# 1. European macroeconomic policies amidst shifting priorities

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## Topics



> The review of the EU's fiscal rules will turn out to be a missed opportunity for achieving a more meaningful balance between fiscal, green and social objectives
>
> **Sotiria Theodoropoulou**

# Introduction

The period since 2019 has seen extraordinary developments in Europe and the world. These include the outbreak of the Covid-19 pandemic, the ongoing climate emergency, the beginning of the war in Ukraine, the energy shock triggered by this war and the ensuing cost-of-living crisis, as well as – more recently – serious armed conflict in the Middle East. These developments were met with notable policy responses and initiatives which, in several ways, marked a departure from reactions to previous crises, such as the global financial crisis of 2008-2009 and the balance of payments/public debt/banking crisis that followed in 2010-2012. While the initial response – both in 2008-2009 and since 2019 – was one of coordinated fiscal stimulus in Europe, in the period from 2019 onwards that stimulus went much further, with a temporary suspension of the fiscal rules boosted by monetary policy tools and relaxations of the state aid rules.

The policy discourse also shifted away from the goal of facilitating numerical flexibility for firms and towards the goal of assisting them and their workers in preserving employment relations by means of job retention schemes, supported by the EU programme SURE (Support to mitigate Unemployment Risks in an Emergency) which was financed by EU borrowing. The EU Member States also agreed to embark on EU borrowing to finance a recovery strategy for the EU for the period up to 2026, stepping up their efforts towards achieving climate neutrality by 2050 with the pledge of 'leaving no one behind'. It appeared that these policy developments were being aligned and financially enabled within the broader context of a tentative revival of Social Europe, which is the theme of this year's Benchmarking Working Europe.

However, this process has not gone unchallenged. The war in Ukraine, following Russia's invasion, resulted in an energy price shock and heightened concerns – building on those already voiced during the pandemic – about the potential threat to Europe's resilience entailed by its dependence on global supply chains. From 2022 onwards, this macroeconomic policy expansion was partly reversed in Europe as inflation shot up to double-digit figures and monetary policy altered course from zero/negative interest rates and quantitative easing. Calls have already emerged for national fiscal policies to become more supportive of monetary policy by pushing inflation rates towards the target of 2%, which implies that they should become more restrictive. The higher interest rates imposed by central banks have also increased the cost of public borrowing, which also affects the EU in connection with the financing of its commitments under the Multiannual Financial Framework (MFF) and NextGenerationEU (NGEU). Meanwhile, Germany's Constitutional Court has recently struck down spending plans aimed at supporting climate change measures in Germany.

At the time of writing, the EU is in the process of implementing its current MFF for the period 2021-2027, and has reached two important agreements. The first relates to the question of how to expand the resources and flexibility of its budget between now and 2027 in order to meet previously unplanned challenges, such as the war in Ukraine and its consequences for the Ukrainian people, and how to finance the rising costs of the NGEU. The second pertains to a review of the EU's economic governance and, more specifically, its multilateral fiscal surveillance framework, with a view not only to remedying the shortcomings that have emerged since the previous reform in 2011-2012 but also to taking on board the current strategic orientations and the lessons learned from the pandemic. All of these frameworks, including the new monetary policy strategy that the ECB adopted in 2021, initially made explicit mention of social and green considerations, with the European Pillar of Social Rights providing the benchmark framework for enhancing the social dimension.

The purpose of this chapter is to review important macroeconomic developments in the EU in 2023 and to examine more closely how the main policy tools at EU and national level have been evolving, including the aforementioned reviews of the EU's economic governance and budget. It assesses these developments and the extent to which they are likely to continue acting as a source of support, amidst shifting priorities, for the EU's social aspirations and ambitions, which have recently been growing.

# Economic developments

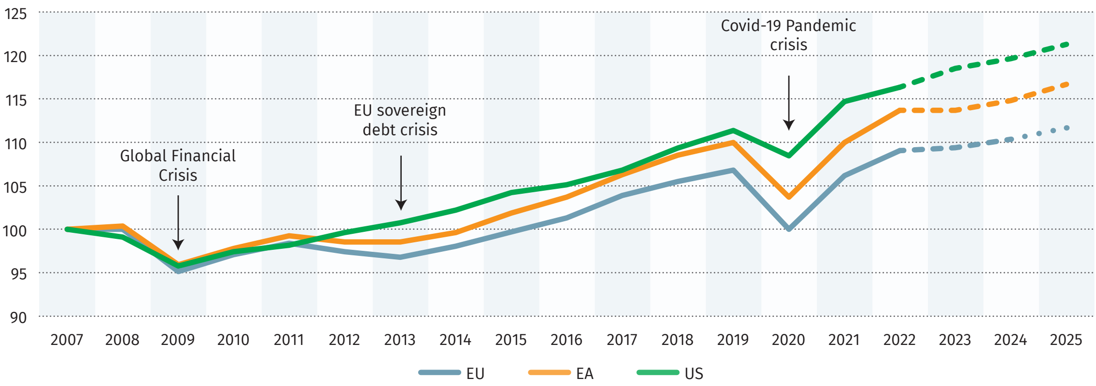
## Growth

In the EU and the euro area, 2023 saw a stalling of the recovery from the recession caused by the Covid-19 pandemic in 2020 (see Figure 1.1). Given the size of the inflation shock, the resilience of output and employment growth in the first half of 2022 had been surprising; following this, however, real GDP growth began declining in the second half of 2022 and came to a standstill at the end of 2022 and in the first three quarters of 2023 (see Figure 1.2). While private final demand held up until the third quarter of 2022, not least thanks to the support measures that many governments in Europe deployed for households and companies (see Figure 1.3), several factors eventually took their toll on consumption and investment; these included the persistence of what started out as energy inflation and its spread to other groups of commodities, the cost-of-living crisis with real labour income losses and the tightening of monetary policy since the summer of 2022. Investment has made virtually zero contribution to GDP growth since late 2022. Although net exports of goods and services were a driver of output growth in late 2022 and early 2023 as the terms of trade improved with declining energy prices, they made a negative contribution to GDP growth as international trade shrunk under the weight of China's economic slowdown and the broader uncertainty from the geopolitical situation (European Commission 2023b). The necessary fiscal adjustments that new economic governance rules will require are also likely to constrain output growth.

> "2023 saw a stalling of the recovery from the recession caused by the Covid-19 pandemic in 2020

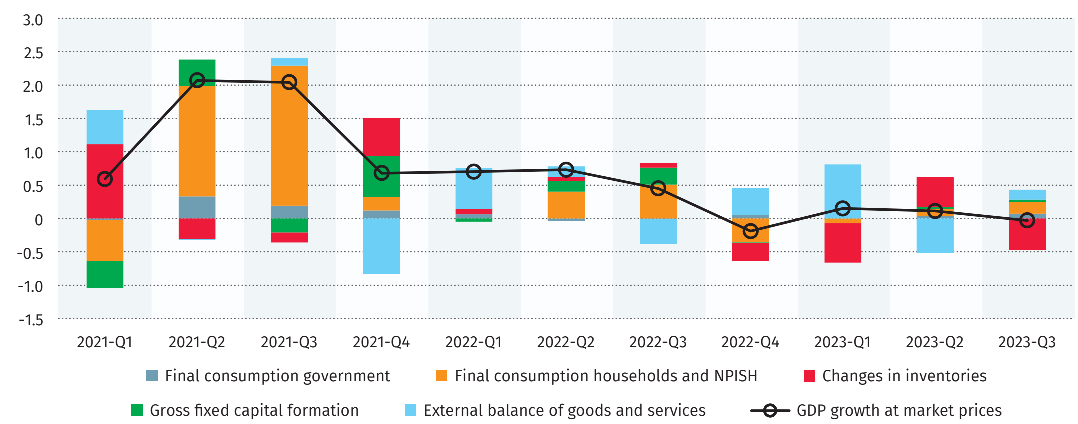
As was the case with the pandemic shock, many EU national governments deployed robust fiscal responses to the energy crisis in order to mitigate its impact on households and firms (see Figure 1.3). In 2022, most of the national

Figure 1.1 **Real GDP growth (2008=100), EU, euro area and US, 2008-2023(e), 2024(f)-2025(f)**



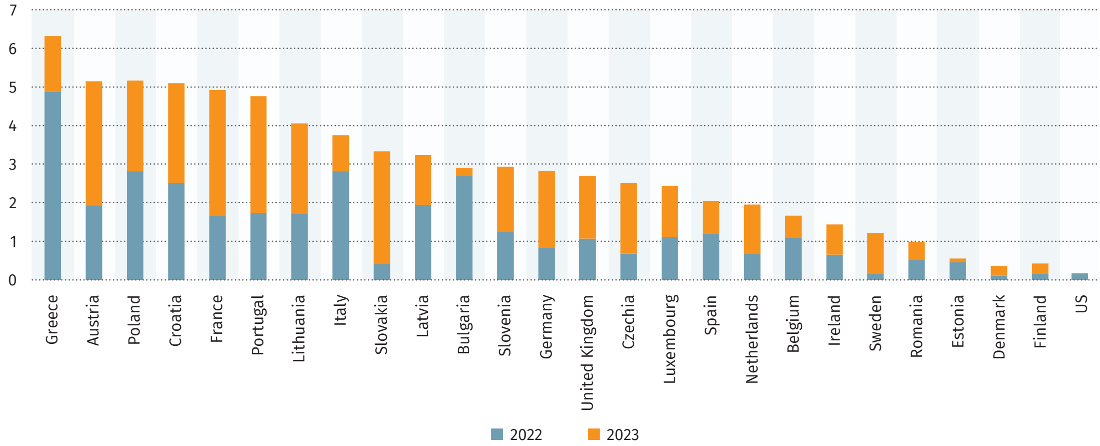

Source: Own calculations using AMECO data (RVGDP).

