

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

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Abstract

This article offers an institutional explanation for the conflicting trends in income inequality both across the Eurozone and within its member states. It argues that the euro's introduction created different economic policy incentives for peripheral and core members. First, the euro's design was a political choice skewed toward deflationary adjustment policies in hard times, leading to falling incomes and employment in the periphery. Second, the institutional incentives of the Eurozone are the opposite for export-driven coordinated market economies and demand-led mixed market economies during booms and downturns, respectively. During the euro crisis, the Eurozone's Northern countries gained at the expense of the Southern ones, while at the same time seeing lower domestic inequality compared to increased inequality in the periphery. This diverging pattern of European inequality was exacerbated by EU economic policy drift, the lack of any real national democratic choice in the periphery, and the growing importance of organized financial interests in Brussels.

Keywords

capital, economic policy, euro, inequality, institutions, labor, varieties of capitalism

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The Euro, Its Crisis, and Recurring 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.¹ 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 in Ireland, caused by the policies of austerity and structural reform that were forced on those countries by the "Troika"—the institutional vehicle combining the European Commission, the European Central Bank, and the International Monetary Fund. At the same time, the euro crisis has fostered the return of the previously narrowing gap in living standards between prospering Northern countries, such as Germany and Austria, and crisis-ridden Southern member states, such as Greece and Spain.

What soon came erroneously to be known as the European "sovereign debt" crisis² and the European Union's economic policy responses to it have brought an abrupt end to the ongoing and still very incomplete process of economic convergence between the coordinated market economies (CMEs) of the Eurozone's Northern core and the mixed market economies (MMEs) of the Eurozone's Southern periphery.³ The unsustainably large external imbalances that triggered the euro crisis in the spring of 2010 laid bare the incompatibility of two different growth regimes or "varieties of capitalism" within the Eurozone.⁴

On the one hand, the less inflation-prone and export-led CMEs—Austria, Germany, Finland, the Netherlands, and Luxembourg—managed to escape the wrath of the bond market vigilantes. They practiced relative wage control during the boom, institutionalized by central bargaining mechanisms between unions, employers, and the

government, and emerged from the crisis relatively unscathed. On the other hand, the demand-led MMEs that are predominant in the euro periphery—Greece, Ireland, and Portugal, but also Italy and Spain—found themselves in the eye of the storm and became subject to intense speculative pressure by financial markets. Those countries in general were more inflation-prone in the relative absence of wage control mechanisms and the presence of political coalitions sheltering their domestic non-tradable sectors.⁵ The MMEs would be subjected to harsh austerity measures by the European Union and end up bearing the brunt of economic adjustment.⁶

More disturbing for the European Union 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 real per capita income of lagging Greece vis-à-vis relatively affluent Germany had been steadily increasing from 0.54 in 1994 to a high of 0.71 in 2007, it worsened again to 0.50 by 2014, well below 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 0.92 and 0.78 in 2007, but down to just 0.75 and 0.67 in 2014, respectively.⁷ In addition, rates of unemployment have been moving in opposite directions, with record low unemployment rates in Germany and Austria contrasted to all-time highs in Greece and Spain. These trends are even more conspicuous if one considers levels of youth unemployment. This adverse evolution has made a travesty of the old EU mantra of “ever closer union.”⁸

Furthermore, the crisis and the multiple social movements it spawned all over Europe in 2011, from Occupy London in Britain to *Il Movimento Cinque Stelle* (M5S) in Italy, and *Los 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.⁹ This trend is particularly striking 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 such as Britain, where inequality has only risen further since the crisis hit in 2008.¹⁰ The higher levels of inequality create the perception both at home and abroad of dwindling European solidarity and a continent adrift and in decline.¹¹ This new situation calls into question the future of Europe’s much-vaunted social model and strength and sustainability of its welfare state, both of which are central to the European Union’s “soft power” projection onto the wider world.¹²

In effect, Europe—and the Eurozone in particular—has been experiencing two types of widening inequality, both of which seem to contain a clear “winner-take-all” dynamic.¹³ First, there has been widening domestic inequality at the level of the European nation state, with a steep overall rise in inequality in the core since the early 1990s, though a noticeable reversal occurred since the 2008 global financial crisis (GFC); and a somewhat distinct trend in the periphery, where inequality only started to rise after 2008, after having seen a rather steep fall during the two decades prior to 2008.¹⁴ Second, since the GFC, there has been a widening gap between Northern core and Southern periphery countries within the Eurozone, with the North (especially Germany) being the big “winner” of the crisis—measured in higher incomes per capita, lower inequality, and increased employment levels—and the South (especially Greece) being the main “loser” of the crisis—as observed in falling living standards, rising inequality, and steep rises in unemployment.¹⁵ 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 2014.

What has caused these opposing trends? This article will explain the return of the North-South gap in the Eurozone as well as the fluctuating patterns of inequality in both Northern and Southern member states since the introduction of the euro starting from the euro's institutional design and the economic policies that were at the heart of that design. The political choices made during the early 1990s, tying together different varieties of capitalism within one monetary union,¹⁶ instituting government policies—both monetary and fiscal—with an outright deflationary bias, would eventually result in distinct “winner-take-all, loser-pay-all” dynamics, which put Jacob Hacker and Paul Pierson's “Winner-Take-All Politics” framework for the United States in a distinctly new light.¹⁷ The role of policy drift at the EU level, the decline of the importance of electoral politics at the national European level (especially in the South), as well as the increasing power of organized financial interests in Brussels, further combined to create an unintended political dynamic, in which the cards would be stacked in favor of the more prosperous Northern countries. At the same time, the policies governing the euro would advance the interests of creditors and capital owners at the expense of debtors and wage earners.

