GREENTERVENTION

Reforming the European budgetary framework and the ecological emergency
Reconciling the Stability Pact and the European Green Deal

As explained in a previous note[1], a reform of the European fiscal framework, known for the Maastricht limits of 60% and 3% of GDP respectively for debt and deficit ratios, is on the EU's agenda. The following considerations continue along the same line. They highlight a gap and make proposals to fill it: while climate and environmental disruptions are already posing major risks to economic activity, financial stability and public finances, most proposals for reforming the European budgetary framework address this aspect only peripherally. Worse, the joint interview with the German and French Finance Ministers on 27 April 2021 confirms the minimalist approach of the two governments: for the former, the rules are sufficiently flexible, while the latter's only concern is that the current level of debt should be considered when calculating the debt targets. Otherwise, the same rules will have the same effects: chronic underinvestment incompatible with the achievement of the climate objectives.

Proposals learning from the past...

Coordinating budgetary policies means mastering the interdependencies between the economies of European countries: avoiding that the policies of one country have a negative impact on the others and exploiting synergies.

The current rules and almost all reform proposals consider two channels of transmission of fiscal policies from one country to another[2]:

- the risk of transmission of a sovereign debt crisis from one country to the others.

- and the short-term effects of a country's fiscal policy on total demand in the Union as a whole and, to some extent, on cyclical divergencies between countries.

Furthermore, there is a third assertion that underpins the rules:

- Accelerating growth through structural reforms and "better" public spending is the way to free up additional fiscal leeway; such spending can under certain circumstances be taken out of the calculation of the deficit.

Ideas for reforming the European budgetary framework are proliferating. Proposals are drawing to various degrees both on lessons of experience and on the new macroeconomic context. But they remain overall based on the three arguments above. The issues at stake in the forthcoming negotiations relate essentially to the following themes: simplification and transparency of the rules; the replacement of singular, rigid rules that apply indiscriminately

[1] The original note in French has been published by the Think Tank of the Nicolas Hulot Foundation
[2] See for example O. Blanchard & al., Redesigning fiscal rules or the recent note of the French Conseil d'Analyse Économique s on the same subject.

to all with objectives adapted to each country; giving place to detailed judgements during the cycle instead of a mechanical approach that has often proved counterproductive; and privileged treatment and exemptions for priority "productive" expenditure. Furthermore, the importance of the Union having a centralized budgetary instrument is generally stressed. Such an instrument would make it possible to relieve the role of national budgets in redressing macroeconomic imbalances and in pursuing the Union's objectives.

... **but ignoring the challenges of the 21st century**

By only focusing on the three channels mentioned above - financial risk, impact on demand, and growth - the reform proposals miss the mark of the 21st century challenges. They ignore a major spill-over effect of fiscal policies: the cost of under-investment in climate policy, mitigation and adaptation, and biodiversity conservation, and more generally in a just transition.

- First, the political cost: the EU's international reputation for keeping its environmental commitments, particularly on climate change, would be affected. Internally, the lack of coordination of fiscal policies taking account of this dimension would encourage “free riding” and therefore undermine the cohesion of the Union.

- Secondly, social cost: in a context already marked by the rise in precariousness and inequalities between and within countries, populations and territories are not equal when faced with climate change and environmental deterioration.

- Thirdly, an economic, budgetary, and financial cost: it contributes to increasing the blatant material risks posed by climate change and biodiversity loss, which are cross country, as well as the transition risks that would result from delayed action. Meanwhile, such risks are well recognized by the financial community and central banks. A report by the Bank of France and the Bank for International Settlements (The Green Swan p.2) states that "financial and climate stability are two interconnected public goods".

For a forward-looking reform

Considering the "cost of inaction on climate and biodiversity" of one country on the other and truly improving the quality of public finances would carry four implications beyond the necessary correction of past dysfunctions.

- First, the trade-off between debt levels and additional public spending in support of environmental and climate policies should no longer be biased in favor of the former, quite the contrary. Given the current state of the threat and the delays in responding to it, a precautionary principle is needed: we can never invest enough in reducing greenhouse gas emissions and protecting the environment. The ring fencing of such expenditure will also stabilize the expectations of private investors and thus economic activity and employment.

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- Secondly, spending shall be incentivized, notably via deduction from the relevant deficit (golden rule), when it supports measures that effectively and verifiably accelerate
the transformation of the European economy towards a sustainable economy: zero

GHG emissions in the context of a just transition. The approach should encourage Member States to define and implement policies combining regulatory measures, taxation, subsidies, and investments in the key sectors of decarbonization and environmental protection[3]. Verifiable result indicators[4] with a proven link to social, climate and environmental objectives would replace the vague objective of "supporting potential growth" that does not necessarily coincide with the objectives of a just transition[5].

- Thirdly, relying on sectoral strategies will also help to avoid the pitfall of "green budgeting", which would be limited to identifying budget item by budget item the expenditure likely to have an environmental impact. This approach is blind to the feasibility and effectiveness of public action including regulatory, fiscal, and complementary spending measures[6]. Some expenditure may be essential to the success of an action even if it is not a capital expenditure in the sense of public or national accounting[7]. Others will only be effective if accompanied by coercive regulatory measures, tax incentives or the removal of counterproductive measures such as fossil fuel subsidies.

- Fourth, the automatic stabilizers of the economy must be strengthened: refusing precarious employment, stabilizing the incomes of the most vulnerable and protecting against new environmental risks, which are uninsurable or only prohibitively expensive for many, is a value on its own and useful for macroeconomic stabilization. But it is also necessary to build consent for the transformations that lie ahead.

Building, as the CAE proposes, the new European fiscal framework without explicitly considering the environmental emergency will continue to bias the implementation of the Stability Pact towards reducing financial debt at the expense of preventive and protective investment. In no way could it change the game; rather, it would deprive the next generation of the future they could otherwise hope for.

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[3] In particular, renewable energies, transports, agriculture, building insulation, and some industrial sectors

[4] For example, in transport, the number of passenger-km or ton-km by rail; in agriculture and land use, the hectares of grassland, or for buildings the number of houses insulated to a certain standard.

[5] See on this subject the note from the European Environment Agency: Growth without economic growth

[6] This method had to be used to implement the Recovery and Resilience Facility. Each investment project is assigned a percentage (0%, 40% or 100%) to represent its contribution to environmental action according to a detailed nomenclature. See the Regulation of the Facility, Annex 6

[7] See World Bank note on "Green Budgeting" p.38