoordinated social and employment policies from endangering the political sustainability of economic integration.

Markets and policies integration

Policies need to be enforced to be effective. Just as allowing each individual taxpayer to choose her own tax rate would make it impossible to raise any revenue, it would be futile to hope that locally chosen policies within a larger integrated market can correct the coordination and information problems that prevent efficiency of decentralized market interactions. Whenever collective policy action is needed to shape imperfect market interactions, integration of markets needs to be accompanied by integration of policies.

All this is just as true for social and labour market policies as for product market regulation or monetary policies. In all policy areas, market integration without policy coordination reduces the effectiveness of collective policies. Integrating policies is not easy, and the need to do so limits the scope of market integration: while larger markets offer obvious productivity gains from specialization and scale, it is more difficult to design and enforce a suitable policy framework for larger and more heterogeneous sets of economic interactions.

In the past, as the range of economic relationships extended beyond prehistoric families and tribes, so did that of collective action. The same advances in organization and communications that allowed markets to extend over broader ranges also made it possible to ensure that markets would neither be deprived of the legal and regulatory infrastructure necessary to their operation, nor distorted by poorly informed and excessively blunt uniform rules. Not many centuries ago, nations emerged as single-market units equipped with strong external boundaries and a uniform, effectively enforced internal institutional framework covering rule-of-law and monetary aspects as well as social and employment issues.

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Policies that address social and employment issues have two related, but conceptually different purposes (see e.g., Bertola, 2007). On the one hand, they aim at social inclusion, redistributing resources towards disadvantaged individuals. In this respect, it is motivated by solidarity, by love for one's neighbour, or by the unpleasant implications of extreme poverty within one's visual range or near one's property. On the other hand, they offer security over each individual's lifetime. Since labour income is the most important resource for most people, policies and institutions that shape employment and wages are an important tool towards this goal; as a side effect, those policies reduce productivity, because governments' information and enforcement powers cannot eliminate completely the effects of insurance on individual incentives to keep and find jobs that make it very difficult if not impossible for private markets to smooth out the standard-of-living implications of labour income volatility.

International market integration interferes with both motivations of national social and employment policies.

Since poverty is most disturbing among one's immediate neighbours and solidarity is weak towards strangers, inclusion policies have a relatively narrow reference frame that, even when bolstered by more or less artificial nationalism, may not even encompass the boundaries of large countries. But if mobility of goods, persons, and capital is not restrained by the borders of countries, then the effects of inclusion policies extend to individuals towards which voters need not feel any solidarity.

And because social insurance is justified by private financial markets' inability to provide insurance against labour income fluctuations, it is more difficult for it to operate when markets become more powerful. Not only is public policy's need to enforce mandatory participation in social insurance programmes hampered by international opt-out options, but the incentive effects of social insurance schemes have more severe implications for production and employment when individuals no longer simply choose whether, but also where to work or draw benefits.

This is obviously a problem when, as markets extend across their borders, constituencies independently choose policies in competition with each other. While competition among individuals in well-regulated markets fosters efficiency, competition among policymakers replicates at the systems level the market failures that collective policies are meant to correct (Sinn, 1997). As policymakers find it harder to choose high taxes (and run the danger of seeing their taxable base disappear abroad) and generous subsidies (recipients of which will be more numerous if immigration is possible), competition among systems triggers race-to-the-bottom mechanisms whereby each local decision-maker tries, and fails, to free-ride on others' vanishing generosity.

Social and employment policy in the EU

Extension of solidarity feelings and mandatory social insurance schemes throughout the borders of nations was supported by customs and passport checks at those borders, and bolstered by suspicion and aggressiveness towards strangers living beyond them. The shortcomings of this arrangement became apparent after two world wars, and Europe engaged in an unprecedented and impressively successful international economic integration experiment.

Europe's supranational policy framework pursues its political war-prevention goal with broad and effective "negative" measures meant to remove national economic borders. Negative integration can certainly build a single market, but not necessarily a market that works well. Yet, the EU features relatively little "positive" integration of policies meant to correct market imperfections, particularly in areas where it cannot rely on the more or less artificial homogeneity of culture that supports national policies.