The main contribution of this article is to show how the institutional design of the euro adopted at Maastricht in 1992 was not a mere technocratic compromise but a political choice, with distributive consequences that would generate these tenacious winner-take-all dynamics. To begin, I define income inequality, lay out Europe's inequality puzzle in greater empirical detail, and sum up the main argument. After a brief review of the existing literature on widening inequality in the advanced industrial

countries since the early 1980s, I develop the conceptual tools for understanding diverse adjustment policy responses, and map out the differing incentives core and periphery countries faced during “normal” and “hard” times. Empirical data follow, showing the contrasting experience of Europe’s CMEs and MMEs. The penultimate section explains the changing patterns of inequality using Hacker and Pierson’s “winner-take-all” framework, by focusing on EU policy drift, the declining importance of national electoral politics, and the growing power of financial interests. The final section concludes.

Europe’s Inequality Puzzle

Any article 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 includes capital income and returns from savings), and wealth inequality (which includes 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 European average.¹⁸ 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 such as education and healthcare).¹⁹

In this article, I will focus on *disposable household inequality*, which adjusts overall market incomes for taxes and transfers, and is corrected for household size and

the cost of living. The main advantage of using this measure is that there are plenty of standardized comparative data available across Europe through the databases of Eurostat, the IMF, or the OECD. The measure also focuses on actual “outcomes,” as it takes into account most government policies enacted to correct for inequalities created by the market—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.²⁰ 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, whereas most continental European countries—with a few exceptions such as France and Belgium—followed suit in the late 1980s.²¹ 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, and the bottom decile saw an increase of only 1.4 percent year on year.²² However, these averages mask significant *national* differences. Not all OECD members experienced widening inequality within the period from the mid-1980s to the late 2000s. Some countries saw the top decile’s share of the income pie expand much faster than others.

The Puzzle

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 and top decile between the mid-1980s and the late 2000s for all twelve original Eurozone members (Euro-12 countries), classified under “North,” “Center,” and “South.” One can see from the table that the trends in the Eurozone’s Northern CMEs and Southern MMEs were very different. The bottom 10 percent of households in Austria, Finland, Germany, the Netherlands, and Luxembourg all saw their incomes grow significantly less than the top 10 percent, while the reverse was true for Greece, Ireland, Spain, and Portugal.²³

Table 1. Average Annual Growth in Real Household Income, Mid-1980s to Late 2000s (Euro-12 Countries).

	Total Population	Bottom Decile	Top Decile	% Difference between Top and Bottom Deciles
North—Core				
Austria	1.3	0.6	1.1	+0.5
Finland	1.7	1.2	2.5	+1.3
Germany	0.9	0.1	1.6	+1.5
Netherlands	1.4	0.5	1.6	+1.1
Luxembourg	2.2	1.5	2.9	+1.4
Center—Middle				
Belgium	1.1	1.7	1.2	−0.5
France	1.2	1.6	1.3	−0.3
Italy	0.8	0.2	1.1	+0.9
South—Periphery				
Greece	2.1	3.4	1.8	−1.6
Ireland	3.6	3.9	2.5	−1.4
Spain	3.1	3.9	2.5	−1.4
Portugal	2.0	3.6	1.1	−2.5

Source: OECD, *Divided We Stand: Why Inequality Keeps Rising* (Paris: OECD Publishing, 2011), 23.

On 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 a more sinister inequality puzzle within the context of the Eurozone between 1998 and 2014 (Table 2). Rather than an overall increase in income inequality,

the peculiar pattern within the Eurozone has been a tale of two very different “Europes.” On the one hand, 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 (including Belgium and France) saw income inequality rise at an accelerated pace compared to the 1980s and 1990s. The Southern and peripheral MMEs by contrast, saw steadily falling levels of income inequality (or broadly constant levels in the case of Italy).

Table 2. Change in Income Inequality since 1998 (GINI Coefficient) (Euro-12 Countries).

	1998 Level	2008 Level	2013/4 Level	Percentage Change (1998–2008)	Percentage Change (2008–2013/4)
North—CMEs					
Austria	24	27.7	27	+15.42	–2.53
Finland	22	26.3	25.4	+19.55	–3.42
Germany	25	30.2	29.7	+20.80	–1.66
Netherlands	25	27.6	25.1	+10.40	–9.06
Luxembourg	26	27.7	28.7	+6.54	+3.61
Center					
Belgium	27	27.5	25.9	+1.85	–5.82
France	28	29.8	29.2	+6.43	–2.01
Italy	31	31	32.8	0.00	+5.81
Southern—MMEs					
Greece	35	33.4	34.5	–4.57	+3.29
Ireland	34	29.9	30.7	–12.06	+2.68
Spain	34	31.9	34.7	–6.18	+8.78
Portugal	37	35.8	34.2	–3.24	–4.47

Note: The 2013 level = 2014 level for Luxembourg, France, Greece, Ireland, and Spain.

Source: European Commission, *Eurostat Online Databank* (Brussels, 2015), and author’s calculations.

Between 2008 and 2013/4, on the other hand, the situation went completely into reverse. The core Eurozone members saw their levels of income inequality fall, with the notable exception of Luxembourg. The periphery countries, with the exception of Portugal, all recorded increases in their Gini coefficients. So, whereas Table 1 reveals the differences in broader long-term trends in income inequality between North and South

between the mid-1980s and late 2000s, underlining the very different long-term patterns in Europe, Table 2 shows that this broad pattern was overturned after 2008.

