Reform of the European budgetary framework and ecological transition:

How to not miss a historic opportunity?

Summary

Known for the 3% maximum deficit and 60% public debt rule, the European budgetary framework is now the subject of an almost unanimous demand for reform. The debate has begun. It will intensify in the autumn of 2021. It will continue in the first half of 2022. The budgetary framework sets the rules by which Member States can trade off priority spending, support for employment and incomes, and public debt management. The current rules prioritise debt reduction, which is seen as the major source of instability, at the expense of supporting activity and financing investments for the future. The objectives of ecological and social transition require more than ever to reverse this order of priorities. The deterioration of the environment and climate change are becoming a major source of instability, while social cohesion is crumbling and the rise in inequality and insecurity is jeopardising our democracies. Taking these risks into account must be put at the heart of the new budgetary framework. This means moving away from rigid numerical rules, making room for informed decisions and reversing the order of priorities. Expenditure associated with sectoral policies supporting social and ecological transition must be given priority funding, the means to stabilise the economy must be strengthened and the appropriateness of public debt must be weighed against the benefits of a preserved environment and a hospitable planet.

Author: Ollivier Bodin, economist, co-founder of Greentervention, former international civil servant.

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A DEBATE WITH AN UNCERTAIN OUTCOME

The debate on the reform of the European budgetary framework has begun. Coordination of the economic policies of highly interdependent countries in an economic union, and a fortiori a monetary union, is necessary, as is reaching a consensus on the orientation of national budgetary policies so as to ensure their coherence. In the short term, this coherence must make it possible to correct macroeconomic imbalances that call into question the performance and stability of the monetary and financial union. In the medium and long term, it is a question of achieving the fundamental objectives of the Union, which must benefit all European citizens in a balanced way. A shared budgetary framework facilitates consensus year after year and stabilises the expectations of public and private actors. However, the consent to the discipline it imposes can only be sustainable if the system demonstrates its effectiveness.

An almost unanimous demand for reform....

The interpretation given to the Maastricht criteria and the strengthening of the budgetary framework agreed following the 2007-11 financial crises are problematic. Well before the suspension of the application of the framework due to the pandemic, it had been assessed as not fulfilling, or only partially fulfilling the functions expected and not being adapted to the challenges of the Anthropocene. The European Budgetary Committee issued an uncompromising opinion in 2019 on the effectiveness and fairness of this framework and reiterated in its 2020 opinion the need for reform. The European Commission launched the process of economic governance reform in early 2020. This process has been suspended due to the health crisis. However, Paolo Gentiloni, the European Commissioner for Economic and Financial Affairs, announced following a Commission communication in March 2021 that the issue of reform could be back on the European agenda in the second half of 2021. The Commission could submit a proposal for legislative reform by the end of the year. The French government has indicated that it intends to make this reform a priority of the French Presidency in the first half of 2022. In an open letter to EU leaders, 68 European NGOs and trade unions, supported by a hundred academics, call for a reform that is commensurate with the social and environmental challenges of the coming decade and ask that such a reform takes place before the general suspension clause of the budgetary rules is lifted. The President of the European Central Bank, Christine Lagarde, has also expressed the wish for reform before their reapplication, a wish also contained in a draft report of the European Parliament.

… but a consensus that will be difficult to find

The fact that the urgent need to reform the European budgetary framework is almost unanimously supported by social, environmental and economic actors does not mean that it will be easy to find a consensus on its terms. There are many contributions from academics and think tanks. Among these contributions, that of O. Blanchard, A. Leandro and J. Zettelmeyer deserves particular attention. The authors question "the very concept of intangible fiscal rules for all countries and all times. Indeed, no rule can claim to adapt to the diversity of possible situations, not least because many of them are impossible to predict". The authors conclude that it is not possible to assess whether a debt is sustainable or not according to a pre-determined threshold. The question of sustainability must be addressed on a case-by-case basis according to agreed general criteria and based on all available information. They also stress that the question of sustainability is not a "yes" or "no" answer, and that uncertainty must be allowed for.

Despite the validity of the argument it is unlikely that a political agreement can be established without recourse to a standard for the level of public debt. The proposals of the institutional actors currently on the table nevertheless partly echo the diagnosis of O. Blanchard and his coauthors. To varying degrees, they focus on four priorities: simplification, differentiation, flexibility and improving the quality of public spending:

- A medium-term objective for public expenditure growth that takes into account growth prospects and allows a public debt target to be reached would become the sole anchor for public finances unlike the current complex rules[1]. However, this target and the speed of approximation would be differentiated across countries and set taking into account other relevant parameters, in particular interest rates.