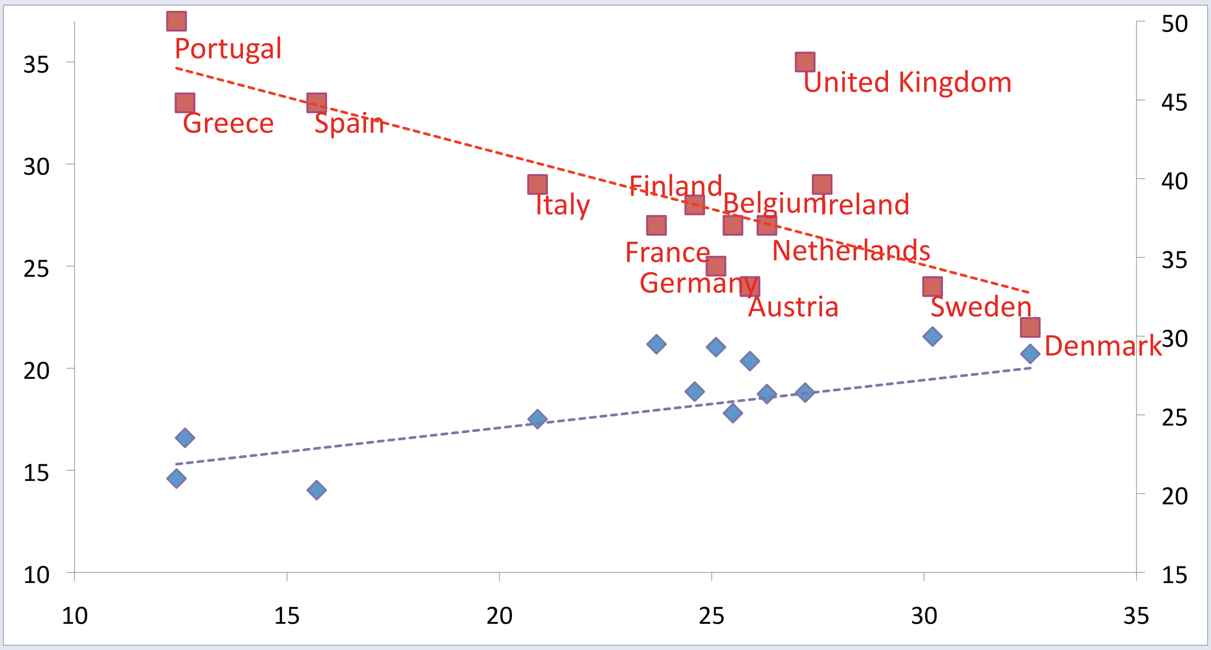
In the EU, the Single Market Programme harmonized regulation that would have restricted trade if allowed to differ across member countries, and would have left markets unable to function if simply dismantled. EU regulation is instead limited to health and safety aspects as regards labour market regulation, very partial as regards service provisions, and very poorly developed in budgetary terms, where since the mid-1980s the EU's small own resources fund even smaller (relative to national government budgets) programmes meant to foster cohesion across peripheral and core countries and regions, rather than across individuals within each country.

While the efficiency costs of local redistribution are higher when markets are integrated, policy choices remain local: EU-level institutions have practically no policymaking power on social and labour market issues that remain entrusted to country-specific regulation, tax, and subsidy policies. The reasons for this can be traced to two related dimensions of heterogeneity, that make it very difficult to harmonize employment and social policy in the EU (e.g., Bertola, 2006).

One has historical roots. There are many ways of redistributing income and reducing labour income risk, and different countries have adopted different tools to control the inequality and volatility of their citizens' incomes. Those equipped with suitable administration schemes prefer to control labour income risk with unemployment and social insurance schemes; others rely more heavily on employment protection legislation, effectively giving employers (rather than bureaucracies) the task of smoothing labour income fluctuations; others still find it easier to entrust to well-developed financial markets the task of allowing households to smooth their labour incomes' fluctuations. Differences across these dimensions underlie the well-known Esping-Andersen (1999) categorization of European welfare states in Anglo-Saxon, Continental, Nordic, and Mediterranean "models," each of which addresses qualitatively similar cohesion and social insurance objectives using different instruments, in ways that reflect political and historical factors, and may be more or less sensitive to international competitive pressures.

A second, related dimension of heterogeneity is that of income levels, and of the resulting variable intensity of market-correcting policies. *Figure 1* illustrates the relationship between per capita income, social

FIGURE 1: IN RICHER COUNTRIES THERE IS LESS INEQUALITY AND PUBLIC SOCIAL EXPENDITURE IS HIGHER



Horizontal axis: per capita GDP in 2000, thousands of euro
Left vertical axis, Gini coefficient of equivalized disposable household income, per cent, 2000 surveys.
Right vertical axis, Total public social expenditure, per cent of GDP, 2000.
Source: Eurostat.

policy expenditure as a percentage of GDP, and inequality of disposable income across the EU15 in 2000. Clearly, inequality is lower in countries where public social policy expenditure is more generous. And just as clearly, social policy is more generous in richer countries. Generosity is easier for the rich if, as discussed above, social policy improves equality at the expense of efficiency and aggregate production. As countries differ not only in terms of the economic costs and political appeal of movements along that trade-off, but also in terms of their ability to produce aggregate income, those that find it easier to produce income also find it easier to bear the efficiency costs of more extensive redistribution. Thus, heterogeneity of economic development levels interacts with historical and political factors in shaping welfare state models: the Nordic countries' expensive combination of high employment, heavy taxation, and generous subsidies is not only unfamiliar, but also unaffordable for poorer and less socially homogeneous countries.

Devising a supranational social and employment framework for such diverse countries is clearly more difficult even than adopting a single monetary policy framework. However, just as a single currency was the logical consequence of product market integration (which needs stable exchange rates) and capital market integration (which equalizes interest rates), so a common employment and social policy framework is logically necessary if one is in a borderless union, throughout which not only goods but also persons, services, and capital are free to move, and market-correcting policies need to be enforced at the collective level.

While international freedom of choice for individual firms and workers logically undermines national policies, and social policy objectives remain important in an EU framework aimed at "growth", "stability", and "cohesion" (Sapir et al, 2004), "positive" supranational harmonization of social and labour market policies proves very difficult across countries with different histories and income levels. In this situation, deregulation is the logical consequence of "negative" market integration. While open subsidization of industry is kept in check by state aid rules, and relaxation of work and safety rules is also prevented by supranational legislation, regulatory and tax competition can be at work in the social and employment policy. In theory, tighter economic integration should be associated with lower social policy expenditure, labour market deregulation, and more pronounced labour income instability. Empirically, comparing countries that did and did not join the EMU and the 1995-99 and 2000-04 periods, Bertola (2010a,b) finds that the tighter economic integration implied by the "One Market, One Money" EMU paradigm was indeed associated with substantially faster deregulation of their product markets, some deregulation of their labour markets, lower social policy expenditure, and higher inequality.

Before the crisis: Lisbon to Lisbon

Tension between integration of markets and lack of social and employment policy harmonization can be relaxed by reduction of the institutional and economic heterogeneity in which that tension is rooted.

