

**The Eurozone's 'Winner-Take-All' Political Economy:  
Institutional Choices, Policy Drift, and Diverging Patterns of Inequality**

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**Abstract:**

This paper offers an institutional explanation for the conflicting trends in inequality both across the Eurozone and within individual member states since the late 1990s. The paper argues that the introduction of the euro created different economic policy incentives for peripheral (or 'mixed market economy,' MME) and core (or 'coordinated market economy,' CME) member states. First, the euro's institutional design was a political choice biased toward deflationary adjustment policies in times of crisis, disproportionately benefiting creditors and capital owners, and leading to falling incomes and higher unemployment in the periphery. Second, the institutional incentives of the Eurozone are the opposite for export-driven CMEs and demand-led MMEs during booms and downturns. A 'winner-take-all, loser-pay-all' outcome – where the Eurozone's richer countries gained at the expense of the poorer ones, while at the same time widening domestic inequality in the periphery – was the result of political choices favoring capital over labor and creditors over debtors, made worse by economic policy drift at the European level, the lack of national democratic choice in the periphery, and the growing importance of organized financial interests in Brussels.

**Keywords:** capital, drift, Eurozone, inequality, institutions, labor, organized interests.

## 1. Introduction: The Euro, Its Crisis, and Returning Patterns of Inequality

The euro crisis, the most significant aftershock of the global financial crisis of 2008, has wreaked havoc on the process of European integration (Parsons and Matthijs 2015). The crisis has also generated a renewed focus on rising income inequality and increasing poverty levels in the Eurozone's Mediterranean countries, as well as Ireland, caused by the policies of austerity and structural reform that were forced upon those countries by the 'Troika,' the institutional vehicle combining the European Commission, the ECB, and the IMF (Blyth 2013). At the same time, the euro crisis has fostered the return of the previously waning gap in living standards between prospering Northern countries like Germany and crisis-ridden Southern member states like Greece and Spain.

What soon erroneously came to be known as the European "sovereign debt crisis,"<sup>1</sup> and the EU's economic policy responses to it, have brought an abrupt end to the ongoing and still very much incomplete process of economic convergence between the coordinated market economies (CMEs) of the Eurozone's 'Northern' core and the mixed market economies (MMEs) of 'Southern' periphery (Hall and Soskice 2001; Hancké, Rhodes and Thatcher 2008).<sup>2</sup> More disturbing for the EU as a whole, the crisis has in fact reversed much of the progress made in the 1990s and 2000s in reducing national income differences between its members. For example, while the ratio of per capita income of lagging Greece vis-à-vis relatively affluent Germany had been steadily increasing since the early 1990s to a high of 0.65 in 2007, it worsened again to 0.47 by 2013, a number close to the prevailing ratio in the early 1990s. And it is not just a Greek tragedy: the corresponding ratios for Italy's and Spain's per capita income vis-à-vis Germany's were 0.87 and 0.83 in 2007, and 0.74 and 0.72 in 2013, respectively (Matthijs and Blyth 2015: 258). Additionally, rates of unemployment have been moving in opposite directions, with record low unemployment rates in Germany contrasted to all-time highs in Greece and Spain (IMF 2014). These trends are even more outspoken if one considers levels of youth unemployment. This adverse evolution has made a caricature of the old EU mantra of 'ever closer union.'

Furthermore, the crisis and the multiple social movements it spawned all over Europe in 2011, from *Occupy London* in Britain to the *Indignados* in Portugal and Spain, have also led to a renewed focus by academics and policy makers alike on the substantial widening in income inequality within Europe's national contexts. This trend is particularly striking

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<sup>1</sup> The euro crisis was in many ways the logical consequence of the US financial crisis, i.e. a private sector banking crisis that necessitated a public sector bailout, which left sovereigns, especially in Europe's periphery, mired in debt. See Matthijs and Blyth (2015), p. 5.

<sup>2</sup> Note that I will refer to the countries of Germany, Finland, Luxembourg, and the Netherlands as either "the North," "the core countries," "CMEs or Coordinated Market Economies" or the "surplus" countries. And instead of using the popular acronym the "PIIGS," I will refer to the countries of Greece, Spain, Ireland, Italy and Portugal as "the South," "the periphery," "MMEs or Mixed Market Economies" or the "deficit" countries (even though Ireland, obviously, is not a part of Southern Europe; also, it's closer to a liberal market economy or LME than the Mediterranean countries, but nevertheless also can be considered a mixed market economy). The other original Eurozone members, such as France, Belgium, and Austria, are not included because they really have elements of both North and South. The countries that have joined the EMU since 2002, including Slovenia, Slovakia, Malta, Cyprus, Estonia, Latvia, and Lithuania, are not included in this analysis.

in traditionally more ‘egalitarian’ societies such as Germany, Denmark and Sweden – all of which have experienced a marked increase in their national levels of inequality since the early 1990s – but also in already unequal societies like Britain, where inequality has only risen further since the crisis hit in 2008.<sup>3</sup> The higher levels of inequality create the perception both at home and abroad of dwindling European solidarity and a continent adrift and in decline (Jones 2012). This new situation calls into question the future of Europe’s much-vaunted social model and strength of its universal welfare state, both of which are central to the EU’s ‘soft power’ projection to the wider world (Menon 2014).

In sum, Europe – and the Eurozone in particular – has been experiencing two types of widening inequality, both of which seem to have a ‘winner-take-all’ pattern to them (Hacker and Pierson 2010a, 2010b). First, there has been widening domestic inequality at the level of the European nation state, with a steep overall rise in inequality in Northern Europe since the early 1990s, though a noticeable reversal occurred since the 2008 global financial crisis (GFC); and a somewhat distinct trend in Southern Europe, with inequality only starting to rise after 2008, having seen a steep fall in inequality during the two decades prior to 2008.<sup>4</sup> Second, since the GFC, there has been a widening gap between North and South at the supranational level, i.e. within the Eurozone, with the North – especially Germany – being the big ‘winners’ of the crisis – measured in higher incomes per capita, lower inequality, and increased employment levels – and the South being the main ‘losers’ of the crisis – as observed in falling living standards, rising inequality, and steep rises in unemployment (Reisenbichler and Morgan 2013). Furthermore, capital owners and creditors in the North have gained disproportionately and at the expense of wage earners and debtors in the South between 2008 and 2013.<sup>5</sup>

What has caused these opposing trends? This paper will explain the return of the North-South gap in the Eurozone as well as the fluctuating and seemingly contradictory levels of inequality in both Northern and Southern member states since the introduction of the euro from the lens of the euro’s institutional design and the economic policies that were part of that design. The political choices made during the early 1990s, tying together different varieties of capitalism within one monetary union (Hall 2014, Regan 2014), instituting government policies – both monetary and fiscal – with a deflationary bias would eventually result in distinct ‘winner-take-all, loser-pay-all’ dynamics. In the inter-European member state game, the cards were stacked in favor of the more prosperous Northern countries; while in the intra-European member state game, the institutional odds favored capital owners and creditors over wage earners and debtors. I will apply the lessons of Hacker and Pierson’s ‘Winner-Take-All Politics’ framework for the United States to the European context focusing on the role of policy drift at the EU level, the decline of the importance of electoral politics at the national level, as well as the increasing power of organized financial interests in Brussels.

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<sup>3</sup> See the papers by Anderson and Hassel, Svallfors, and Hopkin in this special issue.