Figure 1.2 **Contributions in percentage points to GDP growth (%) of main expenditure components, EU, 2021Q1-2023Q3**




Source: Eurostat (namq_10_gdp).

Figure 1.3 **Fiscal responses to the energy crisis (expenditure as % of GDP), EU Member States/OECD member countries, UK and US, 2022 and 2023**



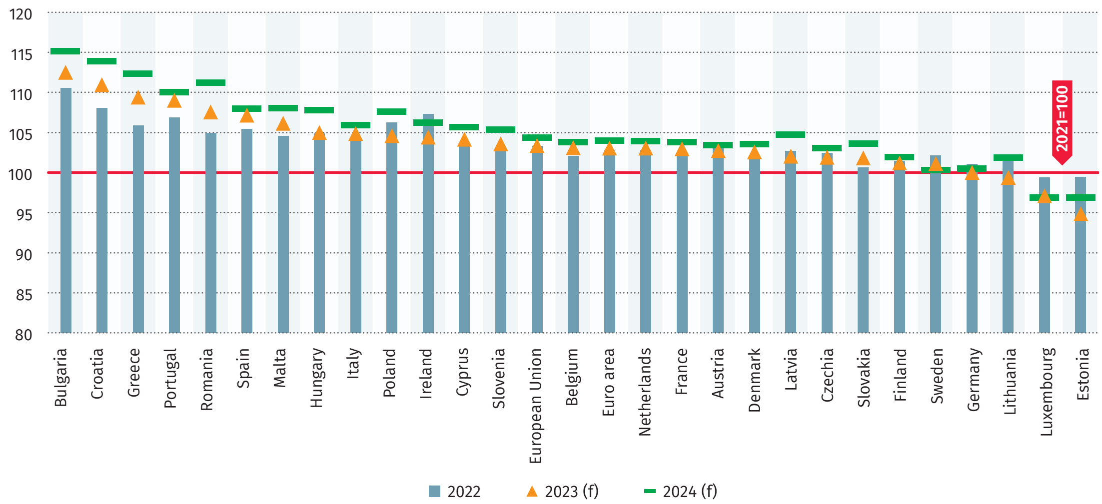

Source: OECD energy support measures tracker.

responses in the EU took up well over 0.7% of GDP (the response of the median OECD member country), while the respective figures for the UK and US were 1.07% and 0.15% of GDP (OECD 2023). The measures that national governments across Europe took to support households and firms in the face of energy price increases started to be phased out in 2023.

The European Commission's Autumn 2023 Economic Forecast suggested that growth could be expected to pick up again in 2024 and 2025, but uncertainty about when the ECB's widely expected policy interest rate reductions will start has been casting doubt over when and how strongly recovery will resume. This uncertainty over forecasts is further amplified by the continued war in Ukraine and the new conflict in the Middle East (European Commission 2023b).

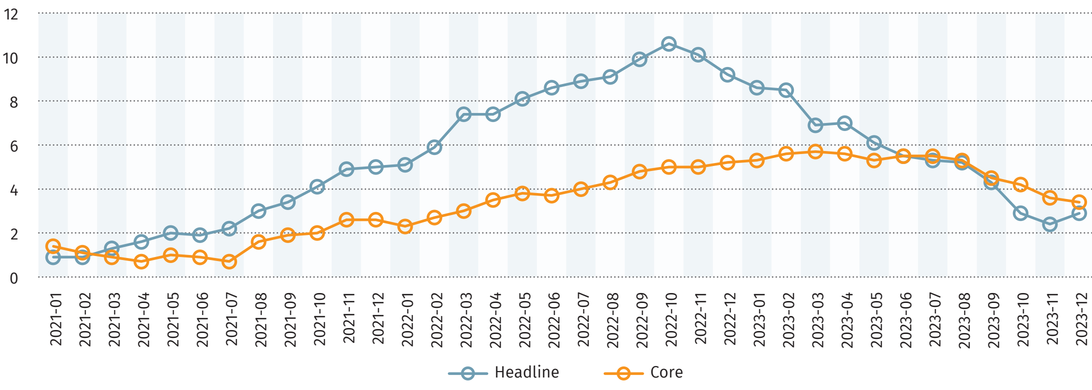
At national level, real GDP per capita growth slowed down everywhere in 2023 compared to 2022 (except Slovakia, where it grew by 1.2%). In 12 Member States (Poland, Ireland, Austria, the Netherlands, Latvia, Czechia, Finland, Sweden, Germany, Lithuania, Luxembourg and Estonia), real GDP per capita even shrank (see Figure 1.4). At the other end of the spectrum, Bulgaria, Croatia, Greece, Portugal, Romania, Spain and Malta experienced real GDP per capita growth rates of between 1.5% and 3.3%. The European Commission's Autumn 2023 Economic Forecast (2023b) suggested that per capita real growth rates would accelerate in 2024 in 22 Member States, while Luxembourg and Sweden were likely to see their real GDP per capita shrink for a second year in a row.

Figure 1.4 **Real GDP per capita in the EU Member States (2021=100), 2022, 2023 (e), 2024 (f)**




Source: Own calculations using AMECO data (RVGDP).

Figure 1.5 **Euro area monthly (year-on-year) inflation rate (%), 2021M1-2023M12**




Source: Eurostat (prc_hicp_manr).

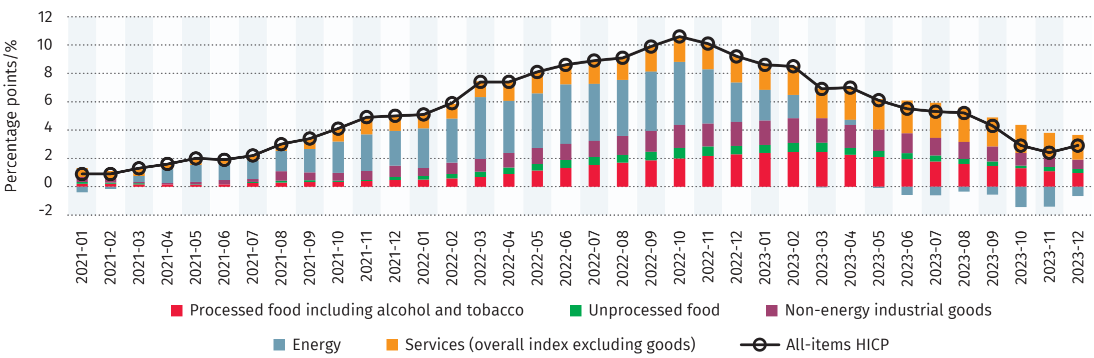
## Inflation-related developments

Euro area headline inflation (Harmonised Index of Consumer Prices (HICP), all-items) continued its deceleration in 2023, after having peaked at 10.6% (year-on-year) in October 2022. By December 2023, its year-on-year rate was estimated at 2.9%, having increased from 2.4% in November 2023 (Eurostat data – see Figure 1.5), whereas the ECB projected a figure of 5.3% for the whole of 2023, which is still well above the target rate of 2%. Core inflation, or in other words the inflation rate excluding the relatively more volatile energy and food price indexes and thus providing an indication of inflation developments that do not necessarily warrant policy reaction, also declined in 2023, but only after having peaked in March of that year. By November 2023, it was estimated to stand at 3.6% (year-on-year).

As Figure 1.6 shows, energy inflation ceased to be the main contributor to headline inflation in the euro area in 2023, and even turned negative from June 2023 onwards. The contributions of non-energy industrial goods and processed food, tobacco and alcohol have also been diminishing. In contrast, the contribution of services inflation has remained stable and even accelerated slightly since summer 2022. These developments reflect how different sectors have adjusted over time to the losses from the shock of 2022 relating to imported commodities (energy and, to some extent, food).

