

# Navigating Constraints for Progress: Examining the Impact of EU Fiscal Rules on Social and Green Investments

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**The political agreement between the Council and the European Parliament has introduced new numerical debt and deficit benchmarks, mandating annual reductions in debt and deficits that will require unnecessary budget cuts. Comparing the political agreement on fiscal rules to estimated social and green investment gaps shows that only three countries (Denmark, Sweden, Ireland) can afford to meet social and green investment needs under these rules. Even if the grants under the Recovery and Resilience Facility (RRF) were to continue post-2026, only five countries (Denmark, Sweden, Ireland, Croatia, and Lithuania) would be able to meet at least minimum social and green investments needs. To allow all member states to meet their social and green public investment needs, an additional €300-420bn a year (2.1-2.9% of EU GDP) annually would be needed.**

The Commission's legislative proposal<sup>1</sup> on fiscal rules marked a step in the right direction, at least recognising the positive impacts of quality public investment on the economy and debt sustainability. However, the revised regulations are fixated on achieving economically ungrounded<sup>2</sup> debt and deficit-to-GDP ratios, and relegate reforms and investments to secondary concerns. They fail to prioritise pressing social, climate, employment, and demographic challenges amid a backdrop of widening social disparities, accelerating climate change, geopolitical tensions at Europe's borders, and an ageing population. Addressing these challenges demands increasing public investments to meet substantial investment gaps.

The EU's fiscal rules are restrictions on public spending designed to ensure debt sustainability. They are built based on the Maastricht criteria, which require governments to maintain budget deficits and public debt below 3% and 60% of GDP, respectively. New fiscal rules were proposed by the Commission in April 2023 and negotiated by the Council and Parliament, with final votes expected in April 2024. Although the objective was to simplify the rules and allow some flexibility to governments to increase debt for public investments to grow the economy and thereby improve debt sustainability, the final compromise includes a series of strict numerical debt and deficit reduction requirements, which limit the flexibility of countries to use public investments to grow out of debt. These rules will require countries to follow specific reference pathways which will require many countries to make budget cuts. The IMF<sup>3</sup> now finds that, on average, this type of fiscal consolidation does not reduce debt-to-GDP and instead increases total debt. As this paper will show, unnecessarily restricting borrowing for quality public investments can

harm the economy and undermine debt sustainability.

The workforce that powers Europe's essential services and goods needs the tools to deliver. Yet, over recent years, these workers are increasingly faced with inadequate infrastructure, equipment, and training<sup>4</sup>, as well as chronic understaffing<sup>5</sup>. A reactive approach that continues to underinvest means infrastructure decaying further, foregoing the upskilling crucial to ensuring Europe continues along a path of high productivity and high added-value, as well as missing the moment to make crucial investments towards climate neutrality. This would lead to worse public services and higher cost to renew or replace infrastructure, and also risks rendering Europe more vulnerable to climate, social, economic, and geopolitical threats.

Moreover, we are witnessing a surge in protests against the unequal distributional effects of current climate action, where the burden falls disproportionately on ordinary people while the extremely rich are not contributing a fair share<sup>6</sup>. A fair transition requires governments to support ordinary people. This means supporting working communities at the frontline of the transition. Only by safeguarding its ability to stimulate the creation and maintenance of quality jobs can Europe anticipate and manage change while preventing the further entrenching of inequalities. Basic infrastructure such as energy grids and transport networks, upon which industry, households and the climate transition rely, requires extremely large up-front investment. These can only be absorbed through fiscal flexibility coupled with progressive taxation that ensures the wealthiest pay their fair share.

The initial repercussions of fiscal rules are already evident. France, for instance, has announced a €1.4 billion reduction in its green transition budget<sup>7</sup>, slashing



investments in energy-efficient home renovations, a move that could ultimately necessitate greater public spending in the future<sup>8</sup> (e.g., higher climate adaptation costs or energy subsidies for low-income families). The Finnish government has announced a catalogue of social welfare cuts<sup>9</sup> and espoused an austerity narrative. Meanwhile, Germany has made substantial budget cuts<sup>10</sup>, including cuts to green investments, which the research institute, Ifo, has shown would have a detrimental effect on economic growth<sup>11</sup> (and thereby also debt sustainability).

This paper will assess the new EU fiscal rules against social and green investment gaps to show that the new rules are insufficient to meet EU social and environmental goals. It will explain why missing social and green investment gaps will make Europe poorer, and harm the EU's social fabric, productive capacity, and ability to invest towards a stronger and more resilient economy. It will finally lay out policy solutions, including continuing to negotiate fiscal rules, progressive taxation, and establishing a long-term investment fund.

## Importance of public investment to meet social and green investment needs

While adequately regulated private finance has a role to play, it has proven to be largely insufficient over the last decades to fill social and green spending gaps, evidenced by the fact private markets have not filled the large gaps outlined in Figure 1.

Furthermore, public services have become increasingly privatised either through governments outsourcing provision of services<sup>12</sup> or explicitly selling off government assets<sup>13</sup>. This privatisation has led to lower quality of public services<sup>14</sup>, which has widened the need for public investments to improve quality. Such privatisation was likely encouraged by short-term cost-saving measures in an era of austerity<sup>15</sup>, but is now in fact causing long-term costs.

Public private partnerships<sup>16</sup> have been another way that private markets have exerted influence

on previously publicly provided services. These have failed to deliver value for money, costing more than public borrowing and ultimately still leaving costs for the public sector to pick up<sup>17</sup>, despite profits falling in private hands<sup>18</sup>. This has increased costs for the users of services<sup>19</sup> and encourages interventions where infrastructure would be profitable rather than where it is needed<sup>20</sup>.

The cost of living crisis has shown that public authorities need to play a greater role to steer our economy and implementing policies to make our lives more affordable. “Fossilflation”<sup>21</sup>, where fossil fuel prices rise due to increased demand or supply constraints leading to inflation and “sellers-inflation”<sup>22</sup>, where big companies have the power to raise prices due to limited competition or high demand, have demonstrated the opportunities for governments to intervene in green energy and challenge market power.