<sup>4</sup> Though, admittedly, the countries of Southern Europe started out with much higher levels than Northern Europe in the late 1980s.

<sup>5</sup> On the role of law during the Eurozone crisis in Southern Europe, see also the paper by Cioffi and Dubin in this special issue.

In order to do so, the paper will proceed in six sections. Section two will define exactly what is meant by income inequality, lay out Europe's inequality puzzle in greater detail, and summarize the paper's main argument. Section three briefly reviews the existing literature, both in economics and political science, that has delved into the causes of widening inequality in the advanced industrial countries since the early 1980s. Section four will develop a theoretical framework to help us understand the underlying incentive structure of Europe's multi-state currency union, including a new typology combining method and burden of adjustment, and describe the differing policy incentives core and periphery member states faced during 'normal' and 'crisis' times. Section five will give some empirical evidence of the theoretical framework, contrasting the experience of Europe's CMEs with its MMEs. Section six will then explain the changing patterns of inequality using Hacker and Pierson's 'winner-take-all' lens, focusing on drift, the declining role of elections, and the power of financial interests. The seventh section concludes.

## **2. Europe's Inequality Puzzle**

Any paper dealing with inequality needs to start by carefully defining what is meant by it. There are significant differences between individual labor income inequality, household income inequality (which include capital income and returns from savings), and wealth inequality (which include the total stock of assets). For example, wealth inequality in Germany is substantially higher than the rest of Europe, as opposed to household income inequality, where Germany scores well below the average (De Grauwe and Ji 2013). It is also important to distinguish between mean and median income levels, as they could be very different and lead policy makers to draw the wrong conclusions. The OECD highlights the differences between wage dispersion among salaried employees (where gender differences could play a big role), individual earnings inequality among all workers (which includes the self-employed) versus the entire working-age population (including those who are inactive or unemployed), household pre-tax 'market' income inequality versus household post-tax 'disposable' income inequality, and household 'adjusted disposable' income inequality (taking into account the actual value of public services like education and health) (OECD 2011a: 26).

In this paper, I will focus on *disposable household inequality*, which adjusts overall market incomes for taxes and transfers, and is corrected for household size and consumer price index. The main advantage of using this measure is that there is plenty of standardized comparative data available across Europe either through the databases of Eurostat or the OECD. The measure also focuses on actual 'outcomes,' as it takes into account most government policies enacted to decrease market inequality, such as progressive income taxation, real estate taxes, and taxes on capital gains, even though it omits the value of publicly provided services, which could be very important for the lower end of the income distribution. Increases in inequality have been largely driven by changes in the overall distribution of wages and salaries, which account for about three quarters of all household incomes (OECD 2011a: 22). At the higher end of the distribution, however, especially at the very top, returns to capital such as overall

appreciation of their existing capital stock, dividends, and interest payments on savings, account for a much higher (and growing) share of household income than at the bottom.

There exists broad consensus in both the academic literature and the economic policy world that income inequality has been systematically rising in most Anglo-Saxon economies starting in the late 1970s, while most continental European countries – with a few exceptions such as France and Belgium – followed suit in the late 1980s (OECD 2011a). While average real household incomes for the whole OECD population rose by 1.7 percent annually between the mid-1980s and late 2000s, the top decile of the income distribution saw its average household income grow by 2.0 percent year-on-year, while the bottom decile only saw an increase of 1.4 percent year-on-year (OECD 2011b).

However, these averages mask significant national differences. Not all OECD members experienced widening inequality within that time period. Some saw the top decile’s share of the pie expand much faster than others. Table 1 shows the average annual percentage increase in real household income for the total population, and compares and contrasts it to the income trends for the bottom decile and the top decile between the mid-1980s and the late 2000s for selected Eurozone countries. One can see that the trends in the Eurozone’s Northern CMEs and Southern MMEs were actually very different. The bottom 10 percent of households in Germany, Finland, Luxembourg, and the Netherlands all saw their incomes grow significantly less than the top 10 percent, while the reverse was true for Ireland, Greece, Spain, and Portugal. Italy seems to be the exception to the North-South divide as it behaved more like a “Northern” country in that the bottom decile there did also much worse than the top decile (OECD 2011a: 23).<sup>6</sup>

Table 1: Trends in Real Household Income by Income Group (mid-1980s to late 2000s)<sup>7</sup>

		<b>Total Population</b>	<b>Bottom 10%</b>	<b>Top 10%</b>	<b>Difference b/w Top and Bottom 10%</b>
<b>NORTH (CMEs)</b>	Germany	0.9	0.1	1.6	<b>+1.5</b>
	Finland	1.7	1.2	2.5	<b>+1.3</b>
	Netherlands	1.4	0.5	1.6	<b>+1.1</b>
	Luxembourg	2.2	1.5	2.9	<b>+1.4</b>
<b>SOUTH (MMEs)</b>	Ireland	3.6	3.9	2.5	<b>-1.4</b>
	Spain	3.1	3.9	2.5	<b>-1.4</b>
	Greece	2.1	3.4	1.8	<b>-1.6</b>
	Portugal	2.0	3.6	1.1	<b>-2.5</b>
	Italy	0.8	0.2	1.1	<b>+0.9</b>

Upon closer inspection of the national inequality data provided by Eurostat, however, which uses the GINI coefficient rather than income growth per decile, there appears to be an even more sinister inequality puzzle within the context of the Eurozone. Rather than

<sup>6</sup> Note that Italy, like Belgium, has its own North-South gap, and has characteristics of CMEs and MMEs.

<sup>7</sup> Data from OECD (2011a), p. 23.

an overall increase in income inequality, the peculiar pattern within the Eurozone has been a tale of two very different ‘Europes.’ During the period starting with the establishment of the European Central Bank (ECB) in 1998 and the onset of the global financial crisis in 2008, the Northern Eurozone’s CMEs of Germany, Finland, the Netherlands, and Luxembourg saw rising income inequality, as measured by their countries’ GINI coefficients. The Southern and peripheral MMEs, including Ireland, Spain, Greece, Italy, and Portugal actually saw falling (or constant) levels of income inequality.<sup>8</sup>

Table 2: Selected Eurozone Countries' Change in Income Inequality (GINI Coefficient)<sup>9</sup>

		% Change (1998-2008)	% Change (2008-2012)
<b>“NORTH” (Core)</b>	Germany	+20.80	-6.29
	Finland	+19.55	-1.52
	Netherlands	+10.40	-7.97
	Luxembourg	+6.54	+1.08
<b>“SOUTH” (Periphery)</b>	Ireland	-12.06	0.00
	Spain	-6.18	+9.72
	Greece	-4.57	+2.69
	Italy	0.00	+2.90
	Portugal	-3.24	-3.63

Between 2008 and 2012, on the other hand, the situation went into reverse. The core Eurozone members saw their levels of income inequality fall, with the exception of Luxembourg, which experienced a small increase of just over one percent. The periphery countries, with the exception of Portugal and Ireland, all recorded increases in their GINI coefficients since the crisis. The exact figures are summarized in table 2. So far, this empirical puzzle has been largely ignored in the academic literature, and therefore in need of further exploration.

In other words, after a period of broad convergence between North and South – both in GDP per capita and in overall levels of inequality – the onset of the global financial crisis has triggered a significant regression back to the levels of the early 1990s. The logical question to ask is: what can explain these diverging tendencies in income per capita and the reversal of the converging trend in national levels of inequality since 2008? I will offer an institutional explanation for the conflicting movements in income inequality across the Eurozone since the late 1990s, by showing that the introduction of the single currency, the euro, in 1999, created radically different policy incentives for peripheral countries on the one hand and core countries on the other, as well as unequal choices during periods of crisis.

