Revised EU economic governance:

Are the European Commission's proposals socially just and environmentally sustainable?

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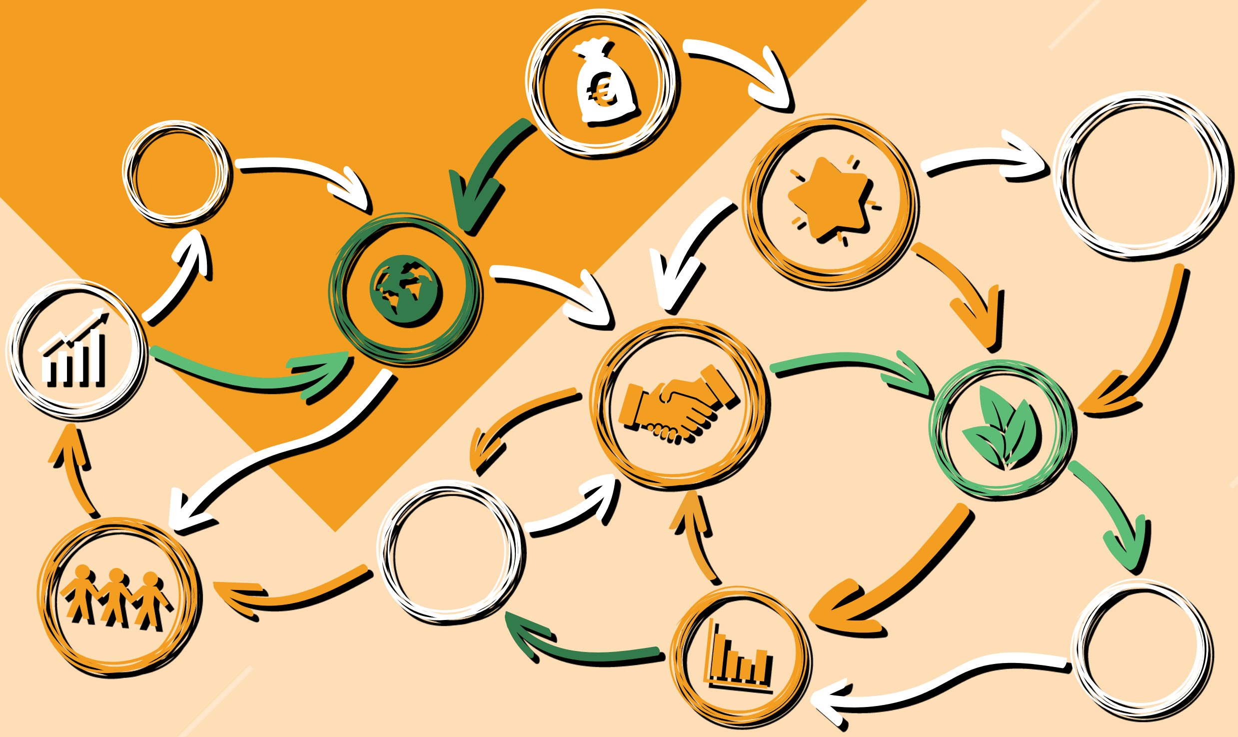

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A SOCIAL EUROPE
FOR ALL WITH ALL

About the authors

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SOLIDAR is a European and worldwide network of Civil Society Organisations (CSOs) working to advance social justice through a just transition in Europe and worldwide. With over 50 member organisations based in 26 countries (19 of which are EU countries), member organisations are national CSOs in Europe, as well as some non-EU and EU-wide organisations, working in one or more of our fields of activity.

Foreword

Mikael Leyi,
Secretary General of SOLIDAR

Fiscal rules, economic governance framework, risks to debt sustainability, 3% of GDP for budget deficits and 60% of GDP for debt - these are words and concepts that often appear in the public debate but do not mean much to most people across Europe. Yet they refer to EU policies that have perhaps the strongest and most direct impact on people's daily lives. The EU's fiscal rules determine how high EU countries' debt and deficit levels can be, and therefore how governments can and cannot spend public money. This is the fiscal space available to sustain our welfare systems and to deal with any current or future crises. As a result, these rules have a major impact especially on those living in a vulnerable situation, whose livelihoods and well-being depend most on the provision of quality public services.

The EU's austerity measures in response to the 2007-2008 financial crisis are a tragic example of how blindly implemented fiscal rules can be destructive of social justice and equality. Fortunately, the EU has recently shown that it has partly learned its lesson. The activation of the general escape clause of the Stability and Growth Pact in March 2020, in the face of the Covid-19 pandemic, allowed Member States to react quickly and adopt emergency measures to mitigate its economic and social impact. Regrettably, the general escape clause will be deactivated in 2024 and there is growing political support for a return to austerity.

Unless fundamental changes are made as part of the reform of the EU's economic rules, this trend is dangerously reminiscent of the political debate before and after the 2008 crises. In the midst of many parallel ongoing crises, the main lesson of the pandemic - that we need to strengthen our societies through social investment and universal public services - should make it clear to everyone that a return to "business as usual" would be nothing short of catastrophic: it would make it impossible to meaningfully address most of today's most pressing challenges, pushing people into poverty and precariousness, widening inequalities and worsening the socio-economic situation of people in Europe. It would have dire consequences for our resilience and preparedness for the future.

The multiplicity and convergence of serious global crises in recent years, such as the climate, energy and health emergencies, have shown the need and urgency for a profound transformation of our capitalist economic model and outdated macroeconomic rules. The adoption of progressive, socially and environmentally sustainable and bold measures is needed. A new vision for the EU economy, and in particular for the EU's economic governance framework, is necessary to set these changes in motion and to ensure that our societies are driven by goals of social justice, climate neutrality and environmental protection and restoration.

We must seize the opportunity presented by the review of the EU's economic governance framework to replace a system that is blind to our current global challenges. We need a system that focuses on the redistribution and investment needed to achieve social rights and justice. Progressive fiscal rules that build fairer, more inclusive and environmentally sustainable societies and economies. This paper aims to answer questions such as:

- Does the European Commission provide an innovative enough vision for new EU fiscal rules, that significantly moves beyond austerity and equips our economies for the current and future social, climate and environmental challenges?
- What would a progressive, socially and environmentally sustainable, and bold economic governance framework look like?
- And more visionarily, what kind of economy should we adopt to ensure both people's well-being and a healthy planet?

We would like to take this opportunity to thank Tommaso Grossi, Alessandro Liscai and Laura Rayner for their informative and much-needed research, which will support our advocacy work. We are also grateful to the European Commission for funding this publication through the EU's Employment and Social Innovation (EaSI) programme.

We hope you find it an interesting read!

Executive Summary

Over the past decade, the European Union's (EU) economic governance framework has evolved into a complex structure of detailed rules and exemptions. The activation of the general escape clause (GEC) of the Stability and Growth Pact (SGP) and the establishment of the Recovery and Resilience Facility (RRF) significantly reshaped this framework. They allowed more fiscal flexibility in response to the severe economic shock caused by the Covid-19 pandemic. Despite these adjustments, the framework requires urgent and thorough reform, not least before the deactivation of the general escape clause, which would see stricter conditionalities forced upon many member states and the potential return of the austerity of the 2010s.

This policy paper is based on an analysis of the European Commission's reform proposals and of the contributions made by member states and other key stakeholders to the debate. These have been complemented by in-depth interviews with policymakers and key stakeholders. It assesses whether current proposals are ambitious enough to meet the expected demands of the years ahead. The paper argues that the EU economic governance framework must take a longer-term, more-holistic approach than has been the case to date. Governance should focus on the well-being economy and the balance among social, environmental and economic objectives. The paper also reflects on whether measures put forward by the European Commission will provide sufficient safeguards against a return to austerity and the strict fiscal conditionality of the past decade, and whether the Commission's stated aim of sustainable and inclusive economic growth can and should be achieved. It also advocates a 'golden rule' for green and social investments and assesses the possibility of establishing permanent central fiscal capacity to finance public goods.

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Overall Recommendations

A golden rule for green and social investments

We propose the implementation of a golden rule for green and social investments as a crucial step towards promoting sustainable, inclusive and resilient economies. Such a golden rule would establish a fiscal policy framework that prioritises social and green investments, placing the planet and people at the centre and exempting these expenditures from the calculation of variables relevant to the SGP. This rule would provide a clear signal of commitment to address social challenges and transition towards a sustainable economy. The implementation of a golden rule should be supported by robust monitoring and evaluation mechanisms to ensure transparency, accountability and an efficient use of resources. The current Recovery and Resilience Facility (RRF) methodology for climate and environmental tracking represents a starting point for the definition and identification of public spending eligible for such treatment. But further improvements are required, which should eventually be supported by external independent evaluators. One short-term solution that could be envisaged is to exempt from the measurement of the deficit all the green and social investments already approved within the RRF framework. In the long term, the Treaty on the Functioning of the European Union could be modified to include a more explicit definition of the investment clause, amending and expanding the scope of Art. 126.3 TFEU.

A common investment fund and the need for a permanent central fiscal capacity (CFC) to finance European public goods (EPGs)

We recommend the establishment of a permanent fiscal capacity as an essential measure for financing European public goods (EPGs). By pooling financial resources from member states, a common investment fund would enable the financing of initiatives that benefit the entire European Union, including infrastructure development, research and innovation, climate action and cohesion policy. Currently, it is crucial to offer specific types of EPGs to implement the twin green and digital transition, to build a common security system within the European social inclusion model and to complement monetary policy measures to control inflation. There is already a compelling case for stating that public or common goods and services have positive externalities.