Table 3. Change in s90/s10 Income Inequality Ratios since 1998 (Euro-12 Countries).

	1998 Level	2008 Level	2013/4 Level	Percentage Change (2003–08)	Percentage Change (2008–13/4)
North—CMEs					
Austria	5	6.6	6.6	+32.00	0.00
Finland	4.8	5.5	5.2	+14.58	-5.45
Germany	5.3	8.1	7.4	+52.83	-8.64
Netherlands	5.3	6.7	5.4	+26.42	-19.40
Luxembourg	5.3	6.2	7.3	+16.98	+17.74
Center					
Belgium	5.5	6.4	5.6	+16.36	-12.50
France	7.3	7	7.1	-4.11	+1.43
Italy	7.7	8.8	11.8	+14.29	+34.09
South—MMEs					
Greece	13	10.6	12.7	-18.46	+19.81
Ireland	9	6.6	7.2	-26.67	+9.09
Spain	12.5	10.6	13.7	-15.20	+29.25
Portugal	14	10	10.6	-28.57	+6.00

Note: The 2013 level = 2014 level for Luxembourg, France, Greece, Ireland, and Spain.

Source: European Commission, *Eurostat Online Databank* (Brussels, 2015), and author's calculations.

As a robustness check, Table 3 presents data for the s90/s10 ratio—the share of all income received by the top 10 percent (s90) divided by the share of the bottom 10 percent (s10)—for the original twelve Eurozone countries. The overall pattern seems to be confirmed: inequality increased substantially in the North and decreased in the South between 1998 and 2008, while decreasing in the North and increasing in the South from 2008 to 2013/4 (again with the exception of Luxembourg).²⁴ Thus far, this empirical puzzle has been largely ignored and is therefore in need of further exploration.

To sum up our puzzle, after a sustained period of broad convergence between North and South—both in GDP per capita and in overall domestic levels of inequality—the onset of the global financial crisis has triggered a significant regression back to levels not seen in Europe since the early 1990s.

The Argument

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 a political and 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 created radically different policy incentives for peripheral countries on the one hand and core countries on the other, as well as unequal choices and levels of policy discretion during periods of crisis. The article rejects the mainstream view that the euro crisis was caused by either fiscal profligacy or a lack of competitiveness on the part of the periphery countries, which supposedly caused them to lose their core export market shares, thereby creating chronic current account deficits that grew unsustainably large.²⁵ Instead, I focus on the free movement of capital within a currency union that lacks a financial union, which suggests the euro crisis was systemic rather than caused by budgetary recklessness or eroding national competitiveness.²⁶

The argument 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. This also left some room for fiscal policy discretion in the periphery. By contrast, the only way for the richer Northern core countries to remain competitive within the Economic and Monetary Union (EMU) was to practice relative wage restraint and enact structural reforms. This initially decreased the return to labor and increased the return to capital, widening income inequality in the North during that period. Unlike in the periphery, there was significantly less space for economic policy choice. The expected result during these normal or good times was relative economic

convergence between the member states of the Eurozone—both in GDP per capita (due to faster growth in the lagging periphery) and in overall levels of income inequality (compare and contrast the Gini coefficients between 1998 and 2008 in Table 2, or the s90/s10 ratios between 1998 and 2008 in Table 3).²⁷

Between 2008 and 2013/4, however, the crisis-ridden 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 were much less affected by the crisis and therefore *had the choice* to respond to the crisis by instituting moderately inflationary policies domestically by letting their automatic stabilizers kick in. This resulted in relatively higher wages and a lower return to capital, which led in turn to declining levels of domestic inequality.²⁸ The inevitable 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 late 1980s, when the North-South income gap on the European 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 “winners”—including Austria, Germany, the Netherlands, Finland, and Luxembourg—get to choose how to respond to the crisis, and have more flexibility in fiscal and labor market policies, while the “losers”—including Ireland and the Mediterranean countries—do not. Just like during the interwar gold standard, the core “surplus” countries can push the burden of adjustment onto the “deficit” countries of the periphery.²⁹ Moreover, this “supra-national” winner-loser

dynamic has also resulted in greater inequality *within* the loser countries, but *not* within the winner countries. The Eurozone crisis, in other words, has unintentionally generated a rather bleak and multilevel 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 exact opposite. Owners of capital, on the other hand, prospered more in the North than in the South prior to the crisis, even though both were bailed out after the crisis.

Inequality in Europe: A Brief Review of the Literature

Economics Accounts

Standard explanations in the economics literature for the increase in the overall level of inequality in most advanced countries tend to emphasize, in order of importance, the role of skill-biased technological change (SBTC), the wage effects of increased international trade and globalization, the impact of low-skill immigration, and the significant returns to getting a higher education.³⁰

The most influential explanation in the economics literature, as put forward by Lawrence Katz and Kevin Murphy, 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.³¹ Daron Acemoglu and David Autor refined this view, 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—such as 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.³² This put greater downward pressure on low-skilled workers’ wages than on the wages of high-skilled

workers and hence induced a polarization in the overall income distribution. The routinization hypothesis also helps to explain the existence of the “missing middle” or squeezed middle class.³³

Other accounts have focused on the effects of international trade and factor movements; though it is doubtful whether intensified trade exposure to low-wage countries is sufficient in explaining the large increases in inequality in most OECD members since the mid-1980s.³⁴ 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.³⁵ “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.³⁶ 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.³⁷ According to the Council on Foreign Relations, the median earnings of a worker in the United States with a bachelor’s degree were 65 percent higher than the earnings of a high school graduate, with workers holding professional degrees such as in law, medicine, and business enjoying a 161 percent wage premium.³⁸

Most recently, in *Capital in the Twenty-First Century*, Thomas Piketty explained rising income inequality in much of the industrialized world as the inevitable result of a fundamental law of capitalism, namely the observation 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.”³⁹ Piketty’s main point is that the falling levels of inequality during *les Trente Glorieuses* (1945–75) marked an exceptional period in history and that capital’s share of income, which started to increase again in the late

1970s, will only continue to expand in the absence of any political intervention.