<sup>8</sup> Italy’s GINI coefficient between 1998 and 2008 remained constant at 0.31. See Eurostat, 2014.

<sup>9</sup> All data are taken from Eurostat (2014) and the calculations are my own.

The argument of this paper goes as follows. Between 1998 and 2008, lower interest rates due to massive capital inflows in the Southern MMEs fueled faster growth and consumption, increasing wages and lowering overall returns to capital, which resulted in falling income inequality in the South. By contrast, the only way for the richer Northern core to remain competitive within the Economic and Monetary Union (EMU) was to practice relative wage restraint and enact structural reforms, initially decreasing the return to labor and increasing the return to capital, leading to widening income inequality in the North during the same time period. The expected result during these ‘normal’ times was relative economic convergence between the member states of the Eurozone – both in GDP per capita (due to faster growth in the periphery), and in overall levels of income inequality.<sup>10</sup>

Between 2008 and 2013, however, the Southern MMEs *had no choice* but to respond to the euro crisis by a series of deflationary spending, price and wage cuts. These policies resulted in deep and long recessions, as well as widening income inequality. The Northern CMEs *had the choice* to respond to the crisis by instituting moderately inflationary policies domestically, which led to increasing wages and a lower return to capital, causing declining levels in domestic inequality. The logical outcome of the euro crisis was to bring about renewed divergence between its member states, both in GDP per capita, and in national levels of inequality. To some extent, the crisis has catapulted Europe back to the early 1990s, when the North-South income gap on the continent was significant and domestic income inequality in peripheral Europe a lot higher compared to the countries of the core.

It is worth noting that the national ‘winners’ – including Germany, the Netherlands, Finland, and Luxembourg – get to choose, and have more flexibility in fiscal and labor market policies, while the national ‘losers’ – including Ireland and the Mediterranean countries – do not. Moreover, this ‘supranational’ winner-loser dynamic also results in greater inequality *within* the loser countries, but *not* within the winner countries. The Eurozone crisis, in other words, has sprouted a rather bleak and multi-level inequality equilibrium. While workers in the North suffered prior to the crisis, and had it relatively good after the crisis, the situation in the South was the reverse. Owners of capital, on the other hand, prospered more in the North than in the South prior to the crisis, but both were bailed out after the crisis.

In this paper, I will argue that this ‘winner-take-all, loser-pay-all’ outcome in the Eurozone – where the richer countries gained at the expense of the poorer ones, while at the same time widening domestic inequality in the periphery – was the result of political choices that systematically favored capital over labor in economic policy. I will show this by analyzing three processes of “winner-take-all politics” first identified in the U.S. context by Jacob Hacker and Paul Pierson (Hacker and Pierson 2010a). They include (1) ‘drift’ in economic policy at the EU level, (2) the decline of the importance of national democratic choice within EMU (especially in the periphery), and (3) the increased importance of organized financial interests in Brussels and the EU.

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<sup>10</sup> Note that this convergence depended on the North having been much more egalitarian than the South to begin with, starting in the 1980s and early 1990s.

### 3. Inequality in Europe: Brief Review of the Literature

#### *a. Economics Accounts*

Standard explanations in the economics literature for the increase in the overall level of inequality in most European countries tend to emphasize, in order of importance, the role of skill-biased technological change (SBTC), the effects of increased international trade and globalization, the impact of immigration, and the growing returns to higher education (Kierzenkowski and Koske 2013).

The most influential explanation in the economics literature, as put forward by Katz and Murphy (1992), remains that widening inequality across the OECD has been driven by an increase in the relative demand for skills, which is caused by exogenous and skill-biased technological change. Acemoglu and Autor (2010) refined this view in 2010, making a crucial distinction between tasks and skills. What became known as the ‘routinization hypothesis’ posited that computerization mainly affected people with so-called ‘medium’ skills – like accountants, legal clerks, administrative assistants, and medical laboratory technicians – who were more likely to move downward rather than upward in the task distribution after losing their job. This put greater downward pressure on low-skilled workers’ wages compared to the wages of high-skilled workers and hence induced a polarization in the overall income distribution. The routinization hypothesis also helps to explain the ‘missing middle’ or squeezed middle class.

Other accounts have focused on the effects of international trade and factor movements, though it is doubtful whether trade exposure to low-wage countries is sufficient in explaining the large increases in inequality (IMF 2007). The consensus seems to be that only about 10 to 15 percent of the rise in income inequality across the OECD is due to international trade (Krugman 2008). “Offshoring” or outsourcing of services abroad has also been found to reinforce labor market polarization, as mainly routinized tasks are outsourced to low-wage countries (Feenstra and Hanson 1996). Immigration overall is found to have a rather small impact on native workers, while the average level of educational attainment is found to be negatively correlated with wage inequality (Kierzenkowski and Koske 2013). According to the Council on Foreign Relations, the median earnings of a worker with a bachelor’s degree were 65 percent higher than the earnings of a high school graduate, with workers holding professional degrees such as law, medicine and business enjoying a 161 percent wage premium (Markovich 2014).

Most recently, Thomas Piketty (2014) explained rising income inequality in the industrialized world as the inevitable result of the return of what he considers to be a fundamental law of capitalism, namely the idea that  $r$  (the rate of return to capital) over the long term is systematically larger than  $g$  (the overall rate of growth), making it capitalism’s innate “force for divergence” (Piketty 2014: 25). Piketty’s main point is that the falling levels of inequality during *Les Trente Glorieuses* were an exceptional period in history and that capital’s share of income, which started to grow again from the late 1970s onwards, will only continue to expand in the absence of any political intervention.



However, as important as Piketty's thesis is, it lacks a clear political theory. As Jonathan Hopkin (2014) has pointed out, "the very economic forces Piketty describes are embedded in institutional arrangements which can only be properly understood as political phenomena" (Hopkin 2014).

### ***b. Political Science Accounts***

So, while the economics literature does a great job at explaining overall upward trends in income inequality in the developed world, it falls short in addressing why certain economies have seen much larger increases than others, while others have recorded falling levels of inequality, or why the income gains in some countries tend to be more heavily concentrated at the very top of the distribution. After all, SBTC and increasing trade flows are 'global' phenomena, which for the most part impact all advanced industrial countries to a similar extent.

The political science literature is much thinner than the economics literature on the subject of inequality, and differs substantially based on the country that is being studied. General large-N studies focusing on labor market policies and institutions have found that the impact of declining unionization and a lower relative minimum wage mainly affects the lower end of the income distribution, while government employment can be a mitigating factor and lead to reduced inequality (Pontussen, Rueda, and Way 2002). Wallerstein (1999) considered institutional and political determinants of pay inequality in 16 countries from 1980 and 1992, and found that the most important factor in explaining pay dispersion was the level of wage setting. The more wage coordination is achieved collectively, the more egalitarian will be the overall distribution of pay. Wallerstein also stressed the importance of trade unions and the share of the labor force that is covered by collective bargaining agreements for achieving more equitable distributions of income.

The OECD study *Divided We Stand* also focused on institutions, and confirmed that product and labor market regulations and institutions have become weaker over time (OECD 2011a: 30). Weaker employment protection legislation, a less progressive income tax, and declining unemployment benefit replacement rates are the most significant in influencing inequality levels, together with 'upskilling' or increased education levels. Pointedly, however, the OECD found that these factors were more important than trade integration, the deregulation of foreign direct investment, or technological progress.

