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Social divergences and the erosion of social cohesion in the EU

Is the reform of EU fiscal rules and economic governance fit for purpose?

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Executive summary

The EU fiscal rules and economic governance framework are currently under reform. This paper studies the negative effects of the successive crises of the last fifteen years on the social cohesion of the EU and assesses whether the Commission's proposals for the new Fiscal Pact create better conditions for dealing with existing social disparities between and within EU member states (MS).

The analysis of the trends in social convergence/divergence between MS and inequality within MS between 2008 and 2022 provides evidence for the erosion of its social cohesion. The old and the new EU "periphery" followed opposite trajectories. Southern Europe, the old periphery, diverged from the countries of the core and the EU-average, while the new MS that joined the EU with 2004, 2007 and 2013 enlargements, the new periphery, converged. At the same time, income inequalities, poverty and social exclusion increased in most EU "core" countries.

Having critically examined the new EU fiscal rules and economic governance framework proposed by the European Commission and recently approved by the Ecofin Council, the paper concludes that these provide the over-indebted MS with very limited additional fiscal room for maneuver in exchange for a stricter, in relation with the current one, control by the Commission and the Council of their compliance with the EU criteria on eligible investments and appropriate structural reforms at national level. In particular, the new process is not combined, after the expiry of NextGenerationEU, with an extension of EU fiscal capacity. This would help, on one hand, the MS to cope with the ecological,

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technological and industrial transformation of their economies, and on the other hand, the EU to fill the gaps in its cohesion policy to address the economic and social disparities and inequalities between and within the MS. Disparities and inequalities undermine social cohesion and fuel social discontent and the rise of the extreme right. Finally, the lack of national and European fiscal space is glaring at the current juncture where the MS are called upon to exercise a restrictive fiscal policy in an international environment of high interest rates that depress investment and job creation.

The paper also discusses alternative proposals for the reform of the Stability and Growth Pact and the economic governance framework of the EU.

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Introduction

The global financial crisis, the Covid-19 pandemic and the ongoing cost-of-living crisis have significantly deteriorated the working and living conditions of workers and popular classes across Europe and are still affecting their wellbeing. At the same time, during the 'permacrisis' of the past fifteen years economic and social divergences have increased both within and between EU Member States (MS) undermining social cohesion and the legitimacy of the project of European integration. Rising inequalities have eroded social cohesion across the EU, including in the countries of its "core", while economic and social divergences between MS have gone hand in hand, with contrasting trajectories of the old and new "periphery" of the EU.

The starting point of our paper is that fostering upward social convergence and tackling social inequalities across the EU is not only a fundamental challenge for the future of EU integration and the main way for preventing further escalation of far-/alt-right forces, but it is also a precondition for the success of the ecological and technological - industrial transformation and the restructuring of European economies, i.e. the green and digital transitions and strategic investment promoting 'open strategic autonomy'.

We argue that, although the European Pillar of Social Rights constitutes an important basis for political initiatives intended to reverse the trend towards the erosion of worker and social rights in the EU, it is impossible to build a socially cohesive Europe only through directives defining minimum social standards for MS, Council Recommendations and EU social policy actions, however important these may be. Upward social convergence of EU MS lagging behind is strongly associated with their upward economic convergence while tackling social inequalities within Member States requires, at the national level, well-functioning collective bargaining and social dialogue as well as anti-discrimination and redistributive fiscal and social policies which are costly and need fiscal space.

In the following months, the Council and European Parliament will have to agree on the final proposal by the European Commission for the reform of the EU economic governance framework, which provides MS with greater leeway to use their fiscal policies and preserve public investment than they had before under the Fiscal Compact. Although the proposal is clearly a positive development, it falls short of creating a sufficient fiscal space for MS at the national level to deal with the great economic, social and environmental challenges they face in the current juncture of 'polycrisis', and more so for MS that are far from/diverge from the EU average and need to converge. It should be clear, though, that sufficient fiscal space at the national level cannot address the problem of the great differences in the borrowing capacity of MS. More fiscal capacity at the national level should be thus supplemented by the extension of EU fiscal capacity and its just distribution to MS through the EU Structural and Investment Funds.

We start our analysis by examining economic and social convergence/divergence and inequalities between and within EU Member States from the beginning of the 2008 global financial crisis to date, to establish trends in the reinforcement/weakening of social cohesion in the EU (section 2). We then assess whether the reform of the EU fiscal surveillance and economic governance framework proposed by the European Commission is "fit for purpose" also from the social convergence and cohesion angle, which is not usually taken on board in most assessments of the Commission's legislative proposals (section 3). Finally, we present alternative reform proposals. These include the adoption of the "golden rule" for social investments and the establishment of a single EU governance/coordination framework for the economic and social policies of the MS.

This puts the economic and social objectives on an equal footing, combined with the expansion of the EU's fiscal capacity. and allocates European resources to MSs according to economic and social convergence and cohesion criteria (section 4).

Economic and social convergences/divergences between and within

EU Member States: the contrasting trajectories of the 'old' and the 'new' periphery

From the foundation of the EEC in 1957 to date, the ideas of shared prosperity and economic convergence have gone hand-in-hand with that of European economic integration, while economic convergence has been considered as the fundamental mechanism and precondition for achieving socio-economic cohesion (Alcidi 2019).

Although cohesion policy was not designated by the Treaty of Rome as a field of Community intervention, the harmonious development of EEC economies through the reduction of regional disparities and of the backwardness of the less favoured regions was mentioned in its preamble as one of the specific goals of the EEC. The European Social Fund and the European Regional Development Fund established in 1958 and 1975 respectively allowed for the funding of joint policies to reinforce the social cohesion of EEC Member States and reduce regional economic and social disparities.

In the 1980s, the enlargement of the EEC with Greece, Spain and Portugal produced a divide between the MS of northern Europe who had strong and stable industrial bases and the less developed and less industrialized southern European periphery. As a result, the Single European Act of 1986, which revised the Treaty of Rome in order to complete the internal market by 1st January 1993 also officially established the EEC's Cohesion Policy to address disparities between regions in GDP per capita and the unemployment rate. This would be achieved by equipping poorer regions with tools and resources from the European Structural and Investment Funds to realize investment and institutional reforms that improve productivity and boost their potential growth, promote employment and prevent social exclusion. The combination of cohesion policy and the internal market was expected to drive upward economic convergence by allowing the poorer Member States to grow faster and catch up with the richer ones.

The Maastricht Treaty (1992), which established the E.U. and launched the EMU, set the criteria for "nominal" economic convergence, which the EU Member States had to meet in order to adopt the euro. These concerned price and exchange rate stability, long-term interest rates, the government deficit and debt. The espousal of the EMU was accompanied by the decision to increase the resources that would be distributed through the European structural funds to the less developed MS/regions of the EU. The purpose of the decision was to compensate through the strengthening of the EU cohesion policy the anticipated negative effects on the less developed MS/regions of the EU from the operation of the Single Market and the austerity policies that the MS would have to implement in order to meet the EMU membership criteria.

Social convergences/divergences between and within EU MS depend firstly on "real" economic convergence/divergence trends in the EU. Fundamental economic variables, such as GDP per capita, productivity and the employment rate are main determinants of the levels and trends in main social indicators, such as real disposable income

per capita, wages or the unemployment rate. Secondly, social convergences/divergences depend on (re)distributional and (anti) discrimination processes and policies at the national and EU levels. Wage determination systems and practices as well as employment and social policies account for the levels and trends in the wage share, social expenditure per capita or as % of GDP, income inequality and poverty, employment, wage and income differentials between different social groups, etc.

In this section we first examine the trends of economic convergence/divergence in the EU from the mid-1990s to the end of the Covid-19 pandemic crisis, before focusing on social convergence/divergence trends between 2008 and 2022, i.e., the period of "permacrisis". Covering the entire period is important in order to (a) draw conclusions about how EU member states have weathered the three major crises of the last fifteen years, if and how well they have been able to protect their citizens' well-being during the recessions and improve it during the recoveries compared to their neighbours and partners (b) gauge the upward convergence effort required by the EU member states which are below the EU average in various economic and social indicators and assess the problem and challenge of social cohesion in today's Europe.

Economic convergence/divergence trends in the EU: literature review

Research on real convergence within the EU has been the subject of several studies in the past. The findings of individual authors vary according to the applied methodology, the period analyzed, and the statistical indicators used. GDP/ income per capita is the chief variable used to examine economic convergence/divergence and we indicatively present below the findings of selected studies on the long-term trends, in order to illustrate the different approaches in the convergence/divergence literature.