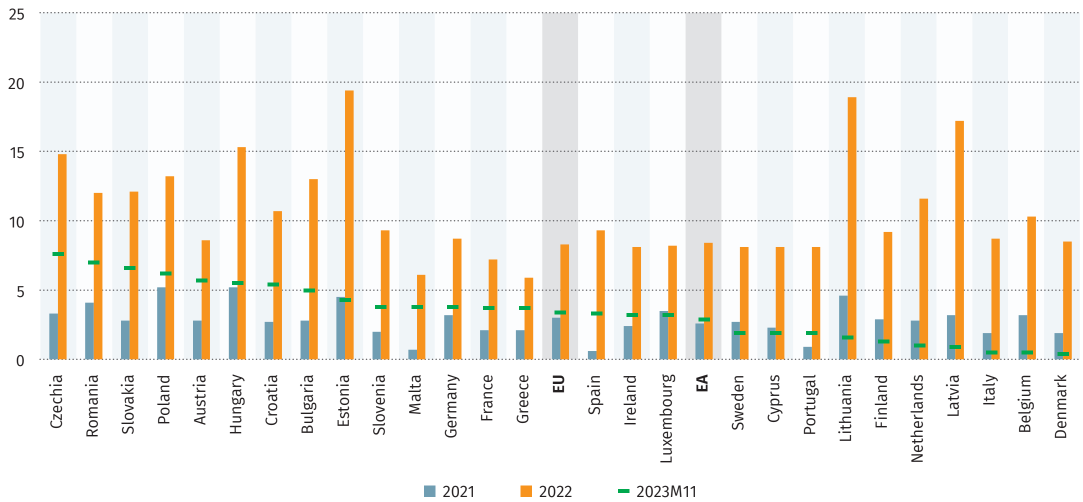
The recent episode of high inflation has in fact manifested itself to very different extents across Member States, depending not only on their exposure to imported commodities, but also on the domestic reaction of unit profits and unit labour costs to inflationary pressures (Figure 1.7). The Baltic states registered the highest annual inflation rates in 2022, ranging from 17.2% in Latvia to 19.4% in Estonia. Nevertheless, by October 2023, inflation (on a year-to-year basis) had declined in all three, including falls to 5% in Estonia and 2.3% in Latvia. Meanwhile, high inflation persisted in Hungary, Czechia, Romania, Slovakia, Croatia, Slovenia, Poland, Bulgaria, Austria, France, Malta, Sweden, Greece and Cyprus in October 2023, with rates ranging from 9.6% in Hungary to 3.6% in Cyprus.

Figure 1.6 **Contributions (in percentage points) to euro area annual inflation of main groups of commodities, and monthly (year-on-year) headline inflation (HICP %), 2021M1-2023M12**




Source: Eurostat (prc_hicp_ctrb).

Figure 1.7 **Headline inflation rate (%) in the EU27 Member States, 2021, 2022, 2023M11**

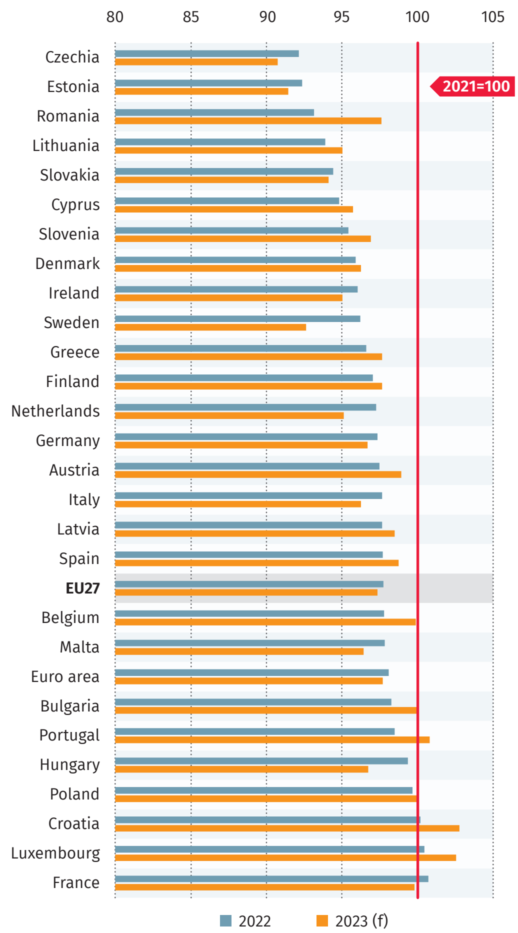



Source: Eurostat (prc_hicp_manr and prc_hicp_aind).

> **The surge of inflation across Europe from 2021 onwards resulted in a cost-of-living crisis, as nominal wage increases did not keep up with inflation**

At the other end of the spectrum, Finland, Latvia, Luxembourg and Italy had inflation rates around the ECB target of 2% in October 2023, whereas Denmark, the Netherlands and Belgium had negative inflation that month.

Figure 1.8 **Real compensation per employee (2021=100) in 2022-2023, EU Member States**



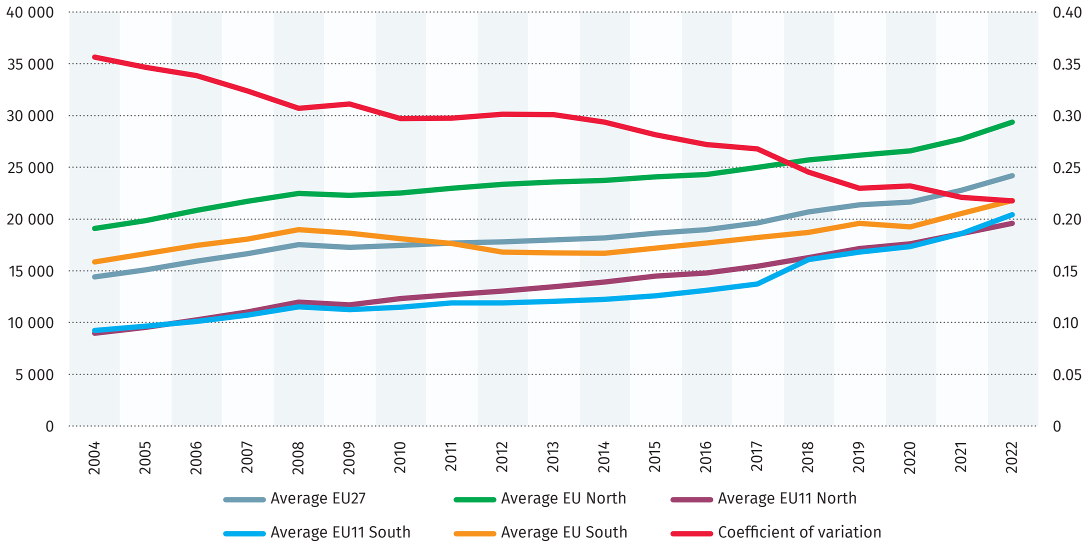

Source: AMECO (RWCDC).

The surge of inflation across Europe from 2021 onwards resulted in a cost-of-living crisis, as nominal wage increases did not keep up with inflation (see also Chapter 3). As Figure 1.8 shows, in all but a handful of EU Member States, real compensation per employee declined in 2022 compared to 2021 and is expected to return to the levels seen in 2021 (when inflation had already started picking up) in only seven Member States. The fact that inflation developments were mostly driven by energy and food price increases (as shown above) meant that households at the lower ends of the income distribution effectively faced higher inflation rates, as energy and food constituted a relatively higher share of their budgets (Claeys, MacCaffrey and Weslau 2022).

## Upward convergence in the EU

The year 2024 marks 20 years since the first wave of accession of the central and eastern European (CEE) Member States that had transitioned to being market economies since the early 1990s. The 'sustained convergence of economic performances of the Member States' is one of the stated objectives of the EU (Article 120(3) TFEU). This 20-year period since 2004 has also been punctuated by multiple crises, in particular since 2008. Several of the Member States who joined in 2004 were seriously affected by the global financial crisis and had to receive financial support from the EU and the IMF. Figure 1.9 shows the evolution of

Figure 1.9 **Upward/downward convergence/divergence right-axis of adjusted gross disposable income of households per capita (left-axis, PPS, EU27 from 2020), EU27 and subgroups, 2004-2022**




Source: Own calculations using Eurostat data (sdg_10_20).

(unweighted[1]) adjusted gross disposable income of households (AGDIH) per capita (in PPS) for the EU27 as a whole and for subgroups thereof, and also shows whether Member States on average converged towards or diverged from that average (coefficient of variation). The indicator reflects the purchasing power of households and their ability to invest in goods and services or save for the future, by accounting for taxes and social contributions and monetary in-kind social benefits. When the coefficient of variation decreases, there is convergence, whereas, when it increases, there is divergence. When the AGDIH per capita increases, the convergence or divergence is upwards, whereas, when it is reduced, the convergence/divergence is downwards. Figure 1.9 also shows the evolution of the (unweighted) AGDIH for different groups of countries, namely the central and eastern European countries which joined from 2004 onwards (EU11), divided in two groups (EU11 North and EU11 South); and the EU North and the EU South.[2]

Different periods can be identified. From 2004 to 2008, the pattern was mostly one of upward convergence in the EU and all the subgroups of countries. This pattern was disturbed in 2008: on the one hand, the AGDIH per capita of the EU South group began to decline/stagnate in contrast with the GDP of the other two groups, while overall the trend within the EU was one of neither convergence nor divergence; on the other hand, there was a clear pattern of upward divergence within the EU between 2012 and 2015. From 2015 to 2019, the pattern of upward convergence resumed, with average GDP per capita increasing in the EU27 and within all groups, while convergence

1. We use the methodology developed by Eurofound (2018) for conceptualising and categorising convergence/divergence. The average used is 'unweighted' to allow all Member States to have the same weight in shaping the trend.