As regards institutional aspects, the social policy dimension has been tackled at the EU level since the 2000 Lisbon summit, and employment policy since the previous Luxembourg summit. The emphasis of both the Lisbon Strategy and the Luxembourg process was on "active" inclusion objectives through market participation, eased by such public policies as education, training, and job search assistance; and "open method of coordination" tools of communication, observation, and comparison of policy and outcome indicators (rather than explicit legislation) as instruments of policy coordination.

Despite initial optimism (Begg and Berghman, 2002), channels of institutional convergence appear rather clogged in practice. Daly (2006) reviews the Lisbon process's institutional structure and developments until 2005, noting that the most social aspects of the Lisbon agenda were over time toned down in favour of economic (including employment) and financial ones. After 2005, the process "relaunched and re-centred on the priority of achieving more and better jobs" by integrating the Broad Economic Policy with the Employment Guidelines. The Commission's monitoring role, however, was diluted, putting more emphasis on National Action Plans and "collective monitoring". Deprived of even naming-and-shaming tools, as well as of any financial carrot or stick (only disbursement of the Social Fund was at a point made conditional on preparation of otherwise broadly disregarded Employment Policy reports), the Lisbon process was arguably doomed to fail not only and most evidently in its goal to "make Europe the most competitive and dynamic knowledge-driven economy by 2010" but also for the less obvious and more essential purpose of controlling regulatory competition.

Neither the Lisbon Strategy, nor the complex negotiations leading to the 2009 Lisbon Treaty equipped the EU with effective coordination tools in the labour market policy area. The Lisbon Treaty (in force since late 2009) is most notable for its long gestation period, including the initial rejection of its draft Constitutional version, some of which was motivated by social and employment concerns: Eurobarometer found that top reasons for a 'no' vote to the European Constitution referendum by French citizens included "loss of jobs" (31%), "too much unemployment" (26%), "economically too liberal" (19%) and "not enough social Europe" (16%).

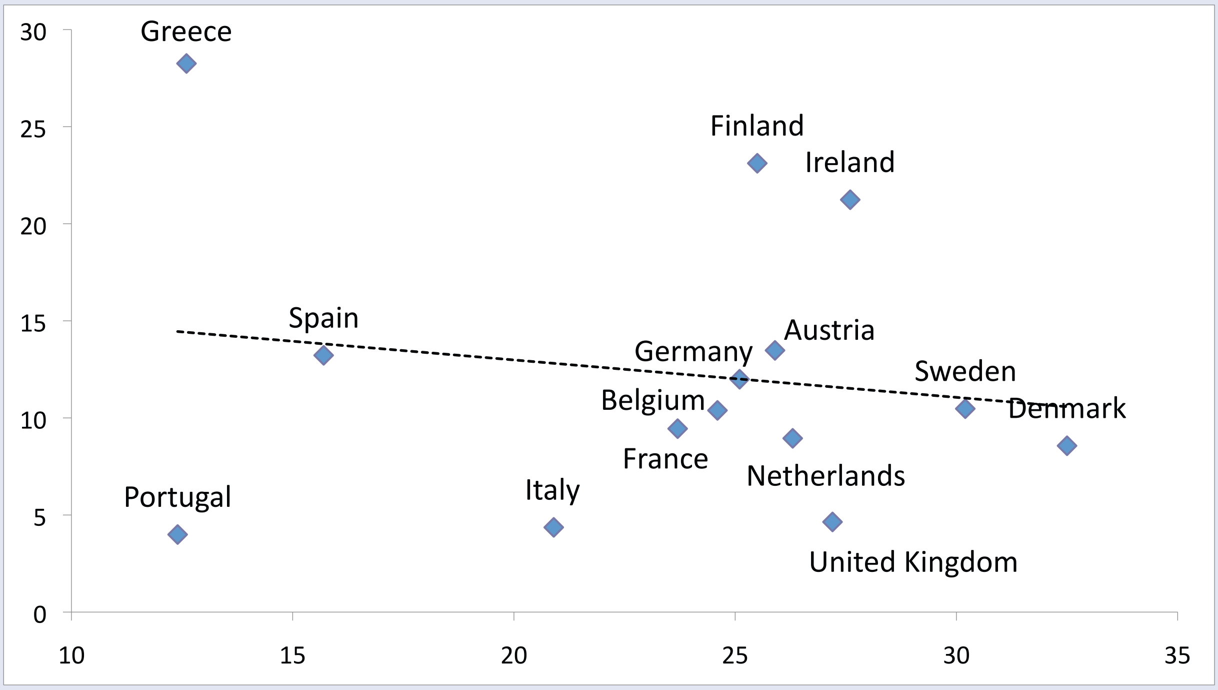
Yet, the Constitution draft was, and the Treaty remains, largely toothless in the social and employment policy areas that member states are unwilling to release to supranational legislation. The Treaty's Article 149 explicitly rules out harmonization of employment policies, leaving their coordination to "open method" procedures. Title X, on Social Policy, mandates unanimity for any EU legislative action regarding social security and social protection of workers; a small door is open in the same Article 153 for a unanimous Council decision, acting on a proposal from the Commission after consulting the European Parliament, to admit ordinary majority decisions as regards employment protection and collective bargaining. This, as usual, prevents any practical implication of the Charter of fundamental rights' proclamations regarding unjustified dismissals (Article 30) and social security benefits (Article 34).