Investing in education, healthcare, long-term care, and childcare yields numerous benefits for society at large, extending far beyond the immediate recipients of these services. These investments lay the groundwork for a healthier, more productive, and more equitable society, ultimately contributing to overall economic growth and stability. When governments allocate funds to improve education, for example, it not only enhances individual learning outcomes but also boosts workforce productivity and innovation<sup>23</sup>. A well-educated population is better equipped to adapt to changing economic demands, driving long-term economic growth and competitiveness. Similarly, investments in healthcare lead to healthier populations and improved labour force participation. Moreover, public investment in long-term care services supports aging populations and individuals with disabilities, enabling them to lead independent and dignified



lives. Additionally, investments in childcare support working families by enabling parents to participate in the labour force, promoting gender equality, and fostering early childhood development, which lays the foundation for future academic and social success<sup>24</sup>.

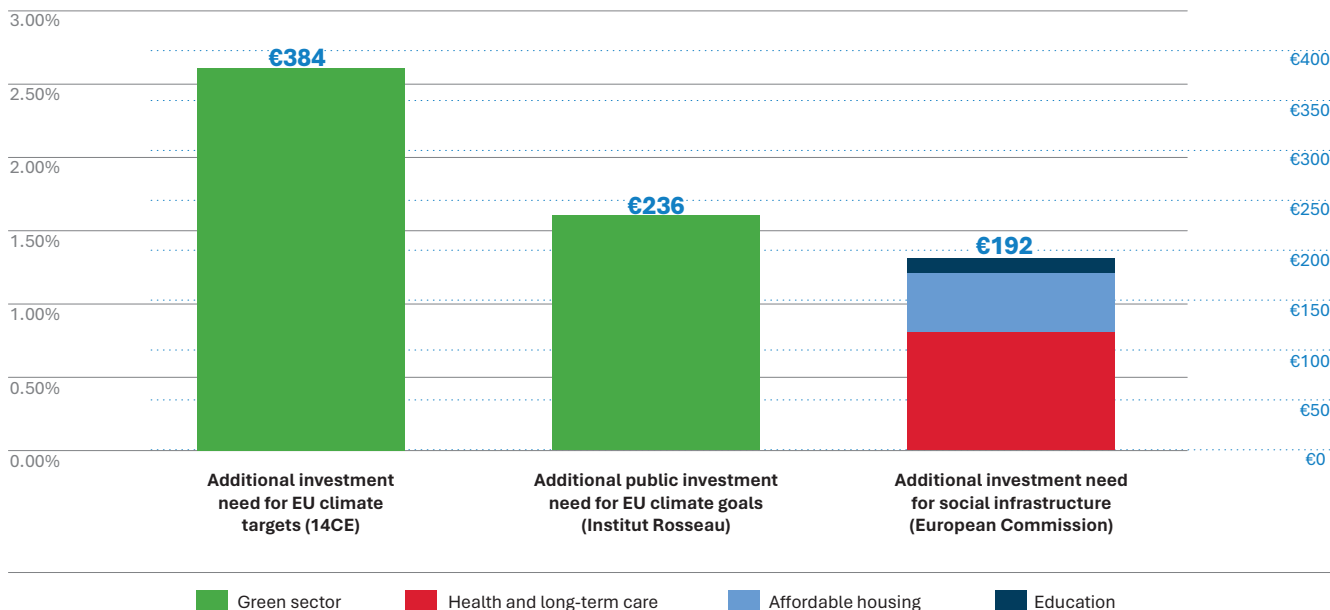
The current discourse surrounding the energy transition assumes that once renewable energy sources become cheaper than fossil fuels, the shift will be swift. However, while renewables may compete with fossil fuels on price, the crucial factor for private investors influencing their decisions is expected profit and renewables are unlikely to provide comparable profits to producers as the profit margins are much lower compared to fossil fuels<sup>25</sup>. To overcome this problem, governments need to implement green industrial policies that favour green or net-zero sectors, while supporting workers in heavily polluting sectors to transition to different jobs. The most efficient way to do this is by using socially conditioned<sup>26</sup> public funds for industrial policies,

and public procurement that incentivises vital transition and net-zero sectors (e.g., renewables, energy efficiency and public transport), while phasing out public support for fossil fuels and other polluting sectors.

Figure 1 shows estimated EU social and green investment gaps. The first bar shows the estimated additional public and private investment needed to achieve European Green Deal objectives, requiring €406bn (2.6% of EU GDP)<sup>27</sup>. The second column shows just the additional public investment to meet the European Green Deal objectives, requiring €260bn (1.6% of EU GDP)<sup>28</sup>. These estimates look at investment needs across a range of areas including greening the power grid, ecosystem protection and pollution prevention<sup>29</sup>. The third column shows the additional public and private investment needed for social infrastructure, requiring €192bn (1.3% of EU GDP)<sup>30</sup>. This includes the need for school and hospital buildings, affordable housing, medical equipment,

**FIGURE 1.** The EU has large investment gaps to meet its green and social goals

**Annual investment gaps (% of GDP, €bns in 2021 GDP)**



Note: Euro figures in graph different to text as adjusted for 2021 GDP



ICT infrastructure, education and training facilities, research and development programmes, and energy efficiency of public buildings. Note this does not include salary or utility costs, as these would be viewed as current day-to-day spending rather than investment.

Funding social and green public investment through borrowing presents several advantages, particularly for initiatives aimed at stimulating economic development and infrastructure development. Borrowing allows governments to spread the cost of investments over time, thereby avoiding immediate implications on tax and spending decisions. This approach enables crucial projects to proceed without the need for immediate tax increases or cuts to existing services. When investing in long-term assets that generate returns over an extended period, such as improving education, transportation infrastructure or renewable energy projects, borrowing can pay for itself. This is because some investments have an outsized multiplier effect, i.e. the final change in economic output is larger than the initial

amount invested. This has been shown to be particularly true for green investments<sup>31</sup>, but also investments in key public services like childcare (See NEF's blog on investing in early years education pays for itself<sup>32</sup>). Focussing borrowing on areas that generate economic growth can help make a country's debt more sustainable<sup>33</sup>.

On the other hand, current social spending like pensions and social security should be financed through progressive taxation. Progressive taxation ensures that those with higher incomes contribute proportionately more to the funding of social programs, thereby redistributing incomes, reducing inequality, and promoting social cohesion. Moreover, progressive taxation can be tailored to target wealthier individuals or corporations, who may have a greater capacity to contribute towards addressing social needs. Overly restrictive fiscal rules, however, mean that governments rationalise cuts to current social spending<sup>34</sup>, to allow for public investments. This is a false dichotomy.

Public investments towards robust social foundations, including improved schools, healthcare facilities, and youth services, are not only key to individual well-being but also critical for the overall strength and prosperity of our economies and societies. Quality education and healthcare contribute directly to a skilled and healthy workforce, enhancing productivity and innovation.

