WIFO ■ RESEARCH BRIEFS
2/2023

Options to Align the EU Fiscal Framework to Green Public Investment Needs

Atanas Pekanov
Margit Schratzenstaller

Options to Align the EU Fiscal Framework to Green Public Investment Needs

Atanas Pekanov, Margit Schratzenstaller (WIFO)

Austrian Institute of Economic Research

Commissioned by European Parliament

Internal review: Stefan Ederer (WIFO), Thomas Wieser

Research assistant: Cornelia Schobert (WIFO)

WIFO Research Briefs 2/2023
February 2023

Abstract

The necessary green transition in the EU requires substantial additional green public investment (GPI) by member countries throughout this decade and beyond. This briefing paper discusses four approaches for a reform of EU fiscal rules to better accommodate higher (debt-financed) GPI: first, an exemption clause for GPI; second, the implementation of a green golden rule; third, a country-specific benchmark share of government expenditures dedicated to GPI recommended by the European Commission; and fourth, an EU Climate Fund. We also discuss these options in relation to the recent Commission proposal from November 2022.

E-mail: atanas.pekanov@wifo.ac.at, margit.schratzenstaller-altzinger@wifo.ac.at

2023/1/RB/22122

Medieninhaber (Verleger), Hersteller: Österreichisches Institut für Wirtschaftsforschung
1030 Wien, Arsenal, Objekt 20 | Tel. (43 1) 798 26 01-0 | https://www.wifo.ac.at
Verlags- und Herstellungsort: Wien

Kostenloser Download: https://www.wifo.ac.at/wwa/pubid/70624

Options to align the EU fiscal framework to green public investment needs

1. Introduction and background[1])

The European Green Deal (EGD) requires massive investment in the decarbonisation of European economies and societies. To achieve the EGD objectives, the European Commission (2021) indicates additional necessary investments for the current decade of 520 billion € per year (3.7% of 2019 GDP) compared to the previous decade: 390 billion annually to decarbonise the economy, and another 130 billion per year to achieve other environmental objectives of the green transition.

The sheer size of this green investment gap implies that a significant part of the funding for the increased investment will have to come from the national rather than the EU level and from private investors (Claeys & Tagliapietra, 2020; European Commission, 2022a). Synthesising existing estimates, Darvas and Wolff (2021) arrive at a public-private ratio of 1:4 to 1:5 and estimate an annual (pre-energy crisis) green public investment (GPI) level of 0.8% of EU GDP on average for the EU for the current decade. Delgado-Téllez et al. (2022) estimate that on average, GPI between 1% and 1.8% of EU GDP is required annually. Against this background, options for reforms of the EU fiscal framework enabling the necessary GPI in Europe need to be explored.

2. Options to support GPI in the EU fiscal framework

2.1 The Commission proposal from November 2022

On November 9, 2022, the Commission (2022b) issued a "Communication on orientations for a reform of the EU economic governance framework". At the heart of the Commission's communication from November 2022 there are three main pillars (Becker et al., 2023). First, the Commission suggests an expenditure rule: net primary expenditures (i.e., total expenditures excluding interest and unemployment payments as well as additional expenditure covered by tax increases) shall serve as the only indicator to gauge compliance with the debt and deficit criteria. The expenditure path shall be determined by the Commission based on a debt sustainability analysis. The second element are national medium-term fiscal-structural plans to be submitted by Member States, detailing the measures to comply with the expenditure path. Third, while the 60% of GDP debt criterion shall remain, however without concrete time frames when to reach it and as an indicative objective, the 3% of GDP deficit criterion shall be monitored and sanctioned stricter in the future.

Altogether, the proposal adds a substantial element of country-specific flexibility and reinforces the long-term orientation of the EU fiscal framework, while at the same time reducing its

[1]) This research brief is based on Pekanov & Schratzenstaller (2023).

complexity. Debt-financed public investment can be considered explicitly, albeit not in the form of a golden rule which would exempt public investment permanently from deficit and debt statistics: rather, the time period allowed to return to a path of decreasing debt ratios can be prolonged from four to seven years if MS submit national medium-term fiscal-structural plans including public investment endorsed by the Commission and adopted by the Council. Furthermore, MS would not be allowed to exceed the 3% deficit limit. GPI is not accounted for separately in the Commission's proposal, and the time frame of up to seven years may be too limited in face of the substantial long-term GPI needs.

