PSL Quarterly Review

vol. 74 n. 299 (December 2021)

Special section: the future of reformed capitalism

Labour's loss: Why macroeconomics matters

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Abstract:

Electoral support for social democracy in Western Europe is in free fall. The implosion of social democracy is largely self-inflicted, because 'Third Way' social democracy alienated its traditional supporters by (a) a deliberate move to the non-reformist, status-quo oriented macroeconomics of the New Keynesian consensus, which de-politicizes macro management and legitimises macro control by technocratic central banks; and (b) its promotion of a middle-class oriented 'cultural liberalism', as compensation for a lack of achievements on the economic front. As a result, Western European social democratic parties became responsible for austerity, rising inequality, social and economic disempowerment, and heightened insecurity—factors which contributed to a hardening of attitudes on cultural issues and migration. Social democracy has to return to its earlier reformist roots. The paper outlines what is needed in terms of fiscal and monetary policy as well as social concertation to create sufficient space for a reformist, productivist, and egalitarian strategy oriented toward full employment—based on a reimagined Keynesianism in which a prominent role is given to the economy's supply side.

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How to cite this article:
Storm S. (2021), "Labour's loss: Why macroeconomics matters", *PSL Quarterly Review*, 74 (299): 249-285.

DOI: https://doi.org/10.13133/2037-3643/17673

JEL codes:
E20; E60; F60; O10

Keywords:
social democracy; full employment; fiscal and monetary policy; New Keynesian macroeconomics; NAIRU; Keynesianism.

Journal homepage:
http: //www.pslquarterlyreview.info

Electoral support for social democracy in Western Europe is in free fall. One of its causes is the steady decline of the industrial working class due to the combined forces of globalisation and robotisation. The industrial working class was the natural constituency for social democratic parties, and in no other continent has this form of government been as dominant in the aggregate employment structure as in Western Europe (Therborn, 1995). However, it is wrong to attribute the crisis of social democracies to the decline of their 'natural' working-class constituency alone. After all, social democratic parties have always had to build class alliances between production workers and other—salaried middle—classes, because nowhere in Western Europe did industrial workers constitute more than 50% of the electorate. Over time, such middle-class voters came to represent an increasing part of the electoral base of social democracies—and industrial workers a decreasing part thereof (Gingrich and Häusermann, 2015; Rennwald, 2020).

* This paper has greatly benefitted from the critical and constructive comments by Thomas Ferguson, Amit Bhaduri, Carlo D'Ippoliti and two anonymous contributors. Financial support from INET is gratefully acknowledged. The *PSL Quarterly Review* temporary series "Special section: the future of reformed capitalism" is guest edited by board member Amit Bhaduri.

Social-democratic parties were able to hold this cross-class coalition together through a strong focus on economic questions, centred around decent wages, stable jobs, affordable housing, accessible health care, and universal social security, all characterized by a Keynesian 'full-employment' orientation in macroeconomic policy (Storm 2021a).[1] For social democratic parties, "full employment took priority over all other goals of economic policy" writes Scharpf (1991, p. xvii), ranking above "increasing real incomes or other distributional goals (and, of course, above the maintenance of price stability or reducing the public sector deficit)" (ibid., p. 15).

It would be difficult to exaggerate the political and emancipatory importance of social democracy's commitment to achieving and maintaining full employment, since

> "Tight labor markets enhance the individual's life chances, opportunities for personal choices, and the possibility of "walking tall". Only full employment, according to the British Labour party economist Thomas Balogh, "removes the need for servility, and thus alters the way of life, the relationship between classes. It changes the balance of forces in the economy" (1982, p. 47). But hard-headed power considerations are at least as important as spiritual concerns in giving weight to full employment. Tight labor markets enhance the power of workers relative to employers and increase the probability that union demand will be met. From this strategic perspective, full employment is a public good and not merely a private good, since it benefits even those workers whose jobs are not in jeopardy." (Scharpf, 1991, p. 16).

Guaranteeing full employment—which required a conscious economic coordination by the state in terms of investment and production—reduced the grip of the market and of market logic on people's lives and undermined the 'wage system' itself, because it socializes the otherwise private or individual risk of unemployment. This makes it impossible for firms to use the threat of job loss to force workers to moderate their wage claims or demands for better working conditions.[2]

Full-employment macro policies (under 'Pax Americana') were key to the self-understanding and political identity of Western-European social democratic parties in the 1960s and early 1970s, and in line with the interests of their political constituents. However, this congruence of self-understanding, identity and interests was shattered in the late 1970s and early 1980s, after the collapse of the Bretton Woods system, the rise of global financial markets, and the end of the post-War economic boom that accompanied the subsequent 1973 oil crisis and made the use of traditional Keynesian policy tools more complicated and less effective (Panitch and Leys, 2001). The global turbulence and crisis of the 1970s pushed Western European nations, led by France and Germany, on a path to further (economic and monetary) integration—meant to stabilise exchange rates—and the resulting European monetary unification, rather than expanding the policy space for social democracy, institutionalised a 'disciplinary austerity' which restricted domestic policy autonomy even more (Bremer and McDaniel, 2020). The structural imperatives of the post-Bretton Woods global economic order and of the European Economic and Monetary Union (EMU) led to the Third Way turn of social democracy in the 1990s, which brought a radical reorientation in its

[1] The European post-WWII experiments in social democracy occurred under the umbrella of (Cold-War) US economic and military protection. The US assisted Europe's post-war economic recovery with aid in the form of the Marshall Plan and the Bretton-Woods international financial architecture. It pacified conflicts of interest within Europe and midwifed the groupings and treaties that would become the European Union. And all the while, it kept Western Europe under the US security umbrella with the NATO treaty and its massive military assets.

[2] This remains true even if one considers the fact that a permanent condition of full employment will encourage the technological displacement of labour in activities that can be automated—because the obviated workers can be re-employed in other socially useful, but non-automatable activities. See Storm (2017).

approach to economics, involving, most notably, the abandonment of 'full employment' as a goal of macro policy.[3] This reorientation weakened the class-based mobilisation of workers and middle-class supporters. As a result, over time, social democratic parties did not only lose the working-class vote, but also the electoral support of key allied social classes—and the critical question is why social democracy chose to do so under the given circumstances.

In answering this question, I first look into the electoral decline of Western European social democratic parties, in relation to the long-run transformation in the class composition of the social democratic vote base. Next, the paper considers the issue of to what extent the rise of 'culture' and 'identity politics' as the main cleavage of Western politics helps to explain the slow death of social-democratic parties. I will argue that the crisis of Western Europe's social democracy is primarily due to a failure of social-democratic parties to articulate a 'reformist' (full-employment-oriented) macroeconomic policy in order to create a (reassembled) coalition between working-class and middle-class voters. Any 'reformist' macroeconomics worth its salt must be based on a commitment to manage aggregate demand in order to achieve and maintain full employment.[4] Hence, as I will argue, the collapse of Western Europe's social democracy has less to do with (financial) globalization, robotisation, EMS/EMU and immigration than with an intellectual failure to reimagine a feasible egalitarian—including, therefore, full-employment—demand-led alternative to the hegemonic neoliberal model.[5] The failure of Western Europe's social democracy is—intellectually, at least—due to its inability to counter the ideological revolution of the 1970s, which succeeded in overthrowing the Keynesian consensus in macroeconomics and economic policy and handing the levers of macroeconomic control to technocratic central banks, with the result that 'government' became the problem, rather than the solution (Storm, 2021a).[6]

This paper, finally, analyses the now dominant consensus macro model—arguing that it rules out, by assumption, any productive role for an interventionist state, supported by the central bank, in keeping the economy close to full employment by means of fiscal stabilization and demand-enhancing economic redistribution. The wholesale acceptance of this macroeconomic consensus[7] doomed (Third Way) social democracy to political and societal irrelevance. A revival of a progressive politics will require a restoration of a far less ideological

[3] Instead, social democrats attempted to promote employment by anti-union labour market deregulation and real wage restraint, having internalised the idea that actual unemployment could not be lowered below the 'Non-Accelerating Inflation Rate of Unemployment' (NAIRU) without leading to accelerating inflation. This is further elaborated in sections 8.1, 8.2, and 8.3.

[4] Because full employment undermines the grip of market logic on people's lives and strengthens the (bargaining) power of workers/unions, it will lead to higher (real) wage growth, better and more stable jobs, and more egalitarian outcomes.

[5] I do not intend to downplay the importance of the 'material conditions'—the post-Bretton Woods global economic order and the EMS/EMU—in constraining the policy space for social democracy, but rather want to focus on the (surprising?) flexibility and willingness of social democrats to accept these material conditions as given, and on the often active role played by leading European social democrats in establishing (rather than fighting against) the exact structural imperatives that do restrict the scope for a full-employment-oriented macroeconomics. Social democrats actively bought into a policy failure—and then lived with it by ideational rationalisation.

[6] After becoming the President of France in 1981, François Mitterrand claimed that his famous "110 Propositions for France" would precipitate a "rupture" with capitalism, but already within a year he decided to abandon his programme and chose the path of capitulation toward austerity (Birch, 2015). Mitterrand's failed stimulus appears to be caused more by lack of principled commitment to reform than by the opposition of bond vigilantes and capital flight, but it nevertheless helped to instil a life-long "fear" of the power of (bond) markets in most social democrats (see Halevi, 2019). As Birch (2021) writes, "the Mitterrand experience is a microcosm of the fate of the entire social democratic left in Western Europe since the 1970s."

[7] See Bremer and McDaniel (2020) for a discussion of the relationship between left-wing politics and mainstream economics.

and technocratic macroeconomics, oriented towards full employment and based on a deeper, less mechanical, more empirical, and effective understanding of Keynesianism.

1. The decline of the left in Western Europe

Social democracy started as a parliamentary, reformist force which accepted capitalism on the condition that it could be regulated by the state. Its ultimate goal was to achieve an emancipation of the working class that eliminated their dependency on the interests of capitalists (Rennwald, 2020). To achieve this, social democrats relied heavily on the promise of successful management of the macro economy—based on an optimistic, crisis-free, and technocratic belief in fine-tuning the economy as proposed by the neoclassical-Keynesian synthesis of Hicks, Hansen, and Samuelson (Scharpf, 1991).

As long as the credibility of this 'bastard' Keynesian programme (to use Joan Robinson's, 1956, phrase) went unchallenged, and as long as the interests of their constituents were met by a stable economy—moving towards, at, or close to full employment—the political fate of social democracies were symbiotically bound to this version of 'Keynesianism'. This symbiosis posed a subtle, but important, danger (Scharpf, 1991): social democrats were reliant on an oversimplified, technocratic, and incomplete version of Keynesian demand management, chosen only for its expediency, and only for as long as it worked. Social democracy's reliance on 'Keynesianism' was not based on its own convictions or on any deeper understanding of the contingent and conditional nature of Keynesian analysis and policy prescriptions (Crotty, 1994).[8]

Social democracy's ethos was egalitarian, and it aimed to achieve social justice and economic redistribution through an interventionist state in macroeconomic policy-making and socioeconomic areas (Marlière, 2010). Social democracy gave priority to developing social security, creating equal access to education and health care, improving the public infrastructure, raising real incomes, shortening working hours, increasing public-sector employment and improving working conditions. Solidaristic wage policies in Sweden (Erixon, 2018) and the extension of workers participation and codetermination in Germany should both be added to the aforementioned list. Social democracy possessed two other essential features: a strong working-class base and a close relationship with the trade unions.

But politically, this working-class base did not translate into social-democratic electoral majorities. To illustrate, historically, the average vote share for social-democratic parties in the EU-12 countries peaked at around one-third during the 1950s (Marlière, 2010). Hence, to achieve their aim, social democrats had to abandon confrontational 'class politics' in favour of cooperative 'coalition politics', based on class compromises. These compromises entailed a commitment to maintain private property of the means of production—which, in turn, implied that ideas of a systemic transformation of private property relations and the employment relationship had to be ditched. Instead, since social democracy chose to stabilize and correct capitalism rather than to replace it, it was forced to depend on indirect instruments of control

[8] Social democrats failed to see that the 'golden age' (1950-1975) in which the interests of the working class and productive firms were (relatively) congruent, was founded on a historically unique configuration of forces: a very fast pace of technological progress (post WWII) and the presence of capital controls (under the Bretton-Woods regime of fixed exchange rates), which together ensured that full employment and high wage growth were compatible with high returns on productive investment by boosting aggregate demand and capacity utilization.

to influence private economic decisions without undermining the growth of private-sector productive capacities, while containing adverse distributional effects (Scharpf, 1991; Bhaduri, 1993). This then is the dilemma: social-democratic policies must at the same time strengthen the productive power of 'capital', stabilise the macroeconomy and counteract the (political) power of capitalists. The result is a careful balancing act, because if, in a class-divided society, capitalists' power is curbed too strongly, the capitalist class possesses an effective instrument for retaliation: the "investment strike" (Kalecki, 1943). This means that the balance of what is 'feasible' would be determined by the interests of the capitalists. Their principal concern was not full employment, but profit, which dictated macroeconomic stimulus in a slump and restraint whenever profits were squeezed by increased wages in a tightening labour market.