Other political accounts, many of them exclusively looking at income trends in the United States, have focused on median voter preferences ("politics as electoral spectacle") or the role of organized interests and policy drift ("politics as organized combat"). Hacker and Pierson (2010a), who emphasize the central role of special interests in influencing legislation that systematically skews the income distribution in favor of the top 1 percent in the United States, deserve much credit for their efforts to bring politics back into the conversation. While Hacker and Pierson are careful to emphasize the organizational transformation of *American* politics, there are direct lessons that can be drawn and causal mechanisms that can be applied to the diverging trends in inequality in the Eurozone. Especially their focus on policy drift (continuing with the

same policies even as the original circumstances have changed), the decline of the importance of electoral politics, as well as their emphasis on organized interests as a major driver for policy change, may have broader relevance and application.

But before we can apply Hacker and Pierson’s insights for the U.S. to the case of the Eurozone, we first have to further develop our theoretical argument in order to better understand Europe’s puzzling trends in income inequality. After illustrating the institutional dynamics behind inter- and intra-European inequality trends and showing additional empirical evidence, we will be able to parse out some of the political drivers behind the euro’s institutional choices and policy incentives.

#### 4. Theoretical Framework: Method versus Burden of Adjustment and Institutional Incentive Structure in a Multi-State Currency Union

Europe’s decision at Maastricht in December 1991 to embark on the uncertain road of monetary union had profound consequences for national economic policymaking, not least by taking the option of external currency realignment off the table. Furthermore, by delegating the authority over monetary policy to an independent central bank with a strong bias towards very low inflation, and fiscal policy discretion hemmed in by the Stability and Growth Pact (SGP) that was signed in July 1997, joining the euro severely limited a member state’s options in managing their economy. Since all economic policy decisions are by nature fundamentally ‘political’ and ‘distributive,’ joining the euro was never a decision free of ideology or politics: as we will see, it favored capital over labor, and creditors over debtors (Friedman 2014). Going forward, any adjustment strategy during hard times would hurt the weaker groups disproportionately more.

##### a. *Understanding the Return of the North-South Gap: Method versus Burden of Adjustment during Crises*

Figure 1: Typology: Method versus Burden of Adjustment

		<i>Burden of Adjustment (“Who Loses?”)</i>	
		Debtors & Workers	Creditors & Capital Owners
<i>Method of Adjustment (“How?”)</i>	Internal	<b>AUSTERITY</b> <i>‘Deflationary’ Measures</i>	<b>DEMAND STIMULUS</b> <i>‘Inflationary’ Measures</i>
	External	<b>DEVALUATION</b> <i>Currency Realignment</i>	<b>DEFAULT</b> <i>Debt restructuring</i>

A useful way to approach the political problem of economic adjustment is to differentiate between the ‘method of adjustment’ a government will embrace in the face of economic difficulties, and which socio-economic groups – either domestic or international – will suffer the main ‘burden of adjustment’ (Simmons 1991). Figure 1 proposes a typology on how to think about the four main possible policy options or ‘shock absorbers’ in an economy. The method of adjustment can either be mostly via ‘internal’ (austerity or

demand stimulus) or via ‘external’ channels (currency devaluation or debt default). The main burden of adjustment can be borne by either debtors or creditors (national or foreign), and additionally, by either domestic workers or capital owners (even though, many workers are owners of capital, and plenty of capital owners receive a significant portion of their income from wages).

The first potential national policy choice – *austerity* – in the top-left quadrant, usually involves a combination of public spending cuts and tax increases on the fiscal side and interest rate increases on the monetary side. Austerity is transmitted into the macro economy mostly via internal channels, i.e. by affecting domestic economic activity in the short term and lowering wages and prices in the medium term. The adjustment burden in the case of austerity falls on both debtors, who see the real value of the debts they owe increase, and on domestic workers, who tend to have relatively little savings, and might suffer either through lower nominal wages (and fixed rent or mortgage payments), cuts in benefits, less generous government services, or higher unemployment. Creditors and capital owners, on the other hand, will see the real value of their savings and outstanding loans increase, and will generally be less negatively affected. The expected result of austerity will be to widen income inequality between rich and poor, as the poor rely mainly on wages or government benefits for their income, and tend to have higher outstanding debts vis-à-vis their overall wealth, while the rich in general get a much higher percentage of their income from capital compared to the rest of society.

The second possible policy choice in the upper-right quadrant – *demand stimulus* – is the other ‘internal’ method of adjustment. Demand stimulus usually entails direct increases in government spending and cuts in taxes on the fiscal side, or interest rate cuts on the monetary side. Demand stimulus normally has the short-to-medium term effect of stimulating domestic economic activity by pushing up aggregate demand, and raising prices and nominal wages in the medium term. In this case, the burden of adjustment will fall disproportionately on creditors and capital owners, who will experience a drop in the real value of their capital and savings, and a lower nominal return. Debtors and workers are likely to benefit, either through a lowering of the real value of their outstanding loans, higher nominal wages, lower unemployment, or better employment prospects. The expected result of demand stimulus is therefore lower income inequality between rich and poor, as the bottom of the income distribution sees its wages go up faster than the top of the distribution, which also sees a lower return to capital.

The two other domestic policy choices in the bottom row of table 1 primarily affect economic activity through the balance of payments. For that reason, I refer to these as the two ‘external’ methods of adjustment. In the bottom-left quadrant, a government can choose a policy of *devaluation*, i.e. to lower the value of its currency vis-à-vis its main trading partners. Devaluation boosts exports and makes domestic firms more competitive with foreign firms, but lowers the purchasing power parity of workers and pensioners, whose nominal incomes are fixed. The latter bear the brunt of the adjustment since devaluation usually goes hand in hand with higher prices of imported goods and services. Debtors who have outstanding loans in foreign currencies will also be significantly worse off. However, devaluation is a bit more complicated and does not so neatly fit into the

quadrant, since workers in export industries will likely keep their jobs, and might even see wages increase, and therefore stand to benefit from devaluation. And obviously capital owners will also see their purchasing power damaged by devaluation, unless they have invested most of their capital abroad. So, devaluation tends to hit debtors and workers more, but also harms capital owners, depending on their consumption and investment patterns. It is probably the response that spreads the burden of adjustment the most equally across society.

The final policy choice – *default* – signifies that the government chooses not to make good on its promise to pay back its outstanding sovereign debt, either partially or not at all, which will mainly affect the creditors to the government and capital owners in the short term. In the case of debt restructuring, the government’s creditors could either be domestic citizens or foreign nationals. If foreign nationals hold most of the outstanding debt, the default option becomes considerably more attractive, given that the domestic fallout from default will be relatively contained, passing on the burden of adjustment to foreigners. This final option usually leads to a deep recession caused by massive capital flight, which will affect all socio-economic groups in society, and is usually considered by far the worst option of all four, and is only ever used as a last resort.