2. The group of EU11 countries includes Bulgaria, Czechia, Estonia, Croatia, Hungary, Lithuania, Latvia, Poland, Romania, Slovenia and Slovakia, or in other words the Member States which joined in 2004 and had transitioned to being market economies in the 1990s; this group is further split into EU11 North (Czechia, Estonia, Hungary Lithuania, Latvia, Poland and Slovakia, that is, Member States which joined in 2004 and whose growth model had been largely FDI-led); and EU11 South (Slovenia, Croatia, Bulgaria and Romania, i.e. certain Member States that joined later and whose growth model was somewhat less FDI-led (Slovenia)). The EU North group includes Belgium, Denmark, Germany, Ireland, France, Luxembourg, the Netherlands, Austria, Finland and Sweden, or in other words the Member States of the EU15 in the north and north-west of the EU; the EU South group includes Cyprus, Greece, Spain, Italy, Malta and Portugal.

was quite pronounced, especially as the average GDP per capita of the CEEs converged to that of the EU South. Divergence occurred again between 2019 and 2021, while the AGDIH per capita of the EU South declined, as the southern EU Member States with large tourism sectors were particularly badly hit by the public health restrictions imposed in the wake of the Covid-19 pandemic. Between 2021 and 2022, upward divergence resumed, suggesting that, on average, the cash and in-kind tax benefit systems of the Member States cushioned to some extent the impact of the cost-of-living crisis on households' disposable income, as real wage growth faltered.

# Policy developments in the EU

## Monetary policy

Starting in July 2022, and despite the fact that inflation was due to a supply shock in the form of high imported energy inflation, the ECB began raising three policy interest rates – the interest rate on the deposit facility, the interest rate on the main refinancing operations and the interest rate on the marginal lending facility,[3] which stood at -0.50, 0.50 and 0.25 respectively. The last such rate increase took place in September 2023, raising them to 4.0, 4.50 and 4.75 respectively, which was the highest since 2008 (see Figure 1.10). At all its meetings from October 2023 to January 2024, the ECB's Governing Council decided to keep rates high but stable. The latest (December) ECB staff projections foresee that headline inflation is set to decline to 5.4% in 2023 and to 2.7% in 2024, more rapidly than was previously forecast, while the risks of slower future output growth have increased due to the tighter financing conditions that monetary policy has created. It is currently expected that inflation will return to the ECB target by 2025. On the other hand, core inflation (on a year-to-year basis) remained well above the 2% target in December 2023 (see Figure 1.6), while the ECB staff projected it to be at 5% for 2023 as a whole.

At the same time, the ECB has been stepping up the 'normalisation' of its balance sheet. From 2014 onwards, the ECB engaged in large asset purchase programmes (APPs) under which it bought corporate and government bonds as well as asset-backed securities from the secondary markets in exchange for liquidity, in an attempt to preserve the transmission mechanism of its monetary policy and stimulate demand in a context where interest rates had reached the zero lower bound. In 2018-2019 and from 2022 onwards, the ECB decided to start scaling down these programmes, with no new purchases and only partial or full reinvestment of the maturing principals of the bonds/securities. From July 2023, the ECB stopped reinvesting redeemed principals from the APPs.

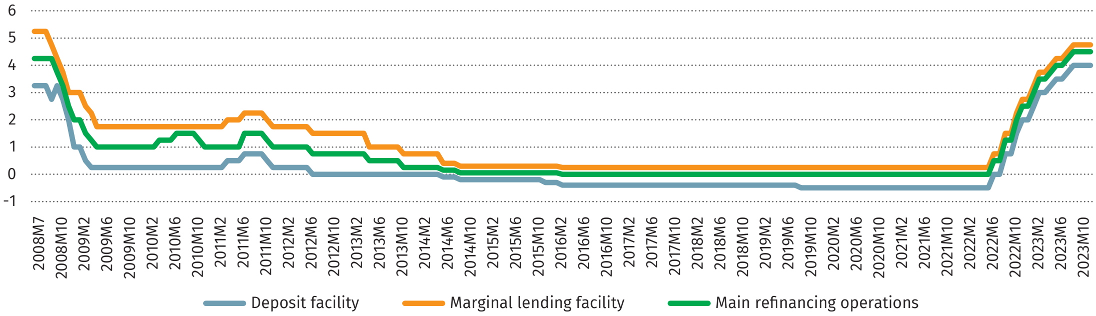
### How conventional monetary policy works

Increases in the ECB's policy interest rates are aimed at increasing the interest rates at which the national banking systems of the euro area generate liquidity, most notably by granting loans, to meet demand for money in the economy and, ultimately, at increasing the interest rates in money and financial markets. Thus, higher central bank interest rates typically result, through market interest rates, in lower consumption and investment both in the private and the public sector, since when they rise, it pays more (in interest) to save more (and thus postpone consumption), while the cost of borrowing to finance consumption and investment increases. Higher interest rates are also likely to result in a nominal exchange rate appreciation, thus putting downward pressure on net exports, which are another component of aggregate demand. These effects result in lower aggregate demand, and since – other things being equal – they also lead to lower job creation and higher unemployment, they eventually put downward pressure on price and wage growth, which can prevent inflation from accelerating further. The responsiveness of prices and wages to lower aggregate demand (and/or higher unemployment) depends on the structural and institutional characteristics of the product and labour markets (such as the degree of competition in the product market, the coordination of collective wage bargaining). The most conventional monetary policy tool therefore aims to keep inflation under control by putting pressure on the demand side of the economy.

In March 2020, the ECB additionally launched the pandemic emergency purchase programme

3. These are the policy interest rates set by the European Central Bank. The deposit facility rate is the interest rate the ECB pays to banks for depositing cash with it; the main refinancing operations rate is the interest rate that banks pay to the ECB in exchange for liquidity (money); and the marginal lending facility rate is the interest rate that banks have to pay to the ECB for overnight lending from it. The deposit facility and the marginal lending facility rates effectively set a lower and upper interest rate limit for the market interest rates then set by banks in the monetary system.

Figure 1.10 **European Central Bank policy interest rates (%), 2008M7-2023M12**




Source: European Central Bank.

(PEPP), whose financial envelope had reached 1.85 billion euros by December 2020. Net asset purchases ceased from March 2022 onwards, whereas the reinvestment of maturing principal payments has continued. In December 2023, it was decided that reinvestments under the PEPP would continue for the first half of 2024 and that the PEPP portfolio would start to be reduced at an average rate of 7.5 billion euros per month until the end of 2024, after which reinvestments would be discontinued. The ECB would also keep on regularly assessing how the targeted longer-term refinancing operations (TLTROs) (under which it provides liquidity to credit institutions (banks) in the euro area at interest rates that are linked to the banks' lending patterns) contributes to its monetary policy stance. In the third cycle of these TLTRO programmes (liquidity provided between 2019 and 2022), the interest rate at which this liquidity was provided to banks was lower than or equal to the (average) deposit facility interest rate.

Despite the fact that their stated purpose was to counter the risks to the monetary policy's transmission mechanism, the ECB asset purchasing programmes have been an important pillar of support for the euro area economies and have also facilitated government responses to the pandemic shock, since they resulted in lower interest rates for borrowing. As shown by Goutsmedt and Fontan (2023), the ECB also shifted its discourse during that period towards wage-setters (calling for stronger wage increases) and fiscal policy-makers (calling for fiscal expansion and even a reform of the Stability and Growth Pact). In that sense, the ECB has also played a role in the drivers enabling the recently observed flourishing of Social Europe, which is the theme of this year's Benchmarking Working Europe.

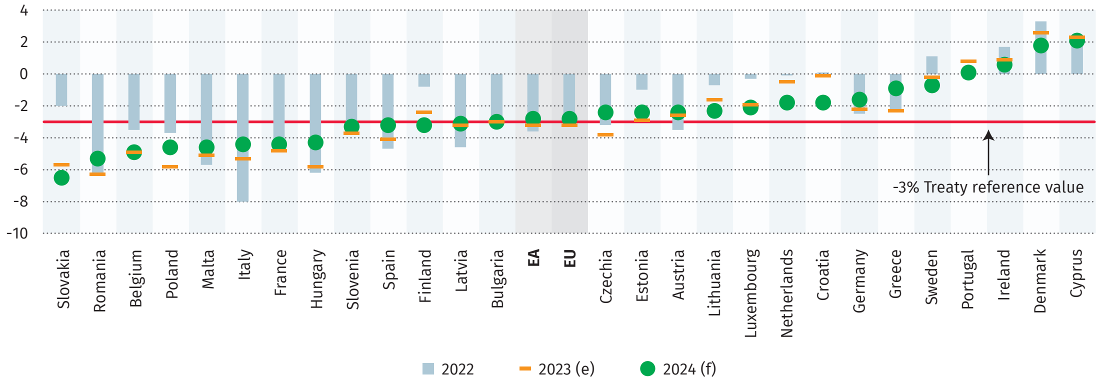
Given these developments, the key questions are whether the ECB's interest rates have peaked by now or whether they are likely to increase again, and whether – and if so, how fast – they could be expected to decrease, thereby easing the pressure on real demand. Although actors in the financial market have forecast that the ECB's monetary policy will start easing as early as March 2024, ECB officials have been more cautious and have managed expectations in their communications, raising yet again their concerns about growing unit labour costs and any potential impact on inflation pressures through the emergence of wage-price spirals. A recent analysis of historical evidence by the IMF has suggested however, that such wage-price spirals have been rare (Alvarez et al. 2022).

## Public finances and fiscal policy

In 2023, the average general government budget deficit (as a share of GDP) in the EU and the euro area remained just above the 3% reference value (3.2%), whereas, in 11 Member States (Romania, Hungary, Poland, Slovakia, Italy, Malta, Belgium, France, Spain, Czechia, Slovenia and Latvia), budget deficits ranged from 6.3% (in Romania) to 3.2% (in Latvia) and 3% (in Bulgaria) (Figure 1.11). According to the European Commission's Autumn 2023 Economic Forecast, budget deficits are expected to stay above the 3% value in 12 Member States in 2024, whereas the EU and euro area average budget deficits are expected to stand at 2.8% of GDP. For 2023, 10 Member States (Finland, Estonia, Austria, Luxembourg, Lithuania, Germany, Greece, the Netherlands, Croatia and Sweden) are estimated to have budget deficits below 3% of GDP, whereas four (Portugal, Ireland, Cyprus and Denmark) are expected to have surpluses.