During the 1950s and 1960s, the age of "cooperative capitalism" (Bhaduri and Marglin, 1990), social democrats managed to hold together a broad coalition of workers and parts of the salaried middle classes, enjoying relatively strong support among large sections of university students, schoolteachers, health-care workers and civil servants—all professionals in social and cultural services (Rennwald, 2020). Although the two sides of the worker-bourgeois coalition have always differed considerably in their cultural attitudes, they had significant shared economic interests—in high wages, stable jobs, social security, affordable (social) housing, and strong unions. Both relied on the welfare state for the schooling of their children, for access to health care, and for the knowledge that they would be able to retire in dignity.

Table 1—*Decades of decline of social democratic parties in Western Europe: vote share in national legislative elections, per cent*

country	*Social-democratic party*	end of the 1990s	circa 2020
Austria	Social democrats SPÖ (1995 versus 2019)	38	21
Denmark	Social democrats (1998 versus 2019)	36	26
Finland	Social Democratic Party (SDP) (1999 versus 2019)	23	18
France	Socialist Party (1997 versus 2017)	24	7
Germany	Social Democratic Party (SPD) (1998 versus 2017)	41	21
Italy	Olive Tree/Democratic Party (PD) (1998 versus 2018)	42	23
NL	Labour Party (PvdA) (1998 versus 2021)	29	6
Portugal	Socialist Party (1999 versus 2019)	44	36
Spain	Spanish Socialist Workers Party (PSOE) (1996 vs 2019)	39	28
Sweden	Social democrats (1998 versus 2018)	40	28
UK	Labour Party (1997 versus 2019)	43	32
	unweighted average	36	23

Source: Taylor (2018).
Notes: first-round results are used for France.

Thus, Western-European social-democratic parties were able to hold this coalition together through a strong focus on precisely these economic questions, underpinned by a

Keynesian 'full-employment' orientation in macroeconomic policy (Storm 2021a). But after the age of 'cooperative capitalism' came to an end in the stagflationary 1970s, Western European social democracy began its decline—as once-solid supporters left and changed over to other parties or turned their backs on the political system. At first, the decline was slow, almost unnoticeable. The average vote share of social-democratic parties in the EU-12 countries was 31.1% in the 1980s and 29.7% in the 1990s (Marlière, 2010). But social democracy's decline then accelerated: the average vote share of EU-12 social-democratic parties was 26.6% in 2000-2009 and only 21% during 2010-2019 (Storm 2021a).

The collapse of traditional social-democratic parties in 11 European countries is illustrated in Table 1. The hardest hit parties are the Dutch Labour Party (PvdA) and the French Parti Socialiste. The Dutch PvdA received the support of 29% of the electorate in 1998, but only 6% in the parliamentary election in March 2021; it is now the sixth-largest political party in the Netherlands. The French Socialist Party received the support of 23.8% of the electorate in 1998 and peaked at 29.4% of voters in 2012, but won only 7.4% of the votes in the parliamentary election of 2017; it is now marginalised as France's fifth-largest political party. The traditional Labour Parties have lost (on average) one-third of their electoral supporters between 1998 and 2021 (Table 1).

2. Structural electoral changes: 1970s versus 2010s

Table 2 provides more insight into the decline in the electoral support for social democratic parties. It presents key findings from a recent longitudinal analysis of the changing composition of the electorate of social democratic parties in five Western-European democracies—Austria, France, Germany, the Netherlands, and the UK (Rennwald, 2020). It can be seen that, in the 1970s, social democratic supporters were, in relative terms, more working class than the total electorate. Fifty years ago, production and service workers represented almost two-thirds of social democratic voters in Austria and the UK, and (almost) one in two social democratic voters in France, Germany and the Netherlands. But Table 2 does also show that already in the 1970s, social democratic parties drew a considerable level of support from other classes, particularly from clerks and socio-cultural professionals (who made up 20-30% of social democratic voters in this period).

However, over time, the production and service workers' support for social democracy weakened significantly (Table 2). The combined support for social democratic parties of production and service workers in Austria and the UK declined from two-thirds in the 1970s to 49% in the 2010s. And in Germany and the Netherlands, the working-class share in the social democratic vote declined from around one half in the 1970s to one-third in the early 2010s. By the 2010s, the class composition of social democratic voters has come to closely resemble the class composition of the general electorate—no other class took a prominent role in place of the working class. Social democratic parties thus morphed into cross-class parties with intermediate levels of support among various classes (Rennwald, 2020). Importantly, this transformation in its voter base occurred alongside the steady decline in the social democratic vote share (table 1).

Table 2 — *Composition of social democratic party electorates and total electorates, per cent*

	Austria				UK				Germany			
	SPO		Electorate		Labour		Electorate		SPD		Electorate	
Class	1971	2013	1971	2013	1971	2010-15	1971	2010-15	1971	2013	1971	2013
1	46	25	35	22	49	15	39	15	38	18	30	18
2	19	24	14	23	18	26	14	25	17	15	15	15
3	12	17	13	15	16	11	18	12	18	18	19	15
4	5	11	5	11	7	14	7	11	7	13	7	14
5+6	12	16	12	17	12	16	13	16	16	21	15	19
7	1	2	1	2	1	3	3	2	1	3	1	4
8	5	4	19	10	3	9	7	12	4	5	11	10
#	55.9	33.0	100	100	46.5	32.2	100	100	42.9	27.4	100	100

	France				The Netherlands			
	SP		Electorate		PvdA		Electorate	
Class	1978	2012	1978	2012	1972	2010-12	1972	2010-12
1	31	18	27	19	29	12	25	12
2	13	21	13	22	20	22	19	20
3	18	8	16	10	22	11	21	12
4	12	17	11	11	9	20	11	16
5+6	14	20	14	20	16	17	14	15
7	1	1	2	1	1	2	2	3
8	12	6	18	10	2	5	8	11
#	24.9	37.0	100	100	35.9	21.3	100	100

Source: Rennwald (2020). Rennwald uses survey data from Political Action: An Eight Nation Study, 1973–1976, distributed by GESIS (www.gesis.org); and for France: Enquête post-électorale française 1978, CEVIPOF, distributed by the Centre de Données Socio-politiques.
Notes: the first column gives the eight socio-economic classes: (1) production workers (assemblers; mechanics; carpenters); (2) service-sector workers (waiters; shop assistants; nursing aids); (3) clerks (secretaries; receptionists); (4) socio-cultural professionals (teachers; medical doctors; social workers); (5+6) technical professionals and managers (engineers; architects; IT-specialists; accountants, consultants); (7) large employers and self-employed professionals (CEO's; lawyers); (8) small business owners (shop owners; artisans; farmers). The British vote shares for 2010-15 are the averages of the elections of 2010 and 2015; the Dutch vote share for 2010-12 are the averages of the elections of 2010-12. # gives the total vote share of the social democratic party concerned (in blue).

Table 2 shows how the decline in the electoral support for social democratic parties is due to (i) the decline of the share of the working class (here defined as production and service workers) in the electorate; and (ii) the decline in working-class support for social democracy. Historical evidence on both determinants appears in table 3. The share in the electorate of working-class voters voting for social democratic parties declined by 12 percentage points (on average) in the five countries included in the table—and by around 20 percentage points in Austria and the UK On average, half of this drop in the working-class support for social democracy must be attributed to the decline of the share of working-class voters in the overall electorate and the other half to changes in working-class preferences—this pattern holds for Germany, the Netherlands, and the UK (table 3).[9]

[9] In France, the share in the electorate of working-class voters voting for the Socialist Party (PS) was higher in 2012 than in 1978, when the vote of French workers was split between the PS and the Communist Party (Rennwald, 2020). By 2012, the Communist Party had collapsed—which contributed to the vote share of the PS in that year.

A first point to note concerning the changed attitudes of working-class voters is that many once-solid supporters of social democracy chose to disengage from the political system.[10] This is illustrated in table 4, which presents the proportions of production and service workers who decided to abstain in Austria, Germany, Great Britain, France, and the Netherlands in the 1970s and the 2010s (Rennwald, 2020). The picture is quite bleak: over time, the proportion of working-class voters who chose to abstain increased from 10% to 31% in Austria; from 29% to 35% in the UK; from 11% to 25% in Germany; and from 7% to 25% in France (table 4). Abstention has in many countries become the first choice of the working class—no single party receives a larger share of working-class votes. And in all countries, except the Netherlands, working-class voters' propensity to abstain increased considerably more than the equivalent propensity of the electorate in general.

Table 3 — *Electoral participation of working-class voters (per cent)*

	working-class share in electorate			working-class share in social democratic vote		
	1970s	2010s	change	1970s	2010s	change
Austria	49	45	-4	65	49	-16
France	40	41	1	44	39	-5
Germany	45	33	-12	55	33	-22
The Netherlands	44	32	-12	49	34	-15
UK	53	40	-13	67	41	-26
unweighted average	46	38	-8	56	39	-17

	share of working-class voters voting social democratic in electorate			*due to change in working class attitudes*	*due to decline of working class*
	1970s	2010s	change		
Austria	36	16	-20	85	15
France	11	14	3	155	-55
Germany	24	9	-15	57	43
Netherlands	18	7	-10	54	46
UK	31	13	-18	57	43
average	24	12	-12	50	50

Source: calculated based on Rennwald (2020).
Notes: the working class is defined as production workers and service workers (classes 1 and 2 in Rennwald, 2020). The percentage change in the share of working-class voters voting for social democratic parties in the electorate has been divided between the change due to the decline in the size of the working class and the change due to altered working-class preferences.

Where did traditional social democratic voters turn to after abandoning the social democratic ship? In an analysis of the electoral decline of social democracy in sixteen industrialised countries (2001-2015), Rennwald and Pontusson (2020) show that 45% of

However, as shown in table 1, the vote share of the PS declined to 7% in 2017—while *La France Insoumise*, a more radical Left movement led by Jean-Luc Mélenchon, received 11% of the French vote.
[10] It should be emphasised that changes in workers' voting patterns take place over several elections. This means that workers who currently abstain from voting are not the same people as those who voted for parties of the left a few decades ago.

former social democratic party voters switched to the mainstream parties of the right in the next election; another 16% switched to the radical left, 16% abstained and 15% changed to the Greens. Only 8% of former social democratic party voters switched directly to the radical right.

Table 4 — *Electoral participation of working-class voters (per cent)*

	Austria		UK		Germany		France		NL	
	1971	2013	1971	2010-15	1971	2013	1978	2012	1972	2010-12
Production workers	91	72	68	65	89	76	93	70	72	74
Service workers	89	67	80	65	88	74	92	79	78	76
Prod. workers/electorate	35	22	39	15	30	18	27	19	25	12
Services workers/electorate	14	23	14	25	15	15	13	22	19	20
Combined vote share	49	45	53	40	45	33	40	41	44	32
Weighted average participation	90	69	71	65	89	75	93	75	75	75
Mean electoral participation	92	78	73	75	93	84	94	80	80	84

Source: Rennwald (2020).

This is confirmed by Häusermann et al. (2021), who find that social democratic parties in Germany, the UK, and Switzerland have only marginally lost to the far-right parties, even over long (lifetime) transition periods.[11] Interestingly, many studies suggest that social democratic parties and radical right parties recruit from different social milieus. Radical right parties draw strong support from non-unionised voters, while social democracy still performs better among unionised voters (e.g., Mosimann et al., 2019). Workers who vote for social democracy do so based on economic considerations, while those supporting radical right parties do so for cultural reasons (Oesch and Rennwald, 2018). Seen from this perspective, social democracy fails to mobilise a more 'leftist' and 'conscious' working-class milieu (which prefers abstention or radical left parties), while radical right parties succeed in mobilising a non-organised and more 'rightist' working-class milieu.

3. Contrasting political views: economics versus culture

It is often held that the decline of social democracy in Western Europe is the result of social democracy's success in curbing capitalism's destructive and un-equalising tendencies, stabilising the growth process and building protective welfare states, which created more equal (educational and professional) opportunities and helped to enhance social mobility. In this account, social democratic parties have become a victim of their own success: social-democratic views and principles underpinning a cooperative version of capitalism have become so strongly internalised and built into our societies and politics that we no longer need (traditional) social democratic parties to promote and protect them. According to this argument, almost all mainstream parties have converged to a centrist social-democratic core of co-operative capitalism, which could be summed up by the quip, to paraphrase Richard Nixon: "we are all social democrats now!"

However, growing popular protests, increased absenteeism, and the rise of the populist (far) right indicate that this particular explanation of the collapse of social democracy is not

[11] Today's working class is ethnically diverse and often holds progressive positions, even on the hotly contested issue of immigration.

convincing. To wit, capitalism's destructive and un-equalising tendencies came out in full force during the global financial crisis of 2008, the ensuing Eurozone crisis of 2010-2014 and post-crisis austerity, as economic growth stalled almost everywhere in Western Europe, income and wealth inequalities increased, social divisions, poverty and job and income insecurity rose, and upward social mobility came under severe strain. The recent COVID-19 economic crisis has further amplified these pre-existing socio-economic stresses and inequalities (Storm, 2021c). The long-term crisis of the capitalist order led to a sizeable backlash against the system viewed as responsible for it—and, on paper, Western-European social and economic conditions were ripe for a revival of social democracy. In reality, this didn't happen. Rather, as social divisions and conflicts grew, faith in democracy declined, and extremism spread, voters turned away from the established social-democratic parties, which failed to channel their anger, anxieties, and insecurities—and traditional social democratic voters turned to other parties or disengaged from the political process altogether (table 4).