However, while Piketty's thesis is hugely important, it lacks a clear political theory. As Jonathan Hopkin has pointed out, "the very economic forces Piketty describes are embedded in institutional arrangements which can only be properly understood as political phenomena."⁴⁰ One of the aims of this paper is to build onto Piketty's framework and Hopkin's insight, by explaining the institutional and political foundations of the return to capital and labor in the context of the Eurozone, which will reveal its winner-take-all nature.

Political Science Accounts

Although 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 should for the most part impact all advanced industrial countries to a broadly 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 affect the lower end of the income distribution, whereas government employment can be a mitigating factor and lead to reduced levels of inequality.⁴¹ Michael Wallerstein considered institutional and political determinants of pay inequality in sixteen countries

from 1980 and 1992, and found that the most important factor in explaining pay dispersion was the level of wage setting.⁴² The more wage coordination is achieved collectively, the more egalitarian the overall distribution of pay will be. 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.⁴³

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.⁴⁴ 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”).⁴⁵ Hacker and Pierson, who emphasize the central role of special interests in influencing legislation that systematically skews the income distribution in favor of the top one percent in the United States, deserve much credit for their efforts to bring politics back into the conversation. Although Hacker and Pierson are careful to emphasize the organizational transformation of *American* politics, direct lessons can be drawn and causal mechanisms 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 national electoral

politics, as well as their emphasis on organized interests as a major driver for policy change, have direct relevance for the Eurozone.

In the next section, I will develop a conceptual framework that lays out how different adjustment policies create different winners and losers in the Eurozone's national political economies, and describe the conflicting policy incentives core and periphery countries face during easy and hard times. After illustrating the institutional dynamics behind inter- and intra-European inequality trends and showing additional empirical evidence in section five, we will be able to parse out some of the political drivers behind the euro's institutional choices and policy incentives.

Winner-Take-All, Loser-Pay-All Europe: The Political Economy of Inequality in a Multi-State Currency Union

How can winner-take-all politics help us understand why Europe built a monetary union that would result in this particular inequality-inducing way? None of the economics and political science literature discussed above can really explain the inequality promoting politics that have been going on in Europe since the late 1990s. 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 toward price stability, and fiscal policy discretion hemmed in by the Stability and Growth Pact (SGP) signed in July 1997, joining the euro severely limited a member state's options in managing their economy.

Now, why would politicians ever want to give up instruments of policy discretion? As Kathleen McNamara has persuasively argued, EMU came about as the result of a broad elite consensus around neoliberal ideas.⁴⁶ Expansionary policies were seen as merely producing inflation, and exchange rate volatility during the years of stagflation in the 1970s and euro sclerosis in the 1980s were seen as part of Europe's economic woes of slow growth and high unemployment. Monetarist theory and fiscal rules had emerged as the main alternative to Keynesian discretion, and Germany was seen as a successful example of pragmatic monetarism.⁴⁷ The idea was also that the euro would rival the dollar, create a deeper pool of finance that would lower interest rates for Europe as a whole, and bring about broad convergence, as long as everyone would abide by the same strict rules of budgetary discipline.⁴⁸ However, those choices made at the time would have significant unintended consequences for the future evolution of income inequality within the Eurozone.

Since all economic policy decisions are by nature fundamentally political and have distributive consequences, joining the euro was never a decision free of ideology or politics: as we will see, the euro's design favored the interests of capital over labor, and creditors over debtors, by firmly putting price stability ahead of full employment on its list of priorities.⁴⁹ Going forward, any adjustment strategy during hard times would hurt the weaker groups disproportionately more. Also, the core countries would maintain higher levels of discretion than the periphery countries during times of crisis and recession, even though it would be exactly the opposite during times of economic growth.

Understanding the Return of the North-South Gap: Who Bears the Main Burden of Adjustment?

If the shock absorber is far to the left, debtors and wage earners will suffer disproportionately, while if the shock absorber is positioned further to the right, this will increasingly affect creditors and capital owners in negative ways.

The first potential national policy choice – *austerity* – all the way to the left, 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 this case 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 monthly 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 compared to 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 shock absorber, right next to *austerity* – *devaluation* – lowers the value of a country's 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 still 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 since workers in export industries will likely keep their jobs, and might even see their 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, hence why it is placed more to the middle of the income distribution.

The third policy choice – *default* – more to the right of devaluation, means that the government chooses not to make good on its promise to pay back its outstanding sovereign debt, either partially or in its entirety, 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 they are domestic citizens, creditors and capital owners will be the big losers. 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. In that case, the burden of adjustment is passed onto foreigners. The default option usually leads to a deep recession caused by sudden stops and 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 therefore only ever used as a last resort.⁵²

The final possible policy choice, all the way to the right – *demand stimulus* – has the opposite effects of austerity. 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 generally 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 receive 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, which experience a lower real return to their capital.