Public investments in the transition are also essential to speed up, make more accessible and contribute to reducing the cost of living. For instance, investments to renovate social housing, or to allow people to receive subsidies for rooftop solar, would significantly reduce the cost-of-living. Similarly, investments in good quality public transport improves access to work and cuts carbon emissions. In contrast, a transition without



sufficient green public investments and focused primarily on pricing carbon (e.g. European Trading System for cars and heating), will mean higher costs and impacts for the vast majority of households<sup>35</sup>. Meanwhile wealthier households have the private capital to invest in electric vehicles, renewables, energy efficiency and heat pumps, and so avoid the carbon price, or are more able to live with the higher cost and continue to pollute. Indeed, the German Environment Agency recently warned that current climate measures risk social unrest if households aren't supported sufficiently<sup>36</sup>. Green public investments are an indispensable ingredient for a socially-just transition.

There has been significant divergence in economic performance between North and South since the global financial crisis, in part due to austerity cuts<sup>37</sup>. This is likely to increase, as some member states have spent much more state aid than others and are likely to continue to do so, as fiscal rules require more fiscal consolidation from some member states compared to others. Designing EU economic

policies, including fiscal policy and industrial policies, requires explicit attention that all member states are able to use public investments towards agreed political objectives, without having to unnecessarily carry out austerity measures.

Moreover, failing to increase public investments in industrial policy may prevent the EU from counteracting the “very worrying trend”<sup>38</sup> of deindustrialisation in the EU<sup>39</sup>. Allowing deindustrialisation to continue would have significant negative effects on Europe’s economic strength and resilience, and also create economic struggles for affected individuals and communities<sup>40,41</sup>. With geopolitical tensions and climate-related trade disruptions likely to only increase in the next few years, Europe desperately needs an investment strategy that builds towards the EU strengthening its manufacturing base and growing manufacturing of key technologies, such as solar panels and heat pumps. Public funding to industry should always be linked to social conditions, such as respect for collective bargaining and workforce upskilling. Environmental conditions could also be considered, such as decarbonising value chains, sourcing resources sustainably and incentivising the development of energy and material-efficient products (e.g. lighter vehicles).

The USA federal government has opted for public investments to stimulate the green and high-tech manufacturing sector<sup>42</sup>. According to the US [Treasury Department](#)<sup>43</sup> this has resulted in a significant surge in total manufacturing plant construction, while real spending on computer, electronics, and electrical manufacturing – areas prioritised for public investment through initiatives like CHIPS and Science Act and the Inflation Reduction Act – has nearly quadrupled in the past year. According to Deutsche Bank<sup>44</sup>, the U.S. has seen the commencement



of construction for 18 new semiconductor facilities between 2021 and 2023. Cumulatively, manufacturing construction spending is currently at its highest level in six decades<sup>45</sup>.

The US experience adds further evidence that, when coupled with social conditionalities, public investment is crucial to delivering an industrial policy that protects and creates quality jobs today and into the future. The EU is currently facing a very large workforce shortage<sup>46</sup>, but its industrial policy approach does not include social conditions so far. The Inflation Reduction Act mandates firms seeking tax credits to hire apprentices for at least 15% of the work, support unionization, support the payment of fair wages, and set up in deprived or former fossil-heavy regions.

## Can the EU afford its green and social investment gaps?

As discussed earlier, the EU desperately needs an increase in social and green public investment. According to the Commission<sup>47</sup>, the EU currently has a social investment gap (e.g. in education, healthcare and affordable housing infrastructure) of €192bn (1.3% of EU GDP in 2021). The Institute for Climate Economics (I4CE) has calculated the EU is only meeting half of its climate investment needs<sup>48</sup> to deliver EU targets leaving an investment gap of €406bn (2.6% of EU GDP in 2022). Note that both of these figures are investment gaps – they do not include day-to-day spending.

Plugging the green and social investment funding gap isn't the sole responsibility of governments, as the gap includes private sector investment as well. However, public investment is essential in delivering social infrastructure, public services, and a fair



transition, as well as targeted and conditional industrial policy.

## Methodology

For social infrastructure investment needs, there are few reports that discuss the public and private split of social investments and none to our knowledge that try to calculate needs by country. Therefore, we use a range of estimates found in the literature and construct our own methodology for identifying social public investment needs per country. In 2018, when the European Commission first calculated its social investment gap<sup>49</sup>, it noted that public sector finances “on average around 90% [of social infrastructure] and varies across sectors.” Therefore, we use this as an upper bound for the expected public investment share of the social infrastructure investment gaps. This would imply just over €170bn of the €192bn gap should be funded by governments.

To get a lower bound estimate, we look at estimates for the public share by sector. The European Commission's €192bn is made up of €15bn on education investment, €120bn of health and long-term care investment and €57bn in



affordable housing investment (as seen in Figure 2). The European Investment Bank has calculated<sup>50</sup> the trajectory of the public and private share of investment in the health and education sectors. Up to 2040, they see the public investment share of healthcare decreasing, with governments only responsible for 40% of total investment in 2040 compared to 65% in 2018. However, in education they see the public share staying stable around 80%. Additionally, a paper by the European Social Housing Observatory<sup>51</sup> shows that affordable housing typically meets 35% of its funding costs through public financing. Therefore, combined with the European Investment Bank estimates, this gives us a lower bound for public share, amounting to just under €80bn funded through public finance of the total €192bn gap.

Therefore, our modelling looks at the affordability of an EU-wide package costing between €80-170bn a year. This range of estimates is useful as it can help account for the fact that closing investment gaps may need an increased share of investment coming from governments and allows for different approaches

taken by governments to meet social investment needs.

Furthermore, to split up the costs by country we employ two different methods for identifying social investment needs. First, we look at all government investment (gross fixed capital formation) in the three relevant sectors: health, education, and housing. Using the investment gaps calculated by the EU Commission, we calculate a gap for each country that would bring it to the EU's hypothetical average after investment. The spending needs per country are proportional to these investment gaps. For example, if a country has a social investment gap half the EU's average, it should get half the average spend, whereas if it has a gap that is double the size it should get double the average spend. If a country has a negative investment gap, then we assume that these countries do not need extra investment.