An alternative and now dominant narrative holds that the decline of social democracy is caused by the breakdown of the once-stable partisan alignment between working-class voters and large sections of the middle classes. This cross-class coalition was weakened because of two factors: (1) a declining overlap in the economic interests of production and service workers (whose jobs were lost or got 'fissured' due to globalisation and technological progress) and middle-class professionals (who were less hurt by globalisation and automation, and even benefited from these trends); and (2) a concurrent increase in the political salience of 'cultural' or 'identity' issues (also largely due to globalisation, European economic and monetary unification, and migration). As a result, what used to be a stable partisan alignment turned into a partisan dealignment, as erstwhile supporters of social-democratic parties began to gravitate to other parties, depending on the stance they take on such 'cultural' or 'identity' issues as those related to immigration, national identity, national sovereignty, and EU membership. In effect, in this perspective, Western-European social-democratic parties could no longer sustain the electoral coalition that had earlier provided the basis for its political power. "The rise of culture as the main cleavage of Western politics helps explain the slow death of social-democratic parties in many countries across the West. In Germany and France, and from Italy to Sweden, left-of-center parties have failed to find a political message that can reassemble the old bourgeois-proletarian coalition" concludes Mounk (2019).

This structural problem facing Western-Europe's social democracy today is illustrated, in a stylised manner, in figure 1. In the figure, voters are categorised along a traditional 'economic' left-right continuum (on the horizontal axis) and along a vertical axis measuring 'socially conservative' views (at the top) and 'socially liberal' views (at the bottom). Potential voters for conservative parties are predominantly aligned in their right-wing views on economic issues and socially conservative opinions on cultural matters.[12] However, potential voters for social-democratic parties are not equally congruent in their preferences: the majority of social-democratic voters are on the left as it concerns economic issues, but they are split (right in the middle) on identity and culture. This defines the conundrum: the cultural views of a substantial fraction of the social-democratic electorate are more readily aligned with socially conservative

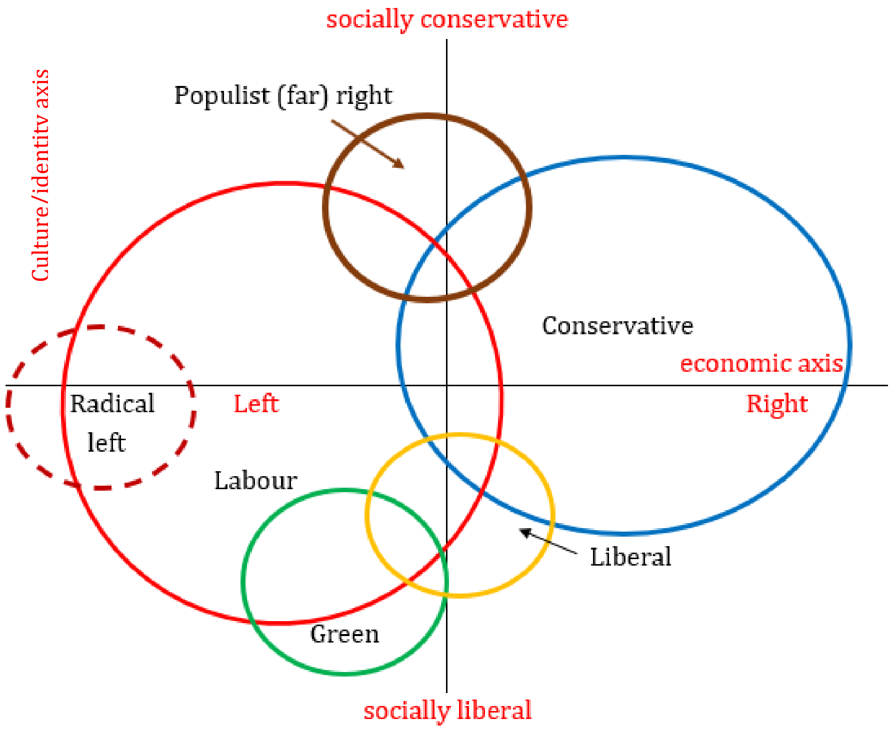
[12] The values on the left-right scale are measured by responses to statements such as: governments should redistribute income from the better off to those who are less well off; big business benefits owners at the expense of workers; and shareholders will always try to get the better of employees if they get the chance. The values on the socially conservative/liberal scale are measured by responses to statements including: young people do not have enough respect for traditional values; people who break the law should be given harsher sentences; and schools should teach the traditional family-based moral values (see Wren-Lewis, 2021).

voters than with other Labour voters. This is where the populist (far) right matters, as it appears to offer a blend of economically 'populist-progressive' views and outspokenly conservative (even reactionary) cultural views (figure 1). In addition, social-democratic parties are losing supporters to the Greens, who (in my stylised figure 1) are assumed to combine socially liberal views on culture/identity and progressive views on economics, and to the (more centrist) Liberals, who combine a centrist economics and socially liberal cultural views.

If we assume (for the moment) that the above diagnosis is correct, the strategic implications of this analysis for social democracy are straightforward. First, social democratic parties should avoid being seen (by the largely conservative mainstream media) to champion socially liberal causes and concerns—in order not to lose the socially conservative Labour vote. This motivation underlies the recent endorsement by social-democratic parties in Western Europe of more restrictive migration policies (e.g., the Danish social democrats campaigned on an anti-migration position in the recent 2019 election). Second, by signalling their own 'reformist' economics to its mostly left-wing supporters, while contesting the reactionary economics of the centre-right parties, social democratic parties should attempt to build strategic progressive majority alliances with the Greens and the centrist social Liberals—which may entail watering down their progressive economics in practice. This two-legged strategy amounts to walking a tightrope—and it is easy to get it wrong.

Culture/identity axis

Figure 1—*Contrasting political views: economics versus culture*



Source: loosely based on Wren-Lewis (2021).

4. But the economics versus culture framing is wrong

While the above diagnosis has merits, it is, in my opinion, flawed in three inter-related respects. The first flaw concerns the assumption that voters still have a meaningful choice between a 'reformist' progressive (macro-) economics of the Left versus a more conservative, market-oriented (macro-)economics of the Right (along the horizontal axis of figure 1). The truth of the matter is that, ever since the 1970s, any differences in macro-economic outlook between the social-democratic parties and centre-right mainstream parties have evaporated—as material conditions changed and all mainstream parties internalised the technocratic new consensus of New-Keynesian macro (Storm, 2021a, 2021b).

New Keynesian macroeconomics created the myth that governments and central banks should refrain from intervening actively, using fiscal and/or monetary policy instruments, to smooth short-run fluctuations or to steer the economy, but rather concentrate on creating the structural conditions for deregulated (labour) markets to grind out the 'natural' long-run equilibrium. "Government does all it can to support enterprise" British Prime Minister Tony Blair and German Chancellor Gerhard Schröder wrote in their 1998 Third Way manifesto, "but never believes it is a substitute for enterprise". The convergence of views on the economy is captured best by Dutch PvdA-leader and Prime Minister Wim Kok, who in his famous Den Uyl Lecture, spoke about the "liberating experience of shedding the ideological feathers" (Kok, 1995), adding: "we no longer speak of a social-democratic 'vision' or 'the alternative' of the PvdA. […] There is no alternative for the societal constellation we have now and therefore it's no use to aim for one."

The New-Keynesian consensus (which I discuss in more detail below) has one profound policy message, which constitutes a radical denial of the promise of Keynesian demand management to keep the economy close to full employment: macro-economic policy faces an inescapable trade-off between 'growth' (or 'efficiency') and 'equality'. Any policy intervention to reduce inequality, for instance by means of labour market regulation and redistribution, carries a welfare cost, because it raises the equilibrium unemployment rate and hence must lower growth. Vice versa, any attempt to permanently raise economic growth means lowering the equilibrium unemployment rate by deregulating the labour market and downsizing the welfare state—which must raise inequality. Andrew Glyn (2006) appropriately called it the 'nasty trade-off' between higher wages and more jobs—or, more generally, between economic growth and egalitarianism.[13]

Social democracy's simultaneous abandonment of a political conception of egalitarianism and of its full-employment orientation in macro policy led to a dramatic decline in democratic participation of working-class voters (table 4). Traditional supporters of social democracy turned away from social democracy, disappointed by the fact that, after "shedding its ideological feathers", it became indistinguishable from the centre-right and conservative parties in matters of economic policy (Spoon and Klüver, 2019). A case in point is the post-2008 voter opposition to austerity policies in the EU, which were in many instances the responsibility of social-democratic parties participating in government. Hence, the working-class dealignment from social democracy has been the result of the deliberate narrowing down

[13] In a recent *New York Times* article, Mankiw (2021) invokes the "nasty trade-off", asking the question: "Can America afford to become a major welfare state?" Mankiw's answer to the question posed in the title of his essay is "no".

of the electorally relevant choice set concerning matters of inequality and redistribution during the 1990s.[14]

But there is more. The transformation of social democracy's economic position towards more accommodation to market forces gave an altogether new importance to 'cultural' issues. In fact, as Martin (2018, p. 169) argues, the promotion of 'cultural liberalism' had the function of 'compensating' for a lack of social democratic achievements on the economic front, while it allowed social democracy, at the same time, to respond to the aspirations of parts of the middle classes. It is in this sense that the increased electoral importance of 'identity politics' is, to a considerable degree, *caused* by the de facto 'technocratization' of economic-policy discourse and the resulting closure of meaningful debate on matters of (macro-)economic policy. Importantly, the increased electoral importance of socio-cultural issues has made social democratic parties increasingly vulnerable to constant conservative attempts to drum up 'culture wars' in order to split the social-democratic vote base, in its own favour and helped by conservative media outlets[15], along the vertical axis of figure 1.

This is, therefore, the second flaw in the 'economics-versus-culture' narrative: social democracy has boxed itself into a corner by deliberately opting for de-mobilising its traditional constituency on the economic dimension, due to which it was forced to rely more strongly on increasing the saliency of the socio-cultural dimension of its political programme. Evidence for Austria, France, Germany, the Netherlands, and the UK by Rennwald (2020) shows that electoral support for redistribution was higher in the 2010s than in the 1970s, and while there were no strong differences on this point among social classes, production workers and service workers were systematically more in favour of redistribution than the average respondent both in the 1970s and the 2010s. At the same time, Rennwald's empirical analysis shows that already in the 1970s, production and service workers were systematically more against immigration than the average voter—and relative to the average citizen, production workers have become more distinctively opposed to immigration over time. This hardening attitude was exploited by populist radical right parties which mobilised (a proportion of) workers for their political projects with a restriction of immigration at its core.

It follows that the changes in social democracy's programme (along both axes of Figure 1) were far larger than the changes in the political attitudes of the working class. Hence, social democratic parties succeeded in actively alienating a large part of its natural vote base—and especially the decline in electoral participation of the working class (table 4) is proof of the failure of social democratic parties to convince their traditional voters to support them on the basis of 'cultural' issues alone. "Isolating the cultural positions of social democracy from its economic positions therefore misses an essential part of the story," Rennwald (2020, p. 97) concludes. Instead of de-emphasising socio-economic issues in favour of socio-cultural positioning, the most important task for social democracy would be to better show how the two are strongly connected (Rennwald, 2020, p. 99).

Following up on this last point, the third—and final—flaw of the 'economics-versus-culture' argument is that it overlooks the fact that voters' attitudes on socio-cultural issues are strongly influenced by their socio-economic position, which, in turn, is heavily dependent on

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[14] Using British survey data covering the period from 1983 to 2010, Evans and Tilly (2012) show that the narrowing of the choices presented to voters, rather than the weakening of class divisions, accounts for the declining political relevance of redistributive values and the class basis of party choice.

[15] Ownership of mass media is a critical factor in our advertising age and in the "industrialization of the mind" (Enzensberger, 1982).

the dominant economic ideology. The record of four decades of New Keynesian management of the Western Europe's economies is not in doubt (Storm, 2021b): long-term growth is declining, suffocated by rising inequalities in income and wealth and by an obsessive-compulsive fiscal austerity by governments, but barely kept alive by rising (private and public) indebtedness and quasi-permanent asset-price bubbles ('financialization'). The resulting increases in (relative) economic deprivation and in income and job security did have sizeable impacts on the electoral support for radical right-wing and left-wing parties in Western Europe.[16] Likewise, the growing opposition to immigration of working-class voters is, to a large degree, directly caused by the rising relative deprivation and insecurity, legitimated by the New Keynesian consensus, which the modernising Third Way social democrats so eagerly embraced more than two decades ago. As Messing and Ságvári (2019) write, "people who feel politically disempowered, financially insecure and without social support are the most likely to become extremely negative towards migrants."

This class of people feels not in control—and one reason for this is because the turn to Third Way social democracy rendered workers more vulnerable to market forces and less likely to use their rights in democratic politics, which again reinforced the dominance of market forces. In a downward spiral, declining working-class mobilisation weakened the welfare state and the weakened welfare state further undermined workers' economic position and their political rights (Rennwald, 2020). The failure of Western Europe's social democracy is—intellectually, at least—a failure to reimagine an effective egalitarian macroeconomic system, oriented toward full employment, after the (mis-diagnosed) crisis of Keynesianism in the stagflationary 1970s (Storm, 2021a).