Between 1945 and the mid-1970s – a period of fast growth and falling levels of inequality all over the advanced industrial world – countries could exploit all four economic policy tools (or a combination thereof). What John Ruggie called the “embedded liberal” compromise, struck in 1944 at Bretton Woods in New Hampshire, had incorporated the 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.⁵³ Nixon’s ending of the dollar’s convertibility into gold in August 1971 foreshadowed the beginning of a new era of flexible exchange rates, deregulation, and quickly rising international capital flows. However, most industrialized countries –

including Britain, the U.S., Japan, and Sweden – kept all four shock absorbers firmly on their policy menus. While everybody paid lip service to market discipline and policy rules during the early 1990s, in practice most advanced economies were prudent to preserve their domestic fiscal and monetary policy levers with a variety of tools, including capital controls, exchange rate measures, and downright prohibitions.⁵⁴ In other words, they all upheld the basic tenets of an embedded liberal world.⁵⁵

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. With the euro's adoption, EMU members put in place a forever-fixed exchange rate to usurp 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, quasi illegal by signing onto a Stability Pact with strict fiscal rules. Given the growing prominence 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 conceivable policy option on the table.⁵⁶

By signing on to 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.⁵⁷ Most advanced industrial countries 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 politicized.

In the Eurozone, by contrast, as we will see next, 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 happens to find itself in (expansionary or contractionary).

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

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.

However, 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 real rate of economic growth. Following the existing rational choice literature on the effects of internationalization on domestic politics, I assume that the relatively scarce factor (capital in the periphery and labor in the core) would lose, while the relatively abundant factor (labor in the periphery and capital in the core) would gain from the euro's introduction.⁵⁸

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 toward 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 no longer possible. Also, no rational investor truly believed the no-bailout clause.⁵⁹ Furthermore, as capital flows from North to South intensified, 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.⁶⁰ So, because of 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 a higher return on capital, together with the already slightly higher returns on capital that had been invested in the Southern periphery. Not surprisingly, the unintended outcome during normal times in the North was widening income inequality.

Phase in the Currency Union’s Overall Business Cycle

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

Figure 2. Economic Policy Incentive Structure in Europe’s Common Currency Union.
Source: Author.

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 broadly “inflationary” policies by discretion during good economic times, resulting in higher wages.⁶¹ 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’s 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.⁶²

The story is reversed during downturns or recessions, however. The MMEs of the periphery now have no choice but to follow broadly deflationary policies, basically by institutional design. This lowers wages while returns to capital are protected—capital owners can buy higher yielding government bonds, or simply pull their money—leading to an increase in the relative income of capital to labor. Fixed capital benefits from “internal devaluation” to drive down costs, whereas mobile capital can just move to safety, thereby externalizing the costs to the rest of the economy. 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 ($r \gg g$).

The core of a currency union during a downturn has more discretion, thanks to falling interest rates triggered by capital flight to safety from the South, which gives them more room to maneuver in economic policy. This can result in r lower than g and therefore lower inequality ($r < g$). 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 or deem politically expedient. The crucial 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. Finally, positive rates of growth in the North and negative growth rates in the South lead to renewed divergence in overall standards of living.

The theoretical framework of Figure 2 broadly corresponds to the inequality data in Tables 2 and 3. The main contribution of Figure 2 is to make the distinction between deflationary policies—which are not necessarily chosen by the national government in question, but must be implemented quasi-automatically and are forced upon the periphery countries in return for a bailout—and inflationary policies—which governments in the core can enact by discretion if they choose to do so.

North versus South: From Convergence to Divergence (1994–2014)

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. In this section, I will put some more empirical flesh on those theoretical bones, before turning to three specific and highly political “winner-take-all” mechanisms that exacerbate these trends.

Eurozone: Between-Country Economic Convergence and Divergence

From the mid-1990s onward, after the 1992–93 crises of the European monetary system, 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 in 1999. 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.

Figures 3 and 4 show the figures for real GDP per capita in all original Eurozone members (except Luxembourg) for 1994, 2008, and 2014, as a percentage of Germany’s per capita GDP (as mentioned at the beginning of this article) and as a percentage of the weighted euro area average, respectively.⁶³ One can see broad convergence (both in terms of Germany’s GDP per capita and the euro area weighted average) between 1994 and 2007, and then divergence between 2007 and 2014 in both figures. Figure 4 shows how Germany’s real per capita GDP, for example, was 109 percent of the euro area average in

1994, fell to 104 percent in 2007, and had grown again to 114 percent in 2014. Greece's real per capita GDP, on the other hand, was 62 percent of the euro area average in 1994, increased to 74 percent in 2007, and collapsed to 57 percent in 2014.⁶⁴

