Benoît Cœuré: Revisiting the European social contract

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the European Conference at Harvard "Europe 2.0 – taking the next step", Cambridge MA, 2 March 2013.

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Ladies and Gentlemen,

It is a great pleasure to attend the European Conference at Harvard. I will argue in my remarks that the management of the current crisis is at least as much about social stabilisation as it is about economic stabilisation. At the heart of the crisis, there is the challenge of redefining the social contract to safeguard the sustainability of Europe's social economy model. This model, set out in the Maastricht Treaty, notably aims to promote "social justice", "solidarity between generations" and "solidarity among Member States".[1] In my view, in order to ensure the sustainability of the social contract and to fulfil its promises both at national and European level, we need three elements: (i) a broad consensus on the definition of fairness, the forms of solidarity and the conditions attached to it; (ii) an institutional architecture ensuring its legitimacy and stability; and (iii) effective policy instruments.

As I will strive to show, a redefinition of the social contract in Europe is essential if we are to restore the sustainability of public policies as well as trust in the state's ability to positively influence economic outcomes. In other words, it is a matter of enhancing the sustainability of national social contracts in a reshaped European framework. Such an evolution will inevitably change the organisation and role of the state, as well as the institutional architecture of Economic and Monetary Union. But this does not mean moving away from the concept of the European social market economy. It means preserving it and consolidating it for the future.

Threats to the European social contract

The Great Recession – as it is often called – did not just have dire consequences for the economy as a whole. It also resulted in a threat to social cohesion, straining the social contract in its different dimensions.

The economic crisis has disproportionately affected the more vulnerable social groups. Low-skilled and young workers were the hardest hit, with a youth unemployment rate of more than 24% in January 2013 in the euro area as a whole (and as high as 55.5% in Spain and 38.7% in Italy). There are signs of a growing mismatch between worker attributes and job requirements across a number of euro area countries, consistent with an outward shift in the aggregate euro area Beveridge curve – i.e. a higher level of unemployment is associated with a given level of vacancies. Future growth depends on human capital being cultivated and expanded. That is threatened if too many workers remain unemployed for too long and lose their employability. The fiscal crisis has also endangered solidarity between generations by calling into question the ability of governments to raise enough revenues to afford the services they provide to the older generation. Finally, the crisis is exerting visible strains on the relationship among the people of Europe, with nationalist temptations that do not help to achieve a consensus on cooperative solutions or to allow a return to stability and growth.

[1] See http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0013:0046:en:PDF, Treaty on European Union, Article 3(3).

A rebalancing is inevitable and is now under way, but it is taking its toll. The longer that rebalancing takes, the higher the social costs. So it is crucial that a sense of urgency is maintained both at national and at European level.

The national level is still central to the definition of the social contract. Seen from within Europe, social contracts vary between Member States because of history and political preferences. Seen from further afield, however, it is apparent that there are common values in, and common challenges to, these national social contracts. We recognise explicitly those common values and sought to have them reflected in the Maastricht Treaty. They include freedom, peace, democracy, tolerance and – vital from a social perspective – solidarity. Upholding those values faces similar challenges across the continent, in particular the sustainability of public policies, which are an expression of the social contract.

Europe is also a political union: the social contract exists both within countries and across countries. The EU can in fact be regarded as perhaps the most ambitious example of the philosophical theories that underpin the social contract. As Thomas Hobbes remarked in his *Leviathan*[2], sovereign states are established to regulate social interactions and avoid the "war of all against all" that would prevail without the rule of law. States, however, compete with each other and therefore may even resort to arms in the absence of a supranational body imposing social contract laws. As was recognised by the Nobel Peace Prize, the European project was the key to ensuring that European states would move from war to peace. States, in Europe, pursued Kant's dream of constitutionalising international law to achieve lasting peace[3]. The doubts I mentioned above, as well as some stirrings of nationalism and protectionism, show that this dream is today at risk. The social contract needs revisiting.

The EU and, to an even larger extent, the euro area have gone beyond a combination of political and economic freedoms with a set of common rules and policies regulating the internal market. As a result, the EU and the euro area have started evolving from a microeconomic and legal construct to a fully-fledged economic union. The European social contract and the national social contracts thus no longer only complement each other: decisions at European level are having an increasing impact on national economic, social and political outcomes, while the externalities of national decisions are also getting larger.