When policy concerns cannot be eased by effective coordination, they act as a brake on market integration. Opposition to the first draft of the Bolkenstein Services Directive, and its rejection by the European Parliament, were largely motivated by fear that supply of cheap, unregulated labour in continental European countries would endanger their social welfare models. A much smaller development in the opposite direction was the establishment of the EU Globalisation Fund, meant to subsidize retraining and mobility for workers in industries hit by competitiveness shocks originating from outside the EU. This policy appropriately targets the social concerns, reviewed above, that reduce the political appeal of international economic integration. Its focus on external globalization forces and its rather small size, however, severely limit its ability to appease concerns about social policy: only a third of European citizens have even heard of it, according to Special Eurobarometer 316.

As to differences in economic development, economic integration might, through labour mobility if not through trade alone, foster income convergence across member countries. To see whether this and other phenomena are empirically relevant, the following figures inspect developments across the EU15 countries, excluding Luxembourg, over a period that starts in 2000 (when the Lisbon strategy was devised, and when the business cycle was near its peak before the small 2001 recession) and ends in 2007 (when the European economy was again near a cyclical peak, just before the large 2008-09 recession).

It is interesting and worrisome to find in *Figure 2* that cross-country convergence of per capita incomes all but stopped among the EU15 between the 2000 and

FIGURE 2: PER CAPITA REAL INCOMES NO LONGER CONVERGE ACROSS THE EU15



Horizontal axis: per capita GDP in 2000, thousands of euro
Vertical axis: 2000-2007 change in GDP per capita, thousands of euro at 2000 prices
Source: Eurostat

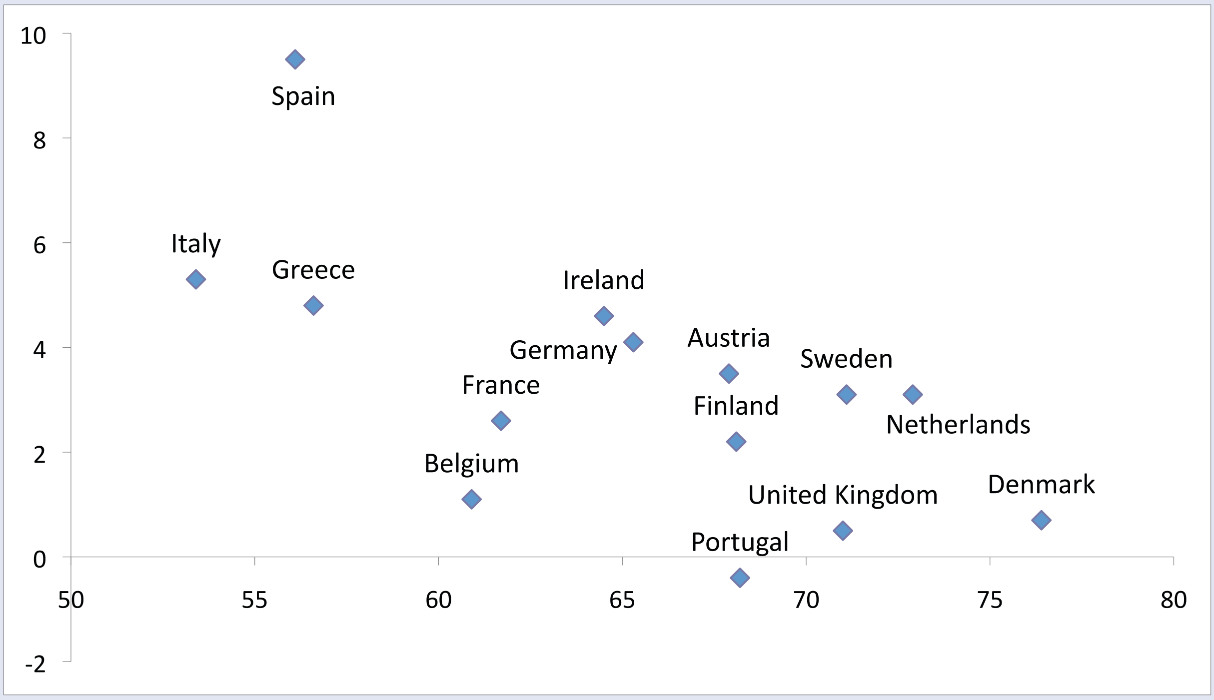
2007 cyclical peaks. Convergence was much stronger in previous decades (and continues to be strong, if uneven, across the EU27). In the 2000s, Ireland's strong performance no longer contributes to convergence, as it starts above average income. If poor Greece had not experienced extremely strong growth, country-specific per capita growth trends would display a positive relationship to initial levels across the EU15, rather than the negative one implied by convergence.

Very interestingly, *Figure 3* shows that, unlike incomes, employment rates did converge after Lisbon across the EU15. *Figure 4*, however, illustrates a strong tendency for employment rate increases to be associated with increasing income inequality. This is not consistent with the "active" labour market policies envisioned by the Lisbon strategy that aim through training and job-search assistance policies to align potentially unemployed workers' skills and employment with their wage aspirations. Rather, higher employment may have resulted from removal of labour market rigidities, such as unemployment benefits and wage floors, that previously equalized household disposable incomes at the same time as they prevented low-wage employment of secondary earners in many families.

Deregulation along these dimensions is a much more plausible theoretical consequence of stronger international competition and more elastic tax bases than the expensive public policies of the Lisbon strategy. And policies that target inequality and control income volatility do tend to lower employment and increase unemployment. In cross-country data, inequality of household disposable income is lower when a country's average unemployment rate is higher, indicating that most of the variation in unemployment is due to institutional features that keep wages higher than the market clearing level, rather than to differences in the efficiency of worker-job matching (Bertola, 2010b).