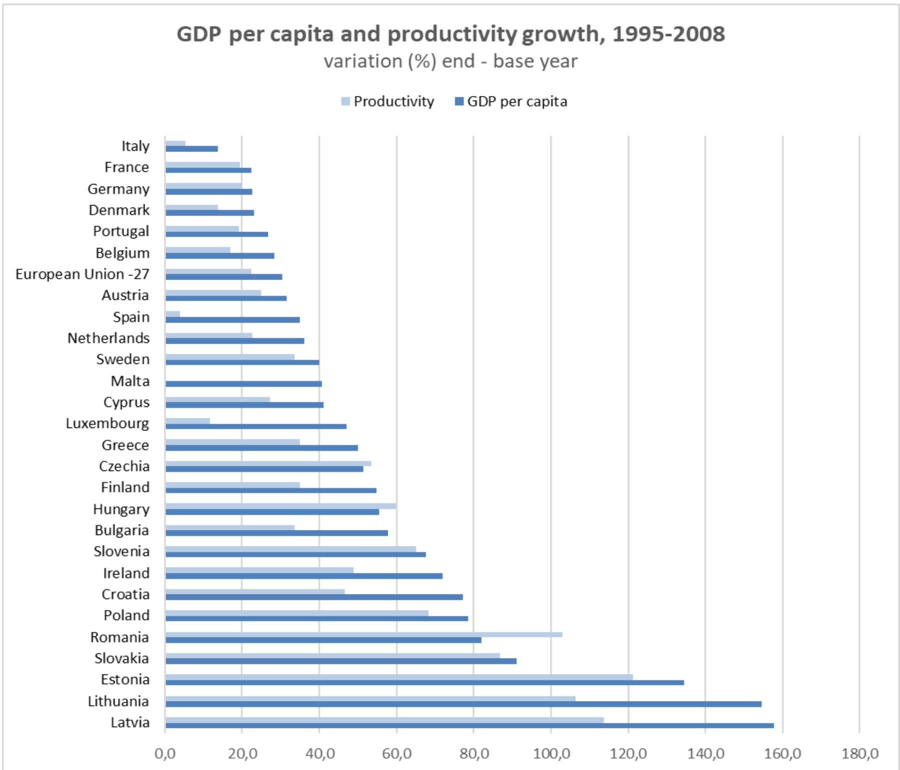
For instance, Cavenaile and Dubois (2011) evidenced an income convergence process within the EU (27 countries) between 1990 and 2007 but also found that the EU was showing significant heterogeneity. Namely, the convergence of Eastern and Central European MS with those of EU-15 was much stronger than that of the countries belonging to EU 15 among themselves. In contrast, Celi et al. (2020) have painted a different picture of the trends than the above during the two decades before the 2008 financial crisis. They maintained that, during these decades, the deregulation of goods, labour and capital markets which shaped the direction of the European integration process, halted the process of convergence in the EU and led to a structural divergence between the core and its southern periphery which incurred deindustrialization and ‘poor’ tertiarisation. Such divergence was partly hidden in the first period of the EMU, i.e., between 2000 and 2008, by massive financial flows to the countries of Southern Europe. The same authors have also attributed the strong growth of Central and Eastern Europe to the huge flow of foreign direct investment which transformed the economies into an essential source of intermediate goods for the German industry. They have argued that the foreign control of production decisions, innovation processes and markets has made it extremely difficult for Eastern MS to undertake an independent, less unbalanced development path (Celi et al. 2018).

It should be kept in mind though, that the pre-financial crisis catch-up process of Eastern Europe was not confined to the Visegrád countries that belong to the “central European manufacturing core” whose heart is Germany (Stehrer & Stöllinger 2015), but included all the former communist countries that are now members of the EU. Andor (2019) has underlined that in spite of their rapid

economic catch-up with the countries of the core, especially since 2004, the upward income convergence of the Eastern EU MS has not been coupled by a similar social convergence while their strong economic performance has been accompanied by internal socio-economic polarization.

Graph 1 provides an overall picture of the change in GDP per capita and labour productivity in all member states of today's EU-27 between 1995 and 2008. The relative performances confirm the upward economic convergence of all the 13 "new" EU member states from the enlargements of 2004, 2007 and 2013 with the EU-15 and that convergence of GDP per capita and productivity had already started before their accession to the EU. The group of the old MS of Southern Europe showed internal differentiation in terms of relative performance over the above period, with the dominant trend being divergence. Italy is the MS of both the former EU-15 and the current EU-27 with the lowest increase in GDP per capita and the second lowest increase in labor productivity in the fifteen years preceding the 2008 financial crisis, while Greece displayed the third best performance in the EU-15 in GDP per capita growth and the second best in the rise of productivity over the same period. Portugal recorded lower than the EU-average growth in both GDP per capita and productivity, while Spain managed to achieve GDP per capita growth equal to the EU-15 average despite having the worst performance in labor productivity (stagnation). As a result of the above developments Italy and Portugal diverged from and Greece converged with the rest of EU-15 countries both in terms of GDP per capita and labour productivity, while Spain's trajectory lies somewhere in between.

Graph 1



Source: Eurostat online database

The global financial crisis of 2008 reversed the general trend of convergence of the 1990s and 2000s both between

countries and between EU regions. During the austerity phase (2010-2015) there was a divergence between EU countries, while the divergence between regions started in 2008 and lasted until 2015, when the coefficient of variation of GDP per capita had recovered at the level of 2000 (Alcidi 2019). Economic divergence during the austerity phase of the 2008 crisis resulted from the recessions produced in the southern European MS by tough fiscal consolidation plans. The recessions destroyed much of the productive capacity of most southern European countries (Greece, Portugal, Spain, Italy, and Cyprus), while the internal devaluation strategy -implemented as part of the economic adjustment programs overseen by the Troika to boost cost competitiveness- left untouched their structural weaknesses (Wigger 2023).

Table 1: **GDP per capita relative to EU-27 in PPP**				
EU-27 = 100				
	2008	2015	2019	2022
Luxembourg	279,0	282,0	251,3	261,3
Netherlands	142,5	131,5	126,9	129,3
Ireland	135,4	180,8	189,4	233,9
Sweden	129,4	128,4	118,9	118,8
Austria	126,9	130,5	125,9	125,3
Denmark	126,8	128,2	126,2	136,6
Finland	123,1	111,1	109,2	109,0
Germany	118,0	124,5	121,0	116,8
Belgium	116,3	120,8	117,6	119,9
Italy	108,4	97,3	96,5	95,6
France	107,8	106,7	105,8	101,5
Cyprus	106,9	83,4	92,8	91,9
Spain	102,1	91,3	90,9	85,2
European Union	100,0	100,0	100,0	100,0
Greece	94,7	70,0	65,7	67,8
Slovenia	90,9	82,7	88,7	92,4
Czechia	85,5	88,6	93,2	91,0
Portugal	81,9	77,5	78,6	77,2
Malta	81,4	97,8	103,6	102,2
Slovakia	72,5	78,6	70,5	68,1
Estonia	69,9	76,4	82,3	87,0
Croatia	64,4	60,9	66,5	72,8
Hungary	63,6	70,1	73,0	77,7
Lithuania	63,6	75,4	84,2	89,8
Latvia	60,1	65,3	69,4	74,1
Poland	56,2	69,3	72,9	79,5
Romania	51,5	56,5	69,6	77,1
Bulgaria	43,3	48,1	53,0	58,7
*Purchasing power parity.				
Source: AMECO database online (accessed on 14.10.2023).				

Finally, Abrhám and Vošta (2022) have analysed convergence/divergence trends between EU MS in GDP per capita (measured in purchasing power parity units) during the most recent period of 2016-2021, which they have divided into a pre-pandemic period of growth (2016-2019) and the pandemic years of crisis (2020-2021). They found convergence of GDP per capita in the EU during the pre-pandemic period and divergence during the Covid-19 years. Convergence during the 2015-2019 period stemmed from the rapid recovery of the German economy that pulled the eastern periphery along with it (Celi et al. 2020), while the economic divergence between EU MS during the Covid-19 pandemic was caused by a lower decline in GDP per capita in the more compared to the less developed EU countries (Abrhám and Vošta 2022).

Table 1 shows how the ranking of EU-27 MS in terms of GDP per capita in purchasing power parity (PPP) units and their distance from the EU-27 average have evolved during
2008-2022. The data clearly point to the downgrading of the position of the Southern European MS (except Malta) due to the toll that the sovereign debt crisis took on their economies and their poor growth performance across the whole period relative to the EU-average. Italy’s, Spain’s and Cyprus’s GDP per capita in PPP was above the EU-average in 2008; it is now below and is surpassed by that of some new MS. Portugal’s below-EU-average position in 2008 has also deteriorated. After the long austerity cure imposed on its economy between 2010 and 2018, Greece had in 2022 the second lowest GDP per capita in the EU, while it was only slightly below the EU average in 2008. The table also illustrates that all new MS (except Cyprus and Slovakia) have converged with the EU-27 average from a lower starting point. The old MS of the core also converged, but from a higher starting point.