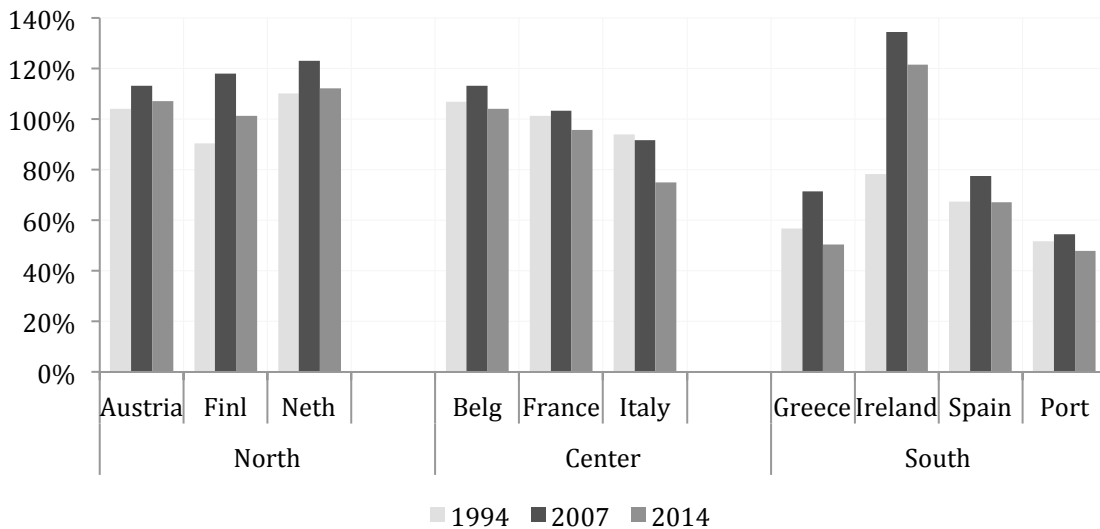


Figure 3. Real Per Capita GDP (Percentage of Germany's).
Source: IMF, *World Economic Outlook Database* (Washington: IMF, 2015), and author's calculations.

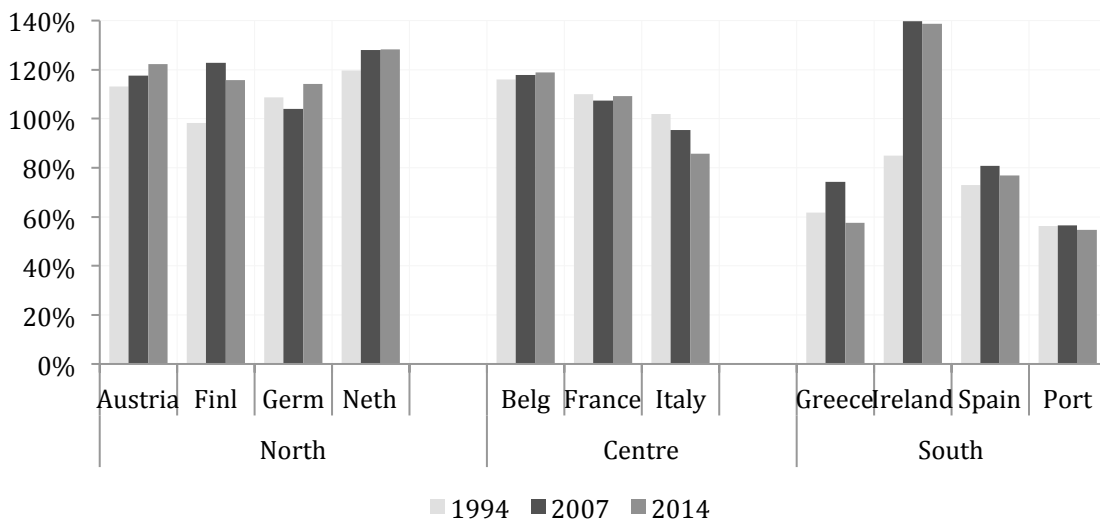


Figure 4. Real Per Capita GDP (Percentage of Euro Area Average).
Source: IMF, *World Economic Outlook Database* (Washington: IMF, 2015) and author's calculations.

But let us compare the absolute figures of Spain and Germany, for example, as they are both in the middle of their respective groups when it comes to living standards. Whereas the absolute gap in income per capita between Germany and Spain in 1994 was €8,442, it had fallen to €7,074 by 2007. But because of the effects of the global financial crisis and the euro crisis, the gap had widened dramatically in just six years to €11,045 by 2014—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 €16,287 in 2007 and €20,892 in 2014.⁶⁵

The convergence and divergence between North and South are 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 nine core and periphery countries 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 in labor markets was completely back. The five Northern states all had unemployment rates of 8 percent or below, with Austria at 5.1 percent, 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 all saw their unemployment rates in 2013 above 12 percent, 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.⁶⁶

Eurozone: Within-Country Inequality Convergence and Divergence

On the issue of inequality within countries, Table 4 shows the change in wage share as a percentage of GDP for all twelve original Eurozone members, based on data from the European Commission.⁶⁷ With the exception of Luxembourg, one can observe a fall of the overall wage share in the CMEs between 1998 and 2008, especially in Germany, Austria, and the Netherlands. Between 2008 and 2014, however, the wage share as a percentage of GDP for all northern and center countries shows a significant increase. In the periphery, in Greece, Ireland, and Italy, we can observe wage shares as a percentage of GDP increase between 1998 and 2008. In Spain and Portugal, however, wage shares fall over the same period. Between 2008 and 2014, all four southern MMEs see significant drops in wage shares, in contrast to the rest of the Eurozone countries. Table 4 therefore confirms our expected pattern, with higher wage shares of GDP indicating lower inequality and lower wage shares suggesting higher inequality.

Table 4. Change in Wage Share (as Percentage of GDP) (Euro-12 Countries).

	1998 Level	2008 Level	2014 Level	Percentage Change (1998–2008)	Percentage Change (2008–14)
North—CMEs					
Austria	57.10	53.71	56.02	–5.93	+4.30
Finland	53.44	53.57	56.77	0.26	+5.96
Germany	58.00	54.54	56.79	–5.97	+4.14
Netherlands	59.96	57.23	60.06	–4.55	+4.93
Luxembourg	51.04	52.38	53.73	+2.62	+2.58
Center					
Belgium	60.62	59.75	60.88	–1.43	+1.89
France	55.47	55.55	57.87	0.14	+4.18
Italy	51.73	52.86	53.40	+2.20	+1.02
South—MMEs					
Greece	50.00	51.41	49.24	+2.82	–4.22
Ireland	50.66	53.58	49.93	+5.76	–6.81
Portugal	60.07	56.68	52.99	–5.64	–6.52
Spain	59.17	57.96	54.53	–2.05	–5.92

Source: European Commission, *Eurostat Database* (2015), and author’s calculations.