Many empirical factors other than economic integration might be driving employment and inequality across the EU15 and over the 2000s. But the plausibility of international competition mechanism is supported by analysis of earlier data, where the tighter economic integration implied by EMU membership indeed

FIGURE 3: EMPLOYMENT RATE CONVERGENCE ACROSS THE EU15



Horizontal rate: Employment rate of working age population, 2000.
Vertical axis: Change of employment rate of working age population, 2000-07.
Source: DG-Ecfin labour market database

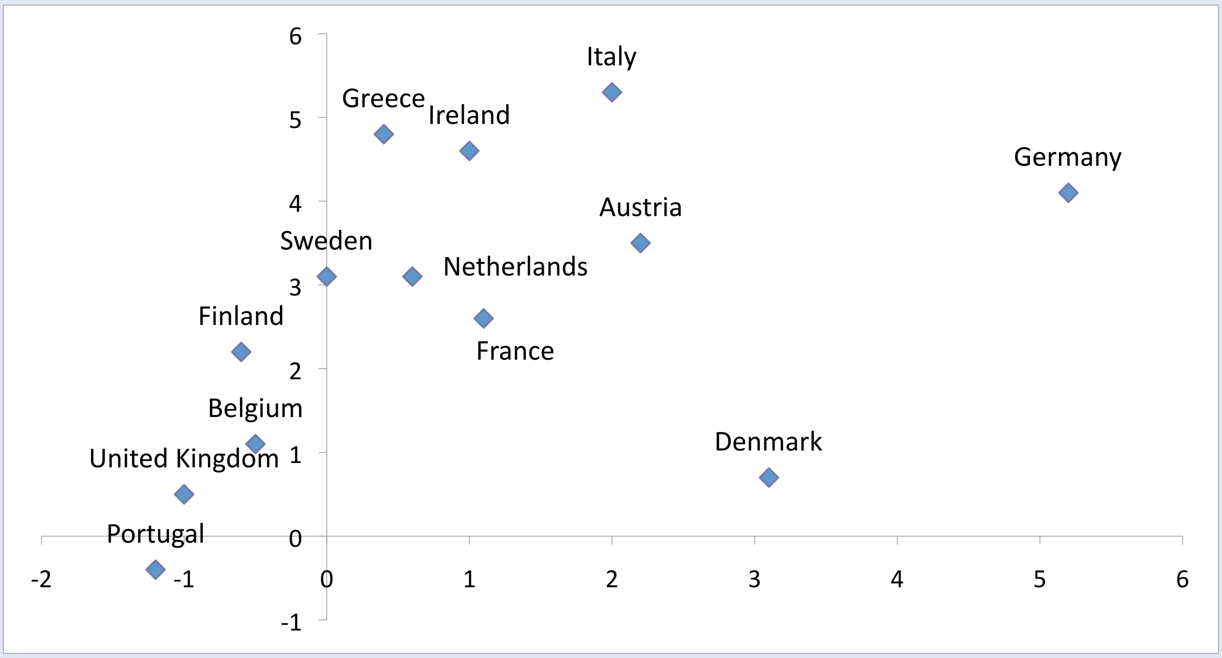
correlates with employment increases, flexibility-oriented changes of labour market institutions, and higher household disposable income inequality (Bertola, 2010a,b). Structural reforms of labour market and social policies are more important in the more tightly integrated Euro area, which includes predominantly countries that arguably did need to reform their old-fashioned labour and social policies (but did not all and always obtain the higher productivity and wages, and easier financial market access, that make flexibility and instability politically acceptable).

Flexibility, finance, and crisis

In the absence of effective coordination, market integration makes it more difficult for countries to interfere with market outcomes in ways that reduce inequality at the expense of employment and productivity. Hence, economic integration fosters efficiency and "growth" at the expense of equality or "cohesion", an example of the tension between different policy objectives of the type discussed in Sapir et al (2004). Of course it might well be worthwhile to trade growth for cohesion. And the welfare implications of labour income shocks might be buffered by easier access to credit and to sensible financial investments, so as to fill the gap left by retreating social policy between household income and desired consumption patterns: from this perspective, it is no coincidence that labour market regulation is looser in Anglo-Saxon and Nordic countries where financial markets are better developed, and not surprising that financial market volumes increased along with employment rates and inequality over the 2000s.

When the great recession hit in 2008, however, the "stability" dimension of policy objectives also became relevant. Countries that had fared best in the years of deregulation and financial development tended to suffer the larger output losses in the crisis (Giannone et al, 2010), and it is possible to trace this relationship between regulation and aggregate stability to the role of automatic fiscal stabilizers in economies where government redistribution is more intense (Dolls et al, 2010).