An expanded role for IFIs and civil society partners

We recommend an expanded role for independent fiscal institutes (IFIs) as a key component of a comprehensive economic and fiscal governance framework. IFIs could potentially perform additional tasks related to the fulfilment of green and social objectives. Examples include the assessment of the long-term impact of climate-related fiscal risks on national budgets and on social sustainability, as well as the identification of national green, social financing needs and quality investments. Moreover, IFIs can contribute to the alignment of national policies with wider European sustainability frameworks, such as the European Pillar of Social Rights. IFIs can support member states in monitoring and implementing projects that promote social inclusivity, environmental sustainability and climate resilience. They can thus help advance the European Union's commitment to a sustainable and just future. At the same time, we stress the need for a stronger involvement of civil society and social partners: They should be included in the consultations taking place at national level during both the design and development phases of fiscal plans.

Introducing a framework for a well-being economy

A well-being economy incorporates policy tools and initiatives in areas such as environmental sustainability, health, education, gender equality, social protection and redistribution. It proposes statistical measures to fill the gap between standard macroeconomic statistics that are used as proxies of societal welfare and indicators that have a more direct bearing on people's lives. We thus recommend the introduction of a framework for a well-being economy and of innovative indicators to measure things such as income inequality, childcare provision and working time. These indicators would accompany, balance or replace traditional macroeconomic ones, such as debt-to-GDP ratio, government deficit and output gap. Building the well-being economy must start by adopting an approach in which macroeconomic stability does not depend on GDP growth. A new paradigm represented by a focus on the well-being economy can represent a compass for fiscal policy too, especially when considering social public expenditure and its long-term returns. Finally, the EU's fiscal framework and Annual Sustainable Growth Strategy (ASG) should be adapted to make them fully consistent with the European Pillar of Social Rights (EPSR) and the well-being economy framework.

A reformed European Semester

The European Semester should become a key vehicle for the implementation of a well-being economy framework, ensuring consistency in EU analyses and recommendations to member states. It should closely monitor domestic implementation of the principles of both the EPSR and the well-being economy framework and of reforms and investment in key sectors of society. There must be improved cross-sectoral cooperation and a better balance between social, environmental and economic policies in the European Semester. We recommend the introduction of a European Commission Executive Vice President for the Well-being Economy, possibly supported by a Directorate, to oversee a reformed European Semester as his or her primary policy objective. The Semester should build on the significant work already done to develop new benchmarks, indicators and integrated scoreboards, such as the Transitions Performance Index, and it should take lessons from the RRF. The Semester should then set targets and monitor progress across the full spectrum of EU objectives, and EU funding should be tied to their achievement. This would also ensure policy coherence and alignment across silos. From a less ambitious perspective, the reformed European Semester should at the very least be able to improve coordination among member states. It could then enhance transparency and properly monitor the implementation of national medium-term fiscal plans to achieve an improvement in the balance between economic, social and environmental objectives.

The Social Imbalances Procedure

We recommend the implementation of the proposed Social Imbalances Procedure (SIP) (sometimes referred to as the ‘Social Convergence Framework’) within the EU’s economic governance framework. Its realisation requires further adjustments and could be based on the existing procedures of Art. 148 TFEU, complementing the already functioning Macroeconomic Imbalance Procedure. We recommend integrating the SIP into a reformed European Semester through the adoption of a comprehensive and integrated scoreboard, encompassing all areas of resilience and well-being. Such a scoreboard would provide a comprehensive overview of member states’ progress towards the development of a well-being economy by 2030, an objective enshrined in EU law in the 8th Environment Action Programme. By incorporating environmental and social aspects of progress, this integrated scoreboard would offer a more nuanced and inclusive perspective on economic governance. In this respect, the well-being economy framework can provide useful guidelines for outlining the SIP.

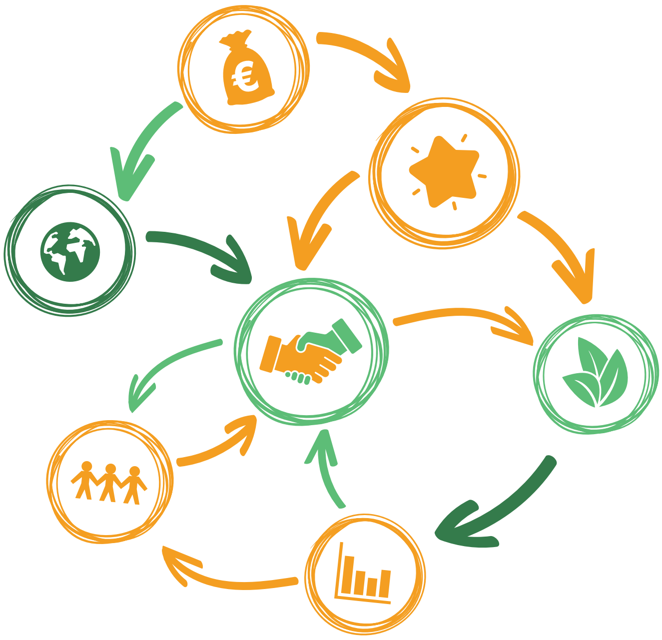
List of acronyms

CFC	Central Fiscal Capacity
CSR	Country-specific recommendation
DSA	Debt sustainability analysis
EC	European Commission
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EFB	European Fiscal Board
EGD	European Green Deal
EMU	Economic and Monetary Union
EP	European Parliament
EPG	European public good
EPSR	European Pillar of Social Rights
EU	European Union
FSP	National medium-term fiscal-structural plan
GDP	Gross Domestic Product
IFI	Independent fiscal institute
MIP	Macroeconomic Imbalances Procedure
MFF	Multiannual Financial Framework
MTOs	Medium-term objectives
NRRP	National Recovery and Resilience Plan
OECD	Organisation for Economic Cooperation and Development
RRF	Recovery and Resilience Facility
SCP	Stability and Convergence Programme
SDGs	Sustainable Development Goals
SGP	Stability and Growth Pact
SIP	Social Imbalances Procedure
TFEU	The Treaty on the Functioning of the European Union

1 Introduction

The EU's economic governance framework, one of its most contentious structures, has been under heavy scrutiny. Despite dramatic transformations in the macroeconomic environment and the enactment of crisis response measures, the substance of Europe's fiscal framework has barely changed since the outbreak of the Euro area crisis. It appears even more outdated after the Covid-19 pandemic and the Russian invasion of Ukraine, which have led to increases in public debt, higher interest rates and recovery plans financed by the issuance of joint European debt.[1] The fabric of Europe's social contract is being altered by deep social and economic inequalities, the structural transformation of labour markets, changing demographics and the challenges arising from a necessary and urgent transition to environmental sustainability. The inability of most governments and policymakers to fully deal with these crises and offer credible policy solutions has led EU observers to advance the idea that the Union has entered an age of 'permacrisis'.[2] In a period characterised by overlapping crises, a sense of insecurity now pervades European societies.

To counteract the permacrisis, the EU must undertake a major transformation, the course of which will test the credibility and stability of the European project. The twin green and digital transition, which forms the fundamental part of this transformation, brings with it significant economic and social costs and requires better coordination and convergence across member states and institutions. The upheavals of the twin transition will be compounded by a 'social transition', entailing profound socio-economic changes that impact people's livelihoods and well-being. Negative external shocks, such as price inflation and the energy crisis, producing uncertainty and job displacement, raise the stakes for this social transformation, which needs to ensure that those in vulnerable situations do not carry the heaviest burden, especially at a time where the EU is particularly exposed to exogenous shocks and the impact of global macroeconomic changes.



The effects of the permacrisis have significantly shifted the context of macroeconomic policies. Current economic and fiscal systems have been accused of failing to cushion macroeconomic shocks and achieve debt sustainability, while

1 Vanhercke, B., Sabato, S., and Spasova, S. (2022) "Policymaking in a state of permacrisis: can the EU uphold its social ambitions?", *Social policy in the European Union: state of play 2022*, Vanhercke, B., Sabato, S., and Spasova, S. (eds). Brussels: ETUI.

2 Zuleeg, Fabian, Janis A. Emmanouilidis, Ricardo Borges de Castro (2021), "Europe in the age of permacrisis", Brussels: European Policy Centre.

at the same time stifling investment and imposing austerity measures with detrimental implications for welfare systems.[3] There have been growing calls by economists, civil society, social partners and policymakers for reforms in the European fiscal framework that would strengthen European economies and societies and make the rules better able to respond effectively to major unforeseeable shocks.[4] The unprecedented economic crisis caused by the pandemic temporarily shifted attention away from the fiscal framework. But its revision is now back on the EU agenda, as the deactivation of the general escape clause nears,[5] government debt levels and borrowing costs remain high, and the current EU legislative period draws to a close.

To address criticisms levelled at the framework and to reshape it to meet upcoming challenges, the European Commission launched the Economic Governance Review in 2020. This was a comprehensive public consultation with key stakeholders and member states to discuss the redesign of the EU's economic and fiscal architecture. The results of the consultation highlighted several needs: to provide adequate space for public investment, particularly in member states lagging the European average; for less-rigid fiscal parameters; and for greater attention to environmental concerns.

Based on the extensive feedback received in the public consultation, the Commission in November 2022 presented orientations for a reformed EU economic governance framework.[6] In April 2023, for the first time since the Euro area crisis, the European Commission tabled a package of legislative proposals to upgrade EU fiscal rules. Under the banner of developing a fiscal rulebook 'fit for future challenges', the stated objective of these proposals was to strengthen public debt sustainability and promote sustainable and inclusive growth in all member states through reforms and investment.