- Greater flexibility and scope for judgement in circumstances requiring a departure from the rule would be introduced.

- Expenditures deemed to be a priority would receive privileged treatment, as "investments" or "green investments" either in the calculation of expenditure relevant to the "rule" or through privileged access to European funding.

The proposals of the European Budget Committee of July 2020 and October 2020 are in this spirit. On 4 March, in an intervention before the Economic and Financial Committee of the European Parliament, P. Gentiloni also went in this direction. A recent report on the future of public finances commissioned by the French government, known as the Arthuis report, partially takes up these ideas.

[1] Described in the Vade Mecum of the Stability and Growth Pact

What is at stake in the negotiations should be the relative priority given to each of these principles and their detailed formulation. We can bet that the discussions will be acrimonious.

The real issue: putting environmental protection at the heart of economic governance

The discussions underway face a major pitfall. There is a strong risk - in the name of a pretended credibility - to continue to think of debt "sustainability" in terms of the growth of public spending in relation to a growth perspective or "potential". This focus on spending and debt levels keeps quality of life, well-being and environmental sustainability far out of the sight of economic and finance policy. Failure to place climate change and biosphere collapse at the heart of the European economic policy software is to condemn oneself to not seeing those developments coming and to not having the means to prevent them:

- Not to see that over the next three decades European populations will face unprecedented threats: climate disruption, loss of biodiversity, increasing environmental toxicity, more frequent health crises. Resilience to these threats is unevenly distributed within each country and between EU countries. The destabilisation of the climate and the environment is already having financial, economic and budgetary impacts. This feedback loop between public policy and the environment must be placed at the heart of European economic governance. The impact of public policies on 'natural capital', environmental preservation and social justice must become the cornerstone of this governance.

- Failure to provide sufficient means for prevention despite the fact that sustainability and resilience are the result of the investment effort and public policies being carried out. The activation of the general suspension clause of the European budgetary rules in March 2020 was associated with a recommendation to Member States: measures to deal with the COVID crisis to support incomes and businesses must be targeted, effective and...**temporary**. In order to master the future, Member States must now adopt targeted, effective and...**permanent** budgetary spending programmes, because the environmental and social sustainability of our economies will not be regained in a few months; and the European commitment to zero net greenhouse gas emissions needs about thirty years to be achieved, provided that the current pace is strongly accelerated.

THE CONTOURS OF A SUCCESSFUL REFORM

Under these conditions, what grid should be used to measure the quality of the proposals that will be made and the agreement that will be reached for the new European budgetary framework[2]? Three criteria are essential, responding to the functions traditionally assigned to public finances:

- Financing public goods

- Support for jobs and incomes

- Managing public debt.

The right policy instruments and the right indicators must be associated to each of these functions to monitor progress and, if necessary, correct the trajectory.

Identify the expenditures needed for the ecological and social transition in order to prioritise them

The new budgetary framework must have as its compass the ecological and social transition, in particular the social and environmental objectives to which the European Union has collectively committed itself. The starting point must be the identification of the public expenditure necessary to ensure the success of this transition and that could benefit from financing at privileged terms.

While estimates exist of the private and public investments needed to achieve the transition[3], the medium/long-term impact of the transition on Member States' public budgets is not yet sufficiently known or even analysed[4].

The development of long-term budgetary programmes associated with policies is particularly necessary in the sectors key for the ecological and energy transition (transport, buildings, energy production and distribution, agriculture, forestry and land use, and important parts of industry). In these sectors, public authorities must pursue complex policies. These policies combine regulatory measures with support for the private investment needed to transform consumption and production patterns, support for research and development, and investment in public infrastructure. They must also provide for changes in the taxation of fossil fuels and the reduction of subsidies for these same fuels. They must anticipate, cushion and compensate for the social consequences of the transformation.