5. Stagflation and social democracy

The stagflation of the 1970s, when supply-side problems (in the form of oil and energy cost-push inflation) and demand-constrained unemployment occurred in combination, could not be solved by expansionary fiscal policy alone, nor by a restrictive monetary policy stance (higher interest rates), or some combination of fiscal stimulus and accommodating monetary policy (see figure 2). While standard fiscal and monetary policy could take care of demand-constrained unemployment, something additional was needed to curb inflation, protect the profits of productive businesses and avoid a recession. John Kenneth Galbraith (1973, p. 8) explains why fiscal and monetary policy could not do the job of halting inflation:

> "The interaction of corporate and trade union power can be made to yield only to the strongest fiscal and monetary restraints. Those restraints that are available have a comparatively benign effect on those with power, but they weigh adversely on people who vote. When no election is in prospect, perhaps such a policy is possible. It will earn applause for its respectability. But it cannot be tolerated by anyone who must weigh its popular effect."

Hence, what was needed to curb the wage-cost-push inflation was a restrictive incomes policy, involving wage restraint by unions, wage and price controls (Galbraith, 1973) and some

[16] See Fetzer (2019) on austerity and the Brexit vote; Dorn et al. (2020) on economic deprivation and the rise of the far left and far right in Germany; Burgoon et al. (2019) on the impact of positional deprivation to individual-level survey data on party preferences in 20 European countries from 2002 to 2014; Guiso et al. (2016) on the impact of economic insecurity on the rise of populist parties (promising short-term protection); and Galofré-Vilà et al. (2021) on the impact of austerity on the Nazi vote.

variant of a tax-based incomes policy (Weintraub, 1972).[17] In more general terms (Scharpf, 1991, p. 37), the critical requirement in any plausible Keynesian anti-stagflation strategy was an explicit institutional mechanism of wage and price controls—a mechanism which would more specifically persuade unions to set aside the particularized calculus of their immediate self-interest in favour of an orientation toward the general, longer-run interest. The problem was that such mechanisms were mostly absent in Western Europe in the 1970s. As a result, a plausible Keynesian road to fight the stagflation was not taken, as a close coordination between the government, the central bank, unions and firms turned out to be unachievable.

It can, of course, be argued[18] that this inability to reconcile the differing interests of different social classes is an inescapable feature of capitalism—a feature that had been obscured by the fact that until the beginning of the 1970s, left-to-centre governments could combine full-employment Keynesian macroeconomic policies with the basic principles of capitalist economies since the former did not jeopardize the latter.[19] If this were the case, the breakdown of the cooperative capitalism of the 1950s and 1960s must be seen as a return to the 'natural' evolution of conflicting-claims capitalism—and from this it follows that the electoral decline of 'reformist' social democratic parties after the 1970s was inevitable. Fundamentally, this interpretation of the 'golden age of capitalism' (as an historic exception to the general laws of capitalism) comes close to suggesting that the capitalist macroeconomy cannot be reformed and can only be transformed by revolutionary change. I beg to disagree—interpreting post-WWII cooperative capitalism as evidence of a successful 'reformist' macroeconomics—and interpret the breakdown of the 'golden age' as a failure of especially social democracy. Stagflation caught Keynesian social democrats unawares—as their oversimplified, crisis-free understanding of Keynesianism had led them to neglect, or underestimate, the political urgency of building tripartite-consensus mechanisms on wage and price coordination as a practicable, concerted solution to potential inflation problems (Scharpf, 1991). This turned out to be a critical failure: during the high-growth years of the 1960s, establishing the institutional mechanisms might have permitted a concerted macro coordination in times of crisis.[20]

[17] Weintraub's (1972) tax-based incomes policy (TIP) was designed to curb inflation without throwing the economy into recession. The idea of TIP, which has been proposed in several variations by several economists, is to impose income tax penalties on employers who give pay increases in excess of gains in productivity or to give income tax relief to workers who accepted modest wage increases.

[18] The author is grateful to one of the contributors for making this point.

[19] This was due to rapid post-WWII technological progress, capital controls and fixed exchange rates; see footnote 6.

[20] In the 1970s, in Great Britain, unions were unable to restrain wages, while in Sweden, neither the government nor the unions were capable of policy coordination. In (West) Germany, Keynesian coordination was not attempted, because of the institutional autonomy of the non-cooperative Bundesbank (Scharpf, 1991). In France, decades of state-led development had forged close ties between business and officials in the powerful national state, but it largely excluded organized labour (which was controlled by the French Communist Party); as a result, France lacked the centralized wage bargaining systems that characterized Scandinavia, for instance, and questions that elsewhere were settled through collective negotiation were determined by state officials (Birch, 2021).

Figure 2—*A typology of macroeconomic problems and policy responses*

	causes	
	demand-side (Keynesian)	**supply-side** (New-Keynesian)
Unemployment	due to lack of aggregate demand *expansionary fiscal policy; higher wages; social insurance (unemployment benefits)*	due to over-regulation of the labour market and costs of the welfare state (NAIRU) *labour market deregulation; wage restraint; activating labour market policies; (re-)schooling and human capital formation*
Inflation	demand-pull inflation *restrictive monetary policy; incomes policy*	wage-cost-push inflation *restrictive monetary policy; austerity; wage restraint*
Current account deficit	excess domestic demand *import controls; exchange controls*	wage-cost push inflation *restrictive monetary policy; austerity; wage restraint*

The result was that oil price shocks did lead to rising inflationary pressure, which in turn contributed to higher (cost-of-living-indexed) wage claims and higher prices—not just in Europe but also in the US. Business profits and business investment were squeezed, the growth of aggregate demand declined and unemployment rose. Central banks became worried about accelerating inflation and began to raise interest rates. Higher interest rates hampered the effectiveness of what remained of Keynesian coordination.

National monetary policy in Western Europe was completely disabled as an element of Keynesian control, after the US Federal Reserve raised interest rates during 1978-1981, in the face of rising US inflation, trade deficits and a falling dollar—to more than 19% in early 1981. In order to prevent massive financial outflows to the US and a depreciation of their currencies, Western European central banks (unwilling to impose capital controls) raised their interest rates in step with the dollar rate.[21] This was a major instance in which the potential conflict

[21] Most European nations had dismantled government exchange control on cross-border financial flows as part of the post-Bretton-Woods internationalization of money and capital markets. The difficulties facing European policymakers were compounded by their countries' membership in the European Monetary System (EMS), the precursor to the Eurozone. By tying their currencies to the German Deutschmark, the EMS further restricted the central bank's ability to adjust monetary policy to meet their countries' macroeconomic needs. German Bundeskanzler Helmut Schmidt and French President Valéry Giscard d'Estaing were the main forces behind the creation of the European Monetary System (EMS) in 1979, a forerunner of the Euro (Deutsche Bundesbank, 1978). The EMS was intended to reduce exchange rate fluctuations within the European Economic Community (EEC), and

between the monetary authority and the fiscal authority became manifest—and was decided in favour of the former. This was not surprising, because, in Germany, the independent position of the Bundesbank was "beyond debate" already in 1978, in the words of social democratic Prime Minister Helmut Schmidt (Deutsche Bundesbank, 1978).[22] Inflation control and a stable exchange rate were essential to Germany's economic model based on manufacturing exports—even at the cost of domestic deflation. Prioritising exchange rate stability, the Schmidt government turned against Keynesian stimulus in other European economies, favouring austerity and deflation instead (Halevi, 2019).

The global recession spurred by the 'Volcker shock' depressed European business investment and consumer demand, right at the time when underutilized production capacities and high unemployment would have called for an expansion of demand.[23] The burden of expanding demand had to borne by fiscal policy alone—and to achieve a given increase in demand, the budget deficit would have to be larger than would have been necessary with monetary policy support. In addition, the higher interest rates considerably increased the cost of expansionary fiscal policy (in terms of higher interest payments on public debt).[24] Worse, since bank credit had become too expensive, business investment could only be financed out of profits, but business profits were squeezed by rising energy costs and wages. Moreover, as long as there was a worldwide stagnation of demand, profitability on real investment would remain below the minimum rate of return of the international capital markets, and as a result, what was remaining of the profits of firms would flow into financial investment rather than into larger productive capacities that would create jobs (Scharpf, 1991, p. 247).[25]

As long as the domestic policies of Western-European countries could neither determine the international rate of interest nor effectively limit the mobility of finance, the only feasible policy options in the early 1980s were to either accept high and growing unemployment or to

especially block Italy from pursuing its strategy of inflation and devaluation. The EMS also provided a shield against the depreciation of the US dollar (Halevi, 2019). But the EMS put pressure to internally adjust on member countries having an external deficit, deflating their demand, cut imports and (arguably) raise exports (ibid.).

[22] Following the demise of the fixed exchange rates system, the Bundesbank had already gained 'independence' from the Ministry of Finance. Until the early 1970s, the government had been responsible for the exchange rate, but with flexible rates of exchange, this responsibility lost its practical significance. Because the exchange rate is dependent on the interest rate set by the central bank, the responsibility for the exchange rate passed to the Bundesbank whose priority is price stability. During 1978-1981, it was thus well within the mandate of the Bundesbank to counter the inflation arising due to the US dollar appreciation and capital outflows.

[23] As explained by Halevi (2019, p. 7), higher US interest rates led to a higher value of the dollar. In response, the German government followed a deliberate policy of internal deflation aimed at keeping domestic effective demand in a subdued state to support German companies' international expansion, both by means of trade as well as by means of foreign direct investment - the latter viewed as an export augmenting factor through the demand it created for German machinery. During this time, the EMS protected German exports to the rest of the Europe and to Italy, in particular. Italy's small exporting firms could not compete with the larger, oligopolistic German exporters of (high-tech) intermediates and capital goods.

[24] Mitterrand's radical Keynesian programme of 1981 suffered the consequences. While it prevented France from sinking into an even deeper recession, it did lead to double-digit inflation and ballooning trade and public deficits. Adding to Mitterrand's difficulties was the growing power of finance after the collapse of the Bretton Woods monetary system. France suffered from continued speculative attacks against the Franc, which was pegged to the Deutsche Mark (Birch, 2021).

[25] Those who recognized and understood the significance of international constraints on domestic social democratic Keynesianism concentrated their hopes on the chance of rebuilding Keynesian options at the international level—and particularly through the economic and monetary integration in the European Community. But the prospects for the success of macroeconomic control would depend on the coordination of monetary, fiscal and incomes policies at the European level. Mechanisms for such coordination were and remain nowhere in sight in the Eurozone which was designed, with the active support of social democratic parties, as a technocratic European-level monetarism rather than a European Keynesianism (see Halevi, 2019 for a discussion).

increase the rate of return on productive investment so much that it could compete again with non-productive financial 'investment'. Any attempt to restore full employment would thus have to be paid for by a massive redistribution in favour of profit income. This was the argument held by supply-side economists (who argued in favour of a reduction of business taxes, increased investment subsidies, lower social security contributions and wage restraint), but also by Keynesian economists[26] who—in hindsight—appeared to argue that aggregate demand, at the time, was profit-led.[27]

6. The power grab by central banks

Facing accelerating inflation, European central banks were not convinced that the restoration of business profitability, needed for economic recovery, would be coming about any time soon—after all, most unions refused to moderate their wage claims in the belief that the monetary authorities would not fully prioritize inflation control, because they were obligated, by their dual mandates, to balance the pursuit of price stability with due consideration of its consequences for (full) employment. Unions expected that monetary authorities would continue to support fiscal policy as before and, hence, assigned monetary policy only a subordinate role in macroeconomic policy-making.[28] It turned out they were very wrong.

Central banks were facing a dilemma. Their first legal priority, price stabilization, was impaired by the expansionary fiscal policies of their governments and by the unwillingness of unions to restrain wage growth. Either central banks had to accept inflation rates higher than they found acceptable or they had to reject the demand for coordinating their monetary-policy decisions with fiscal stimulus (in order to protect employment). The latter course of action would likely have been interpreted as a violation of their mandate and would have brought them into—open—conflict with their administrations, which risked triggering political initiatives to revise the central bank mandate in favour of the maintenance of full employment.

By the early 1980s, central banks found an escape from this dilemma—by invoking the (up-to-then purely academic) argument that the long-run Phillips-curve was not downward-sloping (as assumed in 'bastard' Keynesian models), but vertical at the non-accelerating-inflation rate of unemployment (NAIRU). What the concept of the NAIRU suggested was that fiscal stimulus intended to lower *actual* unemployment below the NAIRU would not just fail to do so, but would also generate run-away (accelerating) inflation. Based on the vertical long-run Phillips-curve and claiming that the actual unemployment rate in the early 1980s was

[26] Social democrats internalized this lesson. West-German Bundeskanzler Helmut Schmidt (1976), a leading European social democrat, articulated it as follows: "The profits of enterprises today are the investments of tomorrow, and the investments of tomorrow are the employment of the day after." (*Le Monde*, July 6, 1976).

[27] The deeper issue was a lack of business confidence, manifested in constant capital flight which put pressure on the government and the unions, and which led to three devaluations of the French Franc in less than two years, despite the currency's status as a major component of the EMS (Halevi, 2019).