The reform of EU economic governance is a crucial opportunity to 'future-proof' the fiscal framework, address the significant issues that have emerged over the past decade, and re-establish mutual trust between member states as a prerequisite for stronger European economic integration. The consultation responses indicate that EU economic governance, including the fiscal rules, should become more mindful of environmental and social issues and should support the policy priorities of the green and digital transition. However, this message has not been properly integrated into the Commission proposals. Instead, the ambition of a more progressive approach to fiscal and economic matters to effectively address the needs of the transition was downsized relative to the November 2022 Commission Communication. Social and sustainability frameworks, such as the European Pillar of Social Rights (EPSR) and the European Green Deal (EGD), are only briefly mentioned, and there is no mention of the Agenda 2030 for Sustainable Development. Moreover, long-term environmental and social

3 *Rayner, L. (2021) "Rethinking EU Economic Governance: Social Investment", Policy Brief. Brussels: European Policy Centre.*

4 *Frank van Lerven, Dominic Caddick, Sebastian Mang and Ludovic Suttor-Sorel (2022), "Europe's fiscal framework – the people's view? How Austerity Made Us Poorer and Less Able to Cope with Crises", New Economics Foundation.*

5 *The general escape clause, which suspended the functioning of the Stability and Growth Pact since the beginning of the Covid crisis in 2020, is expected to be deactivated by the end of 2023.*

6 *European Commission (2022a) "Communication on orientations for a reform of the EU economic governance framework", COM(2022) 583 final, November 9.*

sustainability objectives are secondary in the proposals to medium-term fiscal sustainability, and there is limited recognition of the interplay between them. The current proposal, clearly strongly influenced by the vocal demands of fiscally conservative member states, neglects de facto the positions and ideas of social partners and other civil society actors expressed in the consultation. On the contrary, it stresses the continuation of many of the framework's long-standing weaknesses.

Against this background, this policy paper will contribute to the debate on the reform of the EU economic governance framework. It will reflect on whether measures put forward by the Commission will provide a sufficient safeguard against a comeback of austerity and the strict fiscal conditionality of the previous decade. It will also reflect on whether the reform proposals give sufficient attention to the balance between social, economic and environmental objectives. Most importantly, this paper aims to provide guidance for those participating in the negotiations among the EU institutions, including the Council and members of the European Parliament.

Further analysis of the proposal is required to assess its potentially transformative aspects with respect to the EU's permacrisis and its implications for Europe's social dimension. It will also be important to understand how the revised framework engages with other frameworks aimed at fostering the EU's social acquis, such as the EPSR. This paper provides an assessment of the Commission's proposal and its consequences for the economic governance of the Union, and it will also address the long-standing weakness and limitations of the proposed new governance framework.

The paper is structured as follows. First, it provides an analysis of the current architecture of the European economic and fiscal framework, explaining the tensions between this and the social outlook and the broader policy efforts aiming to reconcile the EU's economic dimension with its environmental and social obligations. Second, the paper analyses the proposals advanced by the Commission for a revised economic and fiscal framework. The content analysis is supported by the findings of in-depth interviews with key stakeholders and policymakers. Third, the paper will advocate the inclusion of a framework for the well-being economy in the revised economic governance framework and the implementation of a 'golden rule' for green and social public investments. It will also argue for the establishment of a central fiscal capacity to realise EPGs, starting with those that aim to fulfil green and social EU objectives. Such changes, accompanied by a framework for the well-being economy, would improve the quality of public finances overall and ensure that member states and the EU prioritise investments that improve economies' long-term trajectories. Fourth, the paper will highlight how a more coordinated economic governance framework could be achieved through a reformed European Semester. This could include a procedure for social imbalances, as well as greater involvement of independent fiscal institutes, civil society and social partners, so that measures attain a higher degree of national ownership. By drawing on these findings and ideas, this paper will outline recommendations for a socially and environmentally sustainable economic governance framework with the potential to advance social justice and achieve a just transition to carbon neutrality.

2 The economic and fiscal framework: flawed from the start?

2.1 Setting the stage: From Maastricht to the Euro area crisis

The current EU economic governance framework dates from the 1992 ratification of the Maastricht Treaty, which included fiscal rules limiting headline deficit to 3% of GDP and debt to 60% of GDP with the aim of achieving long-term debt sustainability.[7] These rules represent the first pillar of the framework and were included in the Stability and Growth Pact (SGP), which was introduced in 1997 to detect and correct excessive deficits among EU member states. If a member state is deemed to have complied with both rules, it is placed under the 'preventive arm' to monitor whether its fiscal policy could negatively affect other EU countries[8] through so-called 'cross-border spillover'.[9] If at least one of the rules is breached, the member state enters the 'corrective arm', and an Excessive Deficit Procedure (EDP) is activated to correct the excessive public debt and/or deficit, potentially culminating in sanctions.[10] The SGP was reformed in 2005, to deal with the impact of the business cycle on budget balances, and again three times in the wake of the financial crisis – in 2011 (Six-Pack), 2012 (Fiscal Compact) and 2013 (Two-Pack). Nevertheless, the underlying framework has remained broadly the same, while its complexity has increased.

Critics have long argued that EU economic governance remains grounded in a neoliberal framework that has forced member states to control their public finances and keep supposedly 'wasteful' welfare states in check.[11] Although intended to be an efficient, information-driven control mechanism, the 60% debt-to-GDP ratio and 3% deficit limits have not been effective in delivering fiscal sustainability. On the contrary, they forced member states to consolidate their finances in the middle of a recession. By strongly limiting the scope of national policies in highly indebted countries, budgetary constraints could also be responsible for slowing social and green investments, thus hampering the success of the twin transition.

Procedures regulating the economic governance framework and promoting fiscal discipline have, over the years, proved strong enough to influence member states' social and employment policies. Many claim that the EU's economic architecture pertains not only to the macroeconomic environment stricto sensu, but

7 *Christofzik D. I., L. P. Feld, W. H. Reuter, and M. Yeter. (2018) "Uniting European fiscal rules: how to strengthen the fiscal framework, German Council of Economic Advisers", Working Paper 04/2018.*

8 *European Court of Auditors (2018) "Is the main objective of the preventive arm of the Stability and Growth Pact delivered?", Special report No. 18.*

9 *Blanchard, O., et al., (2021) "Redesigning EU fiscal rules: from rules to standards" Economic Policy, Volume 36, Issue 106, April 2021, Pages 195–236, https://doi.org/10.1093/epolic/eiab003.*

10 *Claeys, G., Z. Darvas, and A. Leandro (2016) "A proposal to revive the European fiscal framework", Policy Contribution, Issue 2016/07, Brussels: Bruegel.*

11 *Sabato S., Vanhercke B. and Guio A-C. (2022) "A 'Social Imbalances Procedure' for the EU: towards operationalisation", Working Paper 2022. Brussels: ETUI.*

also to the social outlook of the Union. There is an 'asymmetry of competences'[12] between the economic and social spheres at the core of the EU governance, as fiscal rules subordinate social goals to the imperatives of fiscal discipline and economic competitiveness.

Evidence shows that the subordination of social policy to the economic and fiscal sphere has, in several cases, lowered social standards and led to a deterioration of the quality of life.[13] The shortcomings of this asymmetry became increasingly obvious after the 2008 global financial crisis and represented the first major sign of the political instability of the economic governance framework. Attempts to reform the framework aimed to 'reinforce economic policy coordination'[14] and to enhance member states' cooperation in employment, social and macroeconomic affairs.

However, these reforms had a perverse effect, constraining public investment and limiting the scope of fiscal support for recovery from the financial crisis. Many economists have argued, convincingly, that the existing framework is partly responsible for the fiscal austerity that followed.[15] Austerity measures and internal devaluation, in the form of reduced wages or labour market liberalisation, have been ineffective in revitalising member states' economies,[16] while leading to a deterioration in social protection standards.[17] In fact, the policy response to the crisis caused upward convergence trends to stall, triggered socioeconomic disparities among EU countries, and bred scepticism[18] over the mechanisms of the economic governance framework and the democratic accountability of the fiscal surveillance process.

2.2 The shortcomings of the current fiscal framework

While it has undergone modifications and adaptations over time, the economic governance framework's core principles of fiscal discipline and budgetary coordination remain intact. There is consensus amongst the experts consulted for this study over the need to revise the framework. Numerous policymakers and scholars have written about the EMU's 'design failures'[19] and the fallacies and asymmetries of the SGP, a mechanism that was, in many ways, considered flawed from start. As a central component of the EU's economic governance framework, the SGP has faced significant criticism for its inflexibility and inadequate enforcement mechanisms, as well as its limited consideration of member states' specific macroeconomic and social circumstances. Despite enduring criticism and widespread demands for reform, the SGP has demonstrated remarkable resilience, and its survival reflects the degree to which fiscal rigidity is entrenched in the economic governance framework. The interviews with experts validated and reinforced the existing

12 Scharpf F. (2010) *"The asymmetry of European integration, or why the EU cannot be a 'social market economy'", Socio-Economic Review, 8 (2), 211–250.*

13 Corti, F., Sabato, S. and Vanhercke, B. (2019) *"The European (Social) Union is in need of a 'Social Imbalances Procedure".*

14 European Commission (2010) *"Reinforcing economic policy coordination", COM(2010) 250 final, 12 May.*

15 Darvas, Z., P. Martin, and X. Ragot (2018) *"European fiscal rules require a major overhaul", Bruegel Policy Contribution, Issue No. 18.*

16 Blyth, M. (2015) *"Austerity: The history of a dangerous idea". Oxford: OUP.*

17 Andor, László (2022) *"Europe's Social Integration: Welfare models and Economic Transformations". Brussels: FEPS.*

18 Stoetzer, Lukas F. (2021) *"How does income inequality affect support for populist parties?", London School of Economics, 11 November.*

19 De Grauwe, P. (2013) *"Design failures in the eurozone: Can they be fixed?" London School of Economics "Europe in Question", Discussion Paper Series 57/2013.*

literature, and they identified key shortcomings in the current fiscal framework. We have grouped these into four policy areas.

