Towards 'Europe 2020'? Austerity and new economic governance in the EU

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1. Introduction

The financial crisis that broke out in 2008 has turned into an economic and public debt crisis that has swept the EU, with a severe impact on the economies and labour markets of member states. Output growth turned negative in several countries and stagnated elsewhere; unemployment rose; and public debt and deficits soared. Partly in response to the crisis and partly within the framework of a longer-term growth and reform agenda, the EU spelled out the Europe 2020 Strategy in 2010, which for the first time put inclusive growth on an equal footing with smart and sustainable growth – at least on paper. To that end, a headline target of moving 20 million people out of poverty by 2020 was set. The strategy calls for structural reforms in several areas, as well as for steering the public finances of member states onto a sustainable path as soon as possible.

Moreover, in response to the debt crisis that has been threatening the very existence of the euro zone and as a complement to the Europe 2020 Strategy, the architecture of the EU’s economic governance has come under scrutiny with the aim of introducing reforms that would strengthen it against similar crises in the future. At the same time, the euro-zone member states have been trying to contain the public debt crisis which, at the time of writing (September 2013), has spread to seven member states and has become a systemic threat to banking systems in the EU.

National policies in the context of the Europe 2020 Strategy and the new economic governance are to be streamlined and coordinated within what is now called the ‘European Semester’, which is essentially the annual policymaking cycle in the EU. However, both the economic governance reforms and the austerity measures pursued as a response to the debt
crisis have attracted criticism for pushing the European economy into a double-dip recession and strangling growth for several years to come. This risks undermining the objectives of the Europe 2020 Strategy, including that of inclusive growth.

This chapter analyses whether the recent EU economic governance reforms and the austerity measures are likely to affect the prospects of achieving the headline target of lifting 20 million people out of poverty. Fiscal austerity, as pursued in several member states, has been delaying output and employment recovery, leading to prolonged and structural unemployment which is associated with detachment from the labour market. According to the Europe 2020 Strategy, the means of achieving inclusive growth are increasing employment, improving skills and fighting poverty. In this chapter, we focus on poverty because employment creation and improved skills have failed to deliver in terms of reducing poverty in the context of the Lisbon Strategy (Cantillon 2011). Moreover, in the face of the ongoing creation of substandard employment, with its danger of keeping people in low-wage employment, the development of poverty figures tell us more about inclusion than the mere monitoring of employment rates or developments in skills.

The chapter is structured as follows. In Section 2, we provide an empirical picture of the impact of the crisis on labour market outcomes and public finances in order to get a sense of the problems and put into context the macroeconomic policy directions that the new economic governance and initiatives to resolve the crisis propose. In Section 3, we present the policy responses to the crisis and critically evaluate their potential to deliver growth. In Section 4, we analyse the Commission recommendations to member states in the context of the European Semester, the medium-term policy plans of member states in terms of – in particular – social spending and the measures already taken as part of the fiscal austerity packages in several member states in order to assess whether fiscal measures undermine and/or override measures for reducing poverty. Section 5 concludes. To support our arguments, we draw on comparative data sources, such as the European Labour Force Survey and national accounts, official EU level and national policy documents and evidence from national experts on austerity programmes (Matsaganis and Leventi 2011; Theodoropoulou and Watt 2011).
2. The economic crisis in Europe

In this section, we provide an empirical view of the impact of the crisis in Europe with regard to output, employment and unemployment. We also review the evolution of European governments’ public debt and budget balances. All these are crucial parameters for assessing the economic governance reforms and the fiscal austerity measures in terms of their potential to help tackle the current economic crisis and support the Europe 2020 Strategy in meeting its poverty headline target.

2.1 Bleak labour market developments

EU27 average unemployment stood at 10.9 per cent in the second quarter of 2013, 4 percentage points up from the second quarter of 2008 (Figure 1). Employment fell in the same period by 1.7 percentage points

Figure 1 Development of unemployment rates, 2008Q2, 2010Q2, 2013Q2

Note: Unemployment rates for population aged 15–64 years. Figures for the second quarter used as 2013 annual figures not yet available.
Source: Eurostat online data base (Labour Force Survey).
on average. The labour market impact of the large output shocks – average output in the EU fell by 4.3 per cent in 2009 – was thus considerable. At the same time, as Figure 1 illustrates, there has been significant variation in developments in unemployment (and employment) rates in Europe. Particularly Spain and Greece, Ireland, Portugal, Cyprus and the Baltic countries saw huge increases in unemployment and large drops in employment and – with the exception of the Baltic countries, which have recently seen considerable improvements – were among the countries with the highest unemployment rates in 2012. Looking at the initial crisis period (second quarter of 2008–second quarter of 2009) in the Baltic countries rising unemployment was coupled with considerably larger than average falls in output, whereas unemployment in Spain, for example, increased markedly despite below average falls in output (for details, refer to ETUI/ETUC 2012). This points to the absence of such things as working time measures, active labour market policies or early retirement and other exit schemes that can act as buffers. The working of such buffers was particularly evident in the case of Germany, one of the few countries that saw unemployment dropping despite an above average drop in output (for details on the operation of buffers in the crisis, see Leschke and Watt 2010).