In this context, the relationship between the European and national social contracts needs careful consideration. It can no longer rely on a "permissive consensus" and must rest on an institutional architecture that is both effective and legitimate. Moreover, as people increasingly see the impact of policy decisions with European relevance on individual outcomes, it needs to be emphasised that they – and not only the Member States – are partners in the European social contract. The contract will therefore need to involve citizens as much as Member States by making European political institutions more accountable. And the absence of a European *demos* cannot justify opposition to this project. Political fragmentation is the outcome, as much as it is the cause, of an impaired social contract.

The sustainability imperative

John Maynard Keynes famously said: "The long run is a misleading guide to current affairs. In the long run we are all dead".[4] And yet societies live in the long run. Today's choices influence tomorrow's outcomes, just as yesterday's decisions affect today's situation. This is even truer in a low-growth, low- interest-rate environment, which increases the discounted value of tomorrow's costs and benefits. The importance of the long run was widely shown by

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2 Th. Hobbes, *Leviathan: Or the Matter, Forme, and Power of a Commonwealth Ecclesiasticall and Civil*, 1651.

3 See J. Habermas, *Zur Verfassung Europas. Ein Essay*. Suhrkamp Verlag, 2011.

4 J.M. Keynes, "The Theory of Money and the Foreign Exchanges". A Tract on Monetary Reform, 1924.

the crisis. It was doubt about the accumulation and sustainability of debt which caused Greece and then Ireland and Portugal to lose access to markets and which associated the same risk with other Member States. And it is doubt about the *stab*ility of the political system as well as its *ab*ility to adopt legitimate, effective and sustainable public policies that worries citizens in many euro area countries.

This accumulation of debt has taken the form of financial asset bubbles and/or a drift in public debt, depending on the Member State. Warnings on the long-run sustainability of public finances were legion long before the crisis erupted. The build-up of untenable promises is not unique to Europe: the gap between public spending and nominal GDP growth was even larger in the US and Japan – where the average growth rate in government spending exceeded the average nominal GDP growth rate by 1½ and 2 percentage points respectively – than in the euro area, where this difference only amounted to around one-quarter of a percentage point.

In this sense, the crisis propelled us 20 years into the future: it revealed the unsustainable character of the unchecked accumulation of excessive liabilities in the private and public sectors. It forces us to confront challenges today that we thought we had more time to address. It has made the challenge even more daunting by debasing the pool of wealth that can be tapped to fund the social model. IMF projections for growth in advanced economies incorporate marked-down estimates for potential output relative to pre-crisis trends by 10% or more.[5] Such debasing calls for even bolder action to restore sustainability.

In this respect, a central bank can help to mitigate the impact of the crisis, but the steps it takes cannot be a permanent substitute for resolute action by governments. The central bank can buy time for political bodies to act, but it cannot buy enough time for them not to act.

In the crisis, the ECB's continued commitment to price stability and the integrity of the euro has been one of the few elements of certainty in a highly volatile and uncertain environment. This commitment to monetary stability is not only grounded in its economic merits but is also a cornerstone of the social contract. It protects poorer households from the dire effects of inflation on purchasing power. It ensures that no redistribution of wealth takes place that is unsanctioned by democratic processes, which is exactly what inflation does. And it buttresses political stability by avoiding the social unrest that unchecked inflation can cause.

Yet buying time is not indefinitely affordable. There is a cost to any delay in reforms. For as long as entry barriers hinder competition, as long as scarce budgetary resources are not channelled to support job creation and innovation, and as long as the burden of adjustment is disproportionately borne by the weakest in the society, these rigidities will not allow any rebasing of growth on a sustainable footing.

Just as long-term issues caused short-term problems, it is only by working on stabilising our economies and societies over the long term under an agreed contract that EU members will return to sustainable growth. Formulating a vision of our common future, rooted in democratic deliberation, is an urgent priority. It will provide an anchor for, and will enhance both the efficiency and legitimacy of, actions to confront the crisis. Last December's "Four Presidents' report" on the future of Economic and Monetary Union provides a blueprint for such a long-term vision.

Rebalancing the social contract

As political institutions are facing tough choices now because of the unsustainable policies of the past, the question of the distribution of the adjustment burden has become key. It implies

[5] International Monetary Fund, World Economic Outlook, Chapter 1, October 2012.

a redefinition of the social contract both at national level and at European level. What is at stake is nothing less than the sustainability of the European social market economy.

Within countries

The social contract first needs to be rebalanced within each country along two dimensions: between generations and within generations.

Excessive liabilities, even if supported by the market, imply a transfer of wealth from future generations to the current ones – a move that is decided unilaterally by the current generation. Seen from this perspective, fiscal constraints on governments do not appear as a loss of sovereignty but rather as the condition for preserving this very sovereignty over time. Likewise, stronger prudential rules are not a restriction on credit for productive investment, but a check on excessive risk-taking that would otherwise lead to financial instability.