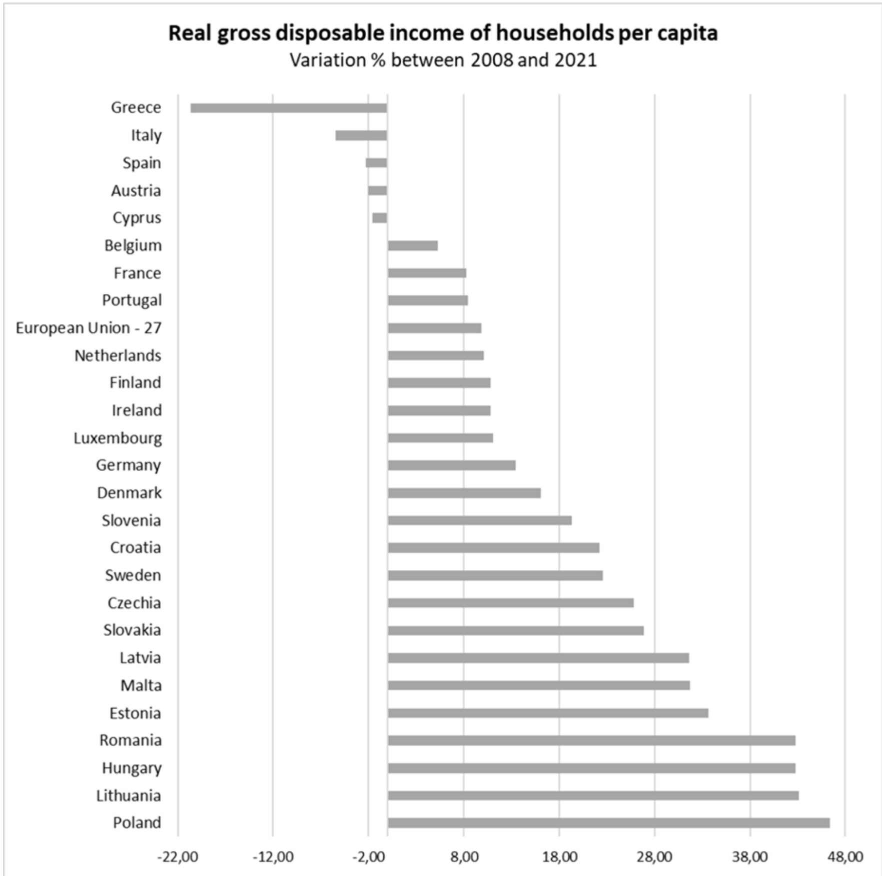
Social convergence/divergence between EU MS since 2008

After having examined the main trends in economic convergence/divergence between EU MS from the mid-1990s to the end of the Covid-19 pandemic crisis, we will now focus on social convergence/divergence in the EU over the 2008-2022 period by studying the trends in the following variables: gross disposable household income per capita at constant prices, employment rate, real wage/remuneration per employee, and poverty and social exclusion.

Real gross disposable income of households per capita: Between 2008 and 2021, the real per capita gross disposable income of households grew by 10% in the EU on average. The mean dissimulates extremely large country differences ranging from -21% in Greece to 46% in Poland, which reflect the legacy of the global financial crisis; the latter hit EU MS in different ways and with varying intensity.

If we measure convergence/divergence in the real gross per capita disposable income of households by comparing dispersion of the values of the variable around the mean in 2008 and 2021, then the coefficient of variation (0.573 in 2008 against 0.568 in 2021) shows that the dispersion was roughly the same in 2021 as in 2008. However, measuring dispersion at the start and end years of the period does not take into account the convergence/divergence trajectories of individual countries or groups of countries towards/from the EU-average trend over the period, as captured by Graph 2.

Graph 2



Source: Eurostat online database

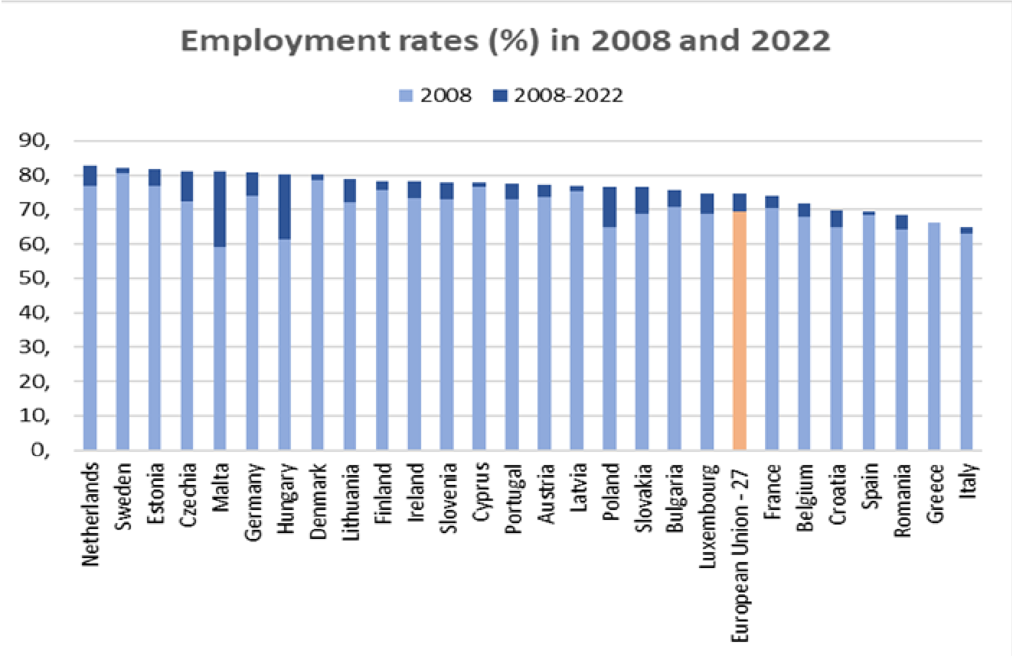
Graph 2 illustrates that twelve out of the thirteen "new" MS that joined the EU with the 2004, 2007 and 2013 enlargements - all except Cyprus - were those that registered spectacular increases of real per capita household income - between 19% and 46% -thus converging towards the older MS as a whole, which displayed a smaller increase. Among the latter, Sweden, Denmark and Germany were the best performers, while most of the southern EU countries (Greece, Italy, Spain and Cyprus) along with Austria registered a reduction in per capita disposable household income.

Convergence/divergence trajectories of the individual countries around the EU-average trend in real disposable income of households per capita is chiefly accounted for by differences in the evolution of the employment rate, real wages and social benefits.

Employment rate: The right to work is a fundamental social right and having access to a good job is the precondition for earning a decent market income and for the well-being of workers and their families. Per capita household income rises at the micro level with the number of labour income earners in the household and, at the macro level, with an increasing employment rate of the working age population. A key effect of the 2008 global financial crisis was the fall of the employment rate of those aged 20-64 years in the EU from 69.5% in 2008 to 67.5% in 2013. The six-year growth period that followed brought this rate to 73% in 2019, well above the 2008 level. After its contraction by one p.p. in 2020, the strong rebound of the EU economy after the end of the Covid-19 pandemic was accompanied by a surge in the number of new jobs while employment also grew during the cost-of-living crisis. In 2022, the EU-average employment rate of the population aged 20-64 years was at 75%, 5.5 p.p. above its 2008 level.

Convergence and divergence trajectories of individual countries to the EU-average between 2008 and 2022 can been seen in Graph 3. All southern European countries that endured sizeable