Looking at the most recent crisis phase, output fell on average by 0.4 per cent (2012), whereas the previous two years had seen average growth. Also, unemployment was still rising in most countries and employment declining in 10 countries. Figure 2 presents the most recent developments in terms of output, employment and unemployment (2012 compared with 2011). Output is still or again declining in 14 countries, notably in Greece and Portugal, whereas some countries are showing output growth of more than 3 per cent, notably Latvia, Estonia and Lithuania, albeit following remarkably large output losses. In this one year period, Greece, Cyprus, Spain and Portugal saw unemployment increase by more than 3 percentage points and by as much as 6.6 percentage points in Greece. At the same time, employment was declining still further, especially in Greece, Cyprus, Portugal and Spain. Looking at the five countries that initially experienced the biggest labour market impact from the crisis we see in particular Spain and, to a lesser degree, Ireland still doing comparatively badly. This contrasts sharply with the Baltic countries where we see major output growth in the most recent period (following the massive contraction there) and strong increases in employment and decreases in unemployment. It is worth noting that the Baltic States at the same time experienced large outflows of labour (Galgóczi et al. 2012).
Figure 2  GDP,* employment and unemployment rates, 2012 (change compared with 2011)

Notes: * GDP as used in Figure 2 refers to gross domestic product at market prices. Employment and unemployment rates for population 15–64 years of age. Source: Eurostat online data base (national accounts and Labour Force Survey).
All in all, the picture that emerges from output and labour market developments in the EU from the beginning of the economic crisis until today is bleak. The end of the initial downturn did not do much to reverse the initial employment losses. We are now in the middle of a double-dip recession, with evidence of deep-seated problems in the financial sector, against the background of the unresolved sovereign debt crisis (although the picture may be brighter in individual countries).

There are negative feedback loops between the state of the labour market, the vulnerability of financial institutions and the sovereign debt crisis. In the short term, uncertainty over growth and employment restrains bank lending and firms’ recruitment. This also makes it more difficult to consolidate public finances, which creates further uncertainty. On the labour market the concern is that lower employment and higher unemployment rates will become entrenched, as happened for instance in the mid-1990s.¹ If the appropriate macroeconomic demand-side measures are not – or cannot – be deployed, the use of market-oriented structural policies increases the risk of poverty and social exclusion. We return to this issue in more detail below.

2.2 The crisis and the state of public finances

The economic crisis that began in the last quarter of 2008 has had substantial and varied effects on public finances in European countries (Figures 3 and 4). On average, the gross public debt to GDP ratio in the EU27 rose from 59 per cent in 2007 (66 per cent in the euro area) to 87 per cent in 2012 (93 per cent in the euro area), while it is expected to rise further to 91 per cent by 2014 (96 per cent in the euro area).² Several EU member states saw their public debt to GDP ratios rise to levels that wiped out the fiscal consolidation of the past 25 years or more. Most notably, Ireland’s debt to GDP ratio rose by 93 percentage points from 25 to 118 per cent between 2007 and 2012 and it is expected to reach 119 per cent of Irish GDP in 2014. Portugal, Spain and the United Kingdom saw rises in their gross debt to GDP ratios of 46–55 percentage points. The Greek ratio climbed from 107 to 157 per cent between 2007 and 2012, but only following the ‘voluntary’ haircut that was agreed in October 2011, and it is expected to go up further to 175 per cent of GDP by 2014.

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¹ www.social-europe.eu/2011/08/rising-unemployment-please-not-199596-all-over-again/
² All figures and forecasts from the AMECO database.
Divisive integration. The triumph of failed ideas in Europe – revisited
In the United Kingdom, the ratio increased from 44 to 87 per cent during the same period and is forecast to reach 91 per cent by 2014. Portugal and Spain also suffered debt to GDP increases of 48 to 55 percentage points between 2007 and 2012, although only the Portuguese ratio has exceeded 100 per cent of GDP, with that of Spain remaining below the EU/euro area averages.

The increases in the gross debt to GDP ratio reflect two factors: first, the deterioration of government budget balances across Europe due to the crisis, reflecting the operation of the automatic stabilisers (Watt 2011), the discretionary stimulus packages (Watt 2009) and the measures to bail out the financial sector; secondly, the contraction of GDP. The average budget deficit rose from 0.9 per cent of GDP in 2007 (0.7 per cent in the euro area) to 4.0 per cent in 2012 (3.7 per cent in the euro area) (Figure 5). Although these average figures conceal a wide variation, only a minority of 11 member states complied with the Stability and Growth Pact’s 3 per cent deficit limit in 2012.

As the credit crunch/financial crisis of 2007–2008 turned into a real-economy crisis, and doubts about the capacity of Greece to repay its debt
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Figure 5: General government budget deficit, EU, 2007, 2010, 2012, 2014 (% of GDP)

Source: AMECO data.
arose in the markets, the failure of European leaders to give a credible and timely guarantee that a member of the euro zone would not (partly) default and the refusal of the ECB to undertake the role of lender of last resort for governments sparked contagion and a debt crisis (DeGrauwe 2011a). It is true that the Greek debt to GDP ratio was relatively high in 2009; however, its sustainability depended not only on this ratio but also on future government balances, the growth rate of the economy and the interest payments the government has to incur in order to keep rolling over its debt. The lack of guarantee meant that the interest rate required from the Greek government to keep on rolling over its debt started to increase, turning what could have been a liquidity problem into a solvency problem (DeGrauwe 2011b). This lack of confidence then spread to other euro-zone members with either high debt to GDP ratios or rapidly increasing government budget deficits. By early 2011, Ireland and Portugal had also sought financial support from the EU and the IMF in order to keep rolling over their public debt, while in the summer of 2011 Spain and Italy also faced very high yield spreads for their government bonds compared with German ones. Eventually, in the summer of 2012 Spain sought financial support to recapitalise its banks, while in 2013 Cyprus became the fourth member state to receive a government bail-out conditional upon a severe adjustment programme.