However, low investment levels may reflect historic large spending so, as a second method, we also look at metrics that measure social need to make sure data reflects this. For health we look at healthy life years expectancy (HLYE) per country, for education we look at the population aged 15-24 not in employment, education nor training (NEETs), and for housing we look at housing cost overburdening rate, the percentage of people paying more than 40% of their income on housing. For NEETs and housing cost overburdening, we adjust a country's need proportional to the EU average – i.e., if a country has double the NEETs of the EU average it should receive double the average support and, similarly, half the average support for housing cost overburdening if a country is at half of the EU average. For HLYE, we assume every country targets the highest HLYE seen in the EU plus two years, as increasing healthy life years by two years has been an EU target in the past<sup>52</sup> and a common goal for all countries can help reduce health inequalities.

After calculating the gap between this goal and a country’s average we compare this to the gap for the EU average. If a country’s HLYE gap is double the EU’s average, it should receive double the average amount of support and half if it is half the average.

We use both investment and needs-based metrics as we understand that the determinants of differences between countries are not purely economic and cannot be solved just by spending more. Together this gives us a range of estimates that provide an illustrative example of how social spending could be broken up in the EU. In reality, such spending would be divided up by a much more intricate process, but we hope by including a range of scenarios our results can capture this somewhat.

For green spending, a recent analysis by Institute Rousseau<sup>53</sup> suggests the EU needs at least an increase of 1.6% of GDP of public

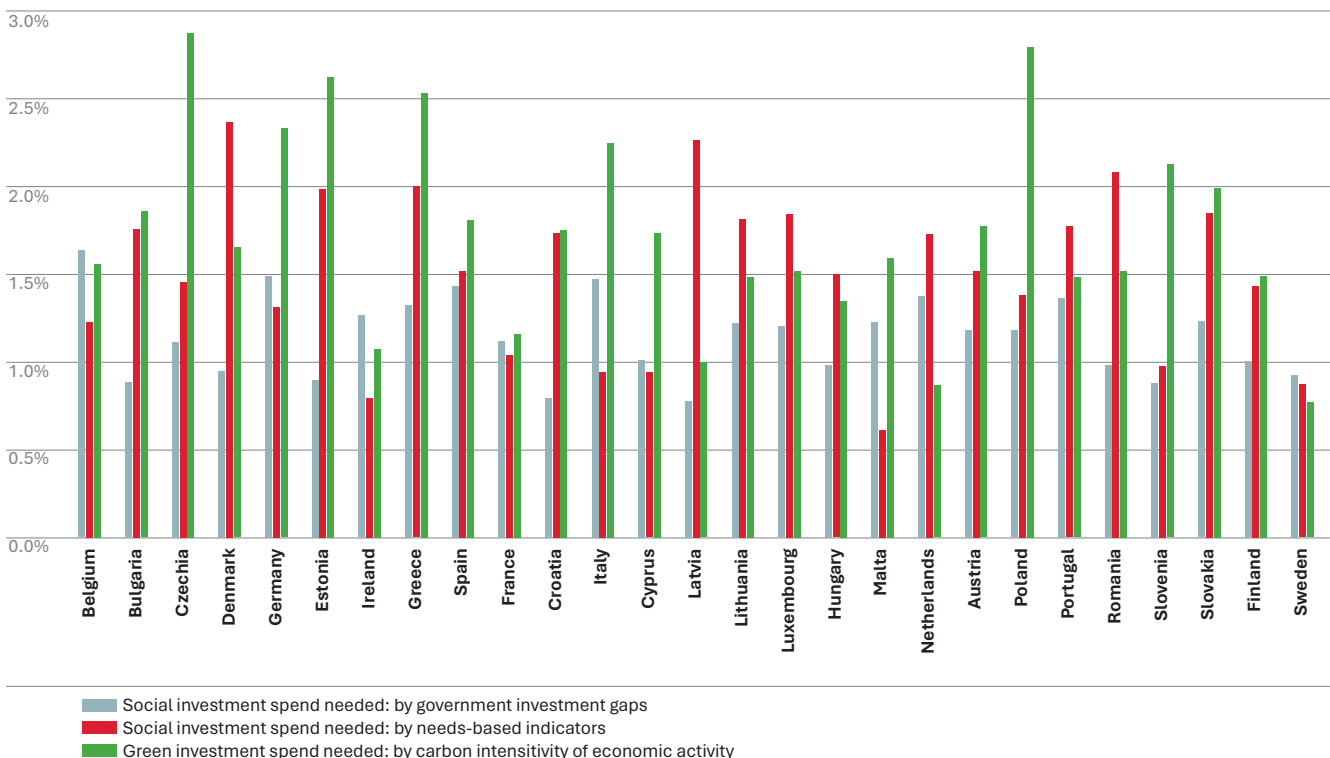
investments to meet its climate obligations. Comparing to I4CE’s figures, this suggests a public share of around 60% to fill these green investment gaps.

To understand the green investment needs per country we can follow Paul van den Noord’s (2023) methodology<sup>54</sup>, where countries’ investment need is calculated by their relative carbon intensiveness of economic activity measured by CO<sub>2</sub> emissions per € of GDP. For example, if a country has the average level of EU carbon intensiveness, it should commit 1.6% of its GDP, which is proportional to the average level of investment needed across the EU. In contrast, a country with half the carbon intensiveness of the EU average would need to commit half of this and a country with double the intensiveness would commit double.

Figure 2 above shows how these social and green investment needs

**FIGURE 2.** Countries require different levels of spending to address social and green investment gaps

**Social and Green Investment Need By Country (% GDP)**



**Note:** NEF analysis of Eurostat and European Commission Investment Gaps

could be split up by country. For social investment, countries that have a need of over 1.3% of GDP have above average government investment gaps in social sectors or above average social needs according to the indicators above. Similarly, for green public investment, countries with investment needs above 1.6% have above average carbon intensiveness of their economic activity.

After adjusting social investment for the high and low public share scenarios explained above, we can now compare the social and green public investment gaps to the fiscal space governments will have.