Between 1945 and the mid-1970s – a period of fast growth and falling inequality all over the advanced industrial world – countries could utilize all four economic policy tools (or a combination thereof). What Ruggie (1982) called the “embedded liberal” compromise, which was struck in 1944 at Bretton Woods, had incorporated the main lessons from the Great Depression and allowed countries to combine internal (full employment) with external (balance of payments) equilibrium through a system of fixed exchange rates, capital controls and domestic discretion over monetary and fiscal policy. Nixon’s closure of the gold window in 1971 heralded the beginning of a new era of flexible exchange rates, deregulation, and rising international capital flows. As a result, most industrialized countries – including the U.S., Japan, and Britain, and later the emerging economies of China, India and Brazil – kept all four policy tools firmly on their menus. While everybody talked the talk of market discipline and strict economic policy rules during the early 1990s, in practice they were all careful enough to preserve their domestic fiscal and monetary policy levers with a variety of capital controls, exchange rate measures, and downright prohibitions (Matthijs 2012). In other words, they all preserved the main tenets of the embedded liberal compromise (Helleiner 2014).

The exception was continental Europe, where France and Germany, along with other members of the then European Community (EC), gradually surrendered their national economic sovereignty and eventually agreed to tie their economic fate together by creating a single currency – the euro – in the early 1990s. With the euro’s adoption, EMU members put in place a forever-fixed exchange rate to supplant their national currencies, controlled by an independent central bank focused exclusively on price stability, but with no de facto lender of last resort functions or common debt instrument. By doing so, European leaders removed one policy tool, devaluation, from their menus of choice, and made the other, demand stimulus, a lot harder by signing onto a Stability Pact with strict fiscal rules. Given the growing importance of international financial markets, and the

importance of sovereign credit ratings for the liquidity of most countries' bond markets, default also became a much less appealing option. In effect, this left austerity as the only realistic policy option (Blyth 2013, Matthijs 2014b).

By constructing the euro, European elites 'disembedded' the Bretton Woods compromise from their national politics, but without putting in place any supranational fiscal transfer mechanisms to guarantee solidarity in times of stress. During a crisis, international commitments would take precedence over domestic concerns, just like they did during the interwar gold standard (Eichengreen 1996). Most advanced industrial countries – from the U.S. to Britain, and Japan to Brazil – could spread the burden of adjustment over their political economy's different constituencies, making the politics of adjustment during both good times and hard times a lot more sustainable and less overtly 'political.' In the Eurozone, on the other hand, as we will see in the next subsection, there are two different institutional dynamics. The economic policy tool a country can wield depends on a country's 'structural' position in the currency union (core versus periphery) or what type of market economy it is (CME vs. MME) as well as the particular phase of the business cycle the Eurozone as a whole finds itself in (expansionary or contractionary).

***b. Explaining Divergent Trends in Domestic Inequality: Different Institutional Incentives for Economic Policy in Core and Periphery***

While Eurozone members' hands have been tied a lot more severely than non-Eurozone members since the late 1990s, especially when it comes to 'external' adjustment, the institutional incentives are very different for Northern core and Southern periphery, as summarized in figure 2, where 'w' stands for the real wage rate (or return to labor), 'r' for the real interest rate (or return to capital), and 'g' for the overall growth rate.

In the early 1990s, wages were a lot higher in the North compared to the South, while interest rates were a lot higher in the South compared to the North. The formation of a currency union, and the preparations towards this end in the 1990s, led to large capital flows from North to South in search of higher yields, and in the secure knowledge that they no longer faced any exchange rate risk, as devaluation was now firmly off the table, and no rational investor truly believed the no-bailout clause (Matthijs 2014a, Jones 2012). Furthermore, as capital flows accelerated from North to South, the core countries realized that the only realistic way to compete in a currency union with the lower wage periphery members was to restrain growth in their overall wages and prices (Johnston and Hancké 2009, Hancké 2013). So, due to the euro's institutional design, Northern countries saw their best option as pursuing broadly 'deflationary' policies, or austerity, which would lead to lower wages, higher profits, and therefore higher return on capital, together with the already slightly higher returns on capital that had been invested in the Southern periphery. Not surprisingly, the outcome during 'normal' times in the North was widening income inequality.

The periphery, on the other hand, initially saw falling interest rates, thanks to the capital inflows from the North, where returns were lower due to the diminishing returns of a much higher capital stock. Lower interest rates fueled investment and consumption, and

allowed the periphery to pursue ‘inflationary’ policies by discretion during normal economic times, resulting in higher wages (Hancké 2013).<sup>11</sup> The combination of higher wages and lower returns to capital in the periphery during a period of boom in the business cycle logically led to falling levels of inequality in the periphery. Higher rates of growth in the South and lower rates of growth in the North had the overall effect of broad convergence in absolute levels of GDP per capita. Applying Piketty (2014) his basic framework, we observe  $r > g$  in the core during boom times, leading to increasing levels of inequality, and  $g > r$  in the periphery, leading to falling levels of inequality.

Figure 2: Economic Policy Incentive Structure in a Currency Union

*Phase in the Currency Union’s Overall Business Cycle*

		Upturn/Boom	Downturn/Recession
<i>Member State “Position” in the Currency Union</i>	“Core CMEs” (e.g. Germany)	<b>‘Deflationary Policy’</b> <i>(By institutional design)</i>  $w \downarrow, r \uparrow$ $r > g$  <b>Domestic Inequality <math>\uparrow</math></b>	<b>‘Inflationary Policy’</b> <i>(By choice/discretion)</i>  $w \uparrow, r \downarrow$ $g > r$  <b>Domestic Inequality <math>\downarrow</math></b>
	“Periphery MMEs” (e.g. Spain)	<b>‘Inflationary Policy’</b> <i>(By choice/discretion)</i>  $w \uparrow, r \downarrow$ $g > r$  <b>Domestic Inequality <math>\downarrow</math></b>	<b>‘Deflationary Policy’</b> <i>(By institutional design)</i>  $w \downarrow, r \uparrow$ $r > g$  <b>Domestic Inequality <math>\uparrow</math></b>

The story is reversed during downturns or recessions, however. The MMEs of the periphery now have no choice but to follow broadly deflationary policies – by institutional design as we have seen earlier. This lowers wages and increases returns to capital through higher interest rates on the countries’ sovereign bonds. Spending cuts and tax increases mainly hurt wage earners and workers who rely on government services much more than wealthier capital owners. In addition, structural reforms initially have the effect of increasing the level of unemployment, especially for the young and the least skilled workers who tend to be concentrated at the bottom of the income distribution. The outcome of these policies is to make the recession worse, as ‘r’ shoots up and ‘g’ turns negative, resulting in higher levels of inequality.

The core of a currency union during a downturn has more discretion, thanks to falling interest rates due to capital flight to safety from the South, which gives them a little more

<sup>11</sup> Note that there was a significant difference in the South between the ‘competitive’ manufacturing sector, where wages were restrained by international competition, while the sheltered, public, and non-tradable services sectors did see significant wage increases. See also Hopkin 2015.

room to maneuver. This can result in ‘r’ being slightly lower than ‘g’ and therefore result in lower inequality. The CMEs of the core can choose to let their automatic stabilizers kick in, and even enact some stimulus and mildly inflationary policies, which will have the effect of increasing wages. Of course, they do not have to follow this path, but at least both firms and governments have the agency to do so if that is what they choose. The main point is that falling rates of return to capital and relatively higher wages in the core during downturns in the currency union can actually lead to falling levels of inequality. Positive rates of growth in the North and negative growth rates in the South lead to renewed divergence in overall standards of living.

The main point of figure 2 is to make the distinction between deflationary policies – which are not chosen by the national government in question, but have to be implemented quasi-automatically and by institutional design – and inflationary policies – which governments can enact by discretion if they choose to do so. Whether the inflationary path is actually taken by the core countries will depend on the economic ideas held by the elites in charge of those economies and on how much fiscal room for maneuver there is (Blyth 2002, Matthijs 2011 and 2014a).