Due to the failure to provide adequate solutions the Greek, Irish and Portuguese debts continued to rise (in the Greek case, even after the ‘haircut’), because under the financial ‘support’ programmes their governments have been effectively loaded with more debt, carrying relatively high interest rates (which were lowered following the European Council meeting of July 2011). At the same time, the severe austerity programmes that were imposed as a condition for receiving aid plunged the three economies into major recession, which worked counter to fiscal consolidation by reducing public revenues, raising benefit expenditure and making spending cuts all the more difficult politically. Recession in those countries, but also in member states facing difficulties financing their public debt in financial markets, has taken a toll on banking systems. The number of non-performing loans increased, deteriorating the balance sheets of the banks that had granted them and thus putting into question their soundness. This created a vicious circle between a banking and a fiscal crisis. Expectations on governments to step in and bail out ailing banks increased negative sentiments on the sustainability of public finances, while governments’ financial difficulties fuelled further fears about the soundness of banking systems.
Summing up, we can see profound effects on European labour markets and government budgets from the crisis with, at the same time, great variation between countries. Against this background we now turn to consider the policies implemented in Europe to the extent that they are driven by European policymaking initiatives and processes. First, we describe the main policy initiatives taken at European level since the crisis, before analysing how they have affected – and will continue to affect – national policy choices and also policy outcomes.


3.1 Europe 2020 Strategy

Partly in response to the crisis, but partly within the framework of a longer-term reform agenda, the European Union has embarked on a complex, multi-layered process of changing the framework within which not only economic but also a wide range of employment-related, social and other policies are designed and implemented by both member states and the European institutions. This process is ongoing. In this section we summarise some of the key developments, focusing on those particularly relevant to the issue of inclusive growth and the headline target with regard to poverty.

The Europe 2020 Strategy is the successor to the Lisbon Strategy, launched in 2000, which ended formally in 2010. Lisbon formulated the strategic goal of becoming ‘the most competitive and dynamic knowledge-based economy in the world, capable of sustainable growth with more and better jobs and greater social cohesion’; this goal was underpinned by a number of EU-level targets. The Europe 2020 priorities and strategy closely resemble those of Lisbon despite the fact that the European Union was not able to deliver on the targets (European Commission 2010a) and probably would not have done so even in the absence of the economic crisis (for a critical account, see Pochet 2010).

The Europe 2020 Strategy puts forward three ‘mutually reinforcing’ growth paradigms: smart growth through knowledge and innovation; sustainable growth entailing resource efficiency and a greener and more competitive economy; and inclusive growth, focusing on high em-
ployment and social and territorial cohesion (European Commission 2010d). Thus, even the social and environmental issues are framed in terms of the growth paradigm. Five headline targets for 2020, covering employment, R&D, climate/energy, education and poverty for the EU as a whole, reflect this strategy.3 The Council’s 10 integrated guidelines for implementation of the Strategy (six focusing on economic policies, three on employment and one on social inclusion and poverty reduction) are supposed to steer and guide reforms in the member states, whereby they are subject to conformity with the fiscal rules of the Stability and Growth Pact (European Commission 2010b). The so-called seven flagship initiatives spell out the policy measures to be undertaken jointly by EU-level and national actors, which concern the policy areas regarded as most important.

In response to the economic crisis that has revealed the interdependencies and spillovers between different areas, the Europe 2020 Strategy seeks to align macroeconomic policy developments and structural reforms within the framework of the so-called ‘European semester’. Stability and Convergence Programmes (which focus on fiscal issues) and National Reform Programmes (covering a wide range of structural policies) are now to be prepared at the same time in the first half of each year to ensure more coherence in reporting, evaluation and recommendations on thematic, as well as on economic and budgetary issues. These can then be fed into the finalisation of national budgets (ex ante policy coordination).4 The aim is to strengthen budgetary discipline and promote macroeconomic stability and growth in line with the Europe 2020 aims.

In the social and employment field, most European coordination takes place through soft law mechanisms, namely the open method of coordination, (OMC), with little leverage for putting pressure on member states to implement or desist from certain policies. As part of the OMC, recommendations are issued (see below) but there are no sanction mechanisms.

3. The targets are as follows: an employment rate of 75 per cent for people aged 20–64; 3 per cent of EU GDP invested in R&D; a list of climate/energy targets; reducing the proportion of early school leavers to below 10 per cent and at the same time increasing the share of young people with tertiary education to at least 40 per cent; and reducing the number of people at risk of poverty in the EU by at least 20 million.

4. This is a further step towards aligning various policy fields. The process started after the mid-term evaluation of the Lisbon Strategy in 2004 when economic, employment and social policies were better integrated by implementing common guidelines and using a common reporting system, the National Reform Programmes.
The components of inclusive growth, in the Europe 2020 definition, are increasing employment, improving skills and fighting poverty (European Commission 2010d: 16–18). Under the general heading of poverty, the focus is on child poverty but also the working poor and the exposure of the unemployed to poverty. It can be considered a step forward that the social dimension has been integrated into the overall Europe 2020 Strategy, but the fact that it is so closely intertwined with employment issues makes it uncertain whether and how member states will address the social inclusion guideline (Zeitlin 2010: 262).

The new Europe 2020 poverty target – to lift 20 million (or one in six) people out of poverty and social exclusion – reflects the need for political compromise (for details, see Mailand 2011). This is illustrated notably by the fact that the EU27 target is measured on the basis of three combined indicators: at-risk-of-poverty rate, severe material deprivation rate and households with very low work intensity. This combination of monetary (relative income poverty) and non-monetary (material deprivation and exclusion from the labour market) components of poverty is supposed to reflect the multifaceted nature of poverty. A key point is that member states can choose whether they want to use the composite EU definition for monitoring poverty or set targets on the basis of a subset of the three indicators or on the basis of national indicators reflecting the specific country situation. Most countries have applied the EU definition but an important subset of countries use other definitions, the most popular being the ‘at-risk-of-poverty rate’ (for a provisional list, see Council of the European Union 2011: 3–4).