[28] Scharpf (1991, p. 177) notes that by the early 1980s, the time horizon of union wage policy had become shorter, as the world economic environment had become more turbulent in the 1970s following the collapse of the Bretton-Woods system of fixed exchange rates and exchange controls. All European economies became exposed to repeated waves of currency speculation and the turbulence of frequent changes in rates of exchange. As a result, the relatively stable wage-price relations in Western-European countries became unstuck. An explicit coordination with other actors—businesses, the state, and the central bank—could have compensated for the increase in uncertainty facing the unions, but such platforms for concerted action to neutralize the effects of increased global turbulence were generally insufficiently developed.

much lower than the NAIRU, central banks could justify *unilateral* increases in the interest rate to reduce inflation and, at the same time, bring actual unemployment back (up) to the NAIRU, "while rhetorically honouring the demand for coordination, and to burden the government, and especially the unions, with making the adjustments necessary for a successful coordination" (Scharpf, 1991, p. 137). The adoption of the NAIRU argument by central banks gave so much instantaneous credibility to the ivory-tower scribblers, responsible for the development of the theory, that soon after, the legend of a counter-revolution to Keynesianism was born.[29] The historical irony is that the concept of the NAIRU gained a strategic importance in macroeconomic policy-making mostly for reasons of political convenience, and quite independently of its theoretical plausibility and empirical robustness (Storm and Naastepad, 2012).[30]

In policy terms, the outcome was a power grab by central banks, which, based on the strategic advantage of having been the first to move, from then on were able to advocate better coordination in macroeconomic policy from the commanding height of technocratic authority—governments and unions had to work within the parameters set by the central banks (notably the interest rate set by the central bank based on the NAIRU estimated by central bank economists). The practical implications were profound. Restrictive monetary policy could be legitimately used to (more than) offset expansionary fiscal policy, in direct conflict with the priorities of government policy; from then on, monetary policy-makers would overtly determine the—increasingly smaller—policy space for the fiscal authority.[31] And central bankers would set the (mostly limited) negotiating space within which unions could effectively bargain for wage increases.[32] Crucially, the risk of unemployment was reprivatized—which, indeed, was the whole point, as the NAIRU was to be used as a macroeconomic device disciplining labour in order to maintain price stability (Storm and Naastepad, 2012).

Following the power grab by central banks, the era of full-employment-oriented macro management definitively came to an end. Keynesian macro control of the economy was no longer possible—and, over time, central banks were able to consolidate their strategic positional gain, after they were granted 'independence' from the fiscal authority and the political process. From then on, supposedly 'neutral' and 'technocratic' monetary policy took precedence over fiscal policy and all other economic policies, by placing 'democratic money'

[29] "The ascendancy of new classicism in academia was [...] a triumph of a priori theorizing over empiricism, of intellectual aesthetics over observation and, in some measure, of conservative ideology over liberalism," writes Blinder (1988, p. 278). See also Storm (2021b).
[30] Note that, at the time, there was no need at all to invoke the vertical Phillips-curve (and rational expectations), because standard Keynesian macro-econometric models of the Tinbergen-Klein variety could well explain the stagflation. For example, according to Klein (1985, p. 293), "the Wharton model, if given a conventional fiscal shock, would generate the usual trade-off relationship, but if given a food or fuel price shock would generate a situation of rising unemployment and rising inflation." Likewise, using the DRI model, Eckstein (1978) showed that the major supply-side causes of the stagflation were higher energy prices, higher agricultural prices, a depreciation of the dollar, price de-control (for inflation) and price controls (for unemployment). See Goutsmedt et al. (2016).
[31] Strongly pushed by central banks, what had started as a more or less fringe Chicago Monetarist argument featuring rational expectations and a vertical (long-run) Phillips-curve and intended to stabilize prices and discipline unions, using mechanical monetary policy rules, evolved into becoming macroeconomics' mainstream model of a technocratic, independent monetary authority, credibly committed to providing markets with the stable framework they needed (Tooze, 2021).
[32] This shows that central bank inflation targeting amounts to a (biased) incomes policy, as noted by Lavoie and Seccareccia (2021, p. 24): "Inflation targeting is an unequitable form of incomes policy because, fundamentally, it is biased against wage earners. It also helps to explain why inflation targeting policy appeals to the financial sector, which grew inordinately during that whole period preceding the financial crisis."

and macroeconomic policy under the control of supposedly competent, but unelected, experts credibly committed to providing (financial) markets with the stable framework they needed (Tooze, 2021). The full price of this structural position change of central banks was to be paid in the decades after the 1980s.

7. The macroeconomics of the Third Way

The Third Way represented an effort to reimagine social democracy in response to the conservative governments, which had ruled most of Western Europe during the 1980s and most of the 1990s,[33] and it was also a reaction to the collapse of communism in the Soviet Union and much of Eastern Europe, which unravelled "the whole skein of doctrines which had bound the Left together for over a century", as Tony Judt (2010, p. 142) explained. Social democracy's long years in opposition coincided with the 'revolution' in economic thinking—one which succeeded in overthrowing the 'bastard' Keynesian consensus, discrediting the full-employment orientation in macroeconomic policy and handing over the economy's steering wheel to technocratic central bankers, committed to low and stable inflation. With remarkable ease, social democratic thinkers dumped their Keynesian beliefs in exchange for the new macroeconomic consensus—which only shows that their earlier support of 'Keynesianism' was based on the shallow grounds of expedience rather than a deeper understanding of Keynesian analysis and arguments.

The reimagination culminated[34] in the already mentioned *Third Way manifesto*, written by Blair and Schröder, titled "Europe: The Third Way/Die Neue Mitte". "Most people have long since abandoned the world view represented by the dogmas of Left and Right," the manifesto began. "Social democrats must be able to speak to these people" (Blair and Schröder, 1998, p. 2). Traditional social democracy assumed, in their view incorrectly, that governments could row the boat, not just steer it. Overall, the two authors concluded, the traditional version of social democracy overstated the weaknesses of markets and undervalued the importance of individual entrepreneurship and business enterprise to the creation of national wealth. Instead, Blair and Schröder (1998, p. 2) argued that "the essential function of markets must be complemented and improved by political action, not hampered by it. We support a market economy, not a market society." No longer willing and capable of thinking in terms of alternatives to, or deeper reforms of, really existing capitalism, Third Way social democracy hoisted the white flag—and accepted the consensus view of a more or less self-regulating and self-stabilising market economy, supported by central bank action. This meant accepting New Keynesian macroeconomics, which promoted central banks independence and fiscal policy rules (biased toward austerity)—with technocratic (monetary) policy anchored at the NAIRU. Let us consider the New Keynesian macro model in more detail.

The core of the New Keynesian macro model is the assumption—or belief—that fluctuations in aggregate demand matter for economic performance only in the short run, while long-run (trend) growth in a market economy is exclusively driven by the supply-side factors 'demography' and 'technological progress'. The belief in this dichotomy between the demand-

[33] These include the governments of Margaret Thatcher (1979-1990) and John Major (1990-1997) in the UK, Helmut Kohl (1982-1998) in (West) Germany, and Ruud Lubbers (1982-1994) in the Netherlands.
[34] Giddens' contribution to the theory of the Third Way is, of course, more substantially important than Blair and Schröder's manifesto (1998).

determined short run and the supply-determined long run has crucial implications for the way we think about macroeconomic policy. To illustrate these implications (while avoiding unnecessary technicalities and jargon), let me assume that the long run 'potential' growth of a market economy can be modelled as follows:

$$y_P = \ell_N \times L \times \lambda \qquad [1]$$

where $y_P =$ *real potential output*; $\ell_N = (1 - u_N) =$ the *equilibrium employment rate*; $L =$ the labour force; and $\lambda =$ the level of labour productivity. Note that $u_N =$ the equilibrium unemployment rate, also known as the NAIRU. In New Keynesian macroeconomics, the NAIRU is the rate of unemployment associated with a level of economic activity at which the inflation rate is constant—at exactly the rate targeted by the central bank (Storm and Naastepad, 2012). The idea is that wages and hence inflation will increase, if actual unemployment is below u_N—which happens when the economy is overheating, as economic activity exceeds y_P. To stop inflation from accelerating, the central bank will increase the interest rate, depressing demand (mostly business investment), lowering output and raising unemployment—until actual unemployment is brought back up to the NAIRU, while inflation is stabilised at the inflation target.

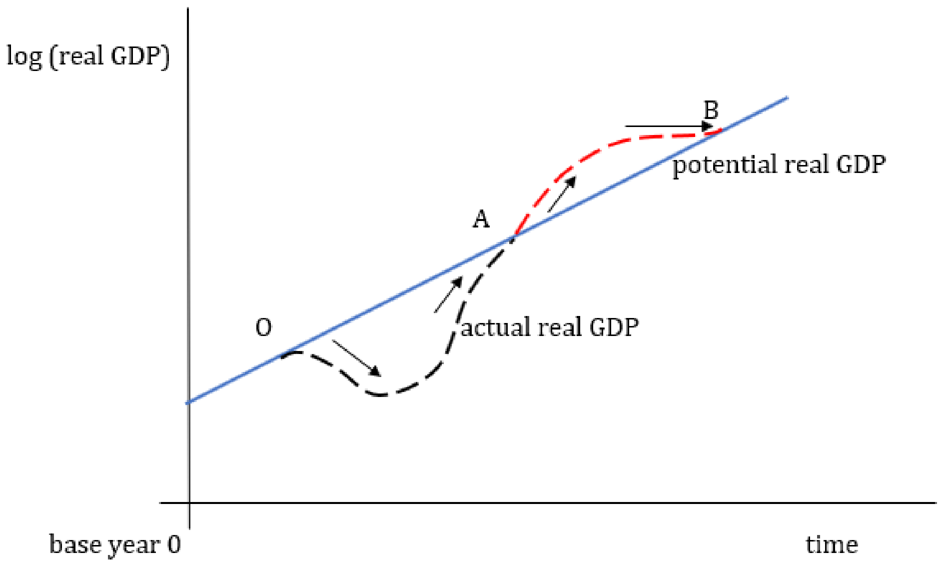
Rewriting eq. (1) in terms of growth rates, we obtain the following expression for potential economic growth:

$$\hat{y}_P = \hat{\ell}_N + \hat{L} + \hat{\lambda} = \hat{L} + \hat{\lambda} \qquad [2]$$

Note that $\hat{\ell}_N = 0$, because u_N is constant, since New Keynesian macroeconomics assumes that central bankers are capable of keeping actual unemployment close to the NAIRU in the long run by means of monetary policy. Hence, eq. (2) gives the growth rate of potential real GDP as a function of the exogenous forces of 'demography' ($\hat{L}$) and of 'technology' ($\hat{\lambda}$). In Figure 3, the straight curve gives steadily increasing potential real GDP. The dashed curve OA represents the evolution of actual real GDP in a period of recession. The recession is caused by a temporary, unanticipated, negative demand shock. As a result, the economy is performing below potential. Actual unemployment will rise above u_N—and the central bank will lower the interest rate, which will encourage private investment. Higher business investment will increase demand, lower unemployment and increase real GDP. The central bank will continue to keep the interest rate (relatively) low for as long as is necessary to bring actual real GDP back to potential real GDP (at point A in Figure 3).

The dashed line AB in Figure 3 represents an unanticipated temporary positive demand shock. Actual real GDP is growing faster than potential real GDP. As a result, actual unemployment is lower than u_N and inflation will rise. The central bank will step on the brake and increase the interest rate and lower demand; as a result, actual real GDP converges back to potential real GDP (which happens at point B in Figure 3). Under the assumptions of the New Keynesian model, fluctuations in aggregate demand do not have permanent effects on potential (long-run) growth. This particular view of the macroeconomy defines, in very specific terms, the scope and (in-)effectiveness of macroeconomic policy-making (Storm and Naastepad, 2012).

Figure 3—*Potential growth and actual growth: convergence*



8.1. Monetary policy

In the New Keynesian model, it is impossible for *monetary policy* to reduce actual unemployment below u_N without triggering (accelerating) inflation in excess of the inflation target. Hence, what used to be a *dual* mandate for central banks—to use monetary policy to stabilise inflation at or below the inflation target and, at the same time, to contribute to maximum sustainable employment (Lavoie and Seccareccia, 2020)—morphed into the *single* mandate of keeping inflation at or below the inflation target.

Such single-minded inflation targeting, it is argued next, would be served best by technocratic, central banks with the ability to conduct monetary policy independently from interference by fiscal and political authorities. This particular claim is based on Kydland and Prescott's (1977) argument that if central banks were dependent on politicians, there would be a bias towards higher inflation without any corresponding benefit, and on the argument by Barro and Gordon (1983) that *credible* central banks need to follow a transparent monetary policy rule.

Importantly, in Europe, the institutional shift towards central bank independence frequently happened under the watch of social democratic governments. For instance, in 1981, under a coalition government including the social democrats, the Bank of Italy gained full autonomy from the Ministry of Finance (the so-called '*divorce*'). As Joseph Halevi (2019, p, 9) writes:

> "since a similar, although historically and institutionally different, process happened in France around 1984, we may conclude that a Maastricht style mentality already existed and was not imposed on these countries from outside. '*Il divorzio*' in Italy and *la rupture du circuit* in France emerged as internal political and economic decisions not demanded by any of the then quite limited, in terms of authority, Brussels' bureaucracy. It is also interesting to observe that politically in Italy the acceptance and the rejection of the divorce did not depend upon the particular ideologies of the political parties. The spendthrift Socialist Party of Craxi's fame was in favour, as

> much as the morally and economically austerian Communist Party. [....] Indeed, the pro-divorce position taken by the Communist Party [...] may have played a role in convincing the less enthusiastic sections of the Christian Democrats to go ahead with it."