## **5. North versus South: From Convergence to Divergence (1990 – 2013)**

Let me summarize the previous section in concise terms. When the currency union is in its overall phase of economic expansion, there will be convergence in both standards of living and inequality levels between core and periphery, with the periphery gaining mostly at the expense of the core. During periods of economic downturn, there will be divergence in standards of living and inequality levels between core and periphery, with the core gaining at the expense of the periphery. The theoretical framework of figure 2 broadly corresponds to the inequality data in table 2. In this section, I will provide further evidence and put some more empirical flesh on the theoretical bones, before

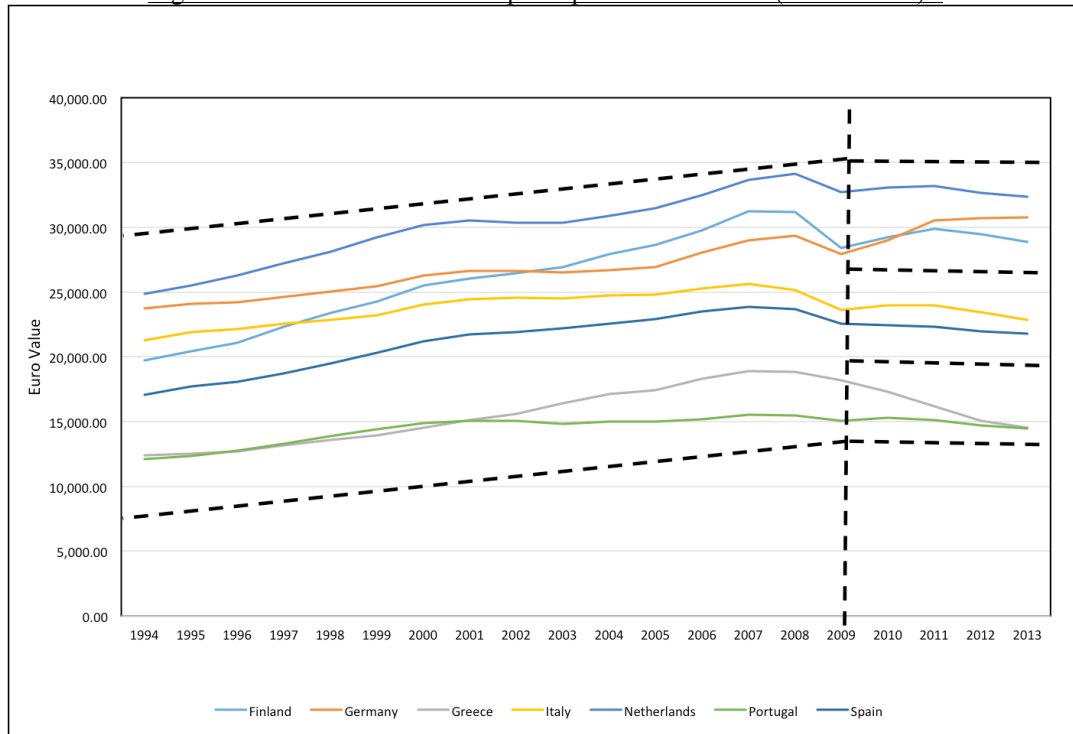
### ***a. Eurozone: Between-Country Economic Convergence and Divergence***

From the mid-1990s onwards, after the 1992-93 EMS crises, it became clear to financial market participants that the European Union was serious about introducing its common currency by the end of the decade. In anticipation of further economic convergence, and with all future EMU members implementing austerity measures to bring their economies into line with the Maastricht Treaty’s ‘convergence criteria,’ Northern capital – ever in search of higher yields – started to flow into Southern Europe, taking advantage of the pending evaporation of any future exchange rate risk and acting on the assumption that the fiscal and structural reforms underway in the 1990s would be consolidated by the euro’s launch. From a financial markets point of view, this resulted in yield convergence of sovereign bonds, which held until well after the global financial crisis hit in 2008.

Figure 3 shows the evolution in real GDP per capita in the Eurozone starting in 1994 for three ‘Northern’ and four ‘Southern’ member states. Let us compare Spain and Germany for example, as they are both in the ‘middle’ of their respective groups when it comes to living standards. While the gap in income per capita between Germany and Spain in 1994 was €6,696, it had fallen to €5,181 by 2007. But due to the effects of the GFC and the

euro crisis, the gap had widened again in just six years to €9,000 by 2013 – a much bigger gap than back in 1994. The gap between the Netherlands and Greece – the North’s best and the South’s worst performer – was €14,749 in 2007 and €17,786 in 2013.

Figure 3: Evolution in Real GDP per capita in 2005 Euros (1994 – 2013)<sup>12</sup>



The convergence and divergence between North and South is even more striking when one looks at unemployment. Ireland, with an unemployment rate of 19 percent in 1991, and Spain, with an unemployment rate of over 24 percent in 1994, saw their respective rates gradually fall to around 4.5 percent and 8.2 percent by 2007, when their unemployment situation went into stark reverse, back to highs of 14.7 percent in Ireland in 2012 and 26.9 percent in Spain in 2013. In 2007, all eight countries (both core and periphery) had an unemployment rate somewhere between a low of 3.5 percent (the Netherlands) and a high of 8.7 percent (Germany). By 2013, the North-South gap was back in unemployment. The four Northern countries all had unemployment rates of 8 percent or below, with Germany at 5.6 percent, Luxembourg at 6.5 percent, the Netherlands at 7.1 percent and Finland at 8 percent. The five periphery states saw their unemployment rates at 12.5 percent in Italy, 13.7 percent in Ireland, 17.4 percent in Portugal, 26.9 percent in Spain, and 27 percent in Greece (IMF 2014).

### ***b. Eurozone: Within-Country Inequality Convergence and Divergence***

On the issue of inequality within countries, figure 4 shows the evolution of the adjusted wage share as a percentage of the total economy for both core and periphery Europe, based on data from the European Commission. The left hand panel has the data of three

<sup>12</sup> IMF (2014), constant 2005 euro prices.



EMU core countries (Finland, Germany, and the Netherlands). One can observe a fall of the overall wage share from well above 60 percent in all three countries in the early to mid 1990s to a low of around 55 percent in 2007. Since the crisis, remarkably, wage shares as a percentage of total GDP have recovered to close to 60 percent again in the North. The evidence in the right hand panel showing the periphery countries is a bit more mixed. Ireland, Italy, Spain and Greece all see their wage share decline starting in the early 1990s, bottom out in the early 2000s (mid 2000s for Spain), and then peak between 55 and 60 percent in 2007. With the exception of Italy, all see the overall wage share fall quite steeply after 2008. Greece is the most extreme case, with a wage-to-GDP share of 62.4 percent in 1990, down to 48 percent in 2013, and Ireland dropping from above 60 percent in the early 1990s to just above 50 percent in 2013.