Previous assessments of the Lisbon Strategy that also focused on growth, employment creation and skills upgrading suggest disappointing outcomes with regard to poverty (Cantillon 2011). Other research has also pointed out that substantial inequalities exist within groups of people

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5. Persons with an equivalised disposable income below the at-risk-of-poverty threshold, which is defined as 60 per cent of the national median equivalised disposable income after social transfers.
6. Severe deprivation is defined as experiencing at least four out of nine deprivation items. The deprivation items are as follows: cannot afford to: pay rent or utility bills; keep home adequately warm; face unexpected expenses; eat meat, fish or a protein equivalent every second day; take a week’s holiday away from home; or buy a car, a washing machine, a colour TV or a telephone.
7. Defined as persons aged 0–59 living in households in which adults worked less than 20 per cent of their total work potential during the past year.
8. For detailed information on the social dimension of the Europe 2020 Strategy see Council of the European Union, 18 February 2011.
with similar skill levels (Franzini 2011). In other words, employment growth and skills acquisition have been shown to be far from unequivocal paths to more social cohesion, even when macroeconomic conditions were more conducive than currently. Depressed output growth, massive increases in unemployment and pressures to decentralise collective wage bargaining are likely to make these links even weaker.

3.2 Economic governance reforms

The Europe 2020 Strategy was drawn up and launched at a time when the European economy – and especially the euro zone – was facing the deepest economic crisis since its inception. In the case of the euro zone, the debt crisis exposed the shortcomings of the economic governance architecture put into place starting in 1992.

A succession of reforms has been implemented over recent years, with initiatives from the European institutions increasingly overlapping with intergovernmental initiatives. The result is a highly complex and confusing institutional mix. The impact of these reforms will become apparent only in the coming years. We seek here to bring out the most important developments and provide an assessment focusing on the impact on inequality and inclusive growth.

The direct European support to countries in difficulty consisted of three main elements. First IMF/EU/ECB (the so-called Troika) financial support packages were put together for Greece, Ireland and Portugal, followed in 2013 by Cyprus. Secondly, the European Financial Support Facility (EFSF) was established as a temporary vehicle supporting euro-zone governments facing prohibitively high interest rates for financing their debt in the markets. Following the creation of a permanent fund, the European Financial Stability Mechanism (ESM), in October 2012 the activities of the EFSF have been gradually wound down. The two funds issue bonds, the proceeds of which are lent on to countries at reduced interest rates in return for fiscal and structural reform commitments. Thirdly, the ECB launched the Securities Markets Programme (SMP) under which it began buying euro-zone governments’ bonds.

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9. An official overview is provided here: http://ec.europa.eu/economy_finance/economic_governance/
At the same time, the spreading of the crisis and its implications forced a rethink with regard to the economic governance institutions and procedures that were in place, leading to a number of important changes at European level.

During 2011 a bundle of economic governance measures, known as the ‘six-pack’, went through the legislative process and entered into force on 13 December. Four of the sets of measures were related to the coordination of fiscal policy and involved strengthening the provisions of the Stability and Growth Pact. The other two related to the issue of ‘macroeconomic imbalances’ – the competitiveness and current account imbalances that had built up prior to the crisis in the euro zone. In May 2013 the fiscal rules were supplemented further, for euro countries only, by the so-called ‘two-pack’, which did not tighten the substance of the regulations but did intensify the frequency of the monitoring and surveillance processes.10 As if this were not enough, in the interval all members of the EU except the United Kingdom and the Czech Republic signed the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. More popularly known as the Fiscal Compact, the agreement was signed in March 2012 and came into force, for the 16 countries that had at the time ratified it, on 1 January 2013. The main feature of the fiscal compact is an obligation to institute an independent fiscal council at national level and commit to running a balanced structural budget (defined as less than 0.5 per cent of GDP unless debt is significantly below 60 per cent).

Overall, the plethora of overlapping new fiscal instruments considerably reinforce the surveillance of fiscal policy under the Stability and Growth Pact (SGP). Latitude in interpreting real-time deviations from a country’s MTO (medium-term objective) has been reduced. A notable change is an insistence on compliance with the debt criterion (60 per cent of GDP), which had previously essentially been ignored and can now constitute grounds, irrespective of the size of the current deficit, for launching the Excessive Deficit Procedure. Countries will be required to achieve rapid downward adjustment towards the threshold (one-twentieth of the gap between the current and target debt-to-GDP ratio per year). The sanctions regime under both the preventive and corrective arms of the Pact is to be tightened, with a more graduated range of sanctions, coupled with

the application of the reverse voting mechanism that makes it harder for member states to block a Commission recommendation to impose sanctions: the member state threatened by sanctions will have to obtain a qualified majority to overturn the recommendation (as opposed to a qualified majority being necessary in order to endorse the sanction recommendation). Sanctions can now be imposed in an amount up to 0.5 per cent of national GDP. Particular regard is to be paid to the expenditure side of the budget, with a norm of linking expenditure to the medium-term rate of economic growth. More attention is also to be paid to fiscal institutions in the member states in order to improve the basis for decision-making and ensuring the provision of correct data.

Surveillance of member states is also to be substantially broadened in comparison with the previous narrow emphasis on the fiscal stance. A new, so-called excessive imbalance procedure (EIP) was introduced under the six-pack, modelled on the excessive deficit procedure in the SGP. Under the EIP the competitiveness and current account positions (see Box 1) of all member states are assessed against a ‘scoreboard’ of relevant indicators. The Commission and the Council can make recommendations to member states if the imbalances are held to be excessive and injurious. Like the SGP there is also a corrective arm under which member states (in the euro area) can be sanctioned for failing to comply with recommendations. A country can be required to deposit up to 0.1 per cent of GDP with the European Commission which, in the case of repeated non-compliance, can be converted into a fine. Decisions on sanctions are taken by the Council, but subject to the new ‘reverse majority’ procedure described above.