In the UK, central bank independence dates back to 1997, when the then Labour Chancellor of the Exchequer, Gordon Brown, granted the Bank of England operational independence. The Maastricht Treaty (of 1992) required the central banks of the prospective member states of the Economic and Monetary Union (EMU) to become fully independent—and the European Central Bank (ECB) was established, as is all too well known, as a supra-national independent, single-mandate central bank.[35] The EMU is a central bankers' union, in other words. In fact, it was the French government, under Mitterrand, that pushed hardest to create an independent European Central Bank, committed to monetary restraint and price stability (Birch 2015). Social democrats are generally convinced that macroeconomic policy should be left to monetary policy and never questioned the independence of the ECB (Bremer and McDaniel, 2020, p. 21). As a result, they were willing to not just give up parliamentary control over monetary policy, but to surrender on fiscal policy as well—and this 'democratic deficit' or 'accountability gap' in monetary (and fiscal) policy-making arguably matters more for social democracy than for parties of the centre and the centre-right.

8.2. Fiscal rules and austerity

In New Keynesian thinking, the space for active *fiscal policy* is even more constrained than for monetary policy. Fiscal stimulus cannot affect potential growth—by the assumptions of the model—and, hence, its only potential use is for short-run business-cycle stabilisation. However, while fiscal policy could—in principle—be used in a downswing to bring about convergence to potential growth, this is considered problematic. In a recession, the government should temporarily increase spending, to bring the macroeconomy to point A (in figure 3), but once point A has been reached, the fiscal stimulus should be discontinued—which may be electorally difficult for reasons related to the political business cycle. Likewise, in the upswing of the business cycle (between points A and B in figure 3), the government should temporarily lower spending, which may be hard to sell politically, because it would end the upswing. So, even business-cycle stabilisation by fiscal policy is no longer considered desirable because the fiscal authority is deemed to be too unreliable, prone to mistakes and willing to prioritise political considerations over New Keynesian logic.[36]

Two institutional reforms have restricted the space for fiscal policy, arguably with the intention to reduce pressures to overspend, particularly in good times. First, by outlawing monetary financing of government debt by the central bank "politicians are kept away from the printing press"—and, at the same time, the fiscal authority is subjected to the (supposedly rational) discipline of international bond markets. Weak fiscal discipline and rising credit risk should be reflected in higher costs of borrowing of the government concerned (compared to more prudent states). Second, the actions of the fiscal authority are limited further by the

[35] The first president of the ECB (during 1998-2003) was Wim Duisenberg, the Dutch former social-democratic Minister of Finance in the centre-left Den Uyl government (1972-1977), the most 'left-wing' government the Dutch ever had. Furthermore, it must be noted that on the June 1st, 1998, when the ECB was officially established, social democrats were in government in 12 out of 15 EU member states.

[36] See Robert Lucas (2003, p. 1), who states that "the potential for welfare gains from better long-run, supply-side policies exceeds by far the potential for further improvements in short-run demand management."

introduction of technocratic fiscal rules that impose long-lasting constraints on fiscal policy through numerical limits on the fiscal deficit and/or the public debt (relative to GDP).[37]

Social democrats (as well as communists) in France and Germany were already infatuated by the fiscal conservatism underlying these institutional restrictions, believing that fiscal deficits were inflationary and would further impoverish the working classes; they have always regarded "sound public finance" as the central pillar of the stability of the social order (Halevi, 2019). The bottom line for Third Way social democracy was sobering: fiscal policy had to be given up as an instrument of stabilisation, redistribution, and growth—which is what Blair and Schröder (1998) agreed to in no uncertain terms. Within the Eurozone this abandonment of fiscal policy was formalised in the (restrictive) fiscal rules[38] of the Stability and Growth Pact (SGP) of 1998-1999, the reformed SGP of 2005, the Euro Plus Pact of 2011, and the Fiscal Compact of 2012. In practice, these rules amount to a disciplinary austerity which, for all practical purposes, left no room for fiscal stabilization (let alone fiscal stimulus).

Importantly, social democratic parties and governments on the left supported fiscal consolidation policies and fiscal rules prior to and during the Eurozone crisis of 2008-2013. For example, despite the heavy rhetoric promoting himself as the 'anti-austerity' candidate during the elections of 2012, François Hollande while president resorted rather quickly to austerity—after he failed to engineer greater fiscal capacity for France through the renegotiation of the new European Fiscal Compact and the creation of Euro-bonds (Bremer and McDaniel, 2020). Hollande justified his decision arguing that austerity was 'inevitable' and at least his government imposed it in a "socially just manner" (ibid., p. 17). The German SPD was, as the junior coalition partner of the CDU-CSU, responsible for changing the German constitution in spring 2009 to introduce a 'debt brake' ('Schuldenbremse'), which became the blueprint for the European Fiscal Compact introduced in 2012. Again, as the junior coalition partner in government, the SPD was co-responsible for achieving budget balance (Wolfgang Schäuble's 'Schwarze Null') in 2014. Of course, the SPD had already abandoned its faith in demand-management in 1999, following the cantankerous departure of Oskar Lafontaine, the Minister of Finance in the first Schröder government (1998-2002). The British Labour Party started austerity in 2010 and later, while in opposition and under Shadow Chancellor Ed Balls (2011-2015), never openly battled the conservative government's austerity policies.[39] As the party's 2015 manifesto stated, Labour's plan "to balance the books" meant "making tough, but fairer choices" (Bremer and McDaniel, 2020, p. 24). The Dutch PvdA was responsible for a heavy dose of austerity during 2012-2017, when it was the junior partner in a government coalition with the conservatives. In general, social democratic politicians justified 'fiscal

[37] Both institutional reforms were pioneered by the French socialists, as Halevi (2019, p. 13) points out, "[i]n the 1980s under the stewardship of the Socialists, France became the epicentre of European austerity both in policy terms as well as in terms of institutional thinking. […] The Socialists manufactured internally the framework which anticipated by several years the Maastricht-Dublin-EMU convergence criteria affecting, rather negatively, as we must now admit, most of Europe. In addition to the internal 3% deficit limit and to the breaking of the financial circuit which sustained the Trésor, the Socialist government of the first Mitterrand presidency developed the concept and practice of *competitive disinflation* …."

[38] The original fiscal rules were defined already in the report on "Economic and Monetary Union in the European Community" by the Delors Committee (in 1989) and reaffirmed in the Treaty of Maastricht of 1992. Note that social democrat Jacques Delors was the Finance Minister under Mitterrand (from 1981 to 1984, see previous footnote) and the President of the European Commission (from 1985 to 1995).

[39] Balls explains his thinking in retrospect as follows: "By 2013, I had to plan on my inheritance not being an economy below trend but an economy, which was on par with a diminished trend. In those circumstances, I could not be in fiscal denial...it was becoming clear that there would have to be some form of fiscal consolidation because there was absolutely a structural deficit, not only a cyclical deficit." (Bremer and McDaniel, 2020, pp. 25-26).

responsibility in the national interest'—arguing that austerity and lower public debts were essential to creating a 'social-investment state' with sufficient room to act. I would like to add, for the record, that the possibility of raising taxes to lower the fiscal deficit and public debt was not seriously entertained anywhere. Significantly, oral history shows that Third Way social democrats routinely couched their economic arguments in terms of the New Keynesian consensus model.[40] The result was, as Bremer and McDaniel (2020, pp. 29-30) point out, a disaster:

> "Unwilling to support 'old' Keynesian policies, contemporary social democratic parties were trapped by their economic ideas and failed to lead the opposition against the current macroeconomic regime [...], while acknowledging that the political and economic consequences of this regime are wholly unsatisfactory. This predicament has contributed to the deepest electoral slump that the social democratic movement in Europe has experienced since the Second World War and created space for populist political forces to emerge on both the left [...] and the far right."

8.3. Structural reforms (meaning labour market deregulation)

The only feasible way in which macroeconomic performance can be permanently improved without producing accelerating inflation in the New Keynesian model is by lowering the NAIRU, u_N. This is illustrated in figure 4: a reduction in u_N will lead to a one-time increase in potential growth (from A to B), after which the economy continues to grow at the same rate as before. However, the only way to reduce the NAIRU is by 'structural reforms'—a popular euphemism used to indicate the weakening of labour unions, the scaling-down of social security and labour taxes, the lowering of minimum wages, the shortening of the duration of unemployment benefits, and the deregulation of the employment relationship by weakening employment (or job) protection laws. In short, to reduce u_N, the labour market must be deregulated in favour of employers. State policy can help by investing in human and physical capital and by providing public goods that markets do not deliver.

For social democracy, this is what "the shedding of the ideological feathers" (Kok, 1995) ultimately meant: accepting New Keynesian dogma that there is a trade-off between 'Scylla' (protecting egalitarianism, but at the cost of high unemployment) and 'Charybdis' (promoting growth of incomes and jobs, but at the cost of greater inequality). Western European social democracy opted for the latter, prioritizing job growth over rising inequality. At the end of the second millennium, Dutch Prime Minister Wim Kok's mantra "jobs, jobs, jobs" became the shared policy priority of all left-of-centre governments in Western Europe, which in the face of historically high rates of unemployment decided to step up job growth (Bonoli, 2004). These social democrat governments operated in the New Keynesian belief that fuller employment is possible only by means of supply-side reforms which reduce the cost of labour and allow for low-wage flexible service jobs, as in the case of the labour market reforms of New Labour (Glyn 2006) and the Hartz-Reforms of the Schröder government (Odendahl, 2017).

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[40] Based on 60 interviews with key social democratic stakeholders in France, Germany, and the UK, Bremer and McDaniel (2020) find that the ideational foundations of social democratic support for austerity post-crisis were drawn from New Keynesianism and supply-side economics. In addition, the fiscal conservatism came quite naturally to many on the (Communist) Left, because it was already part of their ideological makeup that government deficits would lead to inflation which would be 'bad' for the working classes (Halevi, 2019).

Figure 4—*Potential growth: a reduction in the* NAIRU

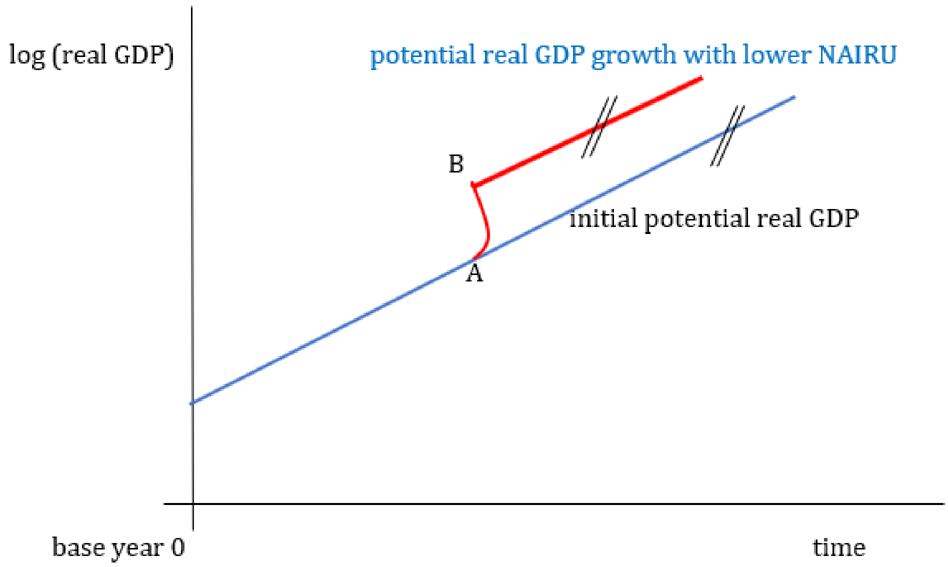

Table 5 presents the decline in the NAIRU (as estimated by the OECD) achieved during the rule of six social democratic governments in the EU. France, Germany, and Italy had much higher NAIRU's than the Netherlands, Sweden, and the UK—a difference caused by the fact that their labour markets were more heavily regulated in favour of labour. The NAIRU is supposed to be a measure of structural unemployment, which changes only slowly, if at all—and if the NAIRU goes down, this must (in New Keynesian theory at least) reflect structural deregulatory reform of an economy's labour market. As table 5 shows, the NAIRUs came down in these six countries, and in most cases in no small measure. Reforms by the Kok governments (1994-2002) contributed to a decline in the Dutch NAIRU by 2.13 percentage points. Structural labour market reforms made by Blair's governments (1997-2007) lowered the British NAIRU by 1.43 percentage points (over a period of ten years), while Jospin's reforms reduced the French NAIRU by 1.24 percentage points (in only five years). But by far the biggest reduction in the NAIRU was engineered by the Schröder government in Germany: after the introduction of the Hartz reforms (Odendahl, 2017), Germany's NAIRU came down from a peak of 9.49% in 2004 to 6.76% in 2010, a 2.73 percentage point reduction. The numbers in table 5 underscore the considerable ambitions of Europe's social democratic governments when it came to labur market deregulation.

I must note here that even if the labour market deregulation was successful in reducing (equilibrium) unemployment, it failed to engineer a return to full employment; the French and the Italians still had to live with unemployment rates of 8.6% and 9.4%, and the Germans and the Swedes with unemployment rates of close to 7%. The supply-side reforms—the cost of which was borne by workers in the form of less stable employment, stagnating wages, and deteriorating quality of working conditions, sustained a large 'disposable' labour force, a flexible reserve army of the under-employed, and through this, raised inequality.[41] This is clear from table 5, which also presents changes in income inequality (as measured by the Gini coefficient of household disposable income) in the six countries over (roughly) the same period of time. Income inequality clearly increased across the board (Italy is the only exception here). In New Keynesian logic, higher inequality is the collateral damage of lower unemployment (per the 'Nasty Trade-Off')—it is something social democracy was willing to accept—and did so with remarkable ease. As Labour Party's Peter Mandelson put it, he "was relaxed about people getting filthy rich" (quoted in Marlière, 2010). Many voters were not—and turned their backs on the social democratic parties.