For the same year, the general government public debt to GDP ratio is estimated to stand at 90.4% for the euro area and 83.1% for the EU (Figure 1.12). For 2024, it is forecast that, in both areas, it will fall by less than 1 percentage point to 89.7% and 82.7% of GDP respectively. For 2023 and 2024 (according to the European

Figure 1.11 **General government budget balance (% of GDP), EU, euro area and Member States, 2022, 2023 (e), 2024 (f)**




Source: AMECO (ULBGE).

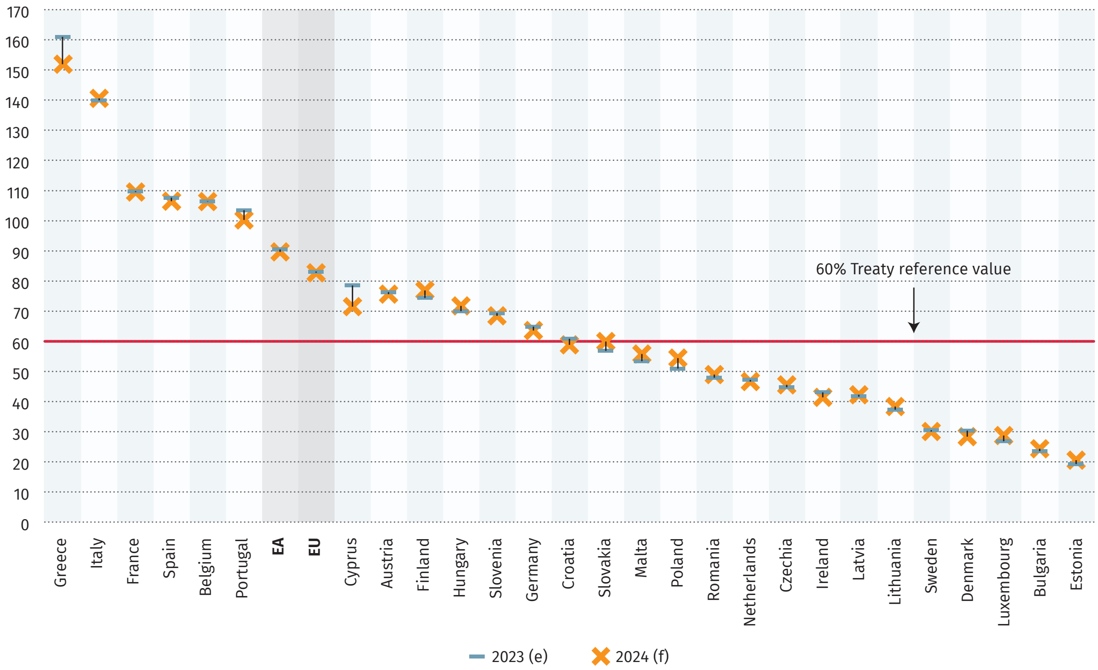
For 2024, it has been recom-mended that most Member States tighten their fiscal policies

Commission's Autumn 2023 Economic Forecast), 12 Member States will have public debt ratios above the 60% reference value, with six of them having ratios over 100%. In most Member States where the public debt ratio is expected to fall between 2023 and 2024, the reduction will be up to around 1 percentage point or lower. Notable exceptions include Greece and Cyprus, where, thanks to relatively high expected inflation and real GDP growth (European Commission 2023c: 35 and 69), the public debt ratio is projected to decline by 9 percentage points in Greece (from 160% to 151%) and by almost 7 percentage points in Cyprus (from 78% to 71%). In several Member States, the public debt ratio is expected to increase by a couple of percentage points between 2023 and 2024.

In 2023, most EU Member States (Belgium, Bulgaria, Denmark, Estonia, Ireland, Greece, Spain, Croatia, Cyprus, Lithuania, Latvia, Luxembourg, Poland, Portugal, Slovenia, Slovakia, Finland and Sweden) maintained an expansionary or neutral/expansionary fiscal policy stance,[4] many of which (Bulgaria, Denmark, Estonia, Ireland, Croatia, Cyprus, Lithuania, Latvia, Slovakia, Finland and Sweden) actually became more supportive than in 2022. For 2024, the European Commission forecasts suggest that most Member States are going to tighten their fiscal policies. Figure 1.13 shows the recommended fiscal adjustment for 2024 for all Member States, which, since 2020, has been operationalised as the change in net general government primary (or, in other words, net of interest payments) expenditure, net of the incremental impact of any discretionary revenue measures, excluding cyclical unemployment expenditure (e.g. on unemployment benefits) but including the change in expenditure financed by the RRF grants and other EU funds, relative to the medium-term (10-year) average potential GDP (nominal) growth rate (European Commission 2023c, p. 4). What is more, based on the country-specific recommendations of 2023

4. The fiscal policy stance of a Member State is aimed at assessing the influence that fiscal policies (public spending and revenues) are likely to have in an economy, most notably whether they are likely to stimulate or suppress aggregate demand. In the context of EU multilateral fiscal surveillance, the fiscal policy stance also allows an assessment of how fast a Member State is approaching the structural primary balance that defines its medium-term objective. Whereas normally only nationally financed fiscal policies are taken into account for calculating the fiscal stance, the large disbursements in Member States of EU funds (most notably from the Recovery and Resilience Facility, but also from the rest of the NextGenerationEU pillar and the EU budget for 2021-2027) mean that the calculation of a Member State's fiscal stance needs to take these financial flows into account, as they are matched by revenue from the EU (European Commission 2023c).

Figure 1.12 **General government debt (% of GDP), EU, euro area and Member States, 2023 (e), 2024 (f)**




Source: Ameco (UDGG).

Council and Parliament negotiators reached provisional political agreement on the Commission's legislative proposal reforming the Stability and Growth Pact

and the assessments of the euro area's draft budgetary plans, an increase in fiscal effort, by reducing the net nationally financed primary expenditure (NNPE) compared the Member State's plans, was recommended in 12 out of 27 Member States. In two of these (Germany and Luxembourg), the recommended reduction was only 0.1-0.2 percentage points of GDP. In another three (Bulgaria, France and Finland), the recommended reduction in the NNPE was below 1 percentage point of GDP (0.6-0.8). In the remaining Member States where greater fiscal effort was recommended, it ranged from 1.8 (Belgium and Latvia) to 5.3 percentage points of GDP (Croatia) (see Figure 1.13).

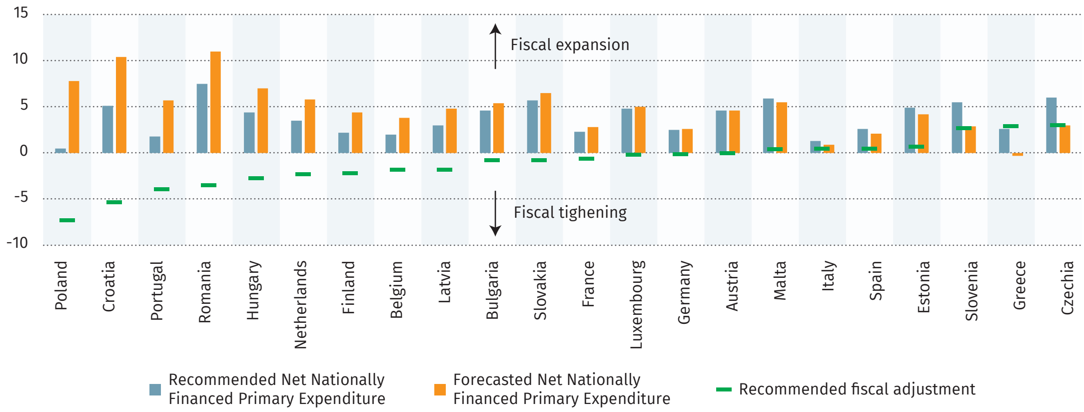
## The economic governance review[5]

On 26 April 2023, the European Commission presented its long-awaited package of legislative proposals for reforming the EU's fiscal framework, formally known as the Stability and Growth Pact (SGP). The package includes proposals for two regulations and one directive. Aimed at amending the so-called 'preventive arm' of the SGP (European Commission 2023f), the first proposed regulation was accompanied by a document with several annexes detailing specific points of the proposal (European Commission 2023a). Subject to the ordinary legislative procedure, Council and Parliament negotiators reached provisional political agreement on 10 February 2024 on the proposal's amended content (Council of the European Union 2024). At the time of writing, the agreement had been submitted for approval by the respective committees of the Council (COREPER) and the European Parliament (ECON). Once approval has been gained, it will be put to the vote in the two institutions.

The second proposed regulation is aimed at amending the 'corrective arm' of the SGP (European Commission 2023d), while the aim of the proposed directive (European Commission 2023e) is to reorient Member States' budgetary frameworks, aligning them with the new fiscal framework set out in the proposed regulations. Both these legislative proposals are subject to amendments by the Council, with only a consultation of the European Parliament required. The Council reached its position on them on 20 December 2023, while the vote of the European Parliament is expected at the same time as that on the regulation on the SGP's preventive arm.