Graph 3



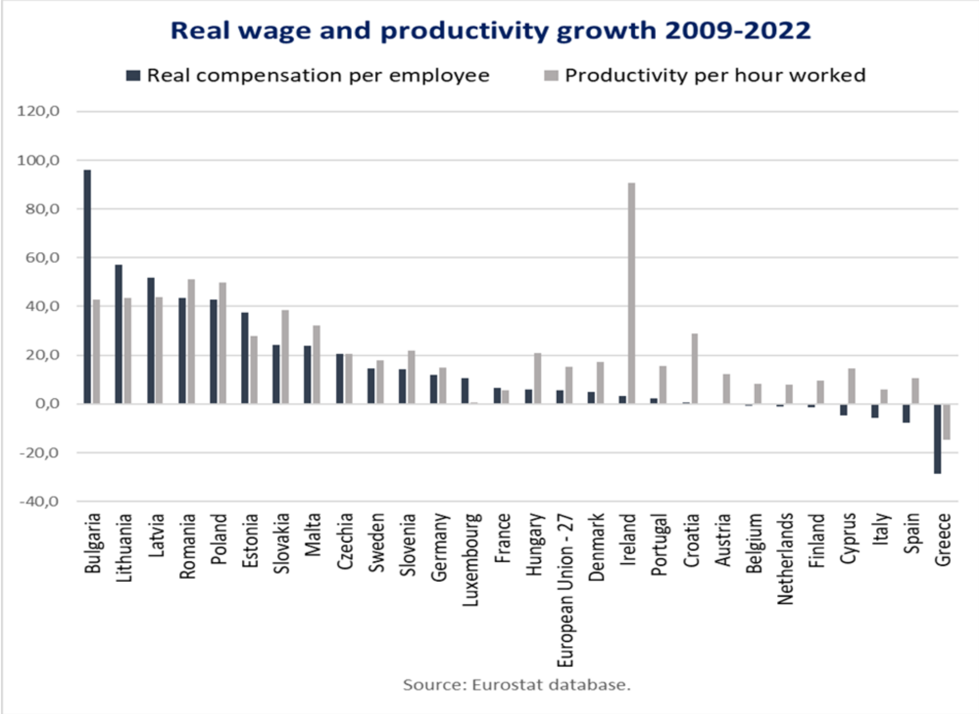
Source: Eurostat online database

recessions and important net job losses due to the implementation of harsh fiscal consolidation programmes during the sovereign debt crisis years (Greece, Spain, Portugal, Cyprus and Italy) saw no or very small increases in their employment rate. Starting with a below-EU-average employment rate in 2008, Greece, Spain and Italy further diverged from the EU-average while Portugal and Cyprus converged since their employment rate was above the EU-average in 2008.

In contrast, a significant increase in the employment rate took place in almost all the 'new' EU MS between 2008 and 2022. The rise was spectacular in Malta, Hungary, Poland and Slovakia (mainly) due to (very) high job growth rates across the period. Starting from a below EU-average employment rate in 2008, the above four countries initially converged by climbing towards and subsequently landed above the EU-average in 2022. However, in all the remaining countries of the group, the observed increase in the employment rate was entirely/mainly due to the reduction in the working wage population due to low fertility and out-migration flows.

Real wage/compensation per employee: Between 2009 and 2022 real wages in all eastern European countries except Hungary strongly converged to the EU average while they diverged in all southern European ones, except Malta. This is the outcome of the huge differential of wage growth rates between these two groups of countries (Graph 4). In most 'new' EU MS (Bulgaria, the Baltic states, Romania, Poland, Czechia, Slovakia, Malta and Slovenia) real wages rose steeply, mainly due to repeated increases in minimum wages by governments and to the contraction of unemployment, which increased the bargaining power of employees. To the contrary, real wages decreased in most southern EU MS (Greece, Portugal, Cyprus, Spain and Italy) during the austerity period of the financial crisis. The initial phase of real wage contraction, was followed by a moderate increase during the 2014-2019

Graph 4

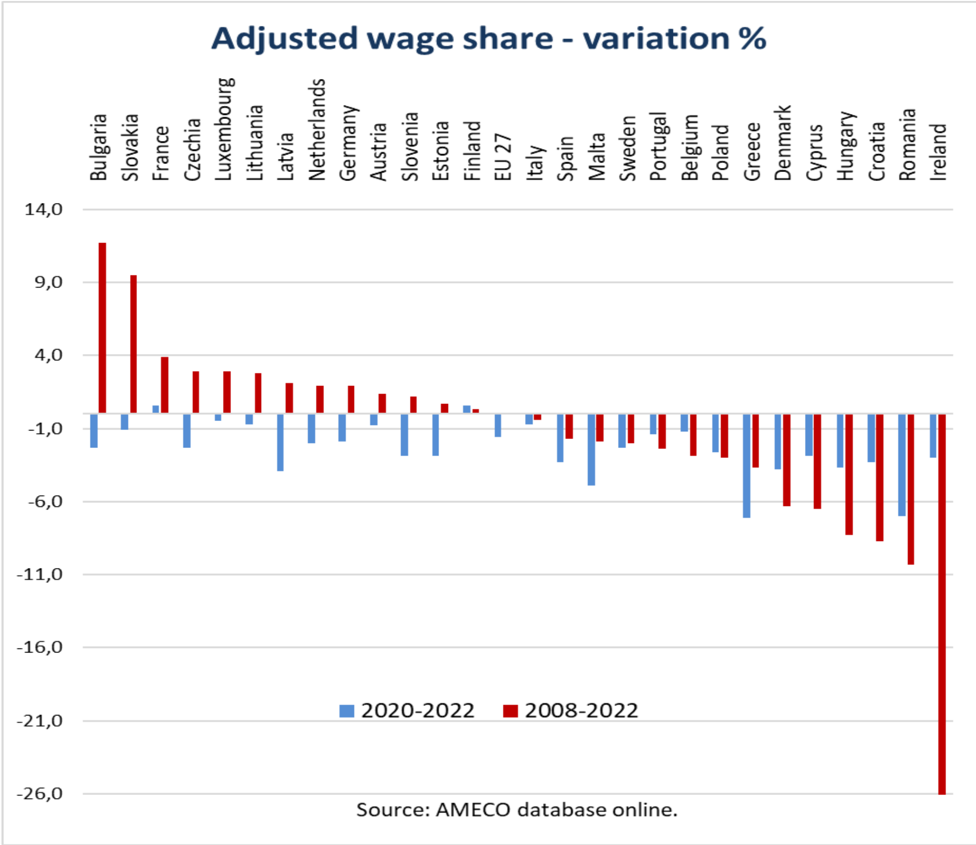


Source: Eurostat online database

period, which yet did not succeed in bringing the purchasing power of wages in these countries back to their peak 2009 level. Besides, in Greece, Cyprus and Spain real wages decreased more than in the EU on average in 2022, i.e., during the cost-of-living crisis, adding to the divergence trend of 2009-2021.

For 'core' EU MS wage developments have been heterogenous. Real wages in Sweden, Germany and Luxembourg saw a significant increase – from 10 to 15% - between 2009 and 2022, while France, Denmark, Ireland and Portugal witnessed real wage growth rates that ranged from 2% to 7% over the same period. Finally, in Austria, Belgium, the Netherlands and discrepancies in labour productivity developments. Most of the countries of the 'core' of the EU, with the exception of Sweden, Germany and Ireland, seem to be stuck in a low productivity growth-low wage growth equilibrium whereas in most 'new' MS the spectacular rise in real wages seems to be driven and accounted for by an equally remarkable productivity growth. However, labour productivity growth is not the only determinant of real wage variation. The bargaining power of labour has also weighed a lot in the outcome of the distributional conflicts across the EU between capital and labour, captured by the change in the wage share between 2009 and 2022 (graph 5).

Graph 5



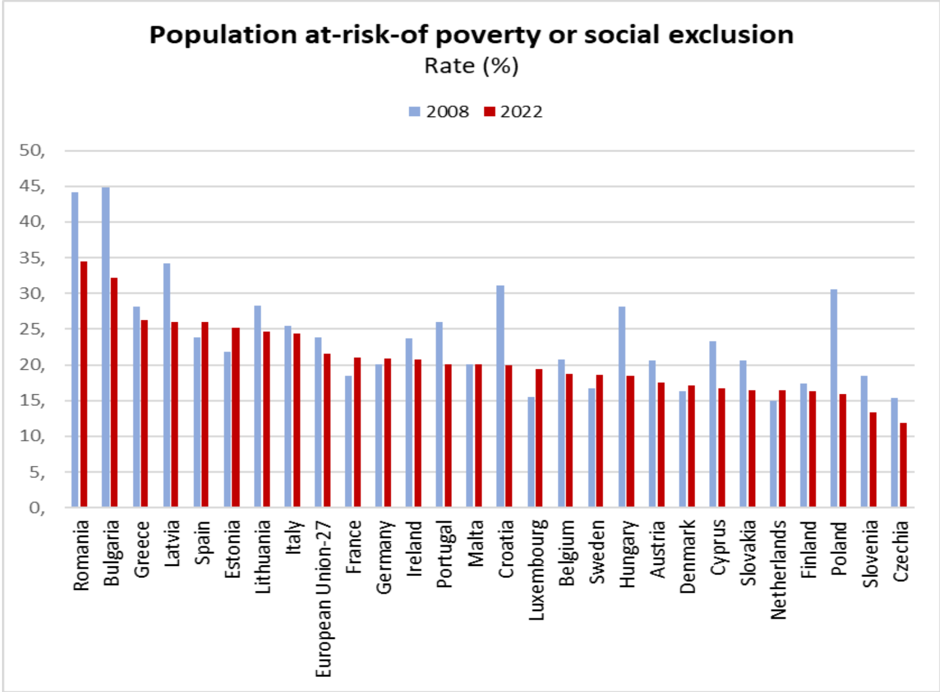
Finland real wages decreased between 2009 and 2022, but this has not undermined their position among the EU countries with high wages.