First, excessive complexity and focus on fiscal discipline. Since the 2008 financial crisis, the European Union has been endeavouring to cope with an unparalleled public debt crisis. Under pressure from financial markets, the EU put in place a new set of procedures and regulations, which the European Trade Union Institute labelled the 'new European economic governance'.[20] In 2010, the European Council created a task force to evaluate the EU's economic governance framework. This proposed, among other things, the enhancement of the SGP and its governance and oversight provisions. The result was the so-called Six-Pack, which strengthened the SGP[21] through multiple additional safeguards, obligations and procedures. These included new sanctions (especially for the medium and long term) through a strengthening of the Excessive Deficit Procedure (EDP). Other provisions introduced a Macroeconomic Imbalance Procedure (MIP) and the 'European Semester for economic policy coordination'. The introduction of these procedures increased the Commission's discretional power in evaluating member states' fiscal positions.[22]

On top of the thresholds of 3% deficit-to-GDP and 60% debt-to-GDP, the Six-Pack and the two-pack introduced a set of additional rules 'aiming at strengthening budgetary surveillance' within the preventive and corrective arms:[23] the expenditure benchmark, the medium-term objectives (MTOs) and the 1/20th debt reduction criterion). However, these rules were designed to perform only under a 'controlled' scenario of fiscal and economic stability. The MTOs failed to target the adjustment of member states' structural budgetary positions needed to ensure their debt sustainability: Most peripheral European countries achieved only a mild debt reduction, while debt-to-GDP ratios rose in some. Only certain countries introduced a constitutional provision on debt – i.e., a mandatory reduction of debt under given circumstances. Moreover, the arbitrary decision to grant more fiscal flexibility to some countries triggered further disagreements between debtor and creditor member states.

The Six-Pack also formally introduced the European Semester, a prescriptive annual policy coordination cycle.[24] The role of the Semester is to synchronise and coordinate various instruments and procedures that link economic, fiscal, employment and social policies. Initially, the Semester focused on macroeconomic and fiscal objectives, encouraging member states to implement fiscal consolidation policies with little consideration for their social implications. Although the focus on social issues has grown over the years, this imbalance persists.

Second, the key fiscal indicator that has been used – the change in the structural balance – does not merely depend on observable government revenues and expenditures. It also relies on uncertain real-time estimates of the output gap, a non-observable fiscal variable

20 Degryse, C. (2012) "The new European economic governance", Working Paper. Brussels: ETUI.

21 Regulations 1175/2011 and 1177/2011 amended 1466/97 and 1467/97, respectively.

22 Mabbett D. and Schelkle W. (2014) "Searching under the Lamp-Post: The Evolution of Fiscal Surveillance", LEQS Paper, 75/2014 (May).

23 European Fiscal Board (2019) "Assessment of EU fiscal rules with a focus on the six and two-pack legislation".

24 Dawson (2018) "New governance and the displacement of Social Europe: the case of the European Semester", European Constitutional Law Review.

that is equal to the difference between actual and potential output. This in turn hinders the transparency of the instrument: Since it relies on the development of external context factors that cannot be totally influenced by national governments via direct interventions on public spending, the member states' room for manoeuvre is limited. Moreover, such a fiscal indicator is sensitive to fluctuations in the economic cycle and subject to large measurement forecast errors, especially during periods of economic volatility and crises.[25]

Third, limited fiscal autonomy for member states and limited incentives for investments and reforms. Countries with larger deficits and higher debt have found the rules too constraining, as they do not provide the fiscal space to promote investment that could improve public finances. But frugal countries saw growing debt in fellow member states as evidence that the rules were not stringent enough. The European Commission has often found itself applying discretionary judgements, even though its normal role is not to make judgements that could be considered to have a political aspect.[26] According to Art. 126.3 of the Treaty on the Functioning of the European Union (TFEU), the Commission 'shall also take into account whether the government deficit exceeds government investment expenditure' if at least one of the Maastricht criteria is breached. But there is no rigorous definition of what could be exempted from the deficit calculation. Furthermore, the Article acknowledges that, in case a member state fails to comply with the obligations included in Art. 126.2 of the TFEU, the Commission must prepare a report that should consider, inter alia, the extent to which 'government deficit exceeds government investment expenditure'.[27] As a result, during periods of fiscal consolidation following the financial crisis and the EU sovereign debt crisis, highly indebted member states were forced to steeply reduce their public investments.

Fourth, the adoption of market-oriented reforms. The specific policies fitting the EU's fiscal architecture have a core of typically neoliberal policy recipes: state withdrawal from social policies, tax reallocation from capital to labour, labour market deregulation and structural reforms aiming to recalibrate member states' 'wasteful' welfare systems.[28] These have had a deleterious impact on societies. In particular, the 'years of neoliberal and deregulatory policies'[29] implemented during the Euro area crisis have in many EU countries led to diminished social cohesion, a deterioration in working conditions, greater inequality and increased poverty.

These issues have contributed to the development of fiscal and macroeconomic imbalances, inducing a 'procyclical' fiscal policy reaction to the economic cycle. This means that, while the economy is expanding, deficits and debt levels are not reduced as much as they should be, while during downturns, fiscal consolidation plans cannot achieve their objectives, and public debt increases. Such

25 *Feld, L. P., C. Schmidt, I. Schnabel, and V. Wieland (2018) "Refocusing the European fiscal framework", CEPR VoxEU column.*

26 *Corti, F., C. Alcidi, D. Gros, A. Liscai, and F. Shamsfakhr (2022) "A Qualified Treatment for Green and Social Investments within a Revised EU Fiscal Framework", Research Report 2022–02. Brussels: Centre for European Policy Studies.*

27 *Tosato, G. L. (2022) "On the revision procedures for EU fiscal rules", Astrid Rassegna No. 1/2022.*

28 *Crespy, A., V. Schmit, (2016) "The EU's economic governance in 2016: beyond austerity?", Social policy in the European Union: state of play 2017, (eds).*

29 *Theodoropoulou, S., and Watt., A. (2015) "An evaluation of the austerity strategy in the Eurozone: was the first Greek bailout programme bound to fail?", The politics of extreme austerity: Greece in the eurozone crisis (eds) Karyotis, G and Gerodimos, R. Basingstoke: Palgrave Macmillan.*

weaknesses have pushed member states into fiscal austerity and weakened the ability of governments to cushion economic shocks in the short and medium term. They have also failed to ensure long-term debt sustainability. Procyclical measures have exacerbated economic and social problems, reducing the size of public budgets and triggering higher rates of unemployment.[30] In short, public investment expenditure was cut to comply with EU rules, especially in member states with high levels of debt and sluggish economic growth,[31] while the promotion of social investment remained weak and de facto constrained by the prevailing conception of competitiveness.

2. 3 The recovery strategy

The management of the Eurozone crisis showed the resilience of austerity-driven economic assumptions, which remained largely unquestioned. Scholars and policy makers have long identified the EU's reliance on 'pervasive austerity'[32] as the 'only game left in town' since the crisis. This idea was challenged after the outbreak of Covid-19, which brought the European economy to a sudden halt and provided an unprecedented stress test for welfare systems. The magnitude of the crisis made abundantly clear the need for an unparalleled mobilisation of public funds.

Initial measures undertaken by the EU were designed as an emergency response, enabling member states to access liquidity and redirect public expenditure to mitigate the social impacts of the pandemic. The activation of the general escape clause of the SGP in March 2020 made it possible to channel public funds into key sectors that were suffering from the unprecedented shock. Although many experts consulted for this study were already dissatisfied with the functioning of the economic governance framework well before the pandemic, the agreement reached at the July 2020 EU summit represented a major breakthrough on the road to reforming the EU's fiscal governance. Interviews with the experts confirm the overall positive assessment of the EU's moves to relax fiscal rules. They welcomed the willingness of EU institutions to go beyond the 'spectre of austerity'[33] that characterised management of the previous crisis. In this respect, the planned review of the fiscal framework was, in principle, an opportunity to promote investment and allow more flexibility in the enforcement of fiscal discipline, with an overall objective of better facing upcoming crises and challenges.

30 *Darvas, Z., P. Martin, and X. Ragot (2018) "European fiscal rules require a major overhaul", Policy Contribution, Issue No. 18, Brussels: Bruegel; McManus, R. and Ozkan, F.G. (2015) "On the Consequences of Pro-Cyclical Fiscal Policy", Fiscal Policies, Vol. 36, No. 1, pp. 29-50. https://www.jstor.org/stable/26604810.*

31 *Crespy, A. and Vanheuverzwijn, P. (2019) "What Brussels Means by Structural Reforms: Empty Signifier or Constructive Ambiguity?", Comparative European Politics, Vol. 17, No. 1, pp. 92–111. https://doi.org/10.1057/s41295-017-0111-0.*

32 *Theodoropoulou, S. (2018) "Labour market policies in the era of pervasive austerity: A European perspective" (1st ed.). Bristol University Press. https://doi.org/10.2307/j.ctt21216s2.*

33 *Rainone, S., and Pochet, P. (2022) "The EU recovery strategy", Working Paper. Brussels: European Trade Union Institute.*

3 The economic governance reform: a window of opportunity?

3.1 Consultations and the Commission's proposals

The comprehensive public consultation[34] began in 2020 and was relaunched in 2021 with stakeholders such as NGOs, academia, think tanks and member states. It was welcomed by social partners and civil society, which saw it as a window of political opportunity and a way to steer the revision of the framework towards common environmental and social objectives. The results of the consultation pointed to the need to make economic governance better incorporate social governance and green governance and thus reinforce the EU's direction towards greater convergence while meeting the ambitions of the twin transition and the EPSR objectives. Specifically, the consultation responses focused on the kind of fiscal rules that a currency area should be equipped with in a highly volatile macroeconomic context.