Figure 4: Evolution of Adjusted Wage Share (% of Total Economy): Core vs. Periphery (1990-2013)<sup>13</sup>

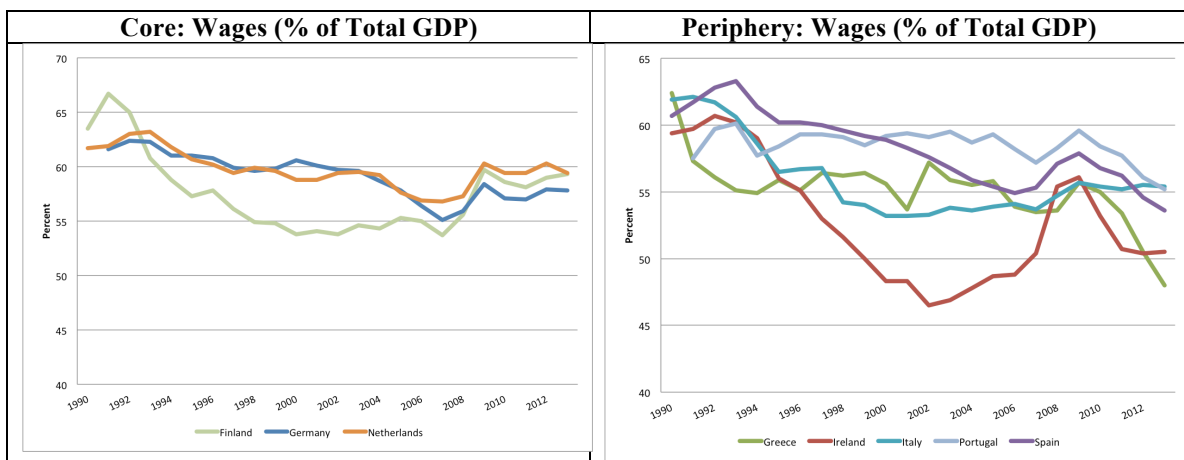
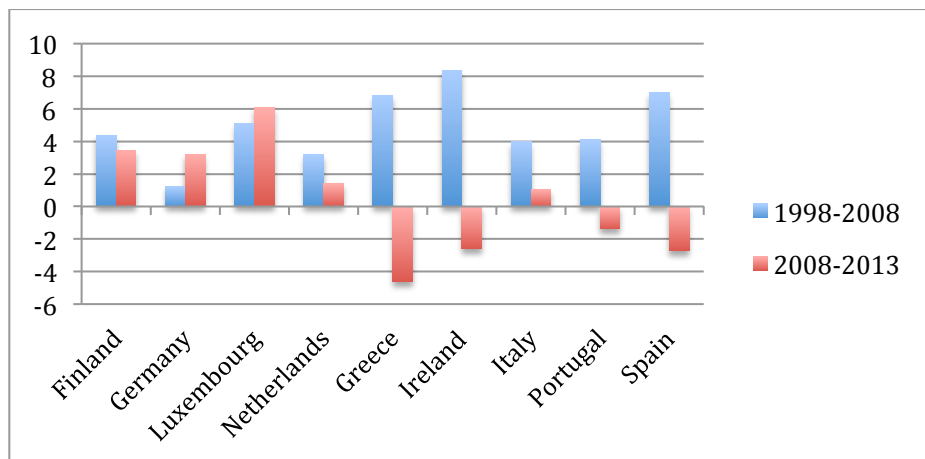


Figure 5: Real Wage Growth in CMEs vs. MMEs (1998-2013)<sup>14</sup>



<sup>13</sup> European Commission (2014)

<sup>14</sup> Measured as (Nominal Wage Growth – Labor Productivity Growth) (period average). Source: European Commission (2014): *Ameco Database*.

While the falling overall share of wages in the economy can explain the widening levels of income inequality in most European countries during the 1990s, the trend is in opposing directions during the 2000s, with further decreasing wage shares in the North deepening inequality until 2008 and improving wage shares in the South lowering inequality. After 2008, the reverse is true. Figure 5 shows real wage growth between 1998 and 2013 for both Northern CMEs and Southern MMEs. It is immediately clear that real wages in the South rose much faster than in the North during the upturn of the business cycle, while most of the periphery saw real wage cuts during the bust. Figure 5 also underscores faster wage growth in Germany during the euro crisis, compared to the decade before that. Bob Hancké (2013) has argued that it was much easier for CMEs during the boom to keep wages in check, while MMEs lacked the central wage bargaining mechanisms CMEs had, leading to much faster wage growth in the South's public and sheltered sectors, though not in their manufacturing sectors, where wages were kept in check by international competition.

The evolution in the cost of capital in the Eurozone is well known by now, and does not need to be repeated here. The cost of capital in the periphery was much higher in the South compared to the North in the 1990s, saw broad convergence after the introduction of the euro, and has seen a wide divergence again since 2010. Starting with widening yield spreads between MMEs and CMEs, plus a monetary transmission mechanism that has been broken since 2010 (with the ECB trying to do whatever it takes to fix it), the real cost of capital in the North is again much lower than in the South (Matthijs 2014a).

Figure 6: Growth Rate ( $g$ ) versus Return to Capital ( $r$ ) in Germany, Spain, and Greece (1998-2013)<sup>15</sup>

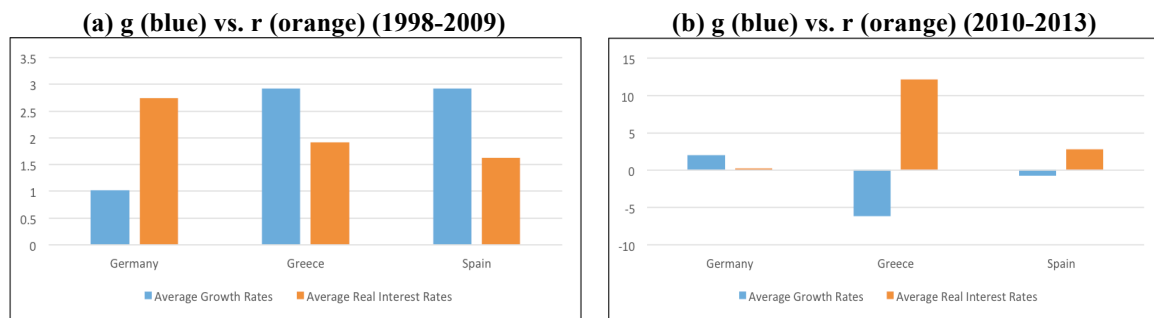


Figure 6 shows additional evidence of the ‘Piketty effect’ in the Eurozone for Germany, Greece and Spain. Germany saw an average growth rate of just 1 percent during the decade prior to the euro crisis, well below its average real interest rate (or return to capital) which was above 2.5 percent ( $g < r$ ), while since 2010, Germany has seen an average growth rate of just over 2 percent with a very low real interest rate of just 0.25 percent ( $g > r$ ). The exact reverse was true for Greece and Spain. Both periphery countries experienced faster growth rates of close to 3 percent during the boom, with interest rates between 1.5 and 2 percent ( $g > r$ ). Since the crisis, both countries have seen negative growth rates, and much higher real interest rates ( $r > g$ ).

<sup>15</sup> European Commission (2014), IMF (2014), OECD (2014), and own calculations.

## 6. Europe's Inequality Dynamics through the Lens of 'Winner-Take-All' Politics

The economic policies that were implemented – both at the EU and national levels – throughout the late 1990s and 2000s were the result of certain choices that were made during the early 1990s, and have been reinforced since then. Those choices at the time were deeply political and would have serious distributive consequences over time. As Jonathan Hopkin has argued, rather than a purely economic phenomenon of growth rates ( $g$ ) and interest rates ( $r$ ), the “forces Piketty describes are embedded in institutional arrangements which can only be properly understood as political phenomena (Hopkin 2014). Especially the policy responses to the global financial crisis and euro crisis were not mere functional reactions to objective economic problems. Certain choices were made, and those choices would favor certain groups in the political economy over others. So, how can we better understand why those specific choices were made in the first place?