Table 5—*The trade-off between unemployment and inequality*

	%-change in the NAIRU under New Labour:		Social-democratic Prime Minister:	Gini coefficients: income mid-1990s	2008	change
France	−1.24%	from 9.87% in 1997 to 8.63% in 2002	Lionel Jospin (1997-2002)	0.28	0.29	0.02
Germany	−2.73%	from 9.49% in 2004 to 6.76% in 2010	Gerhard Schröder (1998-2006)	0.27	0.30	0.03
Italy	−0.05%	from 9.48% in 1996 to 9.43% in 2001	'Olive Tree' governments	0.35	0.34	−0.01
NL	−2.13%	from 6.87% in 1994 to 4.74% in 2002	Wim Kok (1994-2002)	0.25	0.29	0.04
Sweden	−0.57%	from 7.49% in 1994 to 6.92% in 2006	Ingvar Carlsson/Göran Persson	0.21	0.26	0.05
UK	−1.43%	from 7.30% in 1997 to 5.87% in 2007	Tony Blair (1997-2007)	0.31	0.34	0.03

Sources: (a) NAIRU estimates are from: *OECD Economic Outlook Dataset*, n. 105, May 2019;
(b) Gini coefficients of household disposable income are from: Bonesmo Fredriksen (2012). See Storm (2021).
Note: NL = The Netherlands. During 1997-2002, social democrats were in government in 12 out of 15 EU member states.

Although these "structural reforms did succeed in reducing unemployment, they rather spectacularly failed to improve overall macroeconomic performance in the countries concerned" (Storm, 2021). In contrast to what figure 4 'predicts', real GDP growth during 2000-2008 (and later) was considerably below growth in the 1990s in all economies listed in table 5 (except Sweden)—notwithstanding the structural reforms. Hence, the job growth was caused not by higher output growth, but by much *lower productivity growth*. It is impossible to read this as (social and/or emancipatory) progress—because what it reflects on the ground is the growth of low-productivity, low-pay, generally temporary 'alternative working arrangements', mostly in private service industries—arrangements which in post-Schröder Germany are often 'mini-jobs', in Italy are all fixed-term contracts (Storm, 2019), and in post-Kok the Netherlands most often mean temporary self-employment.

9. A counter-counter revolution

Social democracy learnt the wrong lessons from the stagflation of the 1970s—and by embracing New Keynesian thinking and internalizing the 'Nasty Trade-Off' as an inescapable

[41] It is therefore not correct, in my view, to argue that New Labour tried to engineer 'full employment' by means of these supply-side reforms, rather than by the management of aggregate demand. What really matters are the implications of 'full employment' for wage growth, income distribution, the stability and quality of working conditions, and in the end the bargaining power of workers. New Labour's NAIRU-based reforms were intended to create jobs, whatever their quality, and to avoid strengthening the bargaining power of unions.

feature of capitalism, it contributed to locking economies into patterns of slow real-economy growth, driven by debt-financed spending, and rapid growth of the financial sector—featuring rising inequality, more working poor, greater income and job insecurity and declining social mobility. In the process, social democracy actively alienated its constituency. So, what is to be done? What sort of macroeconomic framework can the Left propose to explain its objectives, justify its goals and formulate its strategies? Let me be clear: the issue at stake is not how to manage the current (COVID-19) crisis or the next economic crisis. 'Emergency Keynesianism' is the default response of both the Left and the Right—if only because it constitutes financial capitalism's only available survival kit. Rather, what is at stake is whether social democracy is capable of reimagining a renewed macroeconomic policy regime, oriented towards achieving and maintaining full employment, as an alternative to the defunct New Keynesian regime. Full employment should be its highest goal—and that goal should be defended, even at the cost of reducing the government deficit and maintaining price stability.

9.1 Social democratic Keynesianism redux

A social democratic-Keynesian management of the macroeconomy is possible, provided fiscal policy is supported by an accommodating monetary policy as well as by coordination mechanisms to control wages and prices. A social democratic Keynesianism requires a complete upturn of New Keynesian dogma:

- *Monetary policy*: at a minimum, central banks (including the ECB) must be removed from the commanding heights of macroeconomic control and obliged to coordinate monetary policy with the goal of a full-employment-oriented fiscal policy (even if central banks remain notionally 'independent'). Monetary policy's role must be subordinate to the role of fiscal policy.[42] To realize this, social democrats have to insist that central banks have to go beyond inflation targeting per se and try to balance price stabilization with (full) employment—hence, social democratic parties should fight for changing the ECB's single mandate into a dual mandate (see Lavoie and Seccareccia, 2021 for a similar discussion in Canada).
- *Fiscal policy*: a social democratic fiscal policy has to be freed from the straightjacket of counter-productive fiscal policy rules—which means the disciplinary austerity of the SGP, the 'Euro Plus Pact', and the 'Fiscal Compact' has to go. Crucially, to expand the space for fiscal policy and re-empower the state's public investment function (Skidelsky and Gasperin, 2021), the inflation target of the ECB should be raised from 2% to 4%.[43] Social democrats have to understand that it makes no sense to let financial markets determine the fiscal capacity of the state—this is a fundamentally political decision[44] which involves

[42] This tallies with the thrust of the moderate *Modigliani Manifesto*, published in 1998 by the *Banca Nazionale del Lavoro Quarterly Review*, signed by economists as diverse as Franco Modigliani, Jean Paul Fitoussi, Robert Solow, Alfred Steinherr, Paolo Sylos Labini, Luigi Pasinetti, Rudiger Dornbusch, Alan Blinder, Paul Samuelson, James Tobin, Alessandro Roncaglia, and Olivier Blanchard (Modigliani et al., 1998).
[43] A 4% inflation target is uncontroversial, as it has been proposed by many mainstream economists as well, including Blanchard et al. (2010), Krugman (2012) and Ball (2013). But unlike these authors who believe that a 4% inflation target will create more leverage for the monetary authority, I argue here that the 4% target is essential to enhance the power of the fiscal authority.
[44] This is shown by US President Biden's decision to reverse decades of fiscal conventions and enact a bold $2 trillion *American Jobs Plan* (on March 31, 2021), a stimulus programme focused on infrastructure, the care economy, climate and, as the name implies, creating desperately needed good jobs. Biden's proposal is designed to promote longer-term economic recovery and keep the US competitive, while responding to the economic devastation from the COVID-19 crisis and the climate crisis. Biden's stimulus is raising concerns over the mounting public debt of the US government.

matching society's levels of taxation to its social (spending) ambitions and deciding on how to finance a public deficit (in case it arises).[45] Social democrats should fight against the de-politicization of fiscal and monetary policy. They have to abandon the view that unreliable, spendthrift politicians must be disciplined by 'bond vigilantes', and instead make it clear that it is the other way around: irrational financial investors, who have been consistently wrong in their inflation expectations (Gagnon and Sarsenbayev, 2021)[46] and were responsible for the Great Financial Crisis of 2008, have to be properly 'disciplined' in order to prevent future calamities, protect macroeconomic stability and to protect the real economy from the consequences of financial market indiscipline. This can be done by the taxation of speculative finance and by bringing off-shore wealth and capital back onshore and subordinating it to regulatory democracy and taxation.[47] The regained fiscal policy space should be used to reinstate fiscal policy as "the most effective and reliable instrument for reaching and maintain a full-employment level of economic activity" (Skidelsy and Gasperin, 2021, p. 22).

- *Strengthening institutions for macroeconomic concertation*: social democracy has to reinforce or reimagine ways in which governments can productively involve unions ('labour') and employers ('capital') in the negotiated design and implementation of a concerted public policy. Such tri-partite cooperation and cooperation has a long tradition in Western Europe (Baccaro and Simoni, 2008), but while 'social pacts' were common during the run-up to the membership of the Eurozone (the 1990s), macro concertation was explicitly rejected by many Eurozone governments in the aftermath of the Eurozone crisis (Culpepper and Regan, 2014).[48] Social democracy needs to build those concertation mechanisms which help to control supply-side shocks to prices and wages—as well as shocks to demand and employment. This will require re-establishing, where necessary, the macroeconomic bargaining power of unions, for instance by fighting for constitutionally entrenched work councils in firms and systems of co-determination (as in Germany). A prominent example of such resilience-enhancing concertation is Germany's system of *Kurzarbeit*, which was instrumental in keeping employment relatively stable during the Great Financial Crisis of 2008 as well as during the COVID19 recession, protects workers and their jobs and demand.[49] Another example is the Danish 'flexicurity model'—which includes high income security (through generous unemployment benefits), high numerical flexibility (low job protection), and active labour market policies and is associated with continuous high levels of job-creation and job-mobility, and low levels of youth unemployment and long-term unemployment (Bekker and Mailand, 2018). More generally, as argued by Simonazzi (2021, p. 124), social policies are part and parcel of industrial policy, because these, by supporting the accumulation of individual and collective know-how

[45] Note that Laurence Boone, the chief economist of the OECD, now argues for a rethinking of macroeconomic policy in favour of fiscal policy (rather than monetary policy). Boone advises that governments use fiscal stimulus for as long as necessary (and for as long as interest rates remain low), relegating independent central banks to a secondary role (Giles, 2021).

[46] E.g., Gagnon and Sarsenbayev (2021) find that bond yields have failed to predict inflation over nearly 70 years in the United States, while bond yields are also poor predictors of inflation in France, Japan, and the UK.

[47] Major tax cuts for the rich only push up income inequality, but do not have any significant effects on economic growth and unemployment (Hope and Limberg, 2020).

[48] This is what Italian Prime Minister (and technocrat) Mario Monti (2012) had to say about concertation: "the deep practice of concertation in the past caused the evils against which we are fighting today, and on the basis of which our children and grandchildren do not easily find work. [Unions and employers] should not be actors to which public authorities outsource their political responsibility." (Quoted in Culpepper and Regan, 2014, p. 723).

[49] During March-April 2020, the number of German workers who applied for *Kurzarbeit* exceeded 10 million, or about 20% of the labour force, while official unemployment increased by less than 0.4 million (or 0.8% of the labour force). See IMF (2020).

within firms, contribute to innovation, technical progress, and growth (Storm and Naastepad, 2012). Hence, if anything, coordination and regulation must not be considered a cost and a drain, rather, they constitute efficient frameworks which by helping nations to share the costs and benefits of globalization and technological progress, make firms more flexible and raise productivity and their international competitiveness, while shielding workers.[50] There is no nasty trade-off between equity and efficiency, in other words. "It is becoming increasingly clear," writes Martin Sandbu (2021) in *The Financial Times*,

> "that a solid social model is an engine of productivity. The Nordic countries show that a strong social pillar — encompassing all the dimensions of labour, skills and social protection — can underpin the characteristics that make a market economy work well: trust, high employment, productivity increases and quick adoption of technology, and flexibility in shifting labour and capital from low- to high-productivity uses."

Hence, if anything, (labour-market) regulation has to be strengthened rather than abolished—as in the New Keynesian view of the world.

The Achilles heel of social democratic macro management is the lack of control over international borrowing and lending. Establishing a modicum of domestic policy space will require throwing some sand in the gears of cross-border financial flows—or as Keynes (1942 [1980], p. 149) wrote in a letter to Roy Harrod dated April 19th, 1942:

> "freedom of capital movements is an essential part of the old laissez-faire system and assumes that it is right and desirable to have an equalisation of interest rates in all parts of the world. It assumes, that is to say, that if the rate of interest which promotes full employment in Great Britain is lower than the appropriate rate in Australia, there is no reason why this should not be allowed to lead to a situation in which the whole of British savings are invested in Australia, subject only to different estimations of risk, until the equilibrium rate in Australia has been brought down to the British rate. *In my view the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world. Capital control is a corollary to this.*" (my emphasis)

The top priority for social democrats should therefore be to reform the international financial system in ways that protect the necessary domestic policy space. In so doing, they can join the IMF (2010) which concludes that "use of capital controls – in addition to both prudential and macroeconomic policy – is justified as part of the policy toolkit."[51] Likewise, they can underwrite US Treasury Secretary Janet Yellen's call for a minimum global corporation tax—to stop the race-to-the-bottom tax competition between nations and prevent companies from shifting profits overseas to evade taxes (Rappeport, 2021). However, for as long as cross-border finance remains un- or under-regulated, social democracy has to deal with interest rates that do *not* promote full employment; fiscal policy and macroeconomic concertation must then compensate the sub-optimal monetary policy stance to achieve full employment and stable inflation (figure 2).

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[50] As Andor and Huguenot-Noël (2021) argue, "there is now extensive evidence that expanding social provisions in the form of gender empowerment, active labour market policies, or life-long training boosts employment growth [….] at long last, social protection is no longer seen as a drag on jobs and competitiveness."

[51] The IMF (2010) singles out measures such as taxes on short-term debt or requirements whereby inflows of short-term debt need to be accompanied by a deposit to be placed in the central bank for a certain period of time. The goal of these measures – which are often turned on when capital flows start to overheat and turned off when things cool – is to prevent massive inflows of hot money ('carry trades') that can appreciate the exchange rate and threaten the macroeconomic stability of a country.

9.2. New macroeconomic thinking

Because the social democratic Keynesian coordination outlined above goes against every single tenet of New Keynesianism, it needs new macroeconomic thinking. While it is true that there is not yet a full-fledged alternative theory to replace New Keynesianism, the good news is that some of the contours of a credible alternative can already be clearly seen.