2.2 Options to support GPI in EU MS

We discuss four different options to amend or complement the current fiscal framework to better address climate challenges and ensure the necessary GPI, also taking into account the recent Commission proposal.

2.2.1 GPI exemption clause in the SGP

The most straightforward approach would be to add a GPI definition to the existing investment exemption clause of the Stability and Growth Pact (SGP) and thus enable short run deviations from deficit targets and MTO, similar to the deviation allowed through the investment flexibility clause or the structural reforms clause.

Pros:

- The GPI exemption clause would be easy to implement even in the current EU fiscal framework. It will help frontload GPI, especially if the temporary exemption can be extended over a longer period of time.
- It would not require a legal change, but only an amendment within the flexibility clause of the SGP to include also GPI as a separately defined term and the conditions for activating and proving it.
- The process, conditions, recommendations, and the coordination can be embedded easily into the European Semester.

Cons/potential problems:

- If the envisaged GPI is only eligible after a thorough review of the project in question, this might imply that most investment is realised slowly, and projects would be implemented with a significant time lag due to the required evaluation and assessment process for each project or investment amount.
- The GPI exemption clause would not necessarily incentivise national governments to undertake the investment necessary to close their green investment gaps but would only enable it.
- It would add further to the complexity of the fiscal rules. The three existing escape clauses of the SGP have introduced opacity and have led to uncertainty regarding how binding fiscal rules are in reality.
- Exemption clauses are short-term in nature, applying under exceptional circumstances and for selected projects; they therefore are of limited use considering the

longer-term substantial GPI needs of most MS, which will be the normal state in the foreseeable future instead of exceptional short-term instances (Bénassy-Quéré, 2022).

- A GPI exemption clause oriented at the design of existing exemption clauses would be insufficient to enable the substantial GPI needs in most MS, as it allows only a maximum deviation of 0.5% of GDP initially which is to be corrected in the following four years.

Compared to the Commission's proposal, a GPI exemption clause based on the current design of exemption clauses would cover a shorter timeframe (four instead of seven years), would be applicable under exceptional circumstances and allow a limited deviation of 0.5% of GDP only.

2.2.2 Introduction of a "green golden investment rule"

A golden rule for investment would allow deficit-financed public investment which will not be counted for deficit and debt statistics. A more targeted green golden rule could focus on GPI only.

Pros:

- A green golden rule would incentivise Member States to transform large parts of their expenditures towards GPI.
- A green golden rule is a permanent provision enabling the implementation of longer-term GPI strategies most MS will need in the current decade and beyond.
- It will also protect GPI during cyclical downturns when public investments are easier to reduce or postpone to a later period. This should ensure that long-term investments to fight climate change will not suffer from fiscal tightening.

Cons/potential problems:

- A green golden rule may require changes towards the Fiscal Compact and the expenditure benchmark, which is part of the Six-pack reform.
- It would increase the complexity and administrative burden both from an evaluation and monitoring standpoint.
- It could create inefficient shifts away from green expenditure which has an investment character but is not counted as green investment (e.g., green qualifications) towards GPI which is eligible but possibly less efficient (Bénassy-Quéré, 2022).

Compared to the Commission's proposal, a green golden rule would specifically focus on GPI and not on public investment in general, so that its scope would on the one hand be narrower. On the other hand, a green golden rule would create larger leeway for GPI, as the 3% of GDP deficit limit would be disregarded, as well as the impact of GPI on the debt ratio. Moreover, the green golden rule is a permanent provision, thus better accommodating for the existing long-term GPI needs. In principle, it could be integrated in the reform of the fiscal framework as proposed by the Commission.