In *procedural* terms the European semester and other efforts at strengthening the coordination of economic policymaking can be welcomed as bringing about much needed policymaking coordination. It is a step in the direction of ‘economic governance’ that many from the outset considered indispensable for the operation of a monetary union. The problem, notably in the first year of its operation, was the misguided *substantive* thrust given by the first Annual Growth Survey. One important focus of the reforms is a substantial intensification of the longstanding but largely unjustified and unhealthy European obsession with fiscal deficits and public debt. This not least raises the danger of a dangerous intensification of fiscal austerity and neglecting cyclical stabilisation. The focus on the expenditure side is likely to have negative distributional implications and thus is inimical to inclusive growth.
The attention to be paid to macroeconomic imbalances is, in principle, justified in light of what has been learned during the crisis (see Box 1). However, there are serious concerns about how wage setting at the national level is supposed to be ‘policed’ by policymakers at both EU and national level. The scoreboard used to operationalise the EIP imposes adjustment one-sidedly on deficit countries, rather than taking a symmetrical approach to the correction of imbalances. This is most obvious in the case of the monitoring of current account imbalances themselves, which are considered problematic for deficit countries in excess of (minus) 4 per cent, but for surplus countries only above 6 per cent (in each case taking three-year averages). In the case of unit labour costs there is only an upper threshold. Wages, it seems, can by definition never grow slowly enough. Above all, the reforms represent a missed opportunity to use the crisis to make changes that would enhance growth and employment opportunities in Europe and improve the welfare of European citizens. Notably absent from the reforms is any reference to the role of monetary policy within economic governance. Other matters urgently requiring reform – such as limiting tax competition between EU countries – are not addressed.

Overall, Europe has developed a bewildering array of overlapping policy responses in the area of economic governance. Beyond this confusion, none of the measures proposed, singly or jointly, come close to resolving the key problems facing the euro area.

In the context of the present discussion, which focuses on the prospects for inclusive growth, it can be concluded that the economic governance reforms are based to a considerable extent on a misdiagnosis of the problem (‘it’s mostly fiscal’ and more market-oriented structural reforms are needed). This never constituted an adequate response to the crisis and constrained, in the short run, any prospect of economic growth and ultimately pushed the EU into a renewed downturn. Exacerbating the shift to Continent-wide austerity destroyed any prospect of a swift recovery of demand and output. It also promoted policies (expenditure-side forced consolidation, decentralisation of collective bargaining and a ‘make work pay’ approach to labour market policy) that will tend to make any growth that does occur less ‘inclusive’ (see also Section 4). Finally, it risks embedding retrogressive policies in the longer term (such as a debt brake), thereby depressing public investment.
For most purposes it is an acceptable simplification to equate current account (im)balances with trade imbalances. Deficits, then, arise when a country imports more goods and services than it exports; conversely, surpluses are the result of a country exporting more than it imports. Countries running persistent deficits incur net liabilities (foreign debts) vis-à-vis the rest of the world (or run down net asset positions accumulated in the past), while surplus countries build up net asset positions (or pay down past liabilities).
4. Fiscal austerity against inclusive growth?

Having argued that the new economic governance and fiscal austerity in Europe as a response to the debt crisis pose a serious threat to any kind of output growth – and consequently to employment creation and recovery – we shall now look closer at the planned national measures for achieving the poverty headline target of the Europe 2020 Strategy. These measures have been announced in the context of the European Semesters every spring since 2012. We ask the following questions: do fiscal consolidation policies overshadow policies aimed at reducing poverty in its various guises? Are the policies planned in the context of...
the European Semester mutually supportive and likely to increase cohesion across member states? And which objective is the EU’s priority: consolidation of public finances or poverty reduction?

To answer these questions, we proceed as follows. Section 4.1 highlights how the EU countries have been doing in terms of poverty and social exclusion. Section 4.2 illustrates the extent to which the pressure for fiscal austerity is contradicting the inclusive growth paradigm and particularly its social component. This is done, first, by looking at the planned expenditure cuts – and particularly the cuts in social spending – that the countries report on in their Stability and Convergence Programmes. Second, we look at the emphasis of the Commission’s country-specific recommendations as part of the policy cycle of the European Semester. Finally, we present some measures that were likely to have adverse implications for social inclusion and poverty from selected countries.

4.1 Poverty and social exclusion in the EU

Figure 7 shows how the EU countries were faring with regard to the overall EU headline target on poverty and social exclusion and its three component sub-indicators in 2011 (latest available data).\(^{12}\) The overall target is composed of people who are at risk of poverty and/or suffering from severe material deprivation and/or living in households with very low work intensity.\(^{13}\) In most countries the ‘at risk of poverty rate’ best accounts for the observed poverty, as measured by the composite indicator. However, in the poorest countries – Bulgaria, Romania, Latvia and Hungary – ‘severe material deprivation’ is very pronounced, whereas it is of limited importance in most other countries. In Ireland, the most acute dimension of poverty is represented by ‘low work intensity households’. The overall indicator capturing people at risk of poverty or social exclusion ranges from 15 per cent of the total population in the Czech Republic to 49 per cent in Bulgaria; the EU average was 24.2 per cent in 2011, one percentage point up from 2009. Eleven countries had more than one in four people (>25 per cent) in poverty according to the EU

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12. It is important to keep in mind that the EU headline target refers to relative poverty, implying that poverty means very different things when comparing, for example, the Nordic and the central and eastern European countries. For comparative purposes and to stick with the European definition we will nevertheless use the EU headline target here.