To further strengthen the point, Figure 5 shows real wage growth between 1998 and 2013 for both Northern CMEs and Southern MMEs.⁶⁸ 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. It was much easier for CMEs during the boom to keep wages in check, whereas MMEs lacked the central wage bargaining mechanisms CMEs had, a fact that led 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.⁶⁹

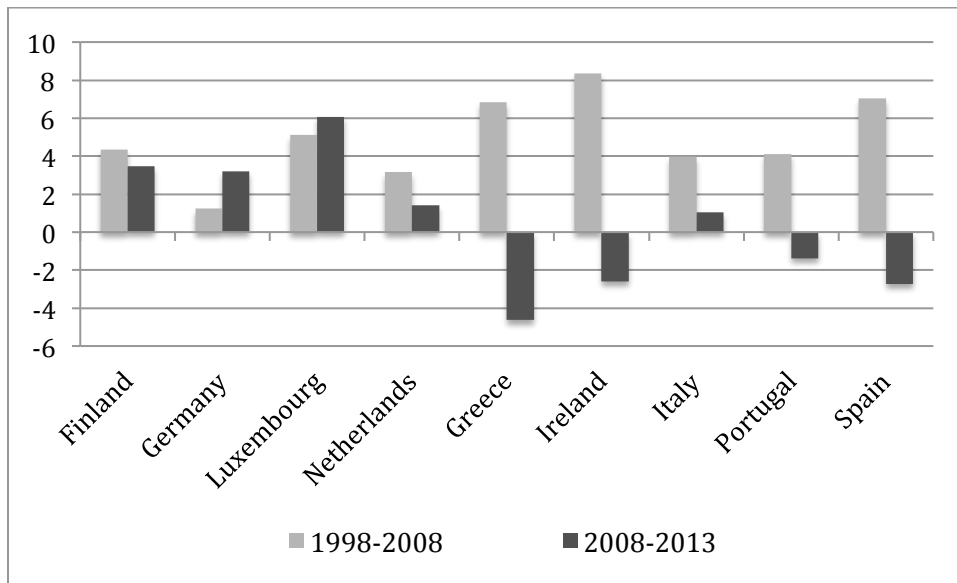


Figure 5. Real Wage Growth in CMEs versus MMEs (1998–2013), Measured as (Nominal Wage Growth – Inflation) (Period Average).

Source: European Commission, *Ameco Database* (Brussels: EC, 2015), and author's calculations.

The evolution of the cost of capital in the Eurozone is well known 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 was again much lower than in the South by 2014.⁷⁰

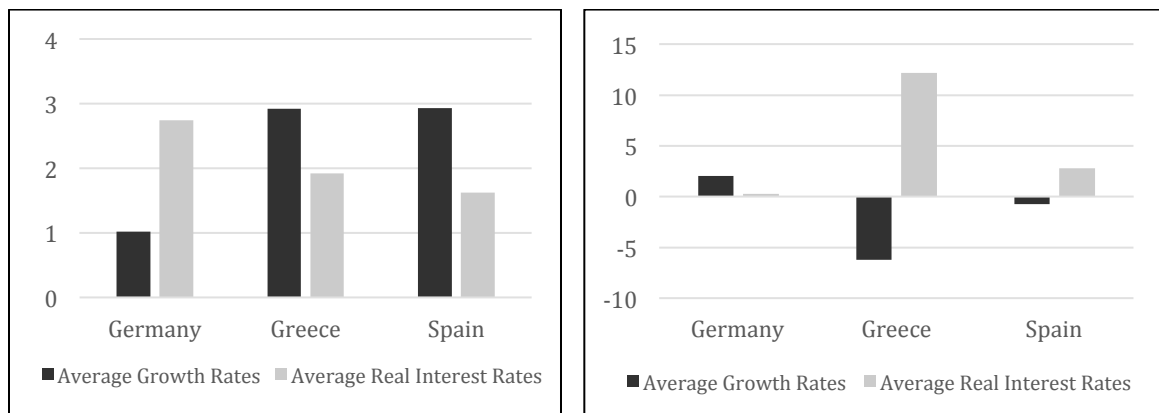


Figure 6. Average Growth Rate (g) versus Return to Capital (r) in Germany, Greece, and Spain during Boom and Bust (Left Panel: 1998–2009; Right Panel: 2010–2013).
Source: European Commission (2015); IMF (2015); OECD (2015); and author’s calculations.

Figure 6 finally shows additional evidence of the “Piketty cause” 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 ($g < r$), whereas 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 ($r > g$).

Europe's Inequality Dynamics through a Winner-Take-All Lens

The economic policies that were implemented—at both the EU and national level—throughout the late 1990s and 2000s were the result of certain choices that were made during the early 1990s, especially by Germany, which happens to be the main “winner” of the euro crisis, and have only been reinforced since then. The policy choices at the time, while sold as merely “technocratic” were in fact deeply political, and would eventually have serious distributive—though largely unintended—consequences. Winner-take-all politics, however, were embedded in the Eurozone design and would directly contribute to and exacerbate the inequality dynamics discussed at the beginning of this article, especially after 2008.