2.2.3 A benchmark for GPI as a share of government expenditures

The third approach would be for the European Commission to recommend a benchmark for each MS as a share of government expenditures that should be committed towards GPI (e.g., a certain percentage of overall government public investment/expenditure). This benchmark share would be based on an estimated country-specific green investment gap. Given this target share of GPI, MS could qualify relevant expenditures for being exempted from the deficit rules.

Pros:

- Legally a benchmark share for GPI would be easy to introduce within the European Semester, by enriching it with GPI goals and adequate indicators.[2])

Cons/potential problems:

- Achieving the goal of mobilising significant GPI in MS will be very much dependent on the implementation of the GPI benchmark share. If it is implemented as a soft law with the European Commission only issuing recommendations to MS about the share of GPI they should invest in, it runs the risk of being ineffective, similar to the Country Specific Recommendations (CSR). On the other hand, an enforcement based on sanctions appears politically unrealistic.

A GPI benchmark share could rather easily be integrated in the Commission proposal of a net expenditure path, by excluding GPI spending from net expenditures. Alternatively, the medium-term fiscal-structural plans submitted by MS could foresee a pre-determined share of GPI in their public investment.

2.2.4 An EU Climate Fund

Another option would be to establish an EU Climate Fund (CF) taking up debt on capital markets and offering loans at favourable interest rates to MS to finance GPI.[3]) Depending on its scope and volume, it could either complement or substitute a reform of fiscal rules aiming to further GPI based on one of the three reform options sketched above.

Pros:

- An EU CF would alleviate the burden of interest payments associated with additional public debt to finance GPI particularly for those MS facing relatively high interest rates.
- It could be used to finance strategically important cross-border GPI projects, particularly in the areas of railway and energy supply infrastructure, which are underfunded based on purely national decision-making and budgets. By collectivising GPI accordingly, the CF would strengthen the EU Single Market (European Commission, 2022c).

---

[2]) Similarly, the EU Greening Initiative has made first attempts to reaching such goals without the need to change other EU law, including the SGP. See: https://ec.europa.eu/environment/integration/green_semester/about_en.htm.

[3]) The cornerstones of an EU CF sketched here are inspired by the proposal by Garicano (2022) who suggests introducing a European Climate Investment Facility. See also the recent proposal launched by the IMF (Arnold et al., 2022) for a debt-financed EU Climate Investment Fund which, however, should grant transfers to MS to fund GPI.

- It would incentivise debt financed GPI particularly in those MS confronted with relatively high interest rates.
- It could make use of already existing EU and national RRF implementation structures.
- It would avoid making EU fiscal rules even more complex (Bénassy-Quéré, 2022).
- An EU CF could help to mitigate a subsidy race within the EU by coordinating MS GPI policies to some extent.

Cons:

- An EU CF would be rather unattractive for those MS enjoying favourable interest rates for their national debt.

Although the recent Commission proposal explicitly aims at increasing the leeway for public investment, the CF could act as a complement to further widen the space for national GPI. It would thus account for the fact that the investment gap probably is biggest regarding green investment, which, however, is not explicitly acknowledged and considered in the Commission's proposal. In addition, it would support cross-border GPI, which is completely neglected in the Commission's proposal.

2.2.5 Summary of options to further GPI in the EU fiscal framework

Table 1 summarises the four options to further GPI in the EU fiscal framework and evaluates them based on several criteria and along several dimensions. Also their relation to the recent Commission proposal is briefly addressed.

Table 1: **Summary evaluation of options for amending the current fiscal framework to better accommodate for GPI**

Proposal	Ensures the necessary investment	Complexity and administrative burden	Legal/institutional changes needed	Further comments
	Options for a GPI-friendly fiscal rules framework			
Golden Rule for GPI	Incentivises MS to make the maximum amount of GPI possible. Allows longer-term and more substantial deviation from deficit targets	Significant increase in complexity and administrative burden	Changes to the Fiscal Compact/Six-pack Reform	Would create larger leeway for GPI than the Commission proposal. Could be integrated in the Commission proposal
Exemption Clause for GPI	Enables, but does not ensure Member States will make sufficient GPI. Allows only limited temporary deviation from deficit targets	Medium increase in complexity and administrative burden	New Communication on the flexibility clause and amendment to the Code of Conduct of the SGP	Would create considerably narrower leeway for GPI than the Commission proposal