5. This section largely builds on the analysis by Theodoropoulou (2023 and 2024).

Figure 1.13 **Recommended fiscal adjustment for 2024 (Percentage points of GDP), EU Member States**




Source: European Commission 2023c and 2023g.

## Key modifications to the preventive arm of the Stability and Growth Pact

The revised fiscal surveillance framework, especially the proposed regulation on the so-called 'preventive arm' of the Stability and Growth Pact, includes four important innovations vis-à-vis the existing rules.

### Fiscal-structural plans

Firstly, each Member State, following a technical dialogue with the Commission, will have to submit a medium-term fiscal-structural plan (FSP). This document will spell out the Member State's fiscal, investment and reform commitments, including those necessary to address recommendations related to the macroeconomic imbalances procedure, for four or five years, depending on the standard length of the national legislature. FSP duration (the so-called 'adjustment period') can be extended for up to a further 3 years (see below for the relevant conditions). Each FSP will be assessed by the European Commission and endorsed following its recommendation by the Council.

### 'Net expenditure' as a single operational indicator for fiscal surveillance

Secondly, monitoring a Member State's compliance with the fiscal rules will, for the duration of the adjustment period, focus on the evolution (or 'path') of the nationally-financed net primary government expenditure (for brevity, henceforth, 'net expenditure') and on any deviations from this path. Essentially, this path will set a series of annual ceilings for net expenditure. The net expenditure would be 'net' of discretionary revenue measures, expenditure on EU programmes co-financed or fully matched by EU funds, while excluding cyclical unemployment expenditure, any one-offs or other temporary measures, and the interest that a government has to pay on existing debt (hence the 'primary'). This net expenditure path will be detailed in each Member State's FSP. The aim of this innovation is to shift the focus of fiscal surveillance to an observable variable within a government's control and away from a structural budget balance.

### Prior guidance by the European Commission: the reference trajectory of net expenditure

Thirdly, the European Commission will provide prior guidance to Member States regarding the underlying medium-term public debt projection framework and results, macroeconomic forecasts and assumptions, and the net expenditure path to be specified in their FSPs. For Member States whose public debt ratio exceeds 60% of GDP or whose budget deficit exceeds 3% of GDP, the net expenditure path proposed in the Commission's prior guidance will be the so-called 'reference trajectory' covering an adjustment period of four years of an FSP and its possible extension by a maximum of three years. If a Member State wishes to propose a net expenditure path allowing for higher annual net expenditure ceilings than the reference trajectory, it will have to provide sufficient justification through sound analysis, forecasts and data for that path to be considered for positive evaluation by the Commission and endorsement by the Council.

Different for each Member State, the reference trajectory will have to fulfil certain requirements. First, it should ensure that, by the end of the adjustment period at the latest, the Member State's public debt ratio will be on a ‘plausibly downward path’[6] or stay at a prudent level below the 60% reference value over the medium term, even if the Member State does not take any additional policy measures (the ‘DSA-based requirement’, (Darvas, Weslau and Zettelmeyer 2023, 4)), A second requirement is that the reference trajectory should reduce the projected general government budget deficit to max. 3% of GDP (or maintain it at this level) over the adjustment period and ensure that it remains under this value in the medium term, even if the Member State takes no additional fiscal policy measures (‘the deficit benchmark requirement’ (ibid. 2023, 4)).

A third requirement is that the evolution of net expenditure should be planned so that the fiscal adjustment effort (i.e., the change in the fiscal structural primary balance) is not delayed until the final years of the adjustment period (the ‘no backloading safeguard’, (ibid. 2023, p. 4)). A fourth requirement is that, if the budget deficit exceeds 3% of GDP for the years of the adjustment period, the reference trajectory should ensure that an annual adjustment of at least 0.5% of GDP in structural terms takes place (‘the excessive deficit’ safeguard, (ibid. 2023, 4)). This requirement is consistent with the Council’s proposal on the ‘corrective arm’ of the SGP (see below).

Furthermore, a ‘debt sustainability safeguard’ will apply to each Member State’s reference trajectory and a ‘deficit resilience safeguard’ to its net expenditure path in its FSP. The debt sustainability safeguard postulates that the reference trajectory should ensure that the public debt-to-GDP ratio of the concerned Member State should decrease on average by at least 1 percentage point per year for Member States with a public debt ratio greater than 90%; and by at least 0.5 percentage point per year for those with a ratio between 60 and 90%. The period to be used for calculating these minimum changes will begin either the year before the start of the reference trajectory or the year in which an excessive deficit procedure is expected to be abrogated, whichever occurs last. In practice, this would mean that the period for monitoring the compliance with this debt sustainability safeguard would only begin after Member States have reduced their budget deficits below 3% (Zettelmeyer 2023).

The aim of the ‘deficit resilience safeguard’ is to ensure that fiscal adjustment (i.e., is the increase in the structural primary balance) continues until a Member State reaches a deficit level providing a common resilience margin in structural terms of 1.5% of GDP relative to the 3% reference deficit. Specific to every Member State, this margin will ensure that, even if a negative shock occurs, the increase in the cyclical part of the budget balance (i.e., the increase in spending and fall in revenues due to the operation of automatic stabilisers such as expenditure on unemployment benefits and lower income tax revenues) would still not result in a headline deficit exceeding 3% of GDP. Additionally, the deficit resilience safeguard stipulates the minimum average annual rate of fiscal adjustment needed to reach that common resilience margin. For FSPs with a four-year adjustment period, the annual improvement of the structural primary balance needed to reach that margin should be 0.4% of GDP, whereas for FSPs where an extension of the adjustment period has been granted, this annual improvement should be to the tune of 0.25% of GDP.

Member States with a public debt ratio below 60% and a budget deficit below 3% may ask the Commission for technical information in the form of the structural primary fiscal balance necessary to ensure that their headline budget deficit stays below this threshold in the medium term, even if the Member State takes no additional fiscal measures. The net public expenditure path in its FSP would have to be consistent with that structural primary fiscal balance[7] and also with the aforementioned ‘deficit resilience safeguard’.

### Investment and reforms in fiscal-structural plans

In a nod to the notion that reforms and investment can have a positive impact on output growth and thus on public debt sustainability but also that they can be important for pursuing policy priorities other than fiscal sustainability, a fourth innovation of the revised SGP preventive arm is that each Member State, regardless of its debt ratio and/or public budget balance, will also include a set of reforms and investments in its FSP. The FSP will have to show how these address

6. The conditions determining the plausibility of the downward path of a Member State’s public debt depends on risk-analysis on its evolution, hence, the ‘risk-based’.

7. The net expenditure path foreseen in the reference trajectory and/or eventually endorsed by the Council will correspond to (i.e., be suited to result in) a structural primary balance (i.e., a government budget balance, excluding cyclical revenues and expenditure, one-offs and interest payments) meeting the different requirements stipulated in the regulation on the preventive arm of the Stability and Growth Pact.

the main challenges identified in the context of the European Semester and particularly the Country-Specific Recommendations issued by the Council to each Member State. Moreover, the FSP will have to explain how investments and reforms will address such common EU priorities as a fair green and digital transition (including consistency with the European Climate Law), social and economic resilience (including the European Pillar of Social Rights), energy security, and wherever necessary, the build-up of defence capabilities. The set of reforms and investment in the FSP should also be consistent with and complement planned reforms and investment to be financed by cohesion policy funds and the Member State's national Recovery and Resilience Plan (for the duration of the Facility).

> Member States will have to explain how investments and reforms will address a fair green and digital transition

A Member State may request that the baseline adjustment period of its FSP be extended by up to three years by proposing reforms and public investment for which it makes a case that, in addition to pursuing the above purposes, they will also enhance the country's growth and the resilience of its economy, support fiscal sustainability over the medium term, address the aforementioned common EU priorities, and ensure that the level of nationally-financed public investment for the duration of the FSP is no lower than the medium-term investment level before the beginning of the plan.

### Key modifications to the corrective arm of the Stability and Growth Pact

In tandem with the proposed changes to the preventive arm of the SGP, the Commission also proposed reforming its 'corrective arm', forcing Member States to correct their fiscal policies when not compliant with 'budgetary discipline' and generating 'excessive deficits'. The proposals would eliminate the Fiscal Compact's 1/20th rule[8] for Member States with public debt ratios exceeding 60% of GDP. Under the proposed reform, a ratio above 60% would only be considered as not sufficiently diminishing and not approaching the 60% reference value at a satisfactory rate (i.e., the Treaty definition of 'excessive public debt') if the Member State's net expenditure deviates[9] from the path set out in its Council-endorsed FSP and its budgetary position is not close to balance or in surplus. This operationalisation is intended to crucially link a Member State's compliance with the public debt fiscal rule with the insights of the Commission's DSA framework but also with the various benchmarks and applicable safeguards mentioned above.

Moreover, if a Member State is found to be in breach of the 3% budget deficit criterion, its 'corrective' net expenditure path should be set so that this *structural* deficit[10] is reduced by a minimum of 0.5% of GDP per year until the headline deficit falls below 3%. This requirement of reducing the budget deficit would be waived if, among others, a general or national escape clause has been activated.