On the fiscal front, effectively balancing the social contract between generations means creating room for stabilising policies in future downturns and protecting the coming generations by forcing the distributional debate to take place in the present. This balancing act focuses on the quality of public expenditures and implies that deficits are justified only to the extent that they deliver sufficient returns in terms of future fiscal revenues (through public investment supporting total factor productivity, for instance, or through the countercyclical impact of automatic stabilisers).

On the financial front, redefining the social contract between generations means realigning today's incentives so that tomorrow's fiscal policy is not threatened by financial dominance. Bailing out banks with taxpayers' money is indeed both unfair and a factor of moral hazard. A closer link therefore needs to be restored between the responsibility that arises out of excessive leverage and the costs associated with deleveraging.

The social contract also needs to be rebalanced between the generations alive today. There is ample room for a debate on the distributional impact of fiscal and economic decisions. Fairness, a concept which has a particular resonance in this university thanks to John Rawls[6], is a legitimate objective: solidarity can help to ensure that economic progress for the many is not achieved at the expense of impoverishing the least fortunate households or depriving them of their right to equal opportunities. A reduction of rents and entry barriers, which notably disadvantage younger men and women on the labour market, is in that sense fully consistent with the objective of fairness, while also making the economy more competitive by setting the right incentives.

National social contracts will continue to differ depending on the distributional choices made by each constituency. But Europeans now have to recognise that such choices need to be fully in line with the sustainability imperative.

Across countries

What does the social contract mean at European level? Here again, there are two dimensions to consider: a horizontal and a vertical dimension.

The horizontal dimension concerns the rights held and responsibilities borne by each Member State vis-à-vis its partners. The vertical dimension concerns the contract that exists between individual citizens and the European Union. Both need to be redefined in the light of the crisis.

The European social contract primarily binds all Member States of the European Union in the pursuit of the EU's objectives, as laid down in the Treaties. I will focus here on another and even more demanding contract, the one that binds the euro area countries. Sharing a single

[6] J. Rawls, *A Theory of Justice*, Harvard University Press, 1971.

currency creates tight links between markets and a high potential for contagion. This means that, at the horizontal level between euro area members, there is an obligation to respect what Isaiah Berlin called the concept of "negative liberty" – to conduct economic policies individually within limits that do not impinge upon the liberty of the other countries. There is another obligation to establish institutions and instruments that preserve the stability of the system taken as a whole. This is an implicit social contract which, before the crisis, was believed to be largely self-enforcing – if not by countries themselves, then by the discipline of financial markets. That this assumption was misplaced is now part of history.

So it is now clear that the contract between states has to be enforced more explicitly, by a stronger "neutral judge". If there are to be open markets and a shared currency between countries, there also have to be stronger common rules – and a stronger European Commission to enforce them. The strengthening of the euro area governance framework that has taken place in recent years is based on this understanding. The rules governing fiscal sustainability have become tougher, with more powers given to the Commission. For instance, the new fiscal compact requires all Member States to run a balanced budget over the cycle, similar to the responsibility of individual states in this country. Under the recently adopted "two-pack" legislation, the Commission will have to sign off on national budgets before they are approved by parliaments. This is a more intrusive role than the US federal government has vis-à-vis the states. Fiscal policies are at the centre of the contract because trust in the currency requires trust in the sovereign. Prolonged fiscal profligacy results in an impotent central bank and a debased currency. But the social contract is not only about fiscal policy. As the founding fathers of the euro very well understood, there is no monetary union without an economic union.

But to a certain extent, this aspect of the social contract between Member States was always understood, just not respected. Why should it be different now? The crisis is one explanation. But it is also the case that the incentives for Member States to abide by and enforce the rules have fundamentally changed. Before the crisis, the ultimate punishment for unsound national policies was believed to be default, in line with the principle of "no bail-out" enshrined in the EU Treaties. But we have seen during the crisis that the mere prospect of euro area countries failing creates negative and possibly self-fulfilling feedback loops, at great cost to the euro area. Without a European budget with a stabilising role, there *have* to be mechanisms for mutual support in the euro area. And as a condition, there *have* to be stronger economic governance and mutual control.

The basic premise of the new social contract between euro area countries, then, is that countries have to abide by the rules of the community, and when they do, they become eligible for mutual support. Euro area governments have earmarked €700 billion for countries that get into difficulty, a sum which can be lent against strong conditionality. And we are now seeing this concept being further developed *before* countries get into difficulty via the new idea of "reform contracts". Countries can decide to undertake difficult structural reforms and receive financial incentives in return. This benefits both parties to the contract by preserving the national character of the decision, while protecting the wider euro area by reducing long-term risks emanating from misguided economic policies.