The survey, which closed at the end of 2021, received 225 contributions from respondents in 25 countries. Responses focused on a selection of themes including the following: the safeguarding of fiscal sustainability through country-specific debt targets; more fiscal space with which to respond to shocks; a simpler framework based on the RRF to foster ownership at member-state level; the development of a framework that prevents macroeconomic imbalances and strengthens social and economic resilience; and more interactions between the SGP and the MIP.[35] In parallel, there has been widespread acknowledgement that the climate crisis and the energy crisis require a rapid change in the current framework, accompanied by adequate space for public investment, particularly in member states lagging the European average.[36]

Based on this extensive feedback, the European Commission released its proposal for a reformed EU economic governance framework on 9 November 2022.[37] The framework tried to reconcile three objectives, according to Commissioner for Economy Paolo Gentiloni: i) to support growth and enhance debt sustainability; ii) to strengthen national ownership of economic decisions and embed them in a revised common framework; and iii) to simplify fiscal rules while preserving their intelligence and scope.[38]

34 European Commission (2022b) "Online public consultation on the review of the EU economic governance framework: summary of responses", SWD(2022) 104 final, 28 March.

35 European Commission (2022b), "Online public consultation on the review of the EU economic governance framework. Summary of responses Final Report", SWD(2022) 104 final, 28 March.

36 Corti, F., C. Alcidi, D. Gros, A. Liscai, and F. Shamsfakhr (2022) "A Qualified Treatment for Green and Social Investments within a Revised EU Fiscal Framework", Research Report 2022–02. Brussels: Centre for European Policy Studies.

37 European Commission (2022a) "Communication on orientations for a reform of the EU economic governance framework", COM(2022) 583 final, 9 November 2022.

38 European Commission (2022c) "Remarks by the Commissioner Gentiloni at the press conference on the economic governance review", 9 November.

On 26 April 2023, the European Commission followed its November 2022 proposal by unveiling a package of legislative proposals to reform the framework.[39] The proposals included greater coordination between economic policy and multilateral budgetary surveillance (the 'preventive arm' of the SGP), as well as a simplification of the EDP (the 'corrective arm'). The document also included a directive aiming to align member states' budgetary frameworks with the new fiscal regulations. The next section focuses in more detail on the proposed novelties.

3.2 Key elements of the proposed fiscal surveillance framework

The proposals include new rules to be incorporated into the framework of the European Semester, and every member state will be required to periodically submit a national medium-term fiscal-structural plan (FSP). To improve debt sustainability, this plan will include an outline of the member state's medium-term fiscal adjustment path, as well as its investment strategies and reform initiatives. The plan should cover a minimum of four years starting from its approval by the Council after an evaluation by the Commission.

For member states identified with imbalances under the MIP, the plans would also include reforms and investments to correct those imbalances. If member states required further time to adopt reforms or investments, they could request an extension of the so-called 'adjustment period' up to an additional three years. In such a case, new enforcement mechanisms would be needed to monitor compliance with the commitments. Furthermore, a country that requested an extension would have to ensure that, at the end of the four-year adjustment period, its public-debt ratio would be lower than it was the year before beginning the FSP.[40]

In its legislative proposals, the Commission indicated the areas of reform and investment relevant for granting the extension of national fiscal adjustment plans. These areas complement the allocations of the National Recovery and Resilience Plans (NRRPs), as they focus on the green and digital twin transition. Nevertheless, neither the RRF nor the extension areas for the national fiscal adjustment plans sufficiently prioritise social investment. The proposed fiscal rules incentivise countries to reallocate their budgets towards EU objectives – that is, towards the creation of EPGs 'by aggregation'. Notwithstanding the guaranteed flexibility, the length of a medium-term fiscal adjustment path could conflict with short political cycles and changing governments, as well as evolving political priorities and macroeconomic circumstances.[41]

Most importantly, the surveillance architecture remains mostly untouched. The SGP's corrective and preventive arms maintain their original role, with some minor novelties. Within the new framework, the 3% deficit rule and 60% debt-to-GDP ratio remain in place, as they are included in the Treaties and there is currently no political will to modify them. This means that the EU rules remain strongly anchored in the

39 European Commission (2023a) "Regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation No 1466/97", COM(2023) 240 final, 26 April.

40 Theodoropoulou, S. (2023) "The European Commission's legislative proposals on reforming the EU economic governance framework: a first assessment". ETUI: Brussels.

41 Liscai, A. (2022) "Assessment of the Commission proposal for a reformed EU economic governance framework", Astrid Rassegna 18/2022.

original macroeconomic assumptions which, according to most interviewees, are unfair, as well as unrealistic. Nevertheless, the 1/20th debt reduction criterion, which has caused extreme levels of economic and social damage in recent decades, is going to disappear. In order to ensure debt sustainability, the legislative proposals presented in April 2023 extend the use of common safeguards by including an annual fiscal adjustment equal to at least 0.5% of GDP. This is to be implemented by member states that have a deficit-to-GDP ratio above the 3% threshold. Moreover, EU countries that have committed to a set of reforms and investments in their medium-term fiscal plans and thus benefit from a more gradual fiscal adjustment path, will not postpone their fiscal effort to later years.

While the original fiscal parameters for debt and deficit would remain unchanged, member states not meeting the latter threshold would be required to resort to 'technical trajectories', namely, a debt reduction path.[42] The 'plausibility of the debt's downward trajectory' is determined through a debt sustainability analysis (DSA) framework and is based on the Commission's own assessment. However, member states have the possibility to make their own counterproposal for a 'technical trajectory' if they can argue that the Commission's evaluation is too pessimistic or rigid. In this case, the Council ultimately decides.

The DSA generates a variety of different distribution paths for each country's debt-to-GDP ratio. These incorporate the impact of shocks to the drivers of debt dynamics drawn from their historical probability distribution. The shocks include primary balances, rate of economic growth, interest rates and the maturity structure of debt.[43] The DSA is subject to forecasting errors and is based on underlying assumptions, leaving room for discretion. Nevertheless, according to experts contacted for this study, it represents a clear improvement over the status quo, which is characterised by rigid compliance to numerical targets.

The Commission proposes a multi-year adjustment plan based on a single operational indicator, the net expenditure path. The path should ensure that, by the end of the plan, the debt trajectory is on a continuously declining path. In particular, the latest legislative proposals by the Commission stated that the trend of net primary expenditure must be lower than that of medium-term GDP over the time horizon of the medium-term fiscal plan. According to the Commission: 'The use of nationally-financed net primary expenditure, i.e., expenditure net of discretionary revenue measures and excluding interest expenditure as well as cyclical unemployment expenditure, as the single operational indicator for surveillance, would allow for the operation of automatic stabilisers, including revenue and expenditure fluctuations outside the direct control of the government.'[44] Moreover, in contrast to the previous indicator, the growth of net public expenditure is neither dependent on revenues,

42 Theodoropoulou, S. (2023) "The European Commission's legislative proposals on reforming the EU economic governance framework: a first assessment". ETUI: Brussels.

43 European Commission (2020) "Debt Sustainability Monitor" Luxembourg: Publications Office of the European Union.

44 European Commission (2022a) "Communication on orientations for a reform of the EU economic governance framework", COM(2022) 583 final of 9 November 2022.

which have been verified to be more sensitive to changes in the economic cycle than expenditure,[45] nor on unemployment and interest expenditure. The latter is particularly sensitive to shifts in market sentiment.[46]

In terms of enforcement procedures, corrective actions would be automatically triggered by deviations from the medium-term expenditure path. However, in the report[47] adopted by the Commission on 24 May 2023, member states are given some room for manoeuvre. The report states that the ommission could decide not to activate an EDP in the presence of a 'relevant factor', i.e., if there were good reasons to trigger a higher deficit or incur higher debt. However, the fiscal eeway granted to member states would not be equal. It would be greater for countries with a low debt challenge (below 60% debt-to-GDP ratio), and it would be reduced as a percentage of deficit and limited in time for countries with moderate or substantial debt challenges, such as Italy.

To increase democratic accountability and build national ownership of the FSPs, greater involvement of the European Parliament and national parliaments is foreseen. The European Parliament may invite the President of the Council, the Commission and, where appropriate, the President of the European Council or the President of the Eurogroup to discuss the policy guidance issued by the Commission, the conclusions drawn by the European Council and the results of multilateral surveillance. The President of the Council, the European Commission and, where appropriate, the President of the Eurogroup, are also expected to report annually to the European Parliament on the results of the multilateral surveillance. In cases where there is a significant risk of deviation from the net expenditure path, the European Parliament can summon the relevant government minister for an exchange of views.

To strengthen national ownership and engagement with social partners and wider civil society, an FSP should mention whether it has been presented to the national parliament and whether there has been parliamentary approval. It should also indicate whether the national parliament had the opportunity to discuss the Council recommendation on the previous plan and, if relevant, any other Council recommendation or decision and any Commission warning. These steps could at least partly eliminate political bias by embedding member states' fiscal policy choices into the plan. This would be similar to the RRF procedure, in which RRFs previously submitted by member states are monitored by the European Commission through a performance-based approach.

National ownership would also be strengthen-ed by giving a wider range of tasks to Independent Fiscal Institutes (IFIs). These would cover the following: (multi-) annual macroeconomic and budgetary forecasts; debt sustainability assessments; fiscal and growth policy impacts; compliance monitoring; reviews of the national budgetary framework; participation in regular parliamentary hearings

45 Christofzik D. I., L. P. Feld, W. H. Reuter, and M. Yeter. (2018) "Uniting European fiscal rules: how to strengthen the fiscal framework, German Council of Economic Advisers", Working Paper 04/2018.

