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How to green the EU's fiscal framework

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Reflecting joint work with Zsolt Darvas

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The essence of the argument

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1. There is a strong prima-facie case for 'privileging' (creating incentives for, protecting) green public investment in the EU fiscal framework.
2. The proposal that is currently in the legislative process falls well short in this respect.
3. It is possible to design a "green fiscal rule" that:
   - safeguards debt sustainability;
   - adequately protects green investment;
   - stays close to the spirit and letter of the current proposal.

Outline

1. The case for a green fiscal rule
2. The EU fiscal governance proposal:
3. How to green the EU fiscal rules

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    - The generic argument
    - The specific argument
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The generic argument for a green fiscal rule

Political economy tends to favour current spending over investment spending

- Government incentives are aligned with 4-5-year electoral horizons.
- Public investments tend to have longer term (10-30 year) benefits.
- Future beneficiaries are insufficiently represented at the polls. Hence, governments underinvest (relative to a social planner with a moderate discount rate).

This distortion could be massive for green public investment.

- Public investment in the next 5-10 years will determine the welfare of *all* future generations, but could require large sacrifices of the current generation.
- Fiscal rules should provide incentives that favour such investments

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Estimated green total investment needs are large: about 2% of GDP per year to achieve a 55% emissions reduction by 2030

European Union		France	
Power grid	34.2	Energy	9
Power plants	25.6	Agriculture	2
Industry	11.3	Industry	4
Residential	106.3	Residential	21
Tertiary	46	Tertiary	27
Transport	129.6	Transport	3
Other	3.4		
Total	356.4	Total	66
% GDP	2	% GDP	2.3

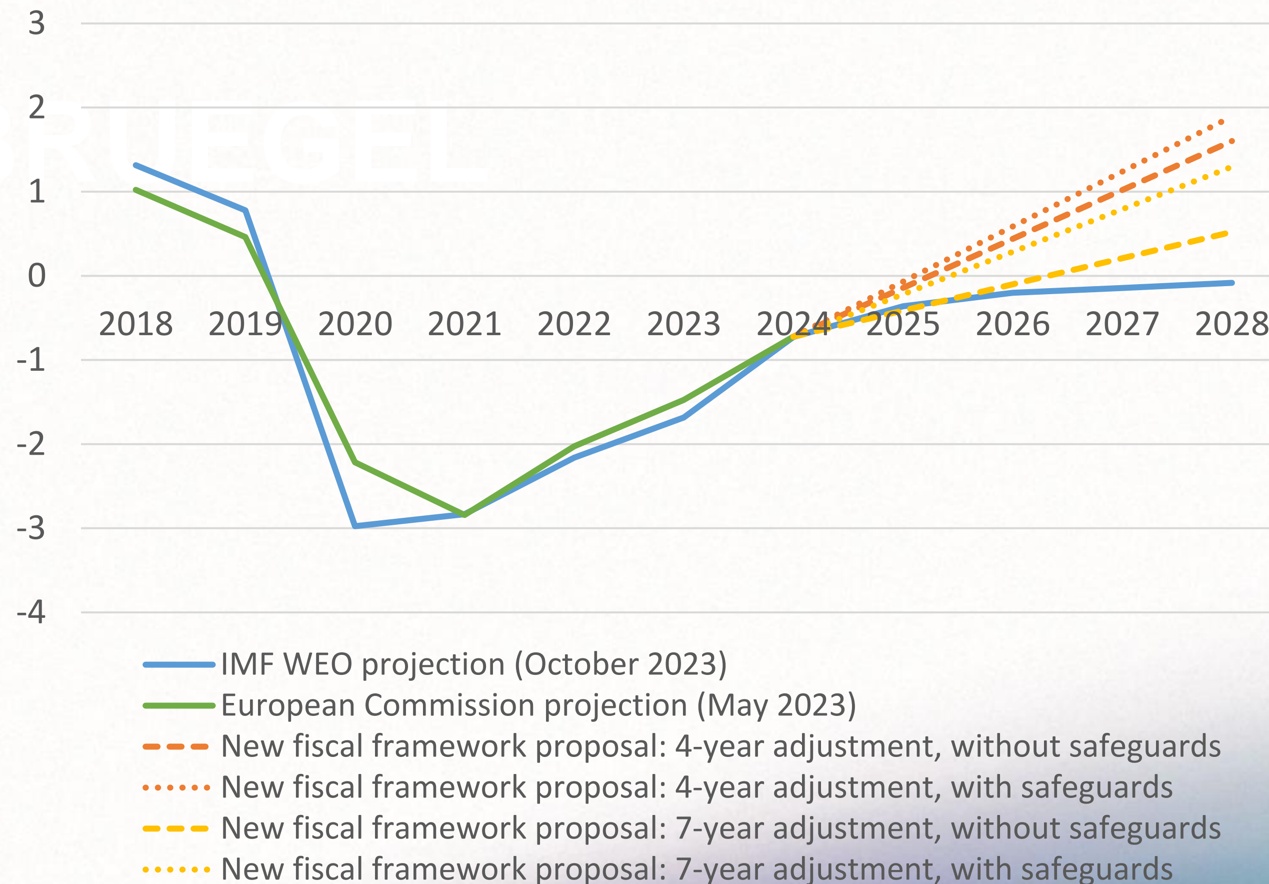
Source: European Commission (2020a) and Pisani-Ferry and Mahfouz (2023). Note: numbers for the EU refer to investment needs to achieve a 55% emissions reduction by 2030 (MIX scenario); numbers for France refer to investment needs to reach the 2030 target for France, compared to a business-as-usual scenario without greening of the economy. The transport component of the Commission estimate is broadly in line with another Commission recovery-related estimate for the transport sector (European Commission, 2020b).