### Results

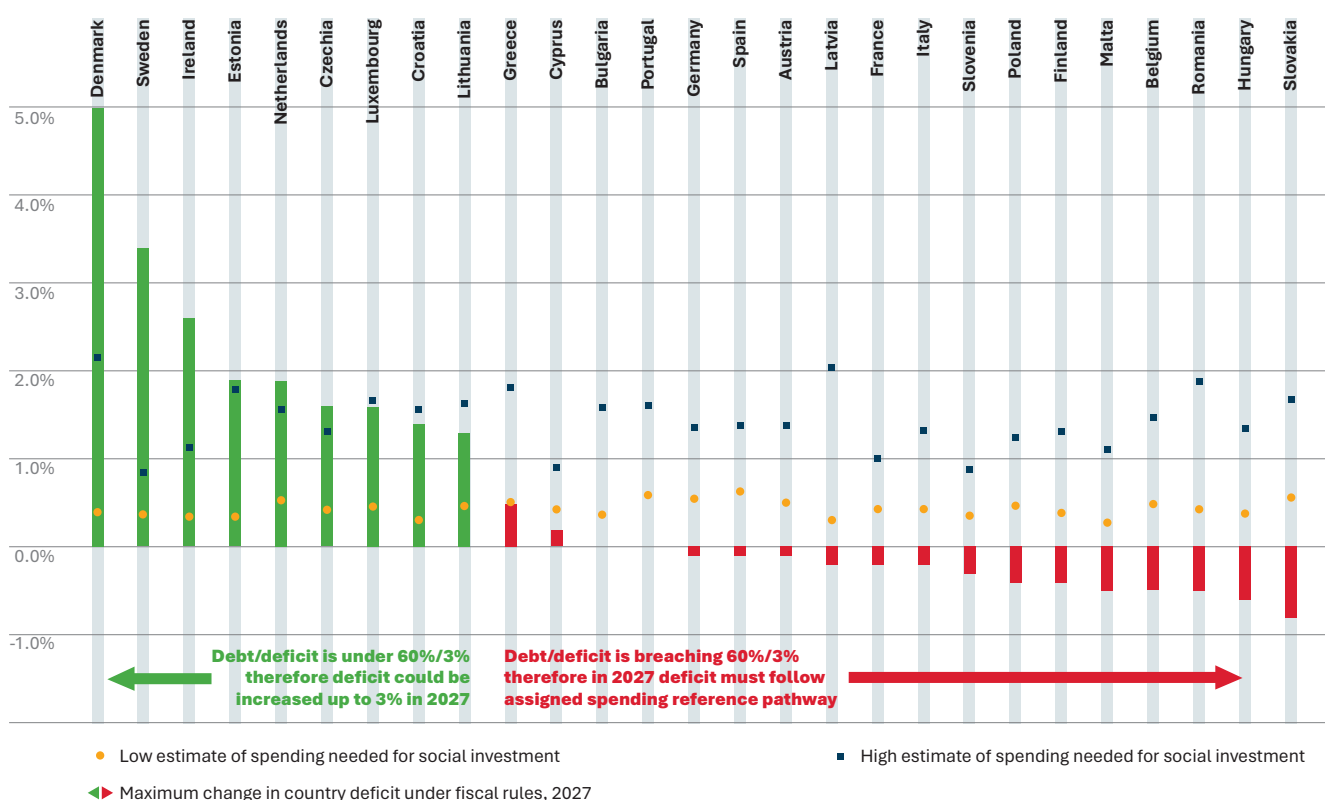
Using Commission projections for deficits under the European Council’s proposal for fiscal rules, we see that all countries breaching fiscal limits would be unable to

meet our minimum estimate for social spend, as shown in figure 3. This is because the majority would be on reference pathways that require cuts in their deficits (bar Greece and Cyprus whose reference pathways allow deficits to increase but under the condition debt-to-GDP is still falling), and therefore such investments would have to be funded through further cuts or increased taxation.

Interestingly, all countries unaffected by the 60% debt and 3% deficit limit would be able to increase their deficits and afford our estimate for the minimum social investment required, if this is all they spent their extra fiscal space under the EU rules on. However, Luxembourg, Croatia and Lithuania would not be able to meet social investments if these were assessed at our higher estimate. Furthermore, while we show such investment gaps are affordable under the EU’s fiscal rules this does not necessarily mean all countries

**FIGURE 3.** Only countries not breaching fiscal rules could meet social investment gaps

Increase in deficits allowed under fiscal rules in 2027 compared to social investment gaps (% of GDP)



Note: NEF analysis of Eurostat and European Commission data

would comply – they may spend on other priorities, not deem these investment gaps important or have their own fiscal rules on top of the EU’s that limit spending further.

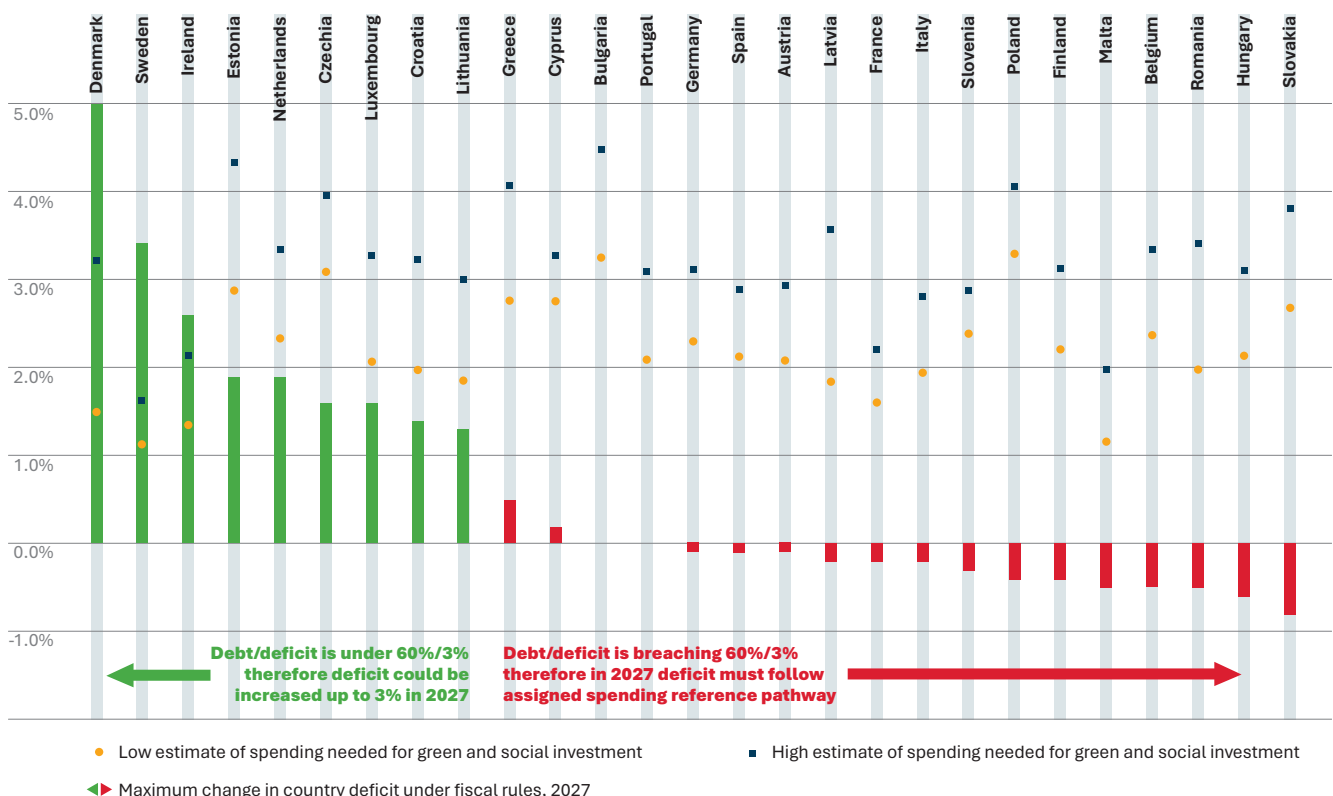
Furthermore, even if investment gaps are seen as important to address by member states, we have so far left out green investment gaps and therefore adding in green investment is needed to see the full picture. Adding in green public investment gaps implies only three countries (Denmark, Sweden, Ireland) can afford to meet social and climate targets under the EU’s fiscal rules, as shown in Figure 4. These results show how even the majority of countries that currently meet the EU’s fiscal rules will be unable to afford to meet their social and green investment gaps as they will become limited by the 3% deficit rule.