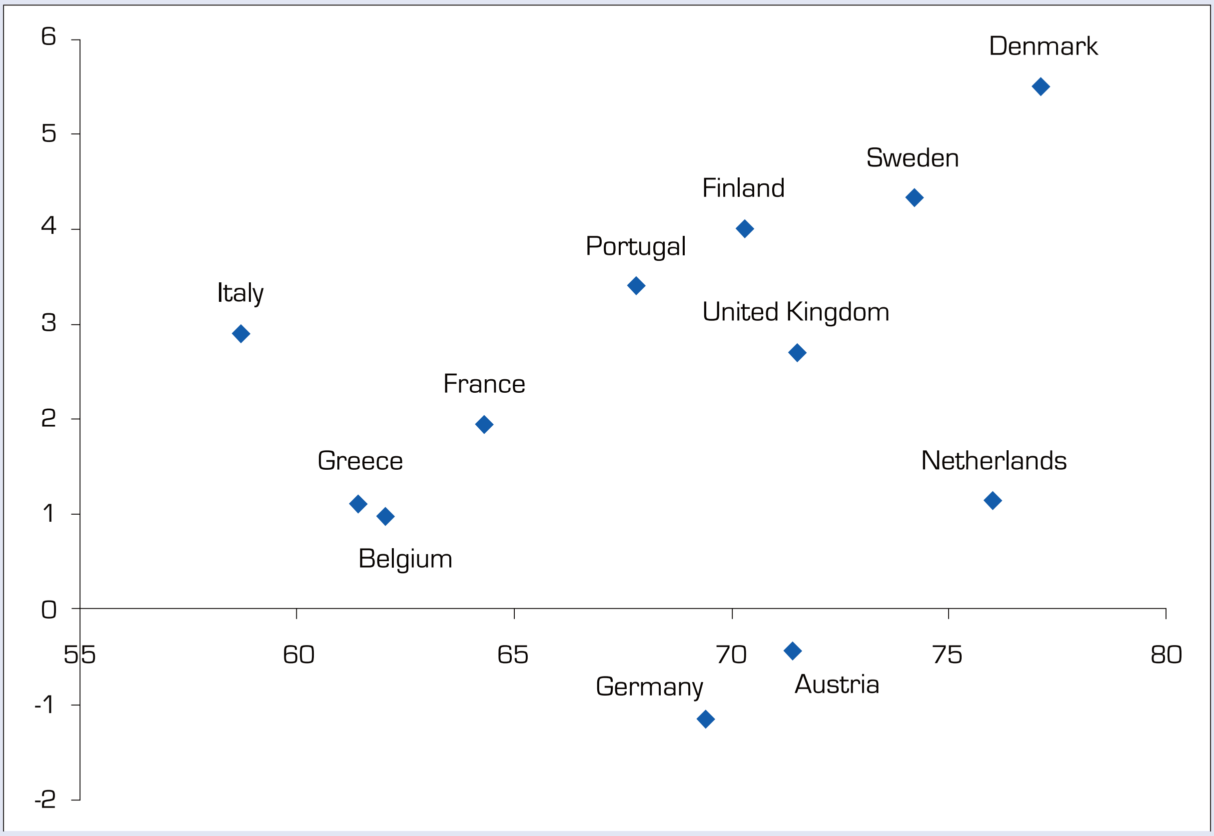
FIGURE 4: HIGHER EMPLOYMENT, MORE INEQUALITY ACROSS THE EU15



Horizontal axis: Change of Gini coefficient of equivalized household income, per cent, between 2000 and 2007 surveys. Source: Eurostat.
Vertical axis: Change of employment rate of working age population, 2000-07. Source: DG-Ecfin labour market database. Spain is not shown (change of Gini=-1.7, Change of employment rate=9.5).

In the context of this paper's discussion, the same taxes and subsidies and wage and employment rigidities that smooth individual labour income fluctuations (and lower employment and effort and hinder productive labour reallocation) also reduce the employment and wage impact of aggregate shocks. Across the EU15 countries, *Figure 5* shows that larger pre-crisis employment rates are indeed associated with larger employment declines in the crisis, to an extent that appears related to the various countries' economic and institutional structure (for example, industry composition and labour market institutions may explain why the relationship between crisis-triggered employment losses and previous employment gains is lower in Germany, the Netherlands, and Austria than in less "continental" countries). Data for Spain and Ireland fall out of the figure's scale: in those countries, extremely fast employment growth was driven by immigration as well as by increased labour market participation, and was followed by even more impressive falls in the crisis, which was all the more serious because of the large weight of construction employment. More generally across the EU, employment losses in the crisis mirrored the employment gains that resulted from the same labour market flexibility that, as shown in Figure 4, also came at a cost in terms of income inequality.

FIGURE 5: CRISIS-TRIGGERED EMPLOYMENT LOSS WAS LARGER WHERE EMPLOYMENT WAS HIGHER



Horizontal axis: Employment rate of working age population, 2007, source: Eurostat.
Vertical axis: Employment fall measured in "Jobs gap" terms (trend employment growth minus actual employment) in 2009 Q4 relative to 2007 Q4, per cent of actual employment in 2009q4; Source: OECD Employment Outlook 2010, Table 1.1.
Ireland (jobs gap=17,03) and Spain (jobs gap=10.98) are not shown.

The financial character of the crisis is relevant to the pattern of cross-country per capita income growth displayed in Figure 2, as well to the welfare implications of the within-country inequality increase that accompanied employment rate growth over the 2000s.

Finance played a hopeful and eventually disappointing role as regards international income convergence. A key pillar of the European Union's development strategy is the idea that relatively backward peripheral countries can, by joining the EU in appropriate circumstances, anchor their institutional structure to a democratic, market-friendly framework that fosters both social and economic development. From this perspective, it is eminently sensible for capital to flow towards countries that are expected to converge to higher levels of economic development, and offer better investment opportunities. Until the recent crisis, this simple idea encouraged Greece and other peripheral countries to borrow freely, and international investors to lend freely.

Within each country, household access to financial markets can substitute the tax-and-transfer schemes that aim at preventing exclusion and smoothing consumption and that, as discussed above, are difficult to implement consistently in large and diverse integrated economic areas. Thus, labour market deregulation was accompanied before the crisis (but not during and after it) by strong private credit growth, again especially in the initially poorer countries whose citizens, expecting their income to grow, borrowed to increase their consumption as well as to purchase durable goods and housing.

Beyond Lisbon and after the crisis

In principle, financial markets could provide some of the protection from competitive shocks that used to be provided by trade barriers, and some of the protection from individual life risks that health, old age, and unemployment insurance schemes find it increasingly difficult to provide in the face of tax base erosion and competitiveness constraints. In practice, the 2008 crisis revealed that financial markets can misjudge individual risks, such as that of mortgage repayment, and confirmed that they are in any case powerless against aggregate events.