To some extent, real wage growth divergences between EU MS over the period under study have reflected

When real wages grow faster than productivity, then the wage share of GDP increases and income redistribution from capital to labour takes place; the opposite happens when productivity grows faster than real wages. Graph 5 shows that, between 2008 and 2022, the adjusted

wage share[1] increased in the majority of 'new' MS that displayed the greatest real wage increases (Bulgaria, Slovakia, Czechia, the Baltic States and Slovenia) but not in Romania and Poland where the wage share dropped significantly. In the opposite direction, the wage share diminished in all Southern EU countries over the same period; more so in Cyprus and Greece and less so in Portugal, Malta, Spain and Italy. The 'core' EU MS are divided with respect to the developments of the wage share; in some this rose (France, Luxembourg, Germany, the Netherlands, Austria, Finland), in the others it reduced (Sweden, Belgium, Denmark). Ireland is an outlier; its wage share plunged by 28.2 p.p. because real wages increased by 3.2% when productivity almost doubled (90.6% rise)[2]. During the cost-of-living crisis the wage share collapsed in all EU MS in 2022 as can been seen on Graph 5. Janssen and Lübker (2023) have integrated this fall in a study of income redistribution between capital and labour over a longer period.

Graph 6



Source: Eurostat online database

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[1] The wage share is defined as the share of wage income in GDP at factor costs. The adjusted wage share includes the imputed income of self-employed workers.

[2] Ireland's latest figures put the country's productivity per hour at about 2½ times the EU average. This is largel due to the country's major foreign sector that accounts for 56% of growth in the value-added of the Irish economy, as officially recorded in national accounts. US multinationals such as Google, Microsoft, Pfizer, Meta, etc. produce lots of very high-value goods and services that may be funnelled through Ireland to avail of its very low corporate taxation while they also perform relocation of property rights and profit-shifting which artificially swell value added. According to the latest report of the EU Tax Observatory, in 2020, Ireland was the second main profit-shifting destination in the EU after the Netherlands and the profits that had been shifted over the 2016-2020 period amounted more than 140 billion US dollars (Alstadsæter et al. 2023). However, if one strips out the foreign sector from calculations, productivity per hour drops but remains around a third higher than the EU average, which means that Irish companies are still helping to drive the economy forward.

Poverty and social exclusion: The at-risk-of poverty or social exclusion rate[3] has decreased in the EU as a whole between 2008 and 2022 with the largest reductions having been noted in the new EU MS (Graph 6).

As these were also the MS with the highest at-risk-of poverty and social exclusion rates in the EU, the reductions led to their convergence towards the EU-average rate. Of equal importance is the increase in the poverty and social exclusion rates in France, Germany, Luxembourg, Sweden, Denmark and the Netherlands, which is a clear sign of erosion of social cohesion in the countries of the 'core' of the EU between 2008 and 2022. Finally, in the case of the southern European EU member states, the reduction in relative poverty, indicated by the trend shown in the chart for the rate of at-risk-of-poverty or social exclusion to shrink between 2008 and 2022, fails by definition to capture the impoverishment of very large population strata in absolute terms due to the economic and social effects of the policies of harsh austerity and internal devaluation they implemented.

From the above trends, there are still great differences between EU countries in the extent of poverty and social exclusion, with the pattern similar to that described for income inequality. Romania, Bulgaria, and the Baltic States, Greece, Spain and Italy are the countries of the EU with the highest rates of population in poverty or social exclusion. However, eastern and southern European countries are internally divided between the low and high poverty/social exclusion ones. The internal divide can be explained by the different institutional and political settings, and social and political coalitions that shape distributional outcomes in each country.

To conclude, from the analysis of social convergence/divergence trends between EU MS on the basis of the cross-country variation of four selected social indicators over the 2008-2022 period covering the three successive major crises that the EU recently experienced, we can conclude that the "new periphery" comprising the MS from Eastern and Southern Europe that joined the EU in 2004, 2007 and 2013 converged with the MS of the "core" with regard to real wages, the real disposable income of households per capita and the at-risk-of poverty or social exclusion rate. Moreover, due to the strong job growth that took place in Malta, Hungary, Poland and Slovakia, in 2022, the employment rate of the above four countries had surpassed the EU average, while in 2008 it was much below the latter. The social convergence of the "new periphery" is associated with economic convergence based on higher GDP and productivity growth than in the EU-15 countries. On the contrary, the "old periphery" of the EU (including Italy and excluding Ireland) has experienced social divergence on the basis of all three indicators: the real disposable income of households per capita, the employment rate and real wages. The social damage caused in Greece, Portugal, Spain and Italy by the harsh austerity and internal devaluation policies imposed by the troika (EC, ECB, IMF) during the sovereign debt crisis, was compounded with the negative effect of the Covid-19 pandemic and cost-of-living crises on incomes and wages.

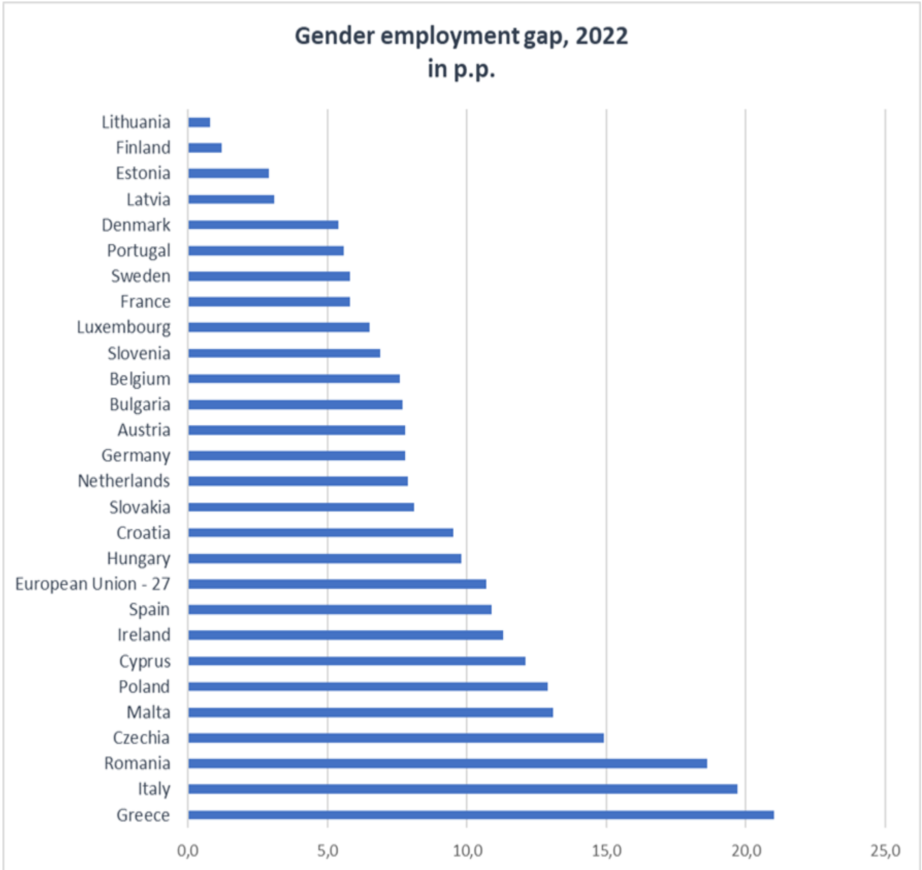
[3] The at-risk-of poverty or social exclusion rate is defined as the share of the population who are either at risk of poverty, or severely materially and socially deprived or living in a household with a very low work intensity. The people at risk of poverty are those with a net equivalised income below 60% of the median of the population as a whole. The people materially and socially deprived are those who declare that they experience an enforced lack of at least 7 out of 13 goods, services or social activities (six related to the individual and seven related to the household) that are deemed by most people to be essential for an adequate quality of life. A household with very low work intensity refers to a household where the total actual labour participation (in months) of working-age household members (18-64 years) is less than 20% of the maximum potential labour participation.

Inequalities within Member States: cross-country disparities

In this subsection we analyse inequalities in employment, income and access to basic social services within EU MS, in order to identify those that need more fiscal space at the national level and assistance from the European Structural Funds in order to tackle them. To compare EU countries, we use the following variables/indicators: the gender employment gap, the income quintile share ratio, and the out-of-pocket expenditure on healthcare. Cross-country disparities in the at-risk-of poverty or social exclusion rate have already been analysed along with trends in social convergence/divergence of MS.

Inequalities in employment: The gender employment gap, measured as the difference between the male and the female employment rates, is a key indicator of inequalities in employment. The EU-average gender gap shrank from 13.4 pp. in 2009 to 10.7 p.p. in 2022. Up to 2013, this reflected the greater negative effect that the global financial crisis had on male than female employment whereas the narrowing of the gap is negligible from 2014 onward pointing to an almost gender-equal job growth during the subsequent years. Nevertheless, country differences remained huge in 2022, ranging from 21 p.p. in Greece to 0.8 p.p. in Lithuania (Graph 7). All southern European countries, except Portugal, alongside Romania, Poland and Ireland are the MS with the greatest gender inequalities in access to employment in the EU.