This means going beyond the approach of marking a budgetary expenditure associated with a particular activity green or white (or associating a percentage, 0%, 40%, 100%, which is supposed to represent the contribution of the expenditure to meeting the environmental objective, as provided for in the Regulation of the Recovery and Resilience Facility - Annex 6). A taxonomy adapted to a limited economic activity quickly finds its limits when applied to a public action combining several

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[2] The issue of decisional processes and of their democratization is not addressed in this note

[3] According to an assessment by the Commission the annual private and public investment gap over the years 2021-30 in the energy transition and the protection and management of the environment in the EU amounts to €470 billons (around 3,6% of 2019 GDP)

[4] The Commission has noted in its assessment of the National Energy and Climate Plans (P. 26) that the identification of investments needs, funding sources and conditions for a just transition plan are not sufficiently addressed.

complementary levers which condition its effectiveness and acceptability. For example, the deployment of charging stations for electric vehicles in a given country will only contribute to reducing CO2 emissions and will only be worthy of the "green" label if electricity production is decarbonised at a sufficiently high rate, if the prohibition of vehicles running on fuel has been announced and if car owners are being provided with an incentive to buy electric cars. And the transition to the electric car will only be fair if the social and territorial challenges, jobs, skills, direct and indirect income, posed to the automotive industry are met. Another example is the necessary transformation of agriculture, which requires regulating production and land use methods, prohibiting certain practices and encouraging others, including by financial means, influencing consumption habits and even activating the levers of foreign trade policy[5]. The examples could be multiplied.

The desirable approach[6] of identifying priority spending through the prism of a strategic view of a sectoral policy must rely on specific outcome indicators that have a clear link with more general social, environmental and climate objectives (income and welfare inequalities, greenhouse gas emissions, soil acidification, biodiversity). A recent study[7] of the three most greenhouse gas-emitting sectors in France, for example, identified a limited number of outcome indicators corresponding to structural variables allowing the contribution of the sector to the climate objective to be assessed.

The European Commission[8] has taken a first small step in this direction by associating indicators with "flagship initiatives" relating, for example, to the transport and production of renewable hydrogen, the rate of thermal renovation of buildings, and the number of charging stations for electric vehicles. The next steps should be to generalise this approach by identifying, country by country, sector by sector, the relevant indicators of results and progress.

From a European perspective, the first question to be asked when assessing a national budgetary policy should no longer be whether public spending is contained at a certain level. It should be, on the basis of relevant indicators, whether budgetary expenditure, taxation and associated regulatory policies allow for the achievement of the medium and long-term social and environmental objectives that the Union has set itself, and in particular whether they allow for the respect of the climate commitment that European countries pursue in common.

[5] See the report by the Fondation Nicolas Hulot

[6] For a review of the various methods to identify "green" public expenditures see the World Bank report concluding : « Climate tagging—as currently practiced—puts too much emphasis on the quantification of climate-related expenditures, with inadequate consideration of policy alignment, efficiency, and effectiveness. » (P38)

[7] Report by Carbone 4, February 2021 « L'État français se donne-t-il les moyens de son ambition climat ? ». For the transport sector, the specific indicators are the growth rate of railways transport, the share of bicycling, the number of passengers per vehicle.

[8] See part IV of the communication on sustainable growth com (2020)575 final

Supporting lasting employment and revenues

Strengthening the macroeconomic stabilisation capacity of fiscal policy, i.e. the ability to smooth the impact of economic cycles on employment and incomes and to eliminate precariousness, must be a second priority of the reformed fiscal rules. Fiscal rules as currently formulated had too often the opposite effect. They have too often led to policies that are pro-cyclical, exacerbating economic downturns, and reinforcing disparities between Member States.

Monetary policy, which policy makers have long relied on to fulfil this stabilising role, is no longer able to do so: interest rates have bottomed out, sometimes even going negative, without any significant recovery in real economic activity or increase in consumer price inflation, while financial asset prices are pushed to record highs. This explains the Central Bank's repeated calls for more active fiscal policies to support employment and economic activity. This strengthening is in the interest of all European countries given the strong interdependencies between their economies. It will mitigate the asymmetric effect of the current rules, which force restrictive policies in case of budgetary overshooting, but have no effect on countries that do not use their budgetary margins.

5 key actions would strengthen the impact of fiscal policy:

- Ringfence the financing of priority transition programmes. Budgetary expenditures associated with such programmes should be deducted, at least up to a certain amount, from the calculation of the deficit relevant for the application of budgetary rules. This will help to stabilise demand and expectations of private actors. The current budgetary rules already provide for the possibility of deducting certain expenditure from the calculation of the relevant deficit. But the purpose of eligible expenditure is to strengthen the "growth potential", not the ecological and social transition. While the two objectives may sometimes coincide, they do not necessarily[9] always do so. Moreover, the conditions set for the deduction of certain expenses are very restrictive, making the use of the "investment" flexibility clause an exception.