For a start, the analytical core of the New Keynesian model is that fluctuations in aggregate demand are cyclical and/or transitory and do not have permanent effects on potential (long-run) growth—which is strictly determined by the supply-side drivers 'technological progress' and 'demographic change' (figure 3). This analytical core is contradicted by a growing body of empirical evidence showing that demand fluctuations do have lasting impacts on potential growth. For instance, Ball (2014), Blanchard, et al. (2015), Fatás and Summers (2016), Fontanari et al. (2020) and Dovern and Zuber (2020) provide evidence that weak demand does lead to sluggish growth and permanent scars.[52] Findings by Girardi et al. (2020) show that *positive* demand shocks also persist in the longer run. The analytical core of New Keynesianism has thus been falsified[53]: demand matters in the long run (see Storm 2017, 2019). This opens up space for social democratic Keynesianism.

These persistent effects on potential output growth of changes in aggregate demand can be explained in terms of equation [2]. Let me first consider (labour) productivity growth, which in New Keynesian thinking is determined by exogenous technological progress. There are sound reasons, however, why higher demand is good for labour productivity growth. As Joan Robinson (1956, p. 96) explained,

> "The rate of technical progress is not a natural phenomenon that falls like the gentle rain from heaven. When there is an economic motive for raising output per man the entrepreneurs seek out inventions and improvements. Even more important than speeding up discoveries is the speeding up of the rate at which innovations are diffused. When entrepreneurs find themselves in a situation where potential markets are expanding but labour hard to find, they have every motive to increase productivity."

To illustrate the mechanisms involved, let me formalise the impact of demand on productivity in terms of so-called Kaldor-Verdoorn effect (Storm and Naastepad, 2012):

$$\hat{\lambda} = \beta_0 + \beta_1 \times \hat{d} \qquad [3]$$

where $\beta_0 =$ exogenous 'technology-push' labour productivity growth; $0 < \beta_1 < 1$ is the Kaldor-Verdoorn coefficient; and $\hat{d} =$ the growth of aggregate demand. The Kaldor-Verdoorn coefficient implies that productivity growth is demand-led, because

> "The stronger is the urge to expand .... the greater are the stresses and strains to which the economy becomes exposed; and the greater are the incentives to overcome physical limitations on production by the introduction of new techniques. Technical progress is therefore likely to be greatest in those societies where the desired rate of expansion of productive capacity .... tends to exceed most the expansion of the labour force (which, as we have seen, is itself stimulated, though

[52] This is acknowledged by ECB President Lagarde (2016): "The longer the demand weakness lasts, the more it threatens to harm long-term growth as firms reduce production capacity and unemployed workers are leaving the labour force and critical skills are eroding. Weak demand also depresses trade, which adds to disappointing productivity growth."

[53] Cf. Wolfers (2016) who lists further falsified concepts: rational expectations, consumption Euler equations, Calvo pricing and New Keynesian Phillips-curves. Lavoie (2018) adds the strong or semi-strong version of the efficient market hypothesis, the Ricardian equivalence theorem, the notion of expansionary fiscal consolidations, and the belief in the usefulness of quantitative easing, central bank independence and inflation targeting to the list.

only up to certain limits, by the growth of production." (Kaldor, 1960, p. 237).

The growth of demand, in turn, is assumed to depend on the growth of autonomous demand $\hat{\theta}$ (which includes public spending), the real interest rate *r*, and the growth of the wage share $(\hat{w} - \hat{\lambda})$:

$$\hat{d} = \hat{\theta} + C \times (\hat{w} - \hat{\lambda}) - \gamma \times r \qquad [4]$$

where $\hat{w}$ = real wage growth; C = the elasticity of demand growth with respect to the growth of the wage share; and γ = a measure of the interest-rate sensitivity of aggregated demand growth. If $C > 0$, demand is wage-led; and if $C < 0$, demand is called profit-led (Bhaduri and Marglin, 1990). Substituting eq. [4] into eq. [3] gives:

$$\hat{\lambda} = \frac{\beta_0 + \beta_1 \times \hat{\theta} + \beta_1 \times C \times \hat{w} - \beta_1 \times \gamma \times r}{1 + \beta_1 \times C} \qquad [5]$$

Assuming that $(1 + \beta_1 \times C) > 0$,[54] it follows from eq. [5] that

- $\frac{\partial \hat{\lambda}}{\partial \hat{\theta}} = \frac{\beta_1}{1 + \beta_1 \times C} > 0$; increases in autonomous demand (including government spending) raise demand and economic growth. The rate of capacity utilization in the economy goes up as a result, raising the profit rate for businesses. Business investment increases (or is 'crowded in'), which further pushes up growth. But rising business investment, in turn, increases productivity growth, because the pace at which the economy's capital stock gets modernized goes up. After all, investment means that new capital goods, embodying the latest technologies, are installed. Higher productivity growth, in turn, raises potential growth in eq. [2]. It is in this sense that a determined demand increase such as the EU Green Deal will raise potential growth.
- $\frac{\partial \hat{\lambda}}{\partial \hat{w}} = \frac{\beta_1 \times C}{1 + \beta_1 \times C} > 0$ if $C > 0$; raising wage (share) growth raises aggregate demand (because as the higher-saving profit-earners receive a lower share of the economic pie, the national rate of savings goes down as the wage share goes up). Capacity utilization goes up, and up goes the profit rate as well. Business investment increases – and as above, productivity growth and potential growth will rise. In line with this, Kiefer et al. (2020) provide evidence that the decline in US potential output follows the long-run decline in the US labour share (during 1947/1948-2015/2016). Similar evidence for the US has been provided by Storm (2017, 2019). This indicates, more broadly, that lower inequality will be 'good' for growth.
- $\frac{\partial \hat{\lambda}}{\partial r} = \frac{-\beta_1 \times \gamma}{1 + \beta_1 \times C} < 0$; lower interest rates lead to higher business investment and a faster growth of the capital stock and productivity. Hence, monetary policy is not neutral. Lord Kahn (1972, p. 139) issued this prophetic warning against restrictive monetary policy already in his 1958 evidence given to the *Radcliffe Committee on Monetary Reform*:

  "The economic waste in such a policy is particularly great if demand is regulated by restricting productive investment, as will be the main result of relying on monetary policy. Not only is there a loss of potential investment. But the growth of productivity is thereby curtailed, thus narrowing the limit on the permissible rate of rise in wages and increasing the amount of unemployment required to secure observance of the limit."

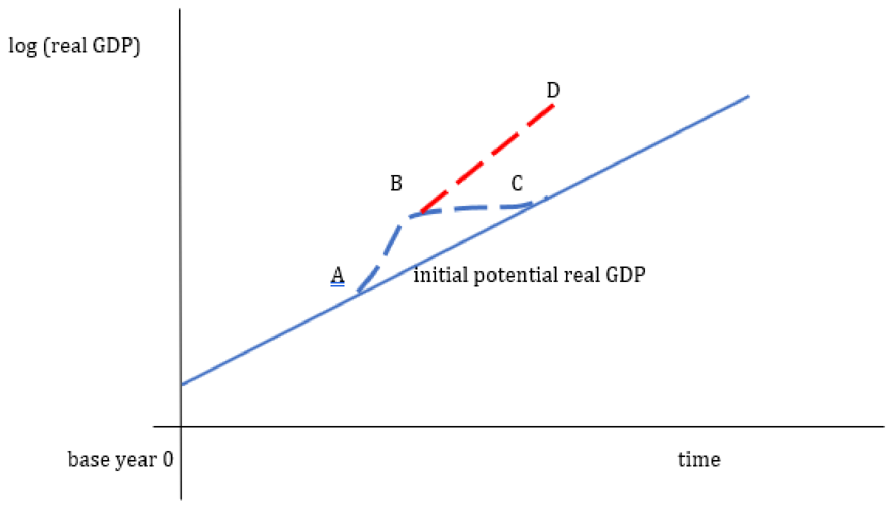
Figure 5 illustrates this point. At time A, demand increases and actual output goes up. In the New-Keynesian model, actual unemployment goes down, while the NAIRU stays unchanged, and the negative employment gap will trigger inflation—which necessitates the

[54] For empirical evidence, see Storm and Naastepad (2012).

central bank to raise the interest rate and bring actual demand down to (unchanged) potential output (at point C). But the Kaldor-Verdoorn effect tells us that the higher demand will raise productivity growth—and hence the growth rate of (steady-inflation) potential output will rise, as is illustrated in figure 5 (the red dashed line BD). The economy settles at a higher level of potential growth and a higher growth rate of (non-inflationary) potential output (point D) compared to the New Keynesian case (point B); in this scenario, the economy is permanently growing faster at a permanently higher level of GDP and at a constant rate of inflation.

The increase in labour productivity growth has also lowered the NAIRU, u_N; it is not difficult to understand why (see Storm and Naastepad 2012). Higher productivity growth raises the permissible rate of growth of wages—as Lord Kahn pointed out—and because wages can increase faster (without leading to excess inflation), there is less need to discipline unions and hence, the equilibrium unemployment rate associated with steady (target) inflation is lower. This implies that the increase in the level of potential output in figure 5 is in part due to a structurally lower rate of unemployment and a higher employment rate ℓ_N in eq. [1]. A determined demand policy can—in principle—succeed in permanently raising growth and lowering u_N at an unchanged (target) rate of inflation (Storm and Naastepad, 2012)—without any deregulation of the labour market, rise in inequality, weakening of union power or weakening of the institutions for macroeconomic concertation. Social democracy must reject the ideology of the 'Nasty Trade-Off' for what it is: a conservative fantasy.[55] The vertical Phillips-curve, which is the basis of claims by central bankers that monetary policy is 'neutral', does not exist (Storm and Naastepad, 2012). Accordingly, social democrats must stand for fair real wage increases and a credible commitment in macroeconomic policymaking to full employment—demands which do not automatically conflict with price stabilisation.

Figure 5—*Permanent impact on potential real GDP of lower demand*



[55] To honest minds, this is not controversial. IMF economists Ostry et al. (2016, p. 39) conclude that "increased inequality [...] hurts the level and sustainability of growth" and the OECD (2014) finds that income inequality has curbed economic growth significantly.

Finally, social democratic Keynesianism must be built on the recognition that a determined policy of demand expansion will create, given time, the very capacity that justifies it. As is shown for the US by Fontanari, et al. (2020), there is a much larger unused labour reserve than is normally recognized by the official unemployment figures and, as a result, the labour force is considerably more elastic—and responsive to higher economic growth—than is assumed in New Keynesian models. What this implies is that a step-up in economic growth induces an increase in the labour force, as previously discouraged workers re-join the workforce. Labour force growth $\hat{L}$ in eq. [2] is therefore not an exogenous variable, fully determined by demography, but is (partly) endogenous—increasing (decreasing) as growth goes up (down). Again, this means that potential growth is affected by actual (demand) growth—and growth accelerations (decelerations) become self-reinforcing processes to some extent. Given this elasticity of the labour force with respect to growth, wages will respond only slowly to growth increases, because 'measured unemployment' declines less than expected. This is a key factor explaining the flattening of the Phillips-curve (as observed by Stansbury and Summers (2020)) and it also means that there is a larger non-inflationary space for fiscal expansion than assumed in New Keynesian models.

Going beyond the empirically falsified New Keynesian approach, the contours of a reimagined Keynesian model give a prominent role to the economy's supply side, emphasizing the links between (demand-determined) capital formation, productivity growth, labour force growth and potential growth (Storm 2017, 2019). Demand determines potential output, which is therefore considerably more elastic than is assumed now—and consequently the 'inflationary threat' of output expansion is smaller than is the understanding now. However, while growth is demand-led, in a full model (see, for instance, Fazzari, et al., 2020), supply constraints (related to imperfectly-elastic labour force growth and imperfectly responsive labour productivity growth, since $0 < \beta_1 < 1$) limit the maximum feasible rate of growth. The recognition of the (at least partly) demand-determined nature of potential growth offers feasible social democratic pathways to economically and societally superior outcomes—compare point C (the New Keynesian outcome) to point D (the reimagined Keynesian outcome) in figure 5.

10. Conclusion

Mark Twain once wrote, "I apologize for such a long letter - I didn't have time to write a short one." Likewise, I have to apologise for this lengthy paper—and keep the conclusion to just a short summary. The dramatic decline in electoral support for social democracy has been the result of the alienation of its supporters by (a) a deliberate move to the non-reformist, non-emancipatory, status-quo oriented macroeconomics of the New Keynesian consensus (the "shedding of its ideological feathers"), which de-politicizes macro management and legitimises macro control by technocratic central banks; and (b) its promotion of 'cultural liberalism', which had to compensate for a lack of social democratic achievements on the economic front, while it allowed social democracy, at the same time, to respond to the aspirations of parts of the middle classes. As a result, social democratic parties became co-responsible for permanent austerity, rising inequality, social and economic disempowerment, and heightened insecurity—which contributed to a hardening of attitudes on cultural issues and migration, and a further alienation from social democracy. The only way out of this downward spiral is for social democracy to return to its earlier reformist roots, which—as argued here—were strongly based on a full-employment orientation in macroeconomic policy. The paper outlined what is needed in terms of fiscal and monetary policy as well as social concertation in order to create sufficient space for such a reformist, egalitarian strategy oriented toward full employment—and it has sketched the contours of a reimagined Keynesianism in which a prominent role is given to the economy's supply side, emphasizing the links between (demand-determined) capital formation, productivity growth, labour force growth, and potential growth.

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