Table 1: **Summary evaluation of options for amending the current fiscal framework to better accommodate for GPI (continued)**

Proposal	Ensures the necessary investment	Complexity and administrative burden	Legal/institutional changes needed	Further comments
		Options for a GPI-friendly fiscal rules framework		
(Binding) share of GPI as a percentage of current expenditure	Incentivises GPI, but risks non-compliance	Medium increase in complexity and administrative burden	Changes to the European Semester	Low political feasibility (if binding) or low compliance (if only with a recommendatory character). Could be easily integrated in the expenditure path proposed by the Commission: alternatively, binding GPI shares in national fiscal-structural plans could be foreseen
EU Climate Fund	Incentivises particularly MS facing high interest rates to make debt financed GPI Incentivises cross-border GPI	Neutral with regard to the EU fiscal frame-work	New legal proposal New Communication on counting CF GPI towards fiscal rules. Changes to the European Semester	Incentives differ across MS depending on country-specific interest rates for public debt. Could act as a complement to the EU proposal to particularly support (cross-border) GPI.

Source: own.

2.3 Challenges and risks

Even though all four proposals for amending the fiscal rules sketched above have benefits in terms of enabling more GPI, they also are associated with various challenges and risks.

A first issue is the definition of GPI. The EU Taxonomy for sustainable activities, which presents itself as a useful basis for such a definition, is contentious in some aspects.

A second challenge is to design the reform in a way that it minimises additional complexity and administrative burden, as the current design of the SGP with all its amendments has already been criticised for being too long, complex, and non-transparent.

Third, monitoring and reporting will therefore be a crucial part of an efficient implementation of any of the above approaches to facilitate GPI in EU MS.

A fourth, related challenge revolves around the measurement of the green (public) investment gap (Bertram et al., 2022), which is important to determine MS specific green (public) investment needs as well as to measure progress in the implementation of the respective investment plans and the related green provisions in the reformed EU fiscal framework.

Fifth, it will be important to avoid short-sightedness, as GPI inevitably involves long-term planning and multiannual projects. Therefore, instead of setting up rules, targets, or exemptions on an annual basis, these should be guided through multiannual plans, similar to the MTO embedded in the SGP.

Sixth, a certain risk is associated with the interest rate environment. Depending on currently highly insecure future political and economic developments, debt-financed GPI may incur considerable future costs for public budgets and may thus be problematic from the perspective of fiscal sustainability, should the most recent trend of increasing long-term interest rates continue. This trend could be aggravated by a significant increase in green investment and by climate change itself, which may raise the real equilibrium interest rate (Darvas & Wolff, 2021).

3. Conclusions

From the perspective of the ever-increasing urgency to advance the green transition, targeted reforms in the EU fiscal framework to increase the space for GPI very generally are preferable to a general relaxation of the stringency of EU fiscal rules, as the latter would not provide incentives to raise GPI (Darvas & Wolff, 2021). Such a targeted flexibilisation of the EU fiscal framework will be particularly important during the current decade: on the one hand, the stepped-up EU climate goals require massive GPI in all EU MS by 2030 and beyond. On the other hand, the deterioration of public budgets due to the ongoing multiple crises bear the danger that public investment in general and GPI in particular fall victim again to the fiscal consolidation efforts to be expected for the near future, aggravated by the recent increase in interest rates. At the same time, targeted approaches to further GPI appear less prone for loopholes compared to a general relaxation of EU fiscal rules. Moreover, considering the uncertain growth effects of GPI (Darvas & Wolff, 2021; Victor, 2022; Pisani-Ferry, 2021) and the possibly changing interest rate environment, targeted approaches appear more advisable from the perspective of debt sustainability.