In composing the report stipulated in TFEU Article 126(3), when a Member State is in breach of either the deficit or debt criterion, the Commission should consider as key relevant factors, among others, the degree of public debt challenges facing a Member State (in line with its Debt Sustainability Analysis framework), including contingent liabilities, rises in the cost of ageing, progress in implementing reforms and investments, and especially policies to implement the EU's common growth and employment strategy, with particular consideration given to financial contributions towards achieving the EU priorities mentioned above. In that sense, while social spending on pension systems would constitute an aggravating factor for recommending whether an Excessive Deficit Procedure should be opened, investment in implementing the European Pillar of Social Rights and the European Climate Law would seemingly be considered as mitigating factors.

8. Under this rule, a Member State's public debt ratio exceeding 60% would be considered sufficiently diminishing and approaching the reference value at a satisfactory pace when over the past three years it has been reduced by an annual average of 1/20th (or 5%) of the difference between the actual public debt ratio and the 60% reference value.

9. If a Member State's public debt ratio exceeds 60%, the European Commission will prepare a report in accordance with article 126(3) of the TFEU if in addition to the aforementioned conditions, the deviations recorded in the control account exceed 0.3 percentage points of GDP annually or 0.6 percentage points of GDP cumulatively (Council of the European Union 2023, 14).
10. The text of the Council proposal does not specify the type of structural deficit upon which the 0.5% of GDP should apply (Council of the European Union 2023), (fiscal) adjustment is commonly measured by the change in the structural primary balance.

## Implications of the new elements of the fiscal rules for Social Europe

Given the political agreement between Council and European Parliament negotiators on the regulation reforming the preventive arm of the SGP and the expected consent of the European Parliament to the regulation reforming its corrective arm and the directive on Member States' fiscal frameworks, a preliminary assessment is possible. As far as the implications for Social Europe are concerned, three questions are important. First whether the emerging new rules are likely to generally constrain public spending in Member States. Second, whether, within the constraints of public spending that the new rules are likely to permit, social spending is sufficiently prioritised and social investment encouraged. And third, whether the new rules are likely to favour social player participation in economic governance.

### Balancing fiscal sustainability with the risk of austerity?

Firstly, the emerging rules would allow for some differentiation and tailoring in each Member State's fiscal adjustment path, depending on the conditions shaping the sustainability of its public debt over the medium term, as defined in the DSA framework used by the European Commission. This greatly contrasts with the mechanical public debt reduction rule prescribing a uniform annual rate of reduction (the notorious '1/20th rule') for all Member States with a public debt ratio exceeding 60% and should therefore make any fiscal adjustment somewhat milder.

Second, the fact that net expenditure will be the key surveillance indicator should make it easier for a Member State to comply with the rules. It should also simplify multilateral fiscal surveillance, making it more transparent, as the use of this indicator itself could, all other things being equal, reduce the procyclicality of national fiscal policies (Theodoropoulou 2023).

Third, the proposed rules aim to coordinate more closely the multi-lateral budgetary surveillance and macroeconomic imbalance procedures by incorporating and aligning the policy actions necessary to comply with their respective recommendations into a single national plan, the FSP. That should maximise synergies between preventing and correcting fiscal and other macroeconomic imbalances, which, as witnessed in the aftermath of the global financial crisis, can result in very painful and socially costly economic adjustments.

However, these improvements are subject to some important limitations.

First, there is a high risk that Member States will be forced into fiscal austerity (or pro-cyclical fiscal policy), i.e., budget cuts when their economies are slowing down or in recession, due to the 'excessive deficit safeguard'. Quantitative evidence by Zettelmeyer (2023) based on Darvas, Weslau and Zettelmeyer (2023) suggests that, under certain assumptions (including four of the criteria that net expenditure paths should fulfil), all but four Member States would on average have to increase their structural primary balances (that is, tighten their fiscal policies) every year between 2024 and 2028 (in the case of four-year adjustment periods), in some cases by over 1% of GDP. Given current macroeconomic and financial circumstances, it is not unlikely that a recession will occur during that four-year period. The fiscal adjustment that would require increasing structural primary balances would in most cases be dictated by DSA requirements.

Secondly, despite the stated necessity of ensuring 'an appropriate level' of public investment, the only condition in the agreed Regulation on the preventive arm regarding the level of nationally financed public investment is that it be 'no lower than the medium-term level before the period of that plan, taking into account the scope and scale of the country-specific challenges' (Council of the European Union 2024, 29) when a Member State seeks an extension of the adjustment period of its FSP. This is a potentially problematic requirement for several reasons.

Firstly, not all Member States may seek an extension of their adjustment period, meaning that this is not a general requirement. Secondly, the Regulation refers to 'levels' of nationally financed public investment, rather than investment as a share of GDP, which may not sufficiently sustain the pressure on Member State governments to maintain the public investment effort as an economy grows. Thirdly, setting the level of investment over the medium term (assuming that this is up to 10 years) before the launch of the FSP as a benchmark will mean that, at least for the 'first wave' of FSPs to be submitted in September 2024, the benchmark will be related to the period since 2014. In many parts of Europe, most notably the South, this period was characterised by mostly lacklustre public investment levels and growth (cf. Brasili et al. 2023), thus setting the bar for public investment in the first FSPs rather low and creating the risk of trapping these high-public-debt Member States in a low public capital stock trap.

All in all, therefore, despite declarations and calls in both Regulations to plan and report on public investment for pursuing common EU priorities, the Regulation on the preventive arm does not provide strong enough incentives and capacities for Member States to maintain nationally-financed public investment spending. This is especially true when one considers the growing rather than diminishing needs generated by the challenges lying ahead in view of ensuring a just twin green and digital transition, upward social convergence and geopolitical security.

### Insufficient safeguards for prioritising social spending and investment

The proposed rules acknowledge in principle and more broadly the need for public investment and reforms to meet important and specified challenges facing European economies and societies and to serve common EU priorities, while also contributing to public debt sustainability and correcting macroeconomic imbalances. Providing the possibility within the process of policy coordination to extend a Member State's adjustment period to allow more time to adjust on the basis of specified investment and reform programmes is also, in principle, a positive incentive.

Explicitly including references to a fair green and digital transition, social and economic resilience, and the European Pillar of Social Rights as common priorities that Member States' public investments and reform will have to address and requiring that FSPs explain how this will be done in the context of a European Semester where a Social Convergence Framework has been recently introduced for identifying risks are also to be viewed positively. In a similar vein, the Regulation on the corrective arm of the SGP states that particular consideration should be given to financial contributions to achieve the common EU priorities defined in the Regulation on the preventive arm as 'relevant [that is, mitigating] factors' when the Commission has to prepare a report on a Member State (under TFEU 126(3)) that may have breached the fiscal rules.

However, at its heart, multilateral surveillance and policy coordination as spelled out in the new SGP rules remain dictated by a narrowly defined fiscal sustainability paradigm whereby climate and social risks enter the sustainability assessment framework of analysis as 'contingent liabilities' for public finances. The Commission's reliance on the DSA framework for assessing the medium-term sustainability of public debt entails a continuing one-way view of the relationship between fiscal sustainability and climate and social risks. As Zettelmeyer's (2023) analysis shows, this framework is likely to shape fiscal adjustment requirements for most Member States with public debt ratios exceeding 60%.

The potential impact of green and social investments on public debt sustainability is not featured in that framework, thus providing not only a limited focus on debt sustainability but also a limited perspective on its determinants. The likely result is that fiscal adjustment recommendations will be too tight to meet such social and green objectives. Moreover, there does not seem to be any consideration of the risks for fiscal sustainability incurred through failing to deliver the level of public investment necessary for managing the green and technological transition fairly. This imbalance is further buttressed by the absence of experts and stakeholders in the independent institutions – whether the European Fiscal Board or the national independent fiscal institutions – able to offer FSP opinions and assessments from a social and green perspective on an equal footing with fiscal policy experts (cf. Dawson 2023).

Additional public investment related to climate change and energy security alone to the average tune of 1.8% of GDP (2019) per year will be necessary in the EU for the period 2021-2030, without including any fiscal costs associated with making the transition a 'just' one (Baccianti 2022). Further investment equivalent to another 1.3% of GDP (2018 levels) will be needed annually until 2030 to close the investment gap in social infrastructure (Fransen, del Bufalo and Reviglio 2018) essential for building lifelong human capital (Hemerijck, Mazzucato and Reviglio 2022). Investment in these areas will have to be sustained and increased for decades in view of the EU's climate ambitions and such challenges as population ageing or higher defence spending.

Favourable provisions for investment spending on social objectives are bundled together with several other priorities to be covered by FSP investment programmes, without any clear and binding prioritisation of some over others. In that sense, FSPs could be favourably assessed for promoting priorities which are not necessarily social. At the same time, evidence from national Recovery and Resilience Plans seems to suggest that the extent of Member State eco-social policies including investments towards achieving green and social objectives is limited (Sabato and Theodoropoulou 2022) (Sabato and Mandelli 2023).

While building up reserves to allow robust fiscal policy support when a shock hits an economy is in principle a sound practice, it is not clear how the optimal choice will be made between this need and other pressing policy challenges, especially as the reference value of 3% of GDP for budget deficits tips the policy scales in favour of fiscal savings. Indeed, there would seem to be no theoretical base for defining the sustainability of public finances.