The most recent income distribution data available are based on surveys carried out in 2007, so the inequality implications of new labour market flexibility in the crisis cannot yet be assessed empirically; even in the future, scarcity of comparable inequality statistics across comparable downturns will make it difficult if not impossible to assess the extent to which integration-related institutional change may have altered the inequality impact of this crisis. Clearly, however, its member countries' trajectories during the early portions of the decade and during the crisis cast serious doubts on the EU's ability to achieve all three (or, after the crisis, even a single one) of its stability, cohesion, and growth objectives.

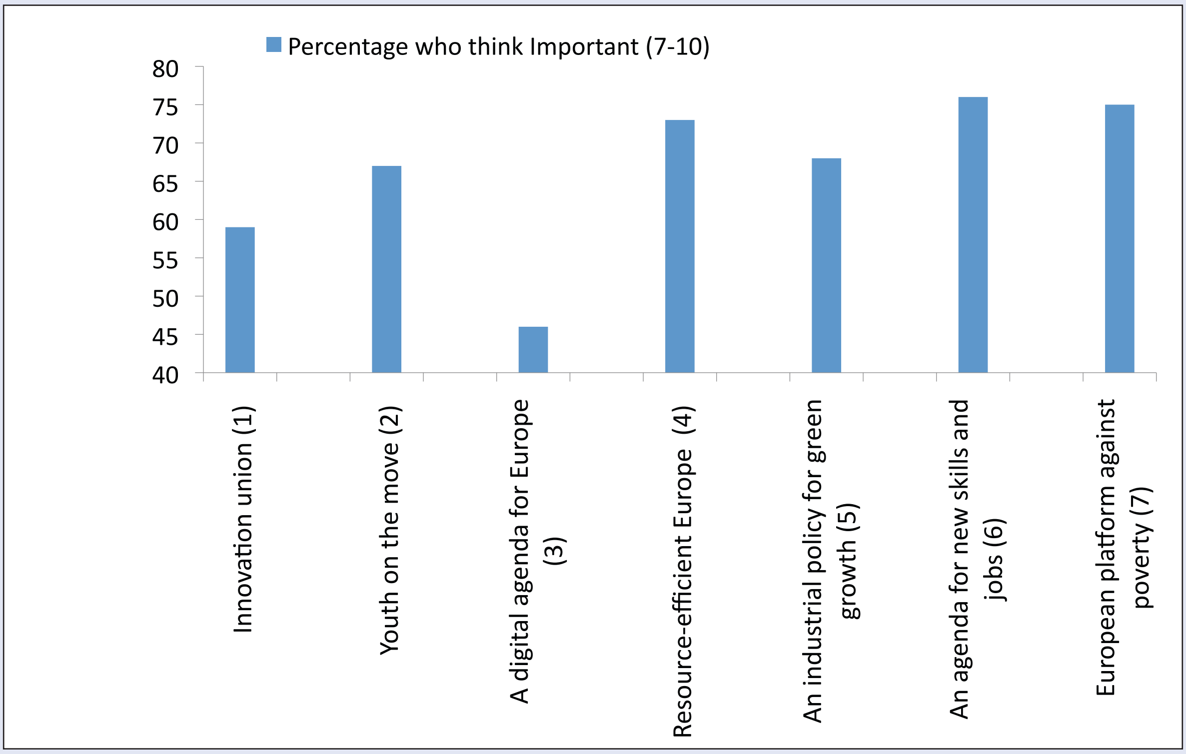
The crisis, showing the ugly side of flexibility, puts in sharp relief the limits of deregulation, economic integration, and financial development's ability to reconcile the market-based "negative integration" EU project with European citizens' taste for income inequality and, as is particularly important for politically crucial middle-class citizens, for protection from income instability. This realization could potentially reverse the mechanisms that, over many decades, have fostered economic integration and market liberalization. Economic integration is politically unsustainable if it results in less generous inequality-preventing social policies, but does not foster the higher productivity that deregulation promises when markets work well and that, as higher income is associated with lower inequality as well as with more generous social policy, could attain both the growth and cohesion objectives of European countries.

Fortunately, international economic integration has displayed remarkable resilience at the global level. Nothing like the autarkic orientation that deepened the Great Depression in the 1930s and precipitated World War II has so far followed the 2008-09 Great Recession. Also in the European context, economic integration appears robust in the aftermath of the crisis, and nothing much has changed as regards policies in the social and labour market policy area. The "Europe 2020" framework launched in March 2010 by the European Commission as the continuation of the Lisbon process pays the usual amount of attention to social aspects, listing "raising employment levels" and "helping the poor and socially excluded" in the last two of the seven guidelines adopted by the European Council in its March 2010 meeting's conclusions.

Subsequent developments are also unsurprising. *Figure 6* shows that a May 2010 Eurobarometer survey found that popular opinion ranks social and employment issues as the top, not the bottom items of its own priority list, which at the bottom features the only Commission flagship initiative launched at the time of writing: the quite technocratic "Digital agenda for Europe" internet-strengthening programme. And, as usual, words are not quickly followed by deeds in this area. The July 2010 European Council conclusions, while stating that "the policies of the Union, and Member States' reform programmes should finally also aim at 'inclusive growth'," establishes policy guidelines for "Member States and, where relevant, the European Union" that refer to social welfare programmes only to recommend that they should be fiscally sustainable, and focuses instead on sound macroeconomic policies, higher productivity, market access. The Council also added, at the top of the "Europe 2020 integrated guidelines", three new priorities regarding public finance sustainability and imbalance redressing.