As Jonathan Hopkin has argued, rather than a purely economic phenomenon of growth rates (g) and interest rates (r), the forces of capitalism Piketty observes are inherently political.⁷¹ Especially the policy responses to the global financial crisis and euro crisis were not mere functional reactions to objective economic problems. Choices were made that favored certain groups in the political economy over others.⁷² So, how can we better understand why those specific choices were made in the first place?

Hacker and Pierson showed in the case of the United States that the widening levels of income inequality—especially the concentration of wealth at the very top—were due to inherently political undercurrents. 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 industry lobby in Brussels, representing the interests of capital owners, or the “politics as organized combat.”⁷³

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 austere 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.⁷⁴

The euro crisis debate in Germany contrasted “saintly” Northern creditors with “sinning” Southern debtors.⁷⁵ However, the euro elite’s policy drift that firmly kept holding on to the narrow mandate of the ECB,⁷⁶ as well as the strengthening of the rules of the SGP through the new Fiscal Pact, was far from neutral, as it 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 in falling standards of living and higher levels of unemployment, as discussed above.

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 and anti-establishment 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.⁷⁷ 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).⁷⁸ 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 mere few months of his election to the Elysée that new president Hollande would have to continue on the austere path of his predecessor and implement long-term structural reform policies.

The “grand coalitions” between center-left and center-right, mathematically necessary to “stay the course” and avoid financial ruin, 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, some preliminary evidence points to its growing power. According to Christine Mahoney, the US 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 than is the case in the European Union.⁷⁹ 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.”⁸⁰ 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 crisis, 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.⁸¹ 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.”⁸² The report’s (conservative) estimate is that the financial lobby outspends all the other organizations lobbying the European Union “by a factor of more than thirty.”⁸³ Furthermore, the report finds that in fifteen of the seventeen 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 are also present at the EU level, even though the concentration of wealth in the top one percent remains largely an American phenomenon. Since the crisis, not only have EU policies been characterized by drift—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.

Conclusion: Winner-Take-All, Loser-Pay-All Europe?

This article has proposed an institutional explanation for the contradictory trends in income inequality in the Eurozone since the late 1990s: whereas 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, I have demonstrated 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, the euro 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, especially 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 December 1991 at Maastricht was meant to further unite Europe by bringing about economic convergence, thereby preserving Europe's welfare states. 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.

Acknowledgements

I would like to thank the editors of *Politics & Society* for very helpful comments on two earlier versions of the article, as well as Julie Lynch and Jonathan Hopkin for their seemingly endless encouragement, feedback, and support. Many thanks as well to Karen Anderson, Cornel Ban, Mark Blyth, Michele Chang, John Cioffi, Ken Dubin, Greg Fuller, Gabriel Goodliffe, Nicolas Jabko, Erik Jones, Kate McNamara, Craig Parsons, Paul Pierson, Stefan Svallfors, and Cornelia Woll for all their useful comments on various previous drafts. The research assistance of Björn Bremer, Brian Fox, Daniel Richards, and Silvia Merler was invaluable. The usual disclaimer applies: any errors and omissions are solely my own.

Declaration of Conflicting Interests

The author declared no potential conflicts of interest with respect to the research, authorship, and/or publication of this article.

Funding

The author received significant financial support from a Johns Hopkins University “Catalyst Award” during the academic year 2015–16, which he gratefully acknowledges.

Notes

¹ Craig Parsons and Matthias Matthijs, “European Integration Past, Present and Future: Moving Forward through Crisis?,” in M. Matthijs and M. Blyth, eds., *The Future of the Euro* (New York: Oxford University Press, 2015), 210–32. See also Miles Kahler and David Lake, eds., *Politics in the New Hard Times: The Great Recession in Comparative Perspective* (Ithaca, NY: Cornell University Press, 2013), 1.

² The euro crisis was in many ways the logical consequence of the U.S. financial crisis, i.e. a private sector banking crisis that necessitated a public sector bailout, which left many sovereign borrowers, especially in Europe’s periphery, mired in debt. See Mark Blyth, *Austerity: The History of a Dangerous Idea* (New York: Oxford University Press, 2013), 51; Matthias Matthijs and Mark Blyth, eds., *The Future of the Euro* (New York: Oxford University Press, 2015), 5.

³ Note that I refer to the countries of Austria, Finland, Germany, the Netherlands, and Luxembourg as either “the North,” “the core,” “CMEs,” “coordinated market economies,” or the “surplus” countries. And instead of using the popular acronym “PIGS,” I will refer to the countries of Greece, Spain, Ireland, and Portugal as “the South,” “the periphery,” “MMEs,” “mixed market economies,” or the “deficit” countries (even though Ireland, obviously, is not a part of Southern Europe: it is closer to a liberal market economy than the Mediterranean countries but can also be considered a mixed market economy). The other original Eurozone members—Belgium, France, and Italy—are referred in this article as the “center” or the “middle” countries, since they all have elements of both North and South, even though Italy is usually included in the periphery while Belgium and France are usually included in the core. The countries that joined the Economic and Monetary Union (EMU) after 2002, including Slovenia (2007), Malta and Cyprus (2008), Slovakia (2009), Estonia (2011), Latvia (2014), and Lithuania (2015), are not included. On the terms CME, LME, and MME, see Peter Hall and David Soskice,

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- ²³ See OECD, *Divide We Stand*, 23. Note that Italy seems to be the exception to the North-South divide: it behaved more like a Northern country in that the bottom decile there also did much worse than the top decile. France and Belgium, on the other hand, seem to have broadly followed the Southern pattern, with bottom decile doing better than the top one.
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