- Develop sustainable European financing mechanisms. The Recovery and Resilience Facility adopted to address the COVID crisis would be an effective model if it were associated with much more rigorous conditions on the pursuit of shared ecological and social sustainability objectives while leaving States the flexibility to adapt policies to their national context. A common debt to finance goods that benefit everyone is in line with the logic of an economic and monetary union. However, the sustainability of such a debt capacity presupposes the ability to raise own resources at European level. Otherwise, the real or perceived risks to national budgets will be an obstacle[10].

[9] See the report by the European Environment Agency https://www.eea.europa.eu/themes/sustainability-transitions/drivers-of-change/growth-without-economic-growth

[10] On 26 March 2021, the German Constitutional Court halted the ratification process of the Facility without yet ruling on the substance. However, it is likely that, without calling into question the principle of the Facility, the court will wish to rule on an argument put forward by the plaintiffs, which essentially concerns the risks that the default of another Member State would pose to the German budget, precisely because of the absence of clearly identified resources to cover the payments.

- Draw lessons from the pandemic on the effectiveness of existing mechanisms in all EU countries to better stabilise incomes in the event of shocks, particularly for people with precarious employment status, as well as to preserve jobs and enable SMEs to absorb liquidity shocks. Tax justice must also become a priority, which means putting an end to tax optimisation practices that play one country off against another. Furthermore, the reorientation of corporate taxation announced by the Biden administration is an opportunity not to be missed to put an end to the race to the bottom of corporate taxes that has been underway in Europe for three decades.

- Strengthen collective security and prevention mechanisms to respond to the rise of new risks, particularly environmental risks, which cannot be insured or for which insurance is not accessible to all.

- Provide sufficient flexibility in the fiscal framework to allow discretionary measures based on an informed and transparent judgement of the economic situation. This will require agreement on a few fiscal and macroeconomic indicators reflecting the state of employment, pressures on productive capacity, private indebtedness, the state of the external accounts, while avoiding automatism. At present, states are mainly encouraged to conduct their fiscal policies according to the distance between actual production and an unobservable potential production, but calculated according to a contestable and disputed theoretical model[11]. Paolo Gentiloni has already indicated that the European Commission will propose to stop using these indicators in the future. This idea should be followed up by introducing a more easily activated flexibility clause for the zone as a whole or for individual countries.

Manage public debt intelligently

The debate often revolves around the level of debt as a percentage of GDP. The fact that the European Treaty opportunistically set a target value of 60% over thirty years ago is obviously not unrelated to this. But the focus on this target led after the last financial crises to budget deficits being reduced too quickly to allow for a consolidation of the recovery, and then to a lost decade for investment. Fortunately, the Eurogroup finance ministers have indicated that they do not want to repeat this mistake as they emerge from the current health crisis, while stressing the importance of medium-term sustainability of public finances. Neither the capacity nor the opportunity for public authorities to go into debt can be assessed on the basis of an arbitrarily fixed numerical criterion that is now anachronistic and detached from its context. Debt capacity can only be assessed on the basis of several indicators, relying on the average interest burden and interest rate for new issues, the possibility of extending maturities and the capacity to raise taxes, and taking into account the interactions with monetary policy. More fundamentally, it is the medium- and long-term benefit of an expenditure and in particular its contribution to reducing climate and transition risks that should guide the investment and debt decision. Strengthening the “natural capital” and preserving a

[11] See for example « Output gap non sense and the EU fiscal rules » https://www.ineteconomics.org/perspectives/blog/output-gap-nonsense-and-the-eus-fiscal-rules ou « Règles budgétaires, semestre européen et dérèglement climatique » https://alaingrandjean.fr/2020/01/06/regles-budgetaires-europeennes-semestre-europeen-dereglement-climatique/

habitable planet must be a priority. This is where the real marker of intergenerational justice lies, not in the level of public debt.

Conclusion

While the positions expressed by the European Commission and others signal a certain openness on all issues, the devil will be in the detail. The most important debate will have to be about the degree of priority to be given to the level of expenditures whose financing will be prioritised over the debt rules. Will European governments have the ambition of the Biden administration and its massive infrastructure rebuilding plan or will they stick to archaic rules that have led to years of underinvestment? The debate will also have to focus on the nature of this spending. It is the outcome of this debate that will mark the real break with the past. Will it be investment spending or spending associated with reforms that "enhance growth potential" and only coincidentally support the ecological transition, as regularly suggested in the Eurogroup conclusions ? Or will it be spending that can effectively shift the European economy towards an ecologically and climate sustainable as well as a socially just economy?

Behind this often technical discussion lies a fundamental political debate. It deserves the broad involvement and mobilisation of the social partners and of European civil society.

Ollivier Bodin, economist, co-founder of Greentervention, former international civil servant.

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