The EU’s fiscal rules will constrain countries’ budgets and force social, green and other policies

to compete politically for extra funds. However, green, and social investments don’t have to compete and there are examples of measures that create jobs and are both social and green, e.g., improving the energy efficiency of schools and hospitals, and retrofitting social homes. The EU’s Recovery and Resilience Facility (RRF)<sup>55</sup> has provided an example of this. The RRF raised funds on capital markets on the entire EU’s behalf in the aftermath of the pandemic. The money raised is used to provide grant and loan funding to EU member states to facilitate the green and digital transition and meet goals on social policy cohesion. Some of these projects have been assessed to jointly meet green and social needs. However, according to Bruegel analysis of the RRF<sup>56</sup>, only 2.5% of social and green investments made were considered to have overlap in achieving both environmental and social goals. By focusing on investments that are

**FIGURE 4.** Only three countries could afford to meet their green and social investment gaps under new EU fiscal rules

Increase in deficits allowed under fiscal rules in 2027 compared to green and social investment gaps (% of GDP)



Note: NEF analysis of Eurostat and European Commission data

both social and green, countries can bring their combined social and green gaps down.

Furthermore, countries should be granted more fiscal capacity to meet their social and green investment targets. The RRF will end at the end of 2026, with no additional funds available in 2027 if no new EU debt-financed facility is created. We model the impact reintroducing the RRF grants could have if countries received the average yearly grant over the 2021-2026 time period in 2027. This scenario would give countries some extra space and would enable Croatia and Lithuania to meet our lower estimate of social and green investment need, as shown below in Figure 5. It is also important to note that if countries have to cut their budgets at the same time as receiving grants, then budget cuts may simply create further social<sup>57</sup> and green<sup>58</sup> investment needs in the long-term,

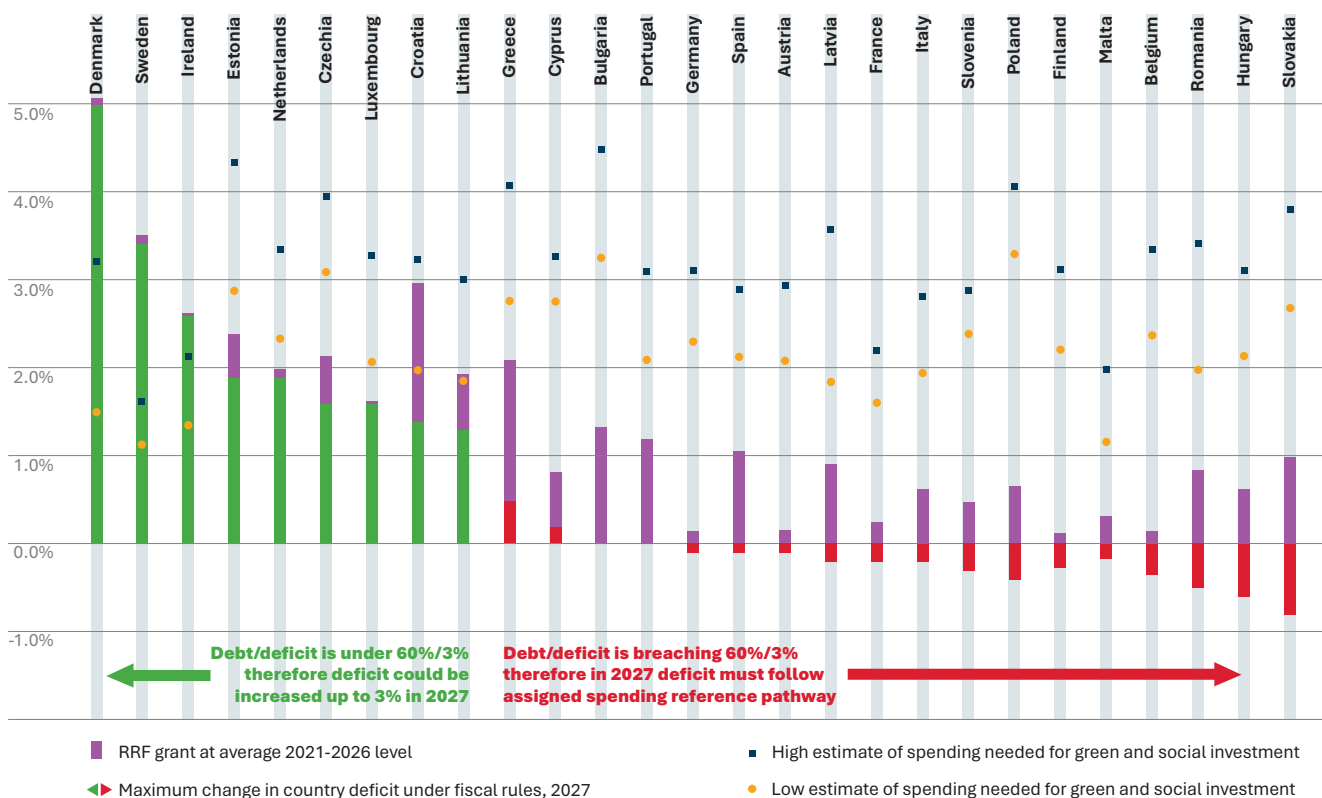
as they have in the past<sup>59</sup>, reducing the impact of improvements in the long-term.