Graph 7

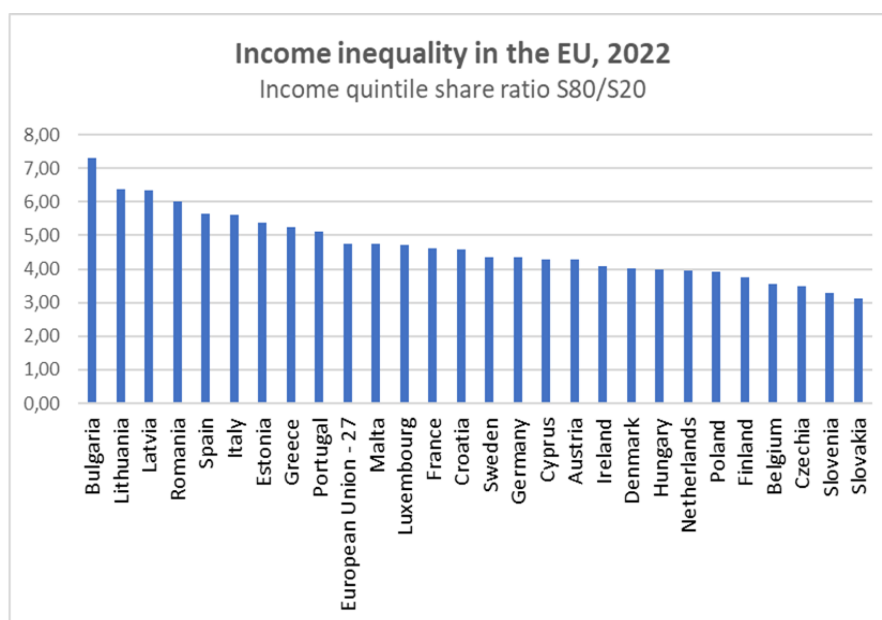


Source: Eurostat online database

Income inequality: The income quintile share ratio S80/S20, measuring

the ratio of the total equivalized disposable income received by the 20% of the population with the highest income (top quintile) to that received by the 20 % of the population with the lowest income (lowest quintile) is a key indicator of income inequality in a country. According to this indicator, income inequality in the EU[4] was the same in 2022 as in 2008; after having increased during the global financial crisis, it narrowed in the following years and recently returned to its 2008 level. However, there are very large discrepancies in the degree of income inequality between EU MS (Graph 8).

Graph 8



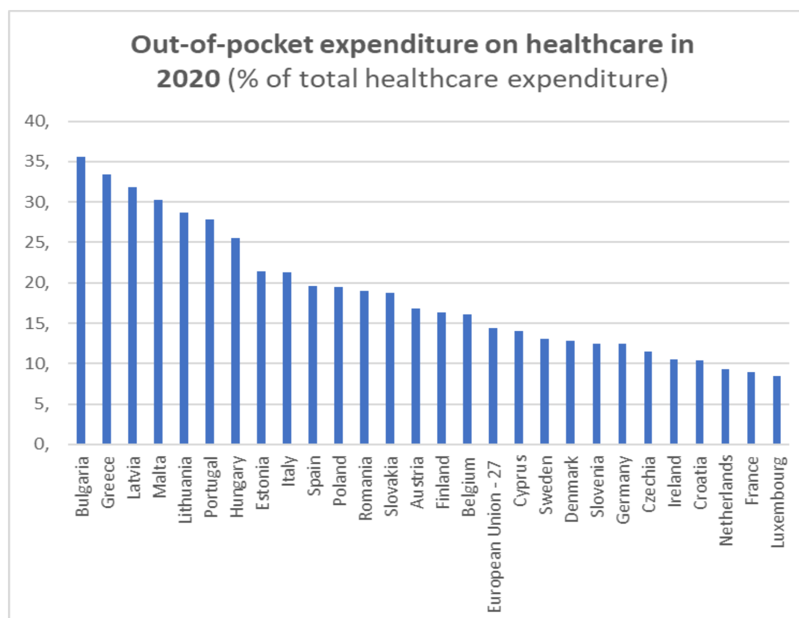
Source: Eurostat online database

Although half of the eastern European countries (Bulgaria, Romania and the Baltic States) and the largest southern European ones (Greece, Italy, Spain and Portugal) are the most unequal countries in the EU with regard to the income distribution, the Visegrád countries and Slovenia are among those with the lowest income inequalities, while Cyprus has lower income inequalities than the EU on average.

Inequality in access to basic social services: Free access to good quality healthcare proved of fundamental significance for European societies in their attempt to cope with and minimize the number of deaths from the Covid-19 pandemic. The latter brought to the fore the importance of public healthcare to ensure basic social rights as well as the vulnerability of citizens and societies from the rampant privatization of the healthcare sector in the past decades. The out-of-pocket expenditure on healthcare is the main indicator measuring the degree of privatization of healthcare services in the different EU MS (Graph 9). According to the most recent available data, the top thirteen ranks of the list of the EU MS according to out-of-pocket expenditure as a percentage (%) of total healthcare expenditure are occupied by eastern and southern European countries. Among the recent EU MS, only Croatia, Czechia and Slovenia appear to have robust public healthcare systems and to keep private healthcare expenditure at low levels.

[4] Estimates of the indicator at the EU level are calculated as the population-weighted arithmetic average of individual national figures.

Graph 9



Source: Eurostat online database

Social convergences/divergences and social cohesion in the EU: the big challenge of Southern Europe

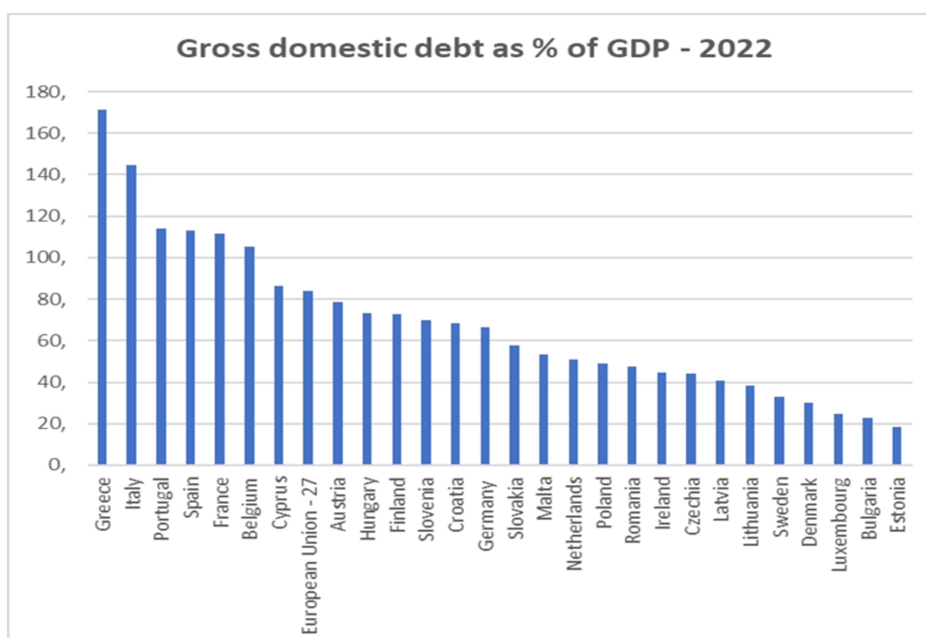
Some general conclusions can be drawn from the above examination of social convergence/divergence between and within EU MS. First of all, with respect to cross-country differences on the basis of GDP per capita, the literature review points to income convergence of EU MS between 2000 and 2009 (pre-crisis period and first years of financial crisis), divergence between 2009 and 2015 (austerity phase and exit from financial crisis), convergence between 2015 and 2019 (between-two-crises growth period) and divergence between 2019 and 2021 (pandemic crisis). It seems that the crisis periods were detrimental for the social cohesion of the EU.

Second, our analysis of trends over the 2008-2022 period on the basis of main social variables-indicators has proved that all "new" MS from the 2004, 2007 and 2013 enlargements of the EU, except Cyprus, have converged towards the older MS as regards the real per capita household disposable income and real wages while most of the southern EU MS (Greece, Cyprus, Italy and Spain) have diverged.

Third, southern and eastern EU MS are heterogenous groups when it comes to within-country income inequalities and poverty/social exclusion rates, but most of the southern European countries and half of the eastern European ones are those with the highest scores in income inequality and poverty/social exclusion rates in the EU. Southern Europe is also much more homogenous than Eastern Europe and 'new' MS as regards gender inequalities in access to employment – southern European countries appear among the EU MS with the lowest female employment rates and the largest gender employment gaps, while most of the eastern European countries have above EU average female employment rates and below EU average gender employment gaps. However, southern and eastern European countries are 'united' and internally homogenous in having the most privatized healthcare systems in the EU.