13. The European Council (18 February 2011: 44–46) illustrates for all EU countries how the three groups overlap.
definition: (in ascending order) Spain, Poland, Italy, Ireland, Greece, Hungary, Croatia, Lithuania, Romania, Latvia and Bulgaria. The Nordic countries are doing particularly well and the continental European countries all perform above average. The Southern European countries exhibit below EU average performance but, with the exception of Greece, are not among the worst performers. The EU2 countries are by far worst performing and the new member states are spread over the whole distribution, with the Czech Republic being the best performer overall.

All countries (Greece, Portugal, Ireland, Latvia and Romania, Hungary, Spain and Cyprus) that are currently or have been recently in receipt

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14. Latvia and Romania had to seek multilateral balance-of-payments assistance from, among others, the EU, the IMF, the World Bank and the EBRD in 2008 and 2009, respectively. To that end, they adopted conditionality programmes spelling out the structural reforms they had to undertake, all of which have been terminated by now. Hungary also received balance-of-payments assistance, although it stopped receiving it before the foreseen end. Greece, Ireland and Portugal had to seek financial assistance from the EU and the IMF in May 2010, December 2010 and May 2011, respectively, as their governments faced
of financial assistance from the EU and the IMF and are thus under particular pressure to engage in rapid fiscal consolidation have poverty and social exclusion rates above or only slightly below (Cyprus) the EU average. The following sections will illustrate the negative impact of the pressure for fiscal austerity on the inclusive growth paradigm and point particularly to the danger of countries drifting apart.

4.2 Stability and convergence programmes against reforms to tackle poverty?

We examine first the plans announced by member states with regard to developments in public expenditure and, particularly, social payments in the context of their Stability and Growth programmes. To put the announced cuts into perspective, Figure 8 illustrates how the different member states are doing in terms of the level of total social expenditure as a share of GDP in 2010 (latest available data from Eurostat, and when shift to austerity policies took place) and the share of total population at risk of poverty or social exclusion in 2011. There is substantial variation in levels of social spending and associated risks of poverty and social exclusion. However, we see that in terms of social spending we can roughly distinguish two clusters of member states, namely the old and the new member states. Within these two clusters, there appears to be a negative correlation between social payments and the risk of poverty/social exclusion, which in fact is stronger among the new member states. In other words, the new member states, which are also significantly poorer on average than the old ones, have lower levels of total social spending as a share of GDP, while also presenting a wider variation of poverty risk, with some of the worst performers in the EU (Romania, Bulgaria, Latvia) but also the best performer (Czech Republic). In terms of the Europe 2020 Strategy, one would therefore expect that at least those member states with higher poverty risk rates would be called upon to make relatively more effort to increase social spending as a share of GDP in order to make progress towards their poverty headline target.

14. (cont. from p. 315) prohibitive borrowing costs in the financial markets, following rising concerns that they would not be able to carry on servicing their debt. Spain obtained financial assistance for recapitalising its banks in the summer of 2012, whereas the Cypriot government was bailed out in March 2013.
Figure 9 presents the risk of poverty or social exclusion in 2011 and the planned evolution (percentage change) of social payments (including both money transfers and transfers in kind) as a proportion of GDP for 2012–2016, according to the Stability and Growth Programmes that were submitted in spring 2013 in the context of the European Semester (see Annex for complete tables on the development of total public expenditure and social payments).\footnote{These figures are the only ones available for the current period and the near future. It should be noted that the Eurostat definition of social payments as used in Figure 8 is different to the one used for the purposes of Stability and Convergence Programmes (see Figures 9 and 10) in that the former includes all costs associated with a social policy programme (for example, administration costs), whereas the latter measures the payments themselves only. That results in a discrepancy in the size of social payments which is fairly large for some countries (such as Sweden, Denmark and Finland) but not others. However, we think that, given the absence of more recent Eurostat data and forecasts on these payments in the forthcoming years, this discrepancy does not affect the analysis.} Cuts in social payments are envisaged in the majority of member states, although they are most severe in Ireland, Croatia, Lithuania, Latvia and Greece and also comparably...
tively high in Romania, Slovakia, Hungary, Sweden and Poland. Except for Sweden and Slovakia these countries are among the ones with the highest proportion of the population at risk of poverty or exclusion. Ireland and Greece are currently under conditionality programmes for the financial help they have been receiving from the EU and/or the IMF and can thus be considered to have suffered a loss of policymaking autonomy. Lithuania was under pressure to demonstrate a commitment to sound public finances as it has been hoping to adopt the euro since 2007.16 Interestingly, Romania, Sweden, Latvia, Lithuania, Slovakia and Poland have all had and are projected to have public debt to GDP ratios well below the 60 per cent that the Stability and Growth Pact stipulates. This implies that there are few fundamental concerns about the

16. Countries giving up their currency and monetary policy tools become vulnerable to financial markets’ beliefs about their capacity to carry on servicing their public debt, as they lose control over their central bank. As the current crisis has shown, a market belief that a government cannot carry on servicing its debt can become a self-fulfilling prophecy, once market participants start requiring a higher interest rate in order to continue lending money to the government. See (DeGrauwe 2011b).
sustainability of their public finances. With the exception of Sweden, and to some degree also Slovakia, there are certainly concerns about the social exclusion of particular groups within their populations, however, and the planned cuts in social payments risk aggravating the situation. Overall, the positive correlation between the extent of poverty/social exclusion and the extent of the planned retrenchment of social spending is profoundly worrying and completely at odds with the EU poverty headline target.