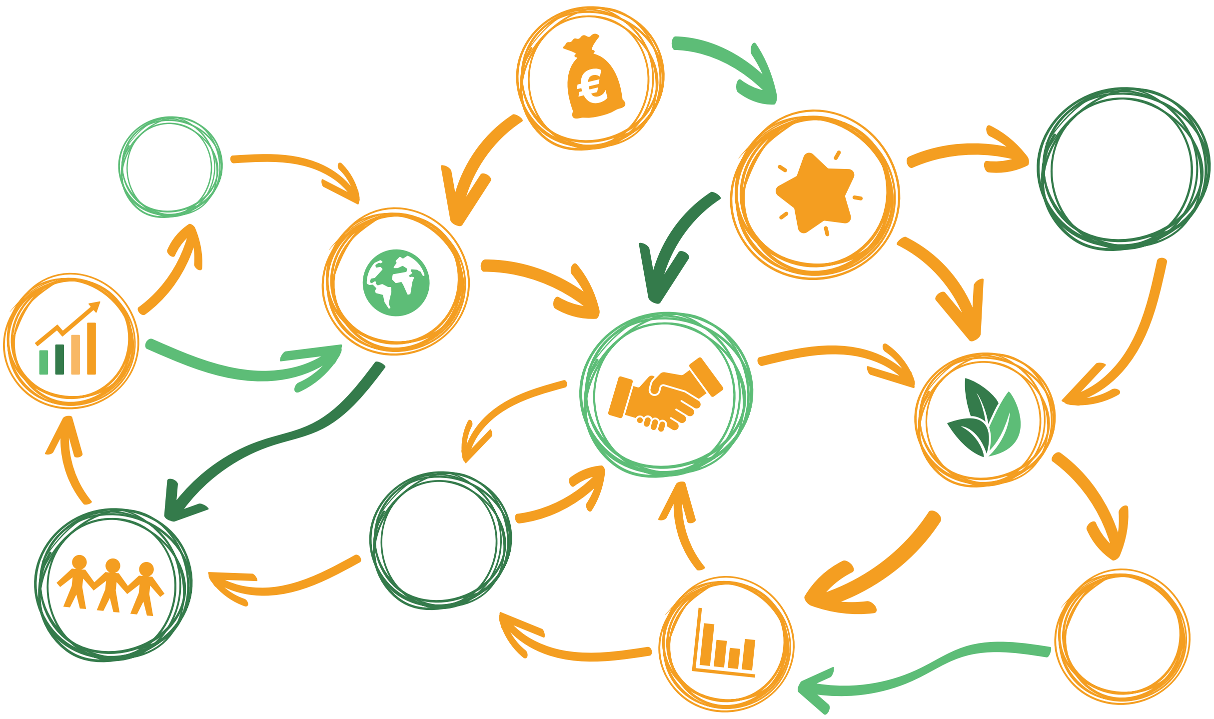
46 Claeys, G., Z. Darvas, and A. Leandro (2016) "A proposal to revive the European fiscal framework", Policy Contribution, Issue 2016/07, Brussels: Bruegel.

47 European Commission (2023b) "Report prepared in accordance with Article 126(3) of the Treaty on compliance with the deficit and debt criteria", COM(2023) 631 final, 24 May.

and assessment of compliance with the expenditure paths envisaged by the FSPs; and the analysis of factors triggering any deviation. According to some of the interviewees, assigning such tasks to IFIs is a positive change. The IFIs' role is also important from a governance perspective, since their independence would guarantee a less biased evaluation approach. Their assessments can take into account economic views that do not necessary align with the mainstream, and they can consider the positions of social partners.

Lastly, the Commission's proposals point to the need for a change in the MIP. To strengthen its preventive role, both the alert mechanism and the in-depth reviews would be designed to have a more forward-looking approach. More weight would be given to growth variables, trends that are expected to be sustained and national policies that have been implemented to address imbalances.

In a nutshell, the proposed EU fiscal framework would be a risk-based surveillance framework that keeps the objective of debt sustainability and adherence to the reference values of the Maastricht Treaty at its core. But it also introduces a degree of differentiation between countries based on their public debt challenges, and it assigns more relevance to the structural reforms and public investment included in national medium-term plans.



4 Policy recommendations

Much of the evidence collected for this study, supported by the expert interviews, cautiously points towards a relatively positive assessment of the proposals published in April 2023. However, this positive assessment is tempered by significant disappointment that the views of civil society and social partners put forward during the consultation phase have not been sufficiently reflected.

The proposals take a lukewarm step towards a less austerity-biased framework and show some effort to adapt it to better account for member states' other potential vulnerabilities, although these remain largely tied to debt sustainability. The impact of fiscal policies and debt reduction on employment and social objectives is recognised, as is the need to meet the ambitions of the twin transition to ensure energy security and open strategic autonomy and the need to address demographic change. Nevertheless, the proposals have not been prioritised. Ultimately, delivering on these objectives will depend on the space found for investment within the rules, especially for those member states with limited fiscal room for manoeuvre.

There should be no misconception that it will be straightforward to address the long-standing weaknesses and fallacies of the economic governance framework and the deepening legitimacy crisis of the EU's institutions and fiscal regulations. The process of reviewing the fiscal architecture of the EU involves a multitude of intricate factors interlinking macroeconomic, social and environmental indicators. These have huge implications for governments inside and outside the Euro area crisis. However, these interlinkages are often kept separate from the reform debate, and economic governance is often still looked at in a silo: The ministers concerned have been principally tasked with raising revenue through taxation or borrowing and with controlling public spending. They have not necessarily been asked to balance the full spectrum of policy objectives in their economic decisions.

A thorough strategic reassessment of the role of the EU and treaty reform is, of course, unlikely. However, if economic reform discussions continue without taking wider considerations into account, then the eventual reform will risk being redundant before the legislative procedure is complete. Such considerations include the reform's links to ongoing discussions on defence, energy transition, reshoring and de-risking, as well as demographic trends, the climate crisis and technological developments. If these factors are not considered, the reformed framework will at best provide workable guidelines for member states and the European Commission. At worst, the framework will be ignored, and flexibility will be demanded and approved to meet the objectives of other urgent EU priorities or in response to new crises. Such flexibility would ultimately undermine the legislation.

The scoping exercise carried out with stakeholders and experts allowed us to identify key policy areas in the revised economic governance framework that could be improved and to understand how to address areas and measures currently neglected by the European Commission.

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4.1 A golden rule for green and social investments

The priority public spending areas that would support the achievement of the twin transition objectives are still far from being concretely identified in the new framework. Moreover, there is no clear inclusion of social objectives in the package of reforms and investments aimed at improving debt sustainability.

A large strand of literature proposes the introduction of a golden rule,[48] meaning that certain investment expenditures would be left out of the calculation of the deficit. Four main arguments have been made in favour of a golden rule: i) It could prevent deficit constraints from leading to strategic underinvestment; ii) if focused on specific classes of public investment, it would be more effective in mobilising resources towards green and social spending;[49] iii) it would guarantee that countries do not include their additional co-financing of EU projects (that is, financing above their national commitments) in their deficit statistics, thereby encouraging them to undertake additional investment in such projects;[50] and iv) debt-financed productive expenditure could improve fiscal sustainability in the medium and long term if it increases potential growth,

48 *See, for instance: Alcidi C., F. Corti and D. Gros (2022) "A Golden Rule for Social Investments: How to Do It", Intereconomics, Vol. 57, No. 1: 26-32; Amato, G., F. Bassanini, M. Messori and G.L. Tosato (2021) "The new European fiscal framework: how to harmonise rules and discretion. A contribution to the European Commission Review of the EU Economic Governance Framework", Astrid Rassegna No. 1/2022; Darvas, Z. and J. Anderson (2020) "New life for an old framework: redesigning the European Union's expenditure and golden fiscal rules", European Parliament Study; Gros, D. and Jahn, M. (2020) "Benefits and drawback of an 'expenditure rule', as well as of a 'golden rule', in the EU fiscal framework", European Parliament Study.*

49 *Pekanov, A. and Schratzenstaller, M. (2020) "The role of fiscal rules in relation with the green economy", European Parliament Study.*

50 *Pekanov, A. and Schratzenstaller, M. (2020) "The role of fiscal rules in relation with the green economy", European Parliament Study.*

as exempted investment expenditure can generate additional assets that counteract increases in debt.[51]

A golden rule could potentially support both green and social investments, in line with EU attempts to boost the twin transition and reduce inequalities. If such a rule were applied only to capital investments, it would largely benefit green investments as opposed to social spending, which mainly comes from current expenditure. This could be (at least partially) fixed by widening the concept of capital to embed current human capital spending, thereby including a large part of healthcare and education spending in the definition of productive investments.[52] Corti et al test three different scenarios to assess the hypothetical impact on the deficit calculation obtained by applying the golden rule to social investment in healthcare and education.[53] The scenarios were tested on a small sample of EU countries (France, Germany, Italy and Spain), and the type of exempted spending was slightly modified for each scenario. All the scenarios exhibited a positive impact on the member states' estimated volume of investment and their (economic and social) returns, confirming the validity of the instrument.

However, despite evidence suggesting a long-term positive impact from social and green public investment, a golden rule on such investment is still hardly debated. This is mainly due to different political stances within the EU and technical difficulties linked to the new fiscal instrument. Agreement on evolving common green and social taxonomies, which should be at the basis of the exercise to classify qualified investments, would be extremely complex and would require strong mutual commitment by all member states. Moreover, frugal countries think this mechanism could be a pathway towards further discretion in the selection of investments, thus leading to excessive fiscal leeway. They think it could thereby trigger negative externalities and potentially hamper the fiscal stability of the Union. At the same time, without a proper definition of the public expenditure items to exempt from deficit calculation, the necessary sustainable investments are not all likely to be treated as a priority, since their financing may frequently conflict with the preservation of the 3% deficit-to-GDP threshold.