All in all, southern Europe is diverging from the EU -average in all main indicators of social well-being and cohesion, while 'new' MS are converging though from low starting points re per capita income and wages. At the same time, old EU MS of the 'core' and Scandinavian countries follow diverging trajectories. Most of them display rising income inequality and poverty and social exclusion rates. Moreover, with the exception of Germany and Sweden, they are stuck in a low productivity growth-low real wage growth or reductions nexus. This means that social cohesion is a big stake for both the EU and the Member States, while social divergences between MS over the past fifteen years are strongly associated with economic divergences triggered by the successive crises and the pre-2008 pattern of EU economic integration.

Graph 10



Source: Eurostat online database

However, the divergence of the European South is by far the biggest challenge, given that the Greek, Italian, Portuguese and Spanish governments are heavily indebted (Graph 10) and will have to implement restrictive fiscal policies from 2024 onwards. In the next section we assess whether the reform proposals of the European Commission are fit for addressing the issues of economic and social convergence and cohesion in the EU.

New EU fiscal rules and economic governance: More but insufficient fiscal space to face major challenges, with tighter control of compliance

Last April the European Commission presented legislative proposals for a comprehensive reform of the EU economic governance framework (European Commission 2023). The Ecofin Council agreed on the proposed reform in December 2023 and mandated the start of the consultation and negotiation procedures with the European Parliament on the required regulations and directive to put in place the new fiscal rules and economic governance framework. An agreement between the two bodies has to be reached before the 2024 European

elections, while the new rules and framework will be implemented from 2025. Hereafter we first explain the reasons and present the main features of the reform and then proceed to its assessment.

The debate on how to reform the EU framework of economic policy coordination and surveillance was initiated in 2015, as a response to the global financial crisis and the euro area sovereign debt crisis and gained momentum with the launch of the European Green Deal and the Covid-19 pandemic. For the proponents of the reform of the Stability and Growth Pact, more leeway in fiscal policies was needed to allow EU MS address two challenges (a) stabilise their economies, preserve public investment and their production capacity and protect the society in the face of shocks, long-lasting economic crises and major health crises, and (b) finance the necessary investment for the green and digital transitions without leaving anyone behind. The above debate evolved in parallel with the one on whether and in what form a common fiscal capacity should be established in the euro area and possibly in the EU (Theodoropoulou 2023).

The Commission's reform proposals

The Commission's proposed reform seeks to respond to the significantly higher levels of public debt in the aftermath of the pandemic by taking on board the lessons from the EU policy response to COVID-19. The key objective of the reform of EU fiscal rules and economic governance is to offer to the MS with high public debt the opportunity for a **smooth fiscal adjustment** that will allow them to **promote growth** through public investment and reforms and, at the same time, **improve debt sustainability**.

The legislative proposals introduce a **new fiscal surveillance process** for the coordination of MS economic policies, to be integrated in the European Semester. The new process makes EU economic governance simpler, places greater emphasis on the medium-term but also strengthens the power of the Council and the Commission to enforce compliance of MS with EU criteria for structural reforms and investment.

In the new process, MS will have to bring together their fiscal, reform and investment commitments **into a single medium-term fiscal-structural plan** setting out their fiscal, reform and investment policies over the course of four years. Fiscal surveillance under the European Semester will now focus on a **single operational indicator**, namely the MS's multi-year **net expenditure targets**, as endorsed by the Council, that will serve as a basis for carrying out annual fiscal surveillance over the lifetime of the MS's medium-term fiscal-structural plan.

The fiscal surveillance of MS with a government deficit above 3% or public debt above 60% of GDP will be based on fiscal policy commitments under their national fiscal adjustment paths i.e., on their net expenditure paths, spreading over four to seven years. The initial reference adjustment path for each MS will be informed by the **Commission's debt sustainability analysis** to ensure that debt is put on a plausibly downward path or stays at prudent levels at the end of the adjustment period, and that the deficit is brought and maintained below 3% of GDP in the medium term. For the MS in breach of the 3% deficit rule, a fiscal adjustment of 0.5% per annum will be required. For those with debt below 60% and deficits below 3%, the Commission will issue guidance based on the structural deficit to ensure that this remains the case.

The **European Semester** will remain the key channel for the Council to endorse the set of reform and investment commitments proposed by MS after an assessment by the Commission against clear common criteria set out in EU legislation (growth-enhancement, debt sustainability, common EU priorities and targets, Country-Specific

Recommendations/CSR[5]); and for the Commission to monitor the delivery of investment and reform commitments contained in MS recovery and resilience and medium-term fiscal-structural plans. The reforms and investments of the medium-term fiscal-structural plans should prevent or correct imbalances detected under the **Macroeconomic Imbalances Procedure**.

On the 21st of December 2023, the Ecofin Council agreed with the proposals by the Commission and integrated some new elements regarding the **excessive deficit procedure**. Firstly, in relation to the debt-based excessive deficit procedure, the Council added the increase of government spending on defence, among the other factors to be taken into account for assessing compliance with the deficit and/or the debt criteria of the MS concerned i.e., the degree of public debt challenges, the size of the deviation, and the progress in the implementation of reforms and investments. Secondly, the Council also decided that the Commission may, for a transitory period in 2025, 2026 and 2027, take into account the increase in interest payments in calculating the adjustment effort within the excessive deficit procedure.

Assessment of the proposed reform

The new fiscal surveillance process has positive aspects which are welcome: (a) the abolition of the 1/20th debt-reduction rule; (b) the replacement of the unobservable and unmeasurable structural deficit by the net expenditure as implementation indicator; (c) the differentiation of fiscal adjustment paths between countries by taking into account their size of their public debt challenges. This implies a smoother fiscal adjustment towards the targets of the Growth and Stability Pact than in the previous framework for the most indebted EU MS, among which all the southern European ones. However, concerning the formation, approval and implementation of medium-term adjustment plans, there is a trade-off between enjoying a tailored and, hence, context-appropriate fiscal policy, on one hand, and vesting non-transparent and potentially unaccountable power in the Commission, on the other (Sweeney and Canelli 2023).

In reality, the positive aspects of the reform are mitigated by the following downsides:

a) The **extent of fiscal leeway** will depend on the debt sustainability analysis which will be informed by the Commission and negotiated with MS; the assumptions for the analysis cannot avoid political assessments.
b) The reform offers to indebted MS **very little additional room for manoeuvre** in exchange of **a tighter control** by the Commission and the Council of their compliance with **EU criteria for investment and reforms** in the framework of the European Semester.[6] For Member States that face substantial public debt challenges, departures from the agreed fiscal adjustment path will by default lead to the opening of an excessive deficit procedure and **stricter sanctions**.
c) The reform **does not guarantee a sufficient**, or sufficiently even, fiscal space across MS to support the green and digital transitions and industrial

[5] Country-specific recommendations addressed by the Council to MS in the framework of the surveillance process under the European Semester.

[6] According to the Commissions' proposals, the set of reform and investment commitments will be endorsed by the Council after an assessment by the Commission against clear common criteria set out in the legislation. These criteria include whether the reform and investment commitments:
are growth-enhancing;
support debt sustainability; and
respond to common EU priorities and targets and relevant country-specific recommendations addressed to the Member State in the context of the European Semester.

policy, provide quality public services and tackle social inequalities;

d) The reform is **not coupled with** the extension of existing or the establishment of new **European fiscal capacity instruments** to assist MS to deal with the common challenges lying ahead and more so the MS with limited fiscal space and the greatest need for economic and social convergence.

e) The reform does not provide for an **integrated governance framework** that puts the attainment of economic, social and environmental policy goals on an equal footing.

Social convergence and cohesion between and within MS: alternative proposals for the new EU economic governance framework

The EEC/EU has a long record of promoting social convergence and cohesion between and within MS mainly through its "cohesion policy" and the European Structural Funds, but also through directives setting minimum labor and social standards and, in recent decades, through the coordination of employment and social policies.

The EU regional/cohesion policy aims at the upward economic and social convergence of the poorest with the richest regions/countries through the co-financing the National Regional Development Plans of the MS. Income is redistributed through the EU budget between the MS that are net contributors and those that are net recipients7. The Covid-19 pandemic crisis has been a catalyst for innovation. The SURE programme allowed MS to protect the jobs and income of workers and the self-employed, while EU cohesion policy was strengthened by a) the creation of the Just Transition Fund, to prevent/ address the social problems created in specific regions from transition to climate neutrality and b) NextGenerationEU which favoured the allocation of resources to the countries most affected by the Covid-19 pandemic crisis.