To what extent are these planned social cuts in line with more general cuts in public expenditure and how much do they reflect a planned rolling back of the welfare state alone? Figure 10 shows how the planned evolution of social expenditure compares with the planned evolution of public spending between 2012 and 2016 according to the Stability and Growth programmes of 2013. A couple of points stand out. First, the retreat of the welfare state within the framework of public spending retrenchment is severest in Romania and Croatia and also comparatively high in Luxembourg, Latvia, Malta, Ireland, Greece and Sweden. Secondly, the retreat of the state and of the welfare state is more

Figure 10  
**Evolution of public and social expenditure, 2012–2016 (%)**

Source: National Stability and Growth Programmes, DG Ecfin.
pronounced in some of the member states whose populations are at relatively high risk of poverty, such as Latvia, Lithuania, Greece and Ireland.

The picture that emerges from these data is that the countries making disproportionate cuts are those that are already doing comparatively badly in terms of poverty and social exclusion. More specifically, especially in those countries in which the EU has had a say in how much the state could spend and what issues it should be focussing on within the framework of financial aid programmes, there has been a rolling back of both public expenditure and social payments.

4.3 EU priorities: predominance of fiscal issues in the country-specific recommendations

Under the impact of the economic crisis on public finances, the alignment of macroeconomic reporting (Stability and Convergence Programmes) and reporting on structural reforms (National Reform Programmes) in the context of the European Semester has to some extent overshadowed the Europe 2020 targets and particularly the inclusive growth agenda. Countries are supposed to give priority to macro-fiscal issues (compare, for example, European Commission 2010c; 2012b). This is expressed, for example, in the 2013 Annual Growth Survey which, as we have seen, is primarily fiscal in orientation, combined with a neoliberal supply-side reform agenda.

The same predominance of fiscal consolidation is evident when looking at the next step in the European Semester, on which we focus in this section: the drawing up of country-specific recommendations based on the submission of the Stability and Convergence and the National Reform Programmes (NRPs). On the basis of the Stability and Convergence Programmes and the NRPs, country-specific recommendations are issued by the European Commission and must be approved by the European Council.17

17. Country-specific recommendations as well as national reform programmes and stability programmes can be found here: http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm
What do these recommendations reveal about the relative priority of fiscal consolidation – as pursued in the context of new economic governance and policies to deal with the debt crisis – over policies to tackle poverty? A first interesting point is that the countries in receipt of financial assistance from the EU and the IMF have not been receiving specific recommendations from the European Commission but have instead been called upon to implement the measures laid down in their respective memoranda of understanding. At most, these memos contain general clauses stipulating that the most vulnerable segments of the population should be shielded from the impact of the fiscal consolidation measures. However, the specificity of actions to that end does not parallel those of reducing budget deficits, while measures of a more positive nature that could actively help to reduce poverty are not mentioned at all (see, for example, European Commission 2011; Ministry of Finance—Hellenic Republic 2011; Portuguese Ministry of Finance and Public Administration 2011). On the contrary, minimum wage cuts were effected in Greece and initially in Ireland, too, although in the latter they were rolled back a few months later. Last but not least, in plans for reforming pension and social security systems, ‘sustainability’ clearly takes precedence over adequacy of benefits; in fact, the latter is often simply not considered.

For 2013, each of the remaining 23 countries received a recommendation on budgetary discipline (always the first recommendation), whereas the remainder of the recommendations vary considerably in content. As regards the Europe 2020 priority of inclusive growth, labour market inclusion clearly predominates over wider poverty prevention goals. All 23 countries – and among them the three countries with the highest employment rates – received recommendations on improving labour market participation, with particular emphasis on enhancing the participation of older workers, promoting active ageing and lifelong learning and providing a ‘youth guarantee’. Recommendations on education and training were issued to 22 countries, recommendations on active labour market policies to 20 and recommendations on pensions to another 14; again, incentives for labour market participation stand centre-stage (for example, enhancing participation of older workers, promoting active ageing and lifelong learning and reducing early retirement and increasing the effective retirement age). With regard to social protection systems, social services and social assistance, adequacy is also mentioned in a number of cases. Seven countries received recommendations on wages (with an emphasis on aligning wage growth and productivity) and eighteen on public services, in most cases with a focus on improving effectiveness.
A number of these measures may be helpful in fighting poverty and social exclusion, but they are more likely to work when job creation is buoyant and some redistribution policies are in place. Only nine countries received recommendations on poverty and social exclusion, namely Belgium, Bulgaria, Spain, Hungary, Lithuania, Latvia, Poland, Romania and the United Kingdom. As laid out in Section 3.1 member states are allowed to use different indicators to report on poverty, and the respective sections in the NRPs thus vary substantially in content and length. This is likely to have rendered the process of issuing recommendations on poverty more difficult.

All five recommendations to the euro area countries, which receive specific recommendations from the Commission, focused in 2013 on macroeconomic issues (aggregate macroeconomic policy stance, fiscal policy differentiation, differences in lending rates to SMEs across member states, the repair of banks’ balance sheets, coordination of economic reforms, especially in the labour and product markets) (compare Council of the European Union 2013). The accompanying, more detailed document (European Commission 2013) does not contain a single reference to inclusive growth and the detailed table entitled ‘Labour market and social indicators’ provides figures on labour productivity and unit labour cost growth instead of the poverty and social inclusion indicators.

To wrap up, at the level of the country-specific and euro-area recommendations, not only do the outcomes of macroeconomic prescriptions risk running counter to the coordination related to smart, sustainable and inclusive growth, but the inclusive growth paradigm – where it is referenced – seems to be strongly driven by a desire to boost labour force participation, largely based on making-work-pay strategies that are of dubious value in a context of unemployment caused primarily by a shortfall of aggregate demand.