To overcome many of the concerns associated with the creation of a golden rule for investment, one solution could be to use an external organisation such as the Organisation for Economic Cooperation and Development (OECD). Such an organisation could undertake a reassessment of the public accounting treatment of public and social investment to account for, inter alia, the return on different types of social investment. This might lead to a reassessment of the definitions of member states' public spending and investments. In the long run, this should improve the quality of public finances overall, ensuring that member states and the EU prioritise investments that will improve economies' long-term fiscal, social and environmental trajectories. Such a reassessment would provide a yardstick

51 *Reuter, W.H. (2020) "Benefits and drawbacks of an "expenditure rule", as well as of a "golden rule", in the EU fiscal framework", European Parliament Study.*

52 *Corti, F., C. Alcidi, D. Gros, A. Liscai, and F. Shamsfakhr (2022) "A Qualified Treatment for Green and Social Investments within a Revised EU Fiscal Framework", Research Report 2022–02. Brussels: Centre for European Policy Studies.*

53 *Corti, F., C. Alcidi, D. Gros, A. Liscai, and F. Shamsfakhr (2022) "A Qualified Treatment for Green and Social Investments within a Revised EU Fiscal Framework", Research Report 2022–02. Brussels: Centre for European Policy Studies.*

for distinguishing between real investments and relabelling for the sake of flexibility.[54] This approach would thus be a way to apply a golden rule.

A further possible short-term solution would be to exempt from the deficit measurement all the green and social investments already approved within the RRF framework. A more explicit definition of the investment clause could then be drawn up to prepare for a change in the TFEU over the long term.[55]

4.2 A common investment fund and the need for a permanent central fiscal capacity (CFC) to finance EPGs

Several stakeholders have mentioned a permanent CFC as essential for the effective construction of the new EU economic governance. It would be able to ensure vertical coordination between national and European fiscal policies as a complement to the horizontal coordination imposed at national level. According to Buti and Messori, 'a CFC could focus on three functions: cyclical stabilisation, support for the implementation of FSPs, and the supply of EPGs'.[56] Progressive forces in the European Parliament are also demanding a permanent fiscal capacity as an instrument to support green and social investment. Most importantly, it would create a level playing field amongst member states after the planned end of the RRF in 2026.

It is understandable that the Commission's proposals did not expand on the topic of a CFC and did not explicitly address its most relevant role today: the production of EPGs. These are controversial topics, which would have risked reinforcing criticism from people who oppose attempts to transform European fiscal rules from a mere constraint on national economic policies into an instrument of cooperation involving vertical coordination between national and centralised fiscal policies.

The realisation of a permanent CFC and the supply of EPGs should not, however, be shelved or left to an indeterminate future date, when new crises will impose the use of these instruments for the very survival of the EU. An opportunity to address this issue will come at the mid-term review of the EU's Multiannual Financial Framework (MFF) that the Commission must propose by the middle of 2024. In the past, the complexity of negotiations over the EU budget has meant that revisions have been marginal. Today, however, European economic governance is at a vital crossroads that makes it desirable and possible to redefine profoundly the allocation (and amount) of that budget's resources. At the current stage, it is crucial to offer specific types of EPGs to implement the twin transition, build the resilience needed to weather future crises and help monetary policy to control inflation. Most importantly, there is already a compelling case for stating that public goods and services have positive externalities and create benefits for uninvolved third parties, citizens, workers and the environment. The Barca Report argues for 'the production of bundles of integrated, place-tailored public goods and services' as having a positive

54 *Rayner, L. (2021) "Rethinking EU economic governance: Social investment", Brussels: European Policy Centre.*

55 *Corti, F., C. Alcidi, D. Gros, A. Liscai, and F. Shamsfakhr (2022) "A Qualified Treatment for Green and Social Investments within a Revised EU Fiscal Framework", Research Report 2022–02. Brussels: Centre for European Policy Studies.*

56 *Buti, M., and Messori, M. (2021) "Euro area policy mix: From horizontal to vertical coordination", CEPR Policy Insight, No. 113.*

'spillover effect' on the overall welfare systems of member states and on the environment.[57]

Discussion of EPGs and a permanent CFC would also allow the internal and external agendas of the EU to be reconciled. In her State of the Union speech in September 2022, Commission President von der Leyen announced bold initiatives in this direction. The establishment of a European sovereignty fund, to be implemented through the revision of the EU's multiannual budget, is a tool to meet the needs and challenges of the EU area. As European economic governance stands at a crossroads today, the availability and centralised use of a fund would mark a major step towards achieving EPGs associated with national reforms and investments selected by the NRRPs and financed by European resources. Similarly, stress some of the interviewees, policymakers and academia are engaged in discussions over an alternative that could be introduced – a common investment fund that could be integrated into the preventive arm and financed through EU resources. More specifically, some experts contacted for this study referred to the strengthening of the Just Transition Fund to enable investments in the green transition and social inclusion.

4.3 Introducing a well-being economy framework

In the scoping exercise, we tested support for and likeliness of adopting a well-being economy framework to accompany the revision of the economic governance framework. The well-being economy framework is a set of policy tools and initiatives in the areas of environmental sustainability, health, education, gender equality, social protection and redistribution. It proposes alternative indicators to measure citizens' and workers' well-being beyond gross domestic product (GDP).

GDP still commonly serves as a proxy for societal welfare,[58] but it fails to capture the broad range of outcomes that matter to people and contribute to their well-being. These elements are material and non-material in nature. They include income and jobs, but also health, education, work-life balance and social interactions. However, GDP ignores the distribution of well-being outcomes across society, as statistical averages mask important disparities between different individuals, households and groups. Moreover, GDP alone does not provide sufficient understanding of the role played by different drivers of economic and societal resilience and the way in which they interact with one another.

As well-being has matured as a statistical and measurement agenda, it has become increasingly relevant as a compass for policy, and a growing number of countries and member states use well-being metrics to guide decision-making and inform budgetary processes. National statistical offices,[59] international organisations such as the OECD[60] and European agencies such as the European Statistical System Committee have developed indicators of quality of life and well-

57 Barca, F. (2009) "An agenda for a reformed cohesion policy: A place-based approach to meeting European Union challenges and expectations", European Commission.

58 OECD (2019) "The Economy of Well-being: Creating opportunities for people's well-being and economic growth", SDD Working Paper No. 102.

59 See, for instance, the UK's Office for National Statistics Measures of National Well-being Dashboard or Ireland's Wellbeing Dashboard.

60 See the OECD's Framework for Measuring Well-Being and Progress.

being for the EU. In line with the Agenda 2030 for Sustainable Development and backed by political forces and social partners, there is now a solid, evidence-based case for going 'beyond GDP' and incorporating much broader policy tools and initiatives. In particular, statistical measures could be proposed that fill the gap between standard macroeconomic statistics and indicators with a more direct bearing on people's lives.

Traditional macroeconomic indicators used to inform the economic and fiscal governance framework (e.g., debt-to-GDP ratio, fiscal deficit and output gap) have proven to be insufficient for assessing environmental and social progress. They also lack transparency. Therefore, a new paradigm represented by the well-being economy represents a better compass for fiscal policy, especially when dealing with social public expenditure and its long-term returns.

To encourage a more holistic perspective in policymaking, interviewees agreed that a reformed economic governance framework must look beyond purely numerical fiscal targets and aim for ecological, social and economic well-being. The framework would then better take into account the effect of today's actions on the ability of future generations to defend their values and interests. By reframing economic policy to deliver shared well-being for people and the environment, its emphasis is shifted away from the pursuit of GDP growth as an overriding metric of societal welfare. A revised economic and fiscal governance framework should incorporate well-being indicators that present a more comprehensive picture of societal progress, such as work-life balance, income inequality, childcare provision and take-up, and work precarity. It must also require member states and the European Commission to state how well-being objectives will guide the budget each year and set spending decisions that incorporate ecological and social objectives together with their fiscal priorities.

The intergenerational nature of the well-being economy framework and the length of time required to enact the twin transition imply that the EU and its member states must adopt a longer-term perspective in their policymaking. This shift would also support greater social investment. The return on this often happens over the long term, so it is not prioritised by member states urgently needing to reach adjustment targets.

4.4 Reforming the European Semester

The European Semester and its prescriptive nature is an ever-present theme in debates over fiscal matters. The Semester's role as a communication channel between the European Commission and member states could help it to coordinate the implementation of a socially and environmentally just transition towards a more social and sustainable Europe.[61] Initially focused on macroeconomic and fiscal policies, the European Semester has to varying degrees gradually integrated social and environmental policies.[62] In 2012, the Semester's Annual Growth Survey included 'tackling the social consequences of the economic crisis' among its key priorities. Since then, the

61 Solidar, "Ensuring a Just Transition". Available at: https://www.solidar.org/en/pillars/ensuring-a-just-transition

62 Sabato S. and Mandelli M. (2021) "Integrating the Sustainable Development Goals into the European Semester: a governance conundrum for the von der Leyen Commission?", in Vanhercke B., Spasova S. and Fronteddu B. (eds.) Social policy in the European Union: state of play 2020. Facing the pandemic, ETUI and OSE, 113-132.

Semester has been gradually 'socialised',[63] initially thanks to the efforts of the then Employment Commissioner Andor, who proposed the addition of social and employment indicators to the MIP. Nonetheless, this has not fully resolved the persisting asymmetry within the coordination instrument between economic and social goals.