The current emphasis of EU policy guidelines on fiscal sustainability and market development is very welcome,

FIGURE 6: POPULAR SUPPORT FOR "EUROPE 2020" INITIATIVES



SOURCE: EUROBAROMETER 73 (FIELDWORK: MAY 2010).

(1) re-focussing R&D and innovation policy on major challenges, while closing the gap between science and market to turn inventions into products. As an example, the Community Patent could save companies €289 million each year.

(2) enhancing the quality and international attractiveness of Europe's higher education system by promoting student and young professional mobility. As a concrete action, vacancies in all Member States should be more accessible throughout Europe and professional qualifications and experience properly recognized.

(3) delivering sustainable economic and social benefits from a Digital Single Market based on ultra fast internet. All Europe ans should have access to high speed internet by 2013.

(4) supporting the shift towards a resource efficient and low-carbon economy. Europe should stick to its 2020 targets in terms of energy production, efficiency and consumption. This would result in €60 billion less in oil and gas imports by 2020.

(5) helping the EU's industrial base to be competitive in the post-crisis world, promoting entrepreneurship and developing new skills. This would create millions of new jobs.

(6) creating the conditions for modernizing labour markets, with a view to raising employment levels and ensuring the sustainability of our social models, while baby-boomers retire ;

(7) ensuring economic, social and territorial cohesion by helping the poor and socially excluded and enabling them to play an active part in society.

since the 1929 Great Depression experience shows that retreat from markets and from economic integration is a natural and dangerous temptation in the aftermath of a severe crisis. But the EU system of economic policies remains unable to connect its supranational priorities with the social and employment concerns of European citizens which a crisis like the recent one heightens, and competition among systems makes increasingly difficult to address for national policies.

What next?

The low profile of EU initiatives after the crisis prolongs a phase of similarly weak progress following the mid-2000s rejection of the Constitutional Treaty by French and Dutch voters, which marked a reassertion of national political priorities, and brought to an end the long previous phase, based on negation of national government powers and on the idea that economic development levels and institutional structure would converge automatically if a common international market could be established across countries in suitable initial conditions.

Even before the crisis, there was no longer any tendency for income levels to converge across the EU15. The still strong, if uneven, income convergence observed across the EU27 may indicate that automatic convergence forces stop working once incomes have converged to the extent they did in the EU15. And the crisis, hitting the periphery more violently than the centre, indicates how delicate and fragile such mechanisms can be.

The Lisbon process's idea that policies and institutions could converge through comparison and imitation, rather than through explicit coordination and harmonization of market-correcting policies, also proved ineffective in practice. The "active" labour market policies envisioned by the Lisbon strategy would need to be supported by substantive coordination measures, such as the co-financing structure typical of proper federal systems. Even before the crisis, over the 2000-07 period, higher employment was instead accompanied by higher inequality, both plausibly resulting from deregulation of labour market rigidities that previously prevented low-wage employment and equalized disposable incomes. And the 2008-09 crisis, hitting hard the employment and income of the most deregulated and market-oriented economies, cast further doubt on the political sustainability of previous developments.

The Constitutional Treaty rejection and the crisis will likely prove to be a watershed from a historical perspective. Realization of the doubtful political sustainability of negative integration has so far frozen integration and shifted power back to politically legitimate national policymakers, especially in the labour and social policy area. If after the 2000s watershed the EU continues along this path, the European project will stagnate. The realization that stealth negative integration cannot deliver on its promises could alternatively be followed by a new phase of clear and coherent assessment of trade-offs between national government powers and economic integration, similar in spirit to the 1980s development that led to the Single Market and to monetary union, but better grounded in popular support.

Employment and social policies would need to be a core element of such renewed integration efforts. They are rooted in local politics and in old life-shaping traditions, and most Europeans would sooner forego integration than social policy, especially as the crisis has shaken faith in substitution of income stability with financial market access. For economic integration to be politically sustainable, it will sooner or later be necessary for member countries to coordinate and harmonize their employment and social policies.

Unfortunately, Europe's current economic and political conditions are not likely to shift its path away from inaction and towards coherent action. The policies and policymaking framework that could in principle reconcile growth and cohesion, in a context of coherent convergence of social models, require economic and political resources that do not appear to be in sight.

Policy reforms that combine greater economic flexibility with better social protection are not only too expensive for countries that even adoption of the *acquis communautaire* body of legislation has not equipped with effective administration tools and a suitable political climate. They are too expensive for any country that, in the absence of a proper federal fiscal budget, accepts full international market integration and the resulting erosion of national taxation and enforcement powers.

And the political process that could lead to harmonized and co-financed national policy systems requires a forward-looking, wide-ranging political climate that is very different from a current situation that sees voters preoccupied by their own local circumstances, and politicians preoccupied with achieving consensus in national media and elections that, even for the European Parliament, are contested along essentially national lines. Depending on the clarity of the political debate and on the identity of participants in that debate, supranational negotiations in this climate might harmfully result in a "race to the top" whereby excessively sophisticated and intrusive regulation is imposed on segments of the European economy that would benefit from flexibility.

The 2008 crisis, like all crises, puts the relevant choices in sharp relief and offers a welcome opportunity to refocus the policy discussion. The main implication of the theory and data reviewed in this paper is that it would be futile to pretend that all is or will be well. Economic integration is unavoidable, because integration of markets has always been and always will be the main source of economic growth. But it is not an automatic process: it entails hard choices, and requires forward-looking conciliation of conflicting narrow and short-run interests for the sake of broad, long-run benefits. Resolution of the tension between economic integration and social protection cannot be forced by negative technocratic reforms. It will realistically need to await development of a suitable European political debate. In the possibly long meantime, it will remain important to continue to assess and discuss the pros and cons of deregulation and economic integration.

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