Since the late 1990s, the coordination of Member States' employment and social policies has also had some influence on social convergence and cohesion along with setting key objectives and targets for the EU as a whole. In 2017, the adoption of the European Pillar of Social Rights triggered an ambitious social policy agenda at EU level. From 2019 to 2022, a number of important Directives were issued on work-life balance, transparent and predictable working conditions, women's participation on the boards of listed companies and adequate minimum wages and pay transparency.

However, as we saw in the previous section, EU regional and social policy did not prevent the deterioration of EU social cohesion between 2008 and 2022, mainly due to the economic and social divergence of southern Europe during the eurozone debt crisis but also due to the deepening income and social inequalities in many "core" countries. Tackling the latter in Member States requires well-functioning collective bargaining and social dialogue, as well as redistributive fiscal and social policies that need adequate funding, especially in the countries with the greatest inequalities. Finally, it is now clear that the green and digital transitions are doomed to exacerbate social inequalities in the absence of public funds not only to invest in up/re-skilling and new jobs but

[7] Looking at the net positions of the 27 EU MS relative to gross national income (GNI), Busch et al. (2022) estimated that the largest net contributors to the EU budget in 2021 were Germany with 0.58 percent of GNI, Netherlands with 0.48 percent, Sweden with 0.46 percent and France and Denmark with 0.43 percent each. In terms of net recipients of the EU budget, Croatia leads the way with 3.08 percent of GNI, followed by Lithuania and Hungary with 3.05 and 2.89 percent, respectively, Bulgaria (2.84 percent), Latvia (2.76 percent), Estonia (2.76 percent), Greece (2.57 percent), Slovakia (1.84 percent), Romania (1.76 percent), Portugal (1.54 percent) and Czechia (1.37 percent).

also to provide income compensation or early retirement opportunities to workers made redundant. Furthermore, funding from NextGenerationEU will be available until 2025-2026 and that from the Just Transition Fund is insufficient. In the near future, MS will have to find their own resources to prevent the deepening of social inequalities and protect social cohesion.

For all these reasons, the EU member states need sufficient fiscal space at the national level and thus we focus on three alternative proposals to those of the European Commission for the reform the EU's economic governance framework and beyond:

First, is the idea of an **integrated governance framework** that puts the attainment of economic, social and environmental policy goals on an equal footing. In order to strengthen the social dimension of the European Semester, to promote upward social convergence and reduce inequalities, the Belgian and Spanish governments proposed at the Porto Summit in 2021 to integrate into the European Semester a '**Social Imbalances Procedure'** (SIP) that would identify, prevent and address the social imbalances that negatively affect the working and living conditions in EU countries and reflect the divergence of each Member State from the common targets and the overarching objectives of the upward social convergence. The procedure would include an alert mechanism and the issuing of Country Specific Recommendation for social imbalances in a critical situation. Fiscal and macroeconomic recommendations should not hamper the correction of social imbalances identified. On the contrary, they should support it by adequate investments and appropriate financial resources for policy response. However, there is no mention of the provision of additional EU funds to MS with critical imbalances to help them correct them.

In July 2022, the Spanish presidency asked the opinion of the European Economic and Social Committee (EESC) on the SIP, which was favourable. The EESC (2023) also recommended that existing rules for funds allocation (ESIF, RRF and others) should become more flexible after negotiations so that they are quickly adapted to correct the social imbalances of countries in critical situation, identified through the SIP. However, the EESC did not recommend enhanced targeted EU financial support to the countries in need and with great divergence.

Given that the Members States were divided on the possible added value of the SIP, the Employment and the Social Protection Committees (EMCO and SPC) were mandated by the French, Czech and Swedish Presidencies to explore ways in which to reinforce the social dimension of the European Semester. The EMCO and SPC submitted in May 2023 a joint proposal to the European Council to introduce a **"Social Converge Framework**" in the European Semester (Council of the European Union 2023). The new framework will be meant to foster a shared understanding of challenges to upward social convergence and improve the pertinence of country-specific recommendations addressed by the European Council to the Member States that make little progress towards the attainment of the EU headline employment and social policy goals through the preparation and publication by the European Commission of "Social Convergence Reports" for the above Members States. These will be based on the findings from the Social Scoreboard indicators and in-depth analysis of qualitative information. However, this is an even more watered-down version of the SIP proposal than that of the EESC.

Another proposal is that '**social investments'** should be discounted from the deficit and debt rules (Hemerijck and Huguenot-Noël 2022)[8]. This is a variant of

[8] Hemerijck and Huguenot-Noël show that expansive European welfare states investing in their citizens, from early childhood education and care to

what other economists call a 'targeted golden rule' whereby public investments should not be counted toward deficits or debt when deemed to benefit the next generation (e.g., investment in education and training, greening the economy etc.) (Bofinger 2022, van den Noord 2023). Last but not least, ETUC (2022) proposes a general application of the golden rule: all net public investments should be financed by debt and excluded from balanced-budget rules. This however requires the elimination of the debt brake from the German Basic Law.

ETUC (2023) has recently proposed a more comprehensive alternative:

- An **EU sovereignty fund for just socio-ecological transition** to finance important projects of common European interest;
- **A European pact for employment and investments** which would include (a) a benchmark for public investments that keeps Europe ahead of key global competitors (b) minimum quantitative benchmarks on public investment growth and net investment levels (c) a golden rule for investments (d) an EU-debt financed budget for investments;
- **A social convergence procedure** that detects and removes **social imbalances** (SIP) with the possibility for social partners to submit negotiated CSRs;
- A **permanent instrument for stabilizing employment** on a revised SURE model.

It is worth stressing that the golden rule for (social) investment is not so important for heavily indebted countries; these, on the contrary, benefit from the creation of additional EU fiscal capacity distributed to MS according to convergence needs and financed either from the fiscal base of EU MS or through the issuing of common EU pubic debt. Last but not least, without additional and targeted financial support of MS with critical social imbalances, a Social Imbalances Procedure may become a disciplinary mechanism for EU MS that do not comply to neoliberal policies recommended by EU institutions.

Conclusion

The trends of social convergence/divergence and evolution of inequalities between and within the EU member states over the past fifteen years, point in the direction of the erosion of its social cohesion between 2008 and 2022. Most of the developed countries of the "core" saw an increase in income inequalities and poverty while throughout the period, the old and new EU 'periphery" followed opposite trajectories. Southern Europe (the old periphery) initially diverged from the countries of the "core" and later on from the EU-27 average, while the new EU MS (the new periphery) converged.

The erosion of social cohesion in most of the old MS, as well as the large income disparities and the inability of the welfare state in most of the Southern European and the new EU MS to provide equal access to basic social services such as healthcare, constitute major challenges that should to be taken into account by the pending reform of EU economic governance. Moreover, in spite of their social convergence, the gap in the disposable income per capita between the new MS and those of the 'core' is still huge. However, the economic and social divergence of southern European countries is by far the biggest challenge for EU cohesion policy, given the size of their sovereign debt and their inability to adopt a different economic and social development model from the one that

active ageing, have engendered virtuous circles of employment and productivity enlarging the revenues on which they depend while the social-investment paradigm, they argue, proved the 'unsung hero' of the Great Recession, cushioning the big welfare states in particular through the credit crunch and the eurozone crisis. They also maintain that the climate crisis should not now imply a turn away to 'hard', infrastructural investment since 'resilient welfare states are the sine qua non for a "just transition".'

proved unsustainable with the 2008 Great Recession.

The new fiscal rules and surveillance process proposed by the European Commission to replace the Fiscal Compact seek to ensure the sustainability of public finances in all EU MS, while providing them with greater fiscal space for public investment in green and digital transitions, taking into account that the overindebted MS are the ones facing the greatest challenges. However, the proposed reform of the EU economic governance framework fails to fill the gaps of the EU cohesion policy in dealing with the social divergences and inequalities between and within the MS that have occurred over the last fifteen years and eroded the social cohesion of the EU.

Having examined in this paper the European Commission's proposal for the new EU fiscal rules and surveillance and economic governance process, we come to the conclusion that, while it certainly has positive aspects, it provides the over-indebted member states with very little additional fiscal room for maneuver in exchange for a stricter control by the Commission and the Council of their compliance with the EU criteria for eligible investments and appropriate structural reforms at the national level. At the same time, the reform is not coupled by a provision/proposal for the (permanent) extension of the EU's fiscal capacity after the end of the NextGenerationEU, which would help on the one hand the MS to cope with the ecological, technological and industrial transformation of their economies, on the other hand the EU to fill the gaps in its cohesion policy, in order to address the economic and social disparities and inequalities between and within the MS that undermine its social cohesion and fuel social discontent and the rise of the extreme right. The lack of national and European fiscal space is glaring at the current juncture when member states are called upon to implement a restrictive fiscal policy in an international environment of high interest rates that depress investment and job growth and the huge challenges ahead that require major public expenditure. The EU should not tie itself down at such critical moments.

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