During the 2019-2024 legislative period, further progress has been made in expanding the singular economic focus of the European Semester to encompass the broader perspective of social and sustainability frameworks such as the EPSR and the SDGs. This progress must not be rolled back. The European Semester should become a key vehicle for the implementation of a well-being framework, ensuring consistency in EU analysis and recommendations to member states. It should closely monitor domestic implementation of reforms and investment in key sectors and of the principles of the EPSR and the well-being economy framework.

In the next mandate, an Executive Vice President for the Well-being Economy, possibly supported by a Directorate, should oversee a reformed European Semester as his or her primary policy objective.[64] The Semester should build on the significant work already done to develop new benchmarks, indicators and integrated scoreboards such as the Transitions Performance Index, as well as on the lessons from the RRF. It should set targets and monitor progress across the full spectrum of EU objectives, and their achievement should be tied to EU funding. This would also ensure policy coherence and alignment across silos.

The reformed European Semester should improve coordination among member states, enhancing transparency and properly monitoring the implementation of national FSPs. As pointed out by some interviewees, the governance tool could be disentangled in a separate regulation, which could be reviewed more frequently and would be easier to amend and less hotly debated. This would, in turn, make the instrument more flexible.

4.5 The case for a Social Imbalances Procedure

Just as the MIP has been a core part of the European Semester, the introduction of a Social Imbalances Procedure (SIP) or social convergence framework has been supported by scholars and policymakers as a potential tool to correct social imbalances. According to the definition given by Vandebroucke et al, social imbalances are a 'set of social problems that affect member states very differently (thus creating 'imbalances') but [that] should be a matter of common concern for all Eurozone members.'[65] The aim of the SIP would be to ensure that certain social, employment and environmental imbalances are detected and corrected with preventive policies before they pose a threat to social cohesion within and across member states. Such imbalances could concern access to lifelong learning, youth unemployment, high levels of income inequality and climate vulnerability.

63 *Zeitlin, J. and Vanhercke, B. (2018) "Socializing the European Semester: EU social and economic policy coordination in crisis and beyond", Journal of European Public Policy, 25(2), 149-174.*

64 *Kuiper, E., Rayner, L., Brady, D., and McLeod, A. (2023) "Wanted: An Executive Vice President for the Well-being Economy", Brussels: European Policy Centre.*

65 *Vandenbroucke F., Diris R. and Verbist G. (2013) "Excessive social imbalances and the performance of welfare states in the EU", Euroforum Policy Paper 3, Leuven: KU Leuven.*

The SIP would thus keep member states' social core in check and make sure that social rights are respected above a certain threshold. However, the practical implementation of the SIP remains to be debated. While this instrument has potential added value for the EU's social acquis, interviewees felt that it needs further elaboration to be fully operationalised. Concerns over the SIP focus on two main aspects: the necessity for clearer delineation of its scope and the refinement of the methodology employed to evaluate the existence and magnitude of social imbalances. Improving understanding of the procedure's boundaries and enhancing the assessment methods are crucial steps towards making it more effective and ensuring a more comprehensive analysis of social imbalances within the economic governance framework. Moreover, unlike for the EDP, a quantitative threshold for 'social development' is intrinsically more difficult to set, except in specific areas where it is calibrated, such as unemployment.

Although it is uncertain whether the SIP will be realised, there is still a strong case for its principles to be integrated into a reformed European Semester through the adoption of a comprehensive and integrated scoreboard, encompassing all areas of resilience and well-being. Such a scoreboard would provide a comprehensive overview of member states' progress towards the development of a well-being economy by 2030, as enshrined in EU law in the 8th Environment Action Programme. By incorporating the environmental and social aspects of progress, this integrated scoreboard would offer a more nuanced and inclusive perspective on economic governance. In this respect, the well-being economy framework can provide useful guidelines for outlining the SIP.

4.6 An expanded role for IFIs, civil society and social partners

Finally, experts state that IFIs could potentially perform additional tasks related to the fulfilment of green and social objectives. They could, for example, assess the long-term impact of climate-related fiscal risks on national budgets or social sustainability, or they could identify national green and social financing needs and quality investments. At the same time, interviewees point out, it should be evaluated whether the lack of a specialised labour force would be counteracted by the further injection of EU funds. This is especially the case for small member states that do not have big fiscal structures.

Experts also stress the need for stronger involvement by civil society and social partners. The capacity should be built to engage and include them in the consultations taking place at national level, during both the design and development phases of fiscal plans. Some interviewees are in favour of establishing an independent DSA working group composed of experts and selected members of civil society (such as the Platform on Sustainable Finance). They believe more variables are required to incorporate all the relevant factors to properly assess member states' debt sustainability risks, such as climate-related indicators and social risks.

5 Conclusion

The time has come for bold and transformative steps towards overhauling the current fiscal framework. The inadequacies of the existing system have been laid bare, and it is clear that mere adjustments or superficial reforms will not suffice. Political leaders must seize the momentum created by the consultations and exchange of opinions with stakeholders to create a new paradigm — a progressive, socially just and environmentally friendly economic and fiscal governance framework. As Europe continues to grapple with economic challenges, there is a growing need to re-evaluate and reform the SGP to ensure a more balanced and effective approach to fiscal policy that promotes both short-term stability and long-term social and sustainability goals. The existing SGP has demonstrated deep inadequacies, particularly in face of the current macroeconomic challenges. Previous proposals to simplify the SGP and introduce national spending rules were steps in the right direction but failed to address the fundamental issues concerning debt criteria and the subordinate role of social policy in European policy. This lack of policy coherence is a significant concern for many stakeholders. To rectify it, a strong linkage needs to be established between the proposed economic and fiscal governance framework and other key policy agendas such as the 2030 Agenda for Sustainable Development, the European Green Deal and the European Pillar of Social Rights. Ensuring coherence and alignment across these policy areas can promote a holistic approach towards achieving sustainability and well-being, while avoiding contradictory or conflicting measures.

At the same time, the experts consulted for this study agree that few steps in the right direction have been made. There has been a general call from many observers for the European Commission not to reintroduce common safeguards that would put a straitjacket on member states' public spending. Such restrictions might lead to future divergence among countries and a variable degree of freedom with respect to the attainment of social and green objectives, depending on the states' different fiscal stances. Many observers now acknowledge the leeway granted to governments – at least nominally – to reduce their deficit spending if they have debt above 60% of GDP.

The EU has vital and urgent investment requirements that need to be met, and they are not restricted to those member states with sufficient fiscal space. If the reformed economic governance framework severely restricts the investment ability of member states with limited fiscal room to manoeuvre, the divergences between member states will be exacerbated, jeopardising the achievement of the EU's key policy ambitions. Europe's urgent investment needs require that this reformed economic governance framework is not only not hostile to investment but rather that it promotes strategic investment. While the RRF has temporarily allowed high levels of public investment, anxieties over spending levels are returning, as its planned end in 2026 draws nearer. There is thus a risk that investment levels will, once again, be reduced. Space for investment must therefore be made explicit through a golden rule with reasonable conditions attached. If frugal member states continue to push for strict conditions around temporary deviations in order to promote investment, it will become as unpalatable to use this flexibility as it was before the reform. Then, only two member states ever applied the investment clause, largely due to its stringent conditions and relatively short timeframe of three years.[66]

The time is also ripe to establish a permanent central fiscal capacity that could spur public investment by supplying European public goods and coordinating national and European fiscal policies. So far, negotiating constraints and the specificity of procedures have caused a separation between the debate on EU fiscal governance reform and the gradual centralisation of financial resources within the EU. However, European economic dynamics make it increasingly evident that the conditions for non-contingent forms of a central fiscal capacity will only be created by a reform of EU fiscal rules that ensures the sustainability of national public budgets without compromising the potential for vital investment. Member states should embrace the cooperative approach of the new fiscal governance and the progress towards a CFC. The mid-term review of the MFF is an opportunity to make this leap.

A more ambitious and transformative approach is required. The EU must be able to preserve debt sustainability, undertake effective macroeconomic policy, and make the required investments in the twin transitions and related social measures independent of the prevailing macroeconomic environment.[67] It is essential to design a new fiscal framework that not only addresses the shortcomings of the past but also aligns with the principles of progressiveness, social justice and environmental sustainability. The newframework should build on existing principles, such as the EPSR, and embrace new ones, such as those in the well-being economy framework.

66 *Darvas, Zsolt and Julia Anderson (2020) "New life for an old framework: redesigning the European Union's expenditure and golden fiscal rules", PE 645.733, p.30, Brussels: European Parliament.*

67 *Mollet, F., F. De Angelis, L. Rayner, (2022) Rethinking EU economic governance: The foundation for an inclusive, green and digital transition, European Policy Centre: Brussels.*

6 Annex: List of interviews (institutions contacted)

1. European Youth Forum, 10/05/2023
2. Foundation for European Progressive Studies, 16/05/2023
3. ETUI, 17/05/2023
4. European Parliament's Committee on Budgets, 25/05/2023
5. Finance Watch, 01/06/2023
6. Social Platform, written contribution

In April 2023, the European Commission proposed a reevaluation of its economic governance framework, seeking to address longstanding criticisms and adapt to the challenges posed by the COVID-19 pandemic, environmental sustainability, and digitalization. However, the question remains: does this proposal offer an innovative vision that goes beyond austerity and effectively prepares economies for current and future social, climate, and environmental challenges?

SOLIDAR, along with co-authors Tommaso Grossi, Alessandro Liscai, and Laura Rayner, enthusiastically contributes to the discussion. They emphasize the urgent need for an overhaul of the EU's economic governance framework, advocating for a new system that prioritizes redistribution and the essential investments necessary to advance social rights and justice.

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A SOCIAL EUROPE
FOR ALL WITH ALL

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