4.4 Evidence from the fiscal austerity packages

To underpin our argument, in this section we have used evidence from national experts (Theodoropoulou and Watt 2011) and other sources

18. The recommendations to Hungary and the Netherlands are only indirectly linked to the poverty headline target, emphasising tailor-made programmes to low skilled and other disadvantaged groups and the labour market integration of vulnerable groups.
on the austerity programmes adopted by late 2010/early 2011 in 17 EU member states to obtain insights into their effects on poverty and social inclusion (on austerity measures and their social impacts, see also the individual chapters of this volume).

Indirect tax hikes, which tend to disproportionately affect those at the low end of the income distribution, were reported in several countries (Poland, Hungary, Estonia, Cyprus and Latvia), most of them at the higher end of the poverty distribution within the EU. Indeed, the EU recommendations state that tax increases, wherever necessary, should focus more on indirect taxes as these are less likely to interfere with employment creation (European Commission 2010b; European Commission 2012a). Nonetheless, some countries (France, Austria, Luxembourg and the United Kingdom under the previous Labour administration) increased progressive taxes (income and wealth taxes). Heise and Lierse (2011), who assess the impact of austerity measures on the European social model for seven European countries, also come to the conclusion that in all these countries the economic crisis and the resulting public debt have been used as excuses for social cuts which in most countries hit low earners disproportionately.

The young working under precarious employment contracts are particularly hard hit in Italy due to the limited coverage of unemployment insurance. The unemployment rate for those under 25 in Italy stood at 27.8 per cent in 2010 (Eurostat LFS data), more than three times higher than the average, which was 8.4 per cent (Theodoropoulou and Watt 2011). This implies a concentration of social exclusion in this group. In a similar vein, in Greece (for details, see Matsaganis and Leventi 2011), because of their very low coverage by unemployment insurance, the unemployed have been particularly affected by the fiscal austerity programme that is a condition of the financial support the country receives from the EU and the IMF. Pensioners have also been targeted. Indirect tax increases have been regressive. Some measures, however, such as some elements of public sector retrenchment, have tended to narrow the income distribution (Matsaganis and Leventi 2011). Overall, as a result of the austerity and the wider recession, 5 per cent of the Greek population saw their 2010 incomes fall below the 2009 poverty line, swelling the ranks of those who were already in poverty (another 20 per cent of the population). However, while the crisis has raised demand for social protection, the supply of social benefits has been reduced rather than increased.
Social benefit recipients have been adversely affected by cuts in Latvia, Romania, Germany, the United Kingdom, Spain and Ireland (Heise and Lierse 2011: 24–26). In Portugal, the recipients of non-contributory benefits (social assistance, which is more likely to be received by people at the margins of the labour market) are likely to suffer most from measures to reduce expenditure on these benefits within the framework of the programme imposed as a quid pro quo for financial support from the EU and the IMF (Portuguese Ministry of Finance and Public Administration 2011). Again, it is worth noting that the majority of these countries are at the upper end of poverty distribution in the EU, and have also been finding it hard to finance their public debt in the markets.

5. Conclusion

Europe is currently going through the worst economic crisis of the post-War era. Unemployment has increased dramatically in several countries, especially among young people, and the prospects for output growth recovery appear gloomy for the next few years. Due to the economic interdependence of EU member states, these developments are likely to spread across the Union and especially within the euro zone. Past experience shows that this combination of high unemployment and prolonged weak output growth is bound to lead to persistently high unemployment, the depreciation of skills and the labour market detachment of unemployed people. The social consequences of these developments will be grave as social exclusion is likely to increase.

Against this background, we have sought to evaluate the coherence of the policy responses promoted at the EU level in response to the crisis and the quest for growth. We have investigated whether the pursuit of fiscal austerity as dictated in the context of the European Semester runs counter to the pursuit of inclusive growth through reducing poverty, which is one of the priorities of the Europe 2020 Strategy. Our answer is affirmative and our argument is spelled out along two axes.

First, the underlying principles of the proposed new economic governance structures are bound to impose a fiscal austerity bias which, under the current circumstances, will inevitably lead to depressed demand and no output growth in the short, medium and, due to hysteresis mechanisms, eventually the long term. This is inimical to growth as such, but is also expected to make any growth that is achieved less inclusive.
Secondly, a closer look at the recommendations to member states and their declared stability and convergence programmes suggests that all policy considerations with regard to tackling poverty and social exclusion are subjugated to fiscal consolidation and other goals. It is not the first time that inclusive growth has been subordinated to other issues, such as macroeconomic concerns, productivity and employment growth, but the crisis and the subsequent austerity measures have further emphasised these tendencies. This predominance of public finance concerns over inclusive growth is particularly striking in the cases of member states that have been performing below the average in terms of poverty and social exclusion, but have no particular problems in terms of the sustainability of their public finances. To that end, we have also provided some evidence from austerity packages already adopted in selected member states (as available) and how they have been adversely affecting vulnerable groups or doing little to improve their position. The crisis could and should have been used as an opportunity to introduce corrections to the previous growth model, of which rising inequality was a prominent feature (Watt 2009). However, the evidence suggests not only that this has not happened, but that current policies are tending to exacerbate the direct negative effects on distribution and poverty/exclusion arising from the crisis itself.

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Annex

Table 1  Evolution of total public expenditure 2012–2016, according to Stability and Growth Programmes 2011 (% of GDP)

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Source: National Stability and Growth Programmes. DG Ecfin.
Table 2  Evolution of social payments 2012–2016, according to Stability and Growth Programmes 2011 (% of GDP)

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Source: National Stability and Growth Programmes. DG Ecfn.