Therefore, with only five countries able to meet social and green investment targets, even if the RRF is extended, it highlights the tightness of the fiscal rules and the inability for the EU to fill its social and green investment gaps under its current framework. To meet such challenges will require policy ambition and honesty around the restrictive nature of fiscal rules.

Therefore, the above results show that by and large the EU will not be able to meet its social and green investments through increased borrowing if it sticks to its fiscal rules with no changes. Yet, these rules are political decisions not economic fundamentals. Such challenges can be overcome with other policies, but the EU will be limiting itself unnecessarily so long as it sticks to fiscal

**FIGURE 5.** Even if the Recovery and Resilience Facility was reintroduced only five countries could meet green and social investment gaps

Increase in deficits allowed under fiscal rules in 2027 compared to green and social investment gaps (% of GDP)



Note: NEF analysis of Eurostat and European Commission data

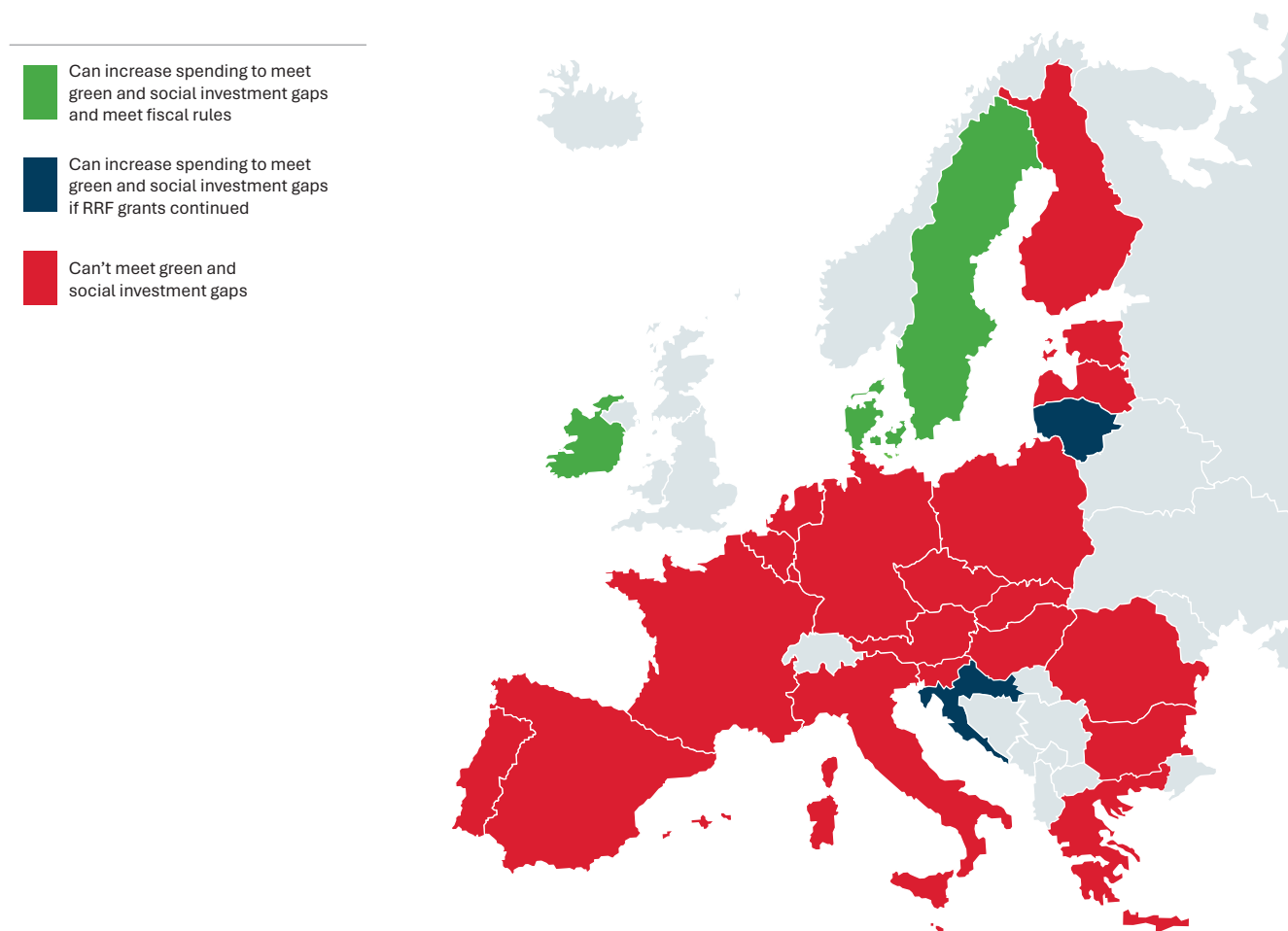
rules that limit borrowing even for necessary social and green investments. Especially, as many of these investments have an outsized multiplier effect and can significantly contribute to debt sustainability.

Figure 6 shows the results of our analysis as a map chart. Countries that are coloured green can meet social and green investment gaps with current fiscal rules, countries coloured in orange would be able to meet green investment gaps if the RRF grants were to be continued, and countries coloured red would not be able to meet social and green investment gaps.

For all member states to meet their additional funding requirements, around €300-420 billion (2.1-2.9% of EU GDP) annually would be

required, assuming funding was perfectly allocated for countries to meet our calculated green and social gap estimates. To make sure such a large gap can be met, the EU must consider reforms to its current economic framework and policies. Below we look at the possibility of more flexible fiscal rules, new progressive taxation, and the creation of a long-term EU investment fund to create more space to meet these gaps.

**FIGURE 6.** Map of social and green investment gaps compared to fiscal rules and continuation of RRF grants





## Recommendations

The following policy reforms should be considered.

### EU fiscal rules

The reformed rules focus on achieving arbitrary debt and deficit-to-GDP ratios, while they should have moved towards more effective criteria for ensuring debt and deficit sustainability, in particular paying increased attention to the quality of public spending. Reforms and investments remain an afterthought in the final text. The rules do not constitute an adequate response to the challenges ahead: accelerating climate change, economic and social divergence, poverty and inequality, fundamental changes to the world of work, and war on EU's borders. All these challenges require a deep transformation of our economy.