### The role of social players

Last but not least, the input of the social partners and other social stakeholders in shaping the national FSPs is limited, whereas only fiscal/economic experts can participate in the European Fiscal Board, the institution that has a privileged advisory role vis-à-vis the Commission and the Council in the process of fiscal surveillance. As Dawson (2023) argues, if a real balance among fiscal, green and social objectives is to be established in the new economic governance framework, assessments and expert opinions feeding into the process should come from experts and/or representatives not just on fiscal matters but also on social and environmental/climate issues.

## The mid-term review of the EU budget

In June 2023, the European Commission published its proposals for a mid-term review, which effectively amount to a topping-up of the EU budget for the remaining years of the 2021-2027 period. Despite the extended financial capacity allocated to the current budget and its complementary recovery pillar (NextGenerationEU), this review became necessary due to several mounting challenges which have required and will continue to require further EU financing. These include the war in Ukraine following Russia's invasion, the energy and migration crisis that were partly a result of that war, and high inflation and high interest rates (Kowald, Pari and Gallo 2024). In February 2024, after agreement had been reached at Council level, the Council and European Parliament negotiators reached a political agreement on how to tackle the challenges.

Overall, the Commission proposed an increase in commitment appropriations of 65.8 billion euros for 2024-2027 plus another 33 billion euros as guarantees for loans to be taken up by Ukraine. Of these funds, 24.4 billion euros would be used to increase the spending ceilings for six out of seven EU budget headings and 5.5 billion euros to increase the envelope for two special instruments existing over and above these budget headings, namely the Flexibility Instrument and the Solidarity and Emergency Aid Reserve (SEAR). In addition, two new special instruments would be established, namely the Ukraine Facility (for a total of 50 billion euros, namely 17 billion euros in grants and 33 billion euros in loan guarantees) and the European Union Recovery Instrument (estimated between 17 and 27 billion euros for 2024-2027) to finance the higher than predicted borrowing costs for the NGEU.

Of the proposed funds to increase the existing EU budget ceilings, 12.5 billion euros would be allocated to Heading 6 'Neighbourhood and the world' and Heading 2 'Migration' to help tackle, among other things, migration challenges, the process of emerging from wars and climate change. Another 10 billion euros would be allocated to Heading 1 (the Invest EU and Horizon lines thereof), Heading 3 (the Innovation Fund line) and Heading 5 (the European Defence Fund) with a view to setting up the Strategic Technologies for Europe Platform (STEP), whereas 1.9 billion euros would go to covering increased expenditure needs due to higher than predicted inflation under Heading 7 'Administration'.

Table 1.1 below shows the Commission's proposals, the amendments to these proposals proposed by the European Parliament, the amounts finally agreed by the European Council (to be voted in) as well as the budget lines whose commitments had to be reduced so as to finance part of the agreed funding increases (compiled by Kowald, Pari and Gallo 2024). A comparison of the proposed adjustments against those that were finally agreed, as well as the agreements reached regarding their financing, points to a major refocusing of challenges and priorities on security and defence and the management of migration flows. The only financing proposal that was upheld in its entirety in the final agreement was that relating to the Ukraine Facility, underlining the existential significance for the EU Member States (albeit not all of them) of keeping Ukraine on its European trajectory. The establishment of STEP, which seeks to support the acceleration of the EU's twin transition while regaining leadership in key sectors and maintaining jobs in a way that preserves the level playing field and thus cohesion within the EU, was allocated only 1.5 billion euros compared to the 10.5 billion euros originally proposed.

As the review of the EU economic governance draws to a close, providing a framework for national fiscal policies that appears less restrictive than the former fiscal rules but nevertheless imposes too many constraints to

Table 1.1 **Revision of EU budget-European Commission and European Parliament proposals, European Council agreement**

| | MFF Revision (euros billion, current prices) | | |
|---|---|---|---|
| | **COM 6/23** | **EP 10/23** | **Eur Council 02/24** |
| **Ukraine Facility - grants** | **17.0** | **17.0** | **17.0** |
| **Strategic Technologies for Europe Platform (STEP)** | **10.0** | **13.0** | **1.5** |
| H 1 - InvestEU | 3.0 | 4.2 | 0.0 |
| H 1 - Horizon Europe | 0.5 | 1.3 | 0.0 |
| H 3 - Innovation Fund | 5.0 | 5.0 | 0.0 |
| H 5 - European Defence Fund | 1.5 | 2.5 | 1.5 |
| **Migration and external challenges** | **15.0** | **19.0** | **9.6** |
| H 4 - Migration | 2.0 | 3.0 | 2.0 |
| H 6 - External action | 10.5 | 11.5 | 7.6 |
| Solidarity and Emergency Aid Reserve (SEAR)* | 2.5 | 4.5 | 0.0 |
| **Inflation and borrowing cost** | **20.8** | **20.8** | **0.0** |
| H 7 - Administration | 1.9 | 1.9 | 0.0 |
| EU Recovery Instrument (EURI) | 18.9 | 18.9 | 0.0** |
| **Flexibility Instrument** | **3.0** | **6.0** | **2.0** |
| **Solidarity and Emergency Aid Reserve (SEAR)*** | **0.0** | **0.0** | **1.5** |
| ***Increases*** | **65.8** | **75.8** | **31.6** |
| Horizon Europe | | | -2.1 |
| EU4Health | | | -1.0 |
| Cohesion/CAP centrally managed programmes | | | -1.1 |
| Heading 6 | | | -4.6 |
| Brexit Adjustment Reserve | | | -0.6 |
| European Globalisation Adjustment Fund | | | -1.3 |
| ***Decreases*** | | | **-10.6** |
| ***Total EU budget (incl. Ukraine Facility - grants)*** | **65.8** | **75.8** | **21.0** |
| ***Ukraine Facility - loans*** | **33.0** | **33.0** | **33.0** |

* The European Commission and the European Parliament suggested an increase of SEAR to cover needs related to migration and external challenges, while the European Council does not specify its use.
** Cascade mechanism.
Source: Kovald, Pari and Gallo (2024:5)

allow the challenges of a just twin transition (green and digital) to be met successfully, it has been suggested that these challenges should instead be tackled through an EU fiscal capacity. Moreover, as the RRF currently covers a significant chunk of national spending on investment, questions have been raised as to whether a number of Member States with high public debt ratios will be able to maintain the required level of spending after 2027, when the RRF funding will expire. However, the EU budget review that is currently coming to an end suggests that, at present, Member States – whose national public budgets have come under increased pressure looking back at the cascading crises they have had to tackle, but also looking ahead to the deactivation of the general escape clause – have been reluctant to commit fresh funds and have instead opted for the redeployment of funds from research and cohesion budget lines.

# Conclusions

As we are approaching the end of this term, we observe, on the one hand, a significant (though not complete) reversal of ideas and patterns in macroeconomic policy-making and EU frameworks compared to the pre-crisis period, and, on the other hand, developments that are too slow given the challenges facing the EU in terms of engineering a just green and digital transition.

The newly agreed rules for the EU's fiscal surveillance are likely to disappoint. While providing some improvement over the currently suspended rules, by allowing Member States more tailored-made fiscal adjustment, the new rules continue to incorporate unduly stringent 'safeguards' likely to undermine this flexibility. They are thus also likely to create pressure on Member State public investment and/or to pit it against current public spending, part of which concerns social benefits and services. This points to some backtracking among Member States in favour of fiscal sustainability at the expense of more space for governments for the handling of common EU priorities such as climate change and social resilience. It would appear that the review of the EU's fiscal rules will turn out to be a missed opportunity for achieving a more meaningful balance between fiscal, green and social objectives in the area of multilateral surveillance and coordination of economic, employment, structural and social policies.

Looking ahead, living up to the growing EU social aspirations and ambitions of recent years would require making the most of the emerging economic governance framework. The new focus on 'net expenditure' in fiscal surveillance allows some leeway to Member States for increasing taxation to finance just green and digital transition. Steps have been taken in launching the Social Convergence Framework within the European Semester to provide more focused assessment of risks to upwards social convergence. The Informal Working Group on Social Investment established by the Spanish and Belgian Council Presidencies has been working on providing evidence on social investment and its potential returns at the macroeconomic and social levels and how these could be better defined and tracked, and ultimately contribute to economic growth and debt sustainability. The insights from this Group's work could help Member States make strong case for social investment in view of implementing the EPSR in their FSPs. The findings of that Working Group will be discussed at a 'jumbo' EPSCO-ECOFIN Council meeting in March 2024, and work on the topic will continue until June 2024 with a view to the adoption of Council conclusions in the same month. This could be a first step for the better alignment of fiscal and social objectives within the parameters of the new economic governance rules.

The debate on the next EU MFF will have to begin in 2025. As national fiscal spending capacity continues to be restricted, a way forward for addressing the common EU priorities would be to enhance the EU fiscal capacity. The definition of 'net expenditure' in the new fiscal rules, excluding expenditure on EU co-financed programmes or fully matched by EU funds, seems to generate incentives for Member States to create fiscal capacity at the EU level for common priorities, including by following up on the RRF which is due to expire in 2026. While EU funding could ease fiscal constraints especially on highly indebted Member States, the conditions for its use should also seek to address the need to integrate more closely climate and social objectives to achieve a better balance between fiscal, climate and social objectives.

There is a very real threat that any appetite to ensure a balance between fiscal, climate and social objectives might be tempered as policy priorities shift towards ramping up defence capabilities under the pressure of new circumstances, most notably the war on European territory and broader geopolitical challenges.

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