References

Arnold, N. G., Balakrishnan, R., Barkbu, B. B., Davoodi, H. R., Lagerborg, A., Lam, W. R., Medas, P. A., Otten, J., Rabier, L., Roehler, C., Shahmoradi, A., Spector, M., Weber, S., & Zettelmeyer, J. (2022). Reforming the EU Fiscal Framework: Strengthening the Fiscal Rules and Institutions. *IMF Departmental Papers*, *2022*(014). https://doi.org/10.5089/9798400209888.087.A001.

Becker, H., Paetz, C., Watt, A., & Watzka, S. (2023). Reform der EU-Fiskalregeln: Kommissionsvorschlag erster Schritt in die richtige Richtung. *IMK Kommentar*, *10*. https://www.boeckler.de/de/faust-detail.htm?sync_id=HBS-008507.

Bénassy-Quéré, A. (2022). How to Ensure that European Fiscal Rules Meet Investment. *VoxEU Column, VoxEU CEPR Debate*. https://cepr.org/voxeu/columns/how-ensure-european-fiscal-rules-meet-investment.

Bertram, L., Hafele, J., Korinek, L., Malvezzi, M., Temory, F., & Engel, M. (2022). *New Fiscal Rules for the EU – Design Choices Matter*. ZOE Institute for Future-fit Economies. https://zoe-institut.de/en/publication/new-fiscal-rules-for-the-eu-design-choices-matter/.

Claeys, G., & Tagliapietra, S. (2020). A Trillion Reasons to Scrutinise the Green Deal Investment Plan. *Bruegel Blog, January 15, 2020*. https://www.bruegel.org/blog-post/trillion-reasons-scrutinise-green-deal-investment-plan.

Darvas, Z., & Wolff, G. B. (2021). A Green Fiscal Pact: Climate Investment in Times of Budget Consolidation. *Bruegel Policy Brief*. https://www.bruegel.org/policy-brief/green-fiscal-pact-climate-investment-times-budget-consolidation.

Delgado-Téllez, M., Ferdinandusse, M., & Nerlich, C. (2022). Fiscal Policies to Mitigate Climate Change in the Euro Area. *ECB Economic Bulletin Articles*, *6*.

European Commission (2021). The EU Economy After COVID-19: Implications for Economic Governance. *COM(2021) 662 Final*.

European Commission (2022a). Towards a Green, Digital and Resilient Economy. Our European Growth Model. *COM(2022) 83 Final*.

European Commission (2022b). Communication on Orientations for a Reform of the EU Economic Governance Framework. *COM(2022) 583 Final*. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52022DC0583&from=EN.

European Commission (2022c). A European Sovereignty Fund for an Industry "Made in Europe". *Blog of Commissioner Thierry Breton, 15 September 2022*. https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_22_5543

Garicano, L. (2022). Combining Environmental and Fiscal Sustainability: A New Climate Facility, an Expenditure Rule, and an Independent Fiscal Agency. *VoxEU Column, VoxEU CEPR Debate*. https://cepr.org/voxeu/columns/combining-environmental-and-fiscal-sustainability-new-climate-facility-expenditure.

Pekanov, A., & Schratzenstaller, M. (2023). *A Targeted Golden Rule for Public Investments? A Comparative Analysis of Possible Accounting Methods in the Context of the Review of the Stability and Growth Pact*. Economic Governance and EMU Scrutiny Unit (EGOV), Directorate-General for Internal Policies, European Parliament. https://www.europarl.europa.eu/RegData/etudes/IDAN/2023/733760/IPOL_IDA(2023)733760_EN.pdf.

Pisani-Ferry, J. (2021). Climate Policy is Macroeconomic Policy, and the Implications will Be Significant. *Peterson Institute for International Economics (PIIE) Policy Brief*, *21–20*.

Victor, P. A. (2022). The Macroeconomics of a Green Transformation: The Role of Green Investment. In Heinrich-Böll-Foundation, ZOE - Institute for Future-Fit Economies, & Finanzwende Recherche (Eds.), *Making the Great Turnaround Work—Economic Policy for a Green and just Transition* (pp. 55–65). Volume 27 of the Publication Series Economic & Social Issues. Heinrich-Böll-Stiftung, Finanzwende & ZOE Institute for future-fit economies.