However, a binding contract between Member States is only needed where national preferences still play a strong role.[7] For instance, it is necessary to work through reform contracts because countries have different approaches when it comes to labour relations or unemployment benefits, based on their own histories and cultures. But where national preferences play a weaker role, it makes sense to shift policies straight to the European level. Then we do not need to set rules and create incentives, because decisions are out of the hands of national authorities. This is the vertical dimension of the social contract in

7 See Ch. Tiebout, 1956, "A Pure Theory of Local Expenditures". Journal of Political Economy, 64:416–424.

Europe that I mentioned earlier – directly between the European level and the ordinary citizen.

Examples of this direct relationship include the regulatory roles of the EU: protecting people from the negative effects of monopolies, regulating against harmful products, and negotiating suitable trade agreements. The EU also plays a role in redistributing resources from richer to poorer regions through the cohesion funds, although these amount to only 0.36% of the Union's GDP.

Where the social contract between the European Union and its citizens needs to be reformed is in three areas.

First, as I already noted, where there is a role for national preferences, there is still a role for Europe to monitor national reform processes, facilitate policy learning and mobilise European instruments (such as the European budget, the European Investment Bank and structural funds) in support of national policies[8].

Second, those policies that belong naturally at European level should be placed there. The clearest example of this is the banking union. It is obvious that banks within a single currency area should be governed by the same rules, supervised in a consistent way, and wound up, if necessary, without pushing individual sovereigns into bankruptcy. It is also the best way to avoid the cost of financial sector excesses falling on taxpayers. This arrangement would also include the stabilisation mechanisms, such as the ESM, needed to ensure that the single currency area can resist extraordinary shocks. In addition, it could include, one day, common financial instruments, provided that control is exerted by the European level over national budgets, under the scrutiny of the European Parliament.

This leads me to the third area. The EU needs to find ways to improve its legitimacy. People in Europe generally feel disconnected from EU decision-making and question whether their voice is being heard. The "European public space" is notably underdeveloped. Decision-making has become more intergovernmental in the crisis, often bypassing the European Parliament. And this democratic deficit will only be exacerbated as the European level gains new powers in the ways I described above. In other words, if we are to strengthen fiscal, financial and economic union in Europe, we have to strengthen political union as well.

We already have a significant degree of political union in Europe – after all, we have been building the EU for more than 60 years. We have a European Parliament, which is directly elected on a proportional basis, like the House of Representatives here. We have a Council of Ministers, which represents the individual Member States, like the Senate. And increasingly, we see that national parliaments are becoming more and more involved in EU decision-making, for instance, by conducting greater scrutiny of Europe's crisis management or the content of European legislation.

The problem comes from the fact that these bodies are not seen as coherent by citizens. People do not know who really represents them in Europe. Is it their Prime Minister? Is it their Member of the European Parliament? Is it their local representative? Instead, they see a process controlled by elites with no truly democratic credentials. And this is, in fact, far from the truth: as I just showed, there are many ways in which elected representatives are involved in European decisions.

The social contract between the EU and its citizens needs to be rebalanced therefore in various ways: by connecting people more directly with the political process at European level; by making the European Parliament more relevant to peoples' lives; by giving national parliaments a more explicit role in holding European decision-makers to account; and by

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[8] See Iain Begg, *Social policies after the crisis*, ELIAMEP-Bruegel conference: Economic Governance in the Eurozone and the EU: Drawing lessons from the crisis, Cape Sounio, Athens, Greece, 10–13 June 2010.

airing the debates on the future of Europe more widely and transparently in the public sphere.

Conclusion

Let me conclude by saying that rebalancing the social contract also means rebalancing growth. For instance, eliminating rents and arbitrary barriers to entry is fair and at the same time frees up growth potential. Re-anchoring fiscal, financial and economic sustainability would allow governments to use fiscal policy counter-cyclically, to reduce interest payments and to reduce risk premia, thereby allowing monetary policy impulses to work better, and freeing fiscal resources that can be used for the public good. Likewise, balancing sustainability and solidarity within Member States and at European level can restore investors' confidence in the capacity of the EU and the euro area to resolve their problems. If this is achieved, the collective response to the crisis will have protected the sustainability of national social contracts while reinforcing the effectiveness and legitimacy of the European contract. It will have demonstrated that Europeans can live up to the motto of the European Union, and remain "united in diversity".

Thank you for your attention.