The final compromise is a setback from the Commission's original proposal, which allowed for more, albeit still insufficient, flexibility to trigger quality public investments, as the proposal allowed for more discretion and did not include as many numerical benchmarks. Applying the debt sustainability analysis (DSA) methodology<sup>60</sup> requires significant fiscal adjustments<sup>61</sup> from Member States. The inclusion of new arbitrary numerical safeguards - particularly the so-called deficit resilience safeguard, which adds a requirement for those countries above the 3% deficit-to-GDP or 60% debt-to-GDP thresholds to reduce their structural deficit<sup>62</sup> to below 1.5% of GDP - is further tightening existing arbitrary and problematic constraints. Overall, the combination of different requirements leads to very heterogeneous and extremely demanding fiscal adjustment for Member States.

Added numerical safeguards lead to confusing, unequal rules for different Member States. For instance, the deficit resilience



safeguard would impose very different obligations on Member States who are just above 60% of debt-to-GDP and 3% of deficit-to-GDP thresholds than for Member States just below.

### Progressive taxation

Inequalities in Europe have deepened, particularly in the wake of the COVID-19 crisis<sup>63</sup>. Profit gains have led to a surge in dividends<sup>64</sup> and stock-buy backs<sup>65</sup>, while investment has not filled green and social investment gaps.

The European Union has recognised the imperative for a socio-ecological overhaul of our economies<sup>66</sup>. Yet, financing this transition via public borrowing faces challenges, as we have shown in this paper. Utilising policy instruments with regressive distributional impacts could exacerbate vulnerabilities among the most disadvantaged. Progressive taxation, including addressing artificially shifting profits overseas, increasing corporate tax to 25%, equalising the rates of capital gains and dividends taxation with income tax, a net-wealth tax on ultra-high net-worth individuals, and other forms

of progressive taxation could be considered.

Profit shifting is when multinational companies reduce their tax burden by moving the location of their profits from high-tax countries to low-tax jurisdictions and tax havens. The European Union's efforts to address profit shifting - and establish fair corporate taxation have faced setbacks, notably with the withdrawal of proposals like the Common Consolidated Corporate Tax Base (CCCTB). Despite calls for measures against profit shifting, the Business in Europe: Framework for Income Taxation (BEFIT) initiative appears lenient, allowing multinational corporations to continue shifting profits within the EU<sup>67</sup>. The European Commission's delayed consideration of formulary apportionment until 2031 raises concerns about the initiative's effectiveness in curbing profit-shifting practices.

Tax competition and corporate tax avoidance have broader implications for workers, including the depletion of public budgets, reduced financing for public services, income inequalities, and obstacles to obtaining a fair

share of corporate profits through collective bargaining. The EU could establish a minimum corporate tax rate of at least 25%. The EU Tax Observatory<sup>68</sup> shows that this would boost EU corporate income tax revenues by approximately €170 billion a year in 2021, surpassing 50% of the current corporate tax revenue collected in the European Union and constituting 12% of total EU health spending. Factoring in the collection of a portion of the tax deficit owed by non-EU multinationals, this figure could increase to €200 billion a year.

Finally, governments should prioritise moving towards a progressive tax system. Policy makers should, for example, investigate equalising the rates of capital gains tax and dividends tax with income tax, a net-wealth tax on ultra-high net-worth individuals, and other forms of progressive taxation to raise funds to finance quality public services, targeted and conditional green industrial policy and a socially-just transition. Such a move, ideally, allows a reduction in the tax for low-income households.

### Long-term EU investment fund

The Next Generation EU fund, which was set up to respond to the Covid-19 pandemic, was deemed as a success by the Commission<sup>69</sup>. There is a compelling case for establishing a more sizeable long-term EU investment capacity to allow all European governments to meet their social and green investment needs. The Next Generation EU program, designed as a response to the challenges posed by the COVID-19 pandemic, has proven to be a crucial tool in fostering recovery and accelerating the green and digital transitions<sup>70</sup>. However, the need for ongoing investment in key areas such as infrastructure, innovation, and social cohesion persists beyond the immediate crisis. A long-term EU investment capacity would provide a stable and predictable framework for



addressing structural challenges and promoting strategic projects that contribute to the Union's objectives. This sustained commitment to investment can stimulate job creation, enhance competitiveness, and bolster Europe's position in the global economy. Moreover, it would reinforce the EU's ability to tackle emerging challenges, such as climate change and technological advancements, by supporting research and development, fostering innovation, and promoting a more sustainable and inclusive economic model. By extending the momentum generated by Next Generation EU, a long-term investment capacity would ensure that the European Union remains at the forefront of economic progress and resilience in the years to come. Nevertheless, implementing a long-term EU investment fund is not sufficient on its own, and fiscal rules must be reformed sensibly to recognise public investment's role in strengthening our economies and contributing to debt sustainability.

Paired with targeted social conditionality, a sufficiently resourced EU investment fund would have a double benefit. By ensuring that workers bargain collectively to claim fair salaries or require upskilling and the hiring of apprentices, public finance can be leveraged to maximise the protection and creation of quality jobs across Europe. Furthermore, conditionality can be used to focus employment creation in areas that are most in need and reduce regional inequality and strengthen social cohesion. Ensuring public money delivers for the common good will boost confidence in EU and national institutions.

## Conclusion

This analysis reveals that the final political agreement on EU fiscal rules introduces stringent debt and deficit benchmarks, which result in only three countries, Denmark, Sweden, and Ireland, being able to afford the necessary social and green investments. Only an additional two, Croatia and Lithuania, could meet social and green investment needs if the grants under the RRF were to continue.

These conclusions show that, politicians should reject the approach of prioritising arbitrarily reducing debt and deficit ratios over pressing social, climate, and employment challenges. Such cuts make Europe poorer, harm the EU's social fabric, productive capacity, and ability to invest towards a stronger and more resilient economy. Addressing these challenges demands increased public investments, especially in social infrastructure and green initiatives, to promote economic development and mitigate climate risks.

For all member states to meet their additional funding requirements, an estimated €300-420 billion (2.1-2.9% of EU GDP) annually would be required, assuming funding was perfectly allocated for countries to meet our calculated green and social gap estimates. This could be covered by more flexible fiscal rules, new progressive taxation, and the creation of a long-term EU investment fund. Without action, these gaps will only grow and cause significant problems down the line. The EU should treat this matter with urgency.

# Endnotes

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