Hacker and Pierson (2010a, 2010b) showed quite convincingly in the case of the U.S. that the widening levels of inequality – especially the concentration of wealth at the very top – were also due to inherently political dynamics. Three of the processes they identified are particularly relevant in the case of the Eurozone, as they either led to the introduction of those particular policies or helped in sustaining them, even as macroeconomic conditions took a dramatic turn for the worse. They are (1) the role of economic policy ‘drift,’ (2) the significant decline of democratic choice at the national level or ‘politics as electoral spectacle’ (especially in the case of the periphery), and (3) the key role of the financial lobby in Brussels, representing the interests of capital owners, or the ‘politics as organized combat’ (Hacker and Pierson 2010a: 169).

First, government economic policy – both at the national level and at the EU level – played a central role in driving the curious inequality patterns across Europe. Not only did the single mandate of the ECB, with an exclusive monetary policy focus on low inflation, have a bias in favor of capital owners and creditors, the same was true for fiscal policy, which due to the rules of the Stability and Growth Pact also had a consistently deflationary bias. Once the euro crisis hit, and the Troika was put in charge of implementing long-term structural reforms in the periphery, both labor market and financial policies likewise systematically favored capital over labor (Cioffi and Dubin, 2014). While the euro crisis debate in Germany contrasted ‘saintly’ Northern creditors with ‘sinning’ Southern debtors (Fourcade 2013, Matthijs and McNamara 2014), the policy drift that firmly kept holding on to the narrow mandate of the ECB, as well as the strengthening of the rules of the SGP through the new Fiscal Pact, was far from neutral, as it they had serious redistributive implications. The EU policy response to the crisis – combining austerity with structural reform in the South – meant that the burden of adjustment would disproportionately fall on the periphery.

Second, the onset of the euro crisis signaled the decline of the importance of national elections, especially in the periphery, as observed in the rise of protest parties on both left and right, and the end of long-standing and relatively stable patterns of political competition between center-left and center-right (Hopkin 2015). Most dramatically in

Italy and Greece, democratic governments were replaced with former EU officials in November 2011, with Mario Monti and Lucas Papademos taking the helm of technocratic governments in Rome and Athens respectively. Both Monti and Papademos were in charge of implementing the austerity cuts and structural reforms the Troika had demanded in return for direct financial support (in the case of Greece), and tacit support by the ECB (in the case of Italy). Even in France, where the socialist François Hollande ousted sitting Gaullist president Nicolas Sarkozy on the promise to reinstate broadly inflationary policies to stimulate growth, it became clear after a couple of months that new president Hollande would have to continue on the austere path of his predecessor and implement long-term structural reform policies.

With ‘grand coalitions’ between center-left and center-right mathematically needed to ‘stay the course’ and avoid financial ruin, this also marked the end of any real democratic choice in Europe’s peripheral countries, sowing the seeds for the continued rise of extremist parties. Rather than taking place in the context of national elections, the real battle during the euro crisis took place in Brussels and Berlin, where the debate was mainly held between EU policymakers, technocrats and financial experts.

Finally, while the power of financial interests and big business lobbies in Brussels is a topic that thus far has been under researched, there is some preliminary evidence that points to its growing power. According to Mahoney (2007), the U.S. institutional context of direct elections combined with private campaign finance is much more likely to lead to ‘winner-take-all’ outcomes biased in favor of wealthier business interests, compared to the EU. Mahoney shows how the lack of those institutional characteristics in Brussels often leads “to much more balanced policy compromises with more advocates achieving some of their policy goals” (Mahoney 2007: 35). There are however strong reasons to believe that the financial industry in the EU has gained in influence since 2007, at the expense of organized labor. Not only has the financial lobby gained in clout since the GFC, they also occupy a privileged position in many of the EU’s official advisory boards.

A joint 2014 report by Corporate Europe Observatory, the Austrian Federal Chamber of Labor and the Austrian Trade Union Federation has found that the financial industry spends a yearly total of €120 million on lobbying activities in Brussels and employs well over 1,700 lobbyists (Wolf et al 2014). With over 700 official organizations in Brussels, the financial industry outnumbers civil society organizations and labor unions by a factor of more than seven, “with an even stronger dominance when numbers of staff and lobbying expenses are taken into account” (Wolf et al 2014: 3). The report’s (conservative) estimate is that the financial lobby outspends all the other organizations lobbying the EU “by a factor of more than 30.” Furthermore, Wolf et al find that in 15 of the 17 expert groups that the European Commission regularly consults business and industry interests dominated.

In sum, some of the ‘winner-take-all’ dynamics that Hacker and Pierson observe in the United States also seem to be present at the EU level. Since the crisis, EU policies have not only been characterized by drift – i.e. instituting the same austerity policies of the 1990s boom during conditions of recession between 2010 and 2013 – but EU politics has

also slowly moved away from ‘electoral spectacle’ to ‘organized combat,’ pitting capital against labor, and debtors against creditors. All three dynamics described in this section warrant more detailed future research.

## **7. Conclusion: Winner-Take-All, Loser-Pay-All Europe?**

This paper has proposed an institutional explanation for the contradictory trends in income inequality in the Eurozone since the late 1990s: while inequality further widened in the North of Europe, following the lead of the United States and the United Kingdom, inequality actually started to decline in EMU’s periphery in the early 2000s, with both trends reversing after 2008. Going beyond the ‘standard’ explanations in economics and political science, this paper has argued that the particular institutional design of the euro gave different incentives for economic policymaking in both core and periphery, with significant consequences for overall standards of living and national levels of inequality.

During the upward phase of the currency union’s business cycle, this led to broad convergence in the Eurozone, with faster growth in the periphery, and slower growth in the core. Wage suppression and higher returns to capital in the North led to widening inequality, while wage increases and lower returns to capital in the South resulted in falling levels of inequality. During an economic downturn, the story went into reverse. The “winner-take-all” northern CMEs have benefited from the euro crisis through lower interest rates, faster growth, and relatively mild austerity measures and reforms, with some maneuvering room for modest wage increases. Not only is growth faster in the North, inequality levels also improved. The “loser-pay-all” southern MMEs have suffered from higher debt-to-GDP ratios, much higher interest rates, negative growth, and Brussels-imposed austerity measures and structural reforms. Not only have standards of living fallen for everyone, inequality has also gotten worse in the periphery.

These opposing trends in income inequality should be seen and explained as deeply political phenomena based on public policy choices that systematically favored the interests of capital owners over workers, and creditors over debtors. The three main ‘winner-take-all’ dynamics that are behind Europe’s inequality patterns are policy drift, the decline of the importance of national elections in the periphery in policymaking, and the rise of organized interests in Brussels, and the increased power of financial lobbying firms in the European Union. Since these patterns of inequality were by no means inevitable economically, they could also be reversed by political choice. The point is that they were not.

The irony is that the creation of the euro in 1991 at Maastricht was meant to further unite Europe by bringing about economic convergence, thereby preserving the European social model. The first decade of the euro seemed to deliver the goods. However, with the onset of the euro crisis, the Eurozone has experienced renewed economic divergence, questioning not only the sustainability of the European social model, but also the future viability of Economic and Monetary Union itself.

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