Source: Pisani-Ferry, Tagliapietra and Zachmann (2023)

This translates into an additional public sector investment requirement of about 1% per year …

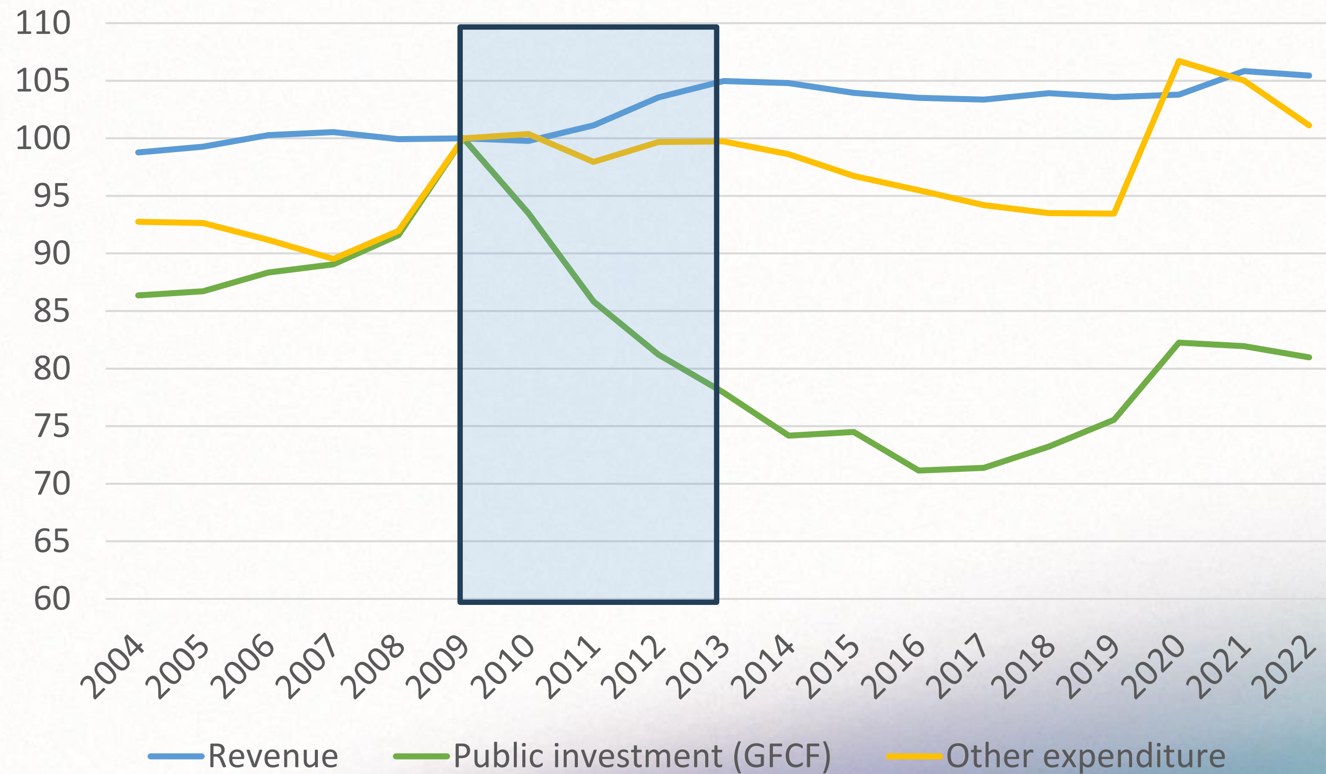
- Darvas and Wolff (2022): public share around 30%
- Pisani-Ferry and Mahfouz (2023): public share 50% for France
- These two estimates additional public sector investment needs of 0.6%-1.0%
- However, the bottom-up approach of Baccianti (2022) suggests 1.8% GDP per year for the public sector alone

… at a time when EU countries are expected to *lower* public deficits (the next 5-8 years).



Source: Darvas and Zettelmeyer (2023); October 2023 IMF World Economic Outlook.
Note: "safeguards" refer to the safeguards originally proposed by the EC in April 2023.

However, in times of high consolidation pressure, public investment is normally the first item to get cut.



Source: AMECO database
Note: shaded area denotes crisis period

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The specific argument for a "green fiscal rule": summary

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- EU governments need to substantially *raise* green public investment at a time when they need to *lower* public deficits (namely in the next 5-8 years).
- In times of consolidation needs, public investments tend to suffer disproportionately.
- To the extent that consolidation needs are policy-influenced—through the design of a new euro area fiscal framework—critical investment should be shielded from consolidation pressures.
- This argument applies disproportionately to green investment, because it is 'extra critical' in the next 5-8 years.

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The EU's economic governance review (EGR): main elements

1. Country-specific medium-term fiscal adjustment requirements, based on Commission's debt sustainability analysis (DSA) and 3% deficit benchmark
   - Motivated by efficiency/subsidiarity: Don't require more fiscal adjustment than needed for debt sustainability and to satisfy Treaty.
   - Expected to raise "national ownership" and hence member state compliance.
2. Possibility of extending 4-year adjustment period to 7 years if countries commit to credible reform/investment plans
   - To create incentives for reform and allow high-debt countries to lower debt by raising growth rather than just through austerity.
3. A set of "safeguards" (simple rules dictating minimum deficit and debt reduction).
   - Added in April 2023 legislative proposal to address mistrust of member states in EC-controlled DSA. Under negotiation with member states.

The ‘safeguards’ in their latest iteration

(November 8, 2023 “landing zone” document of the Spanish EU presidency)

Safeguard name	What it means
No backloading	*“Fiscal effort … should be linear as a rule and at least proportional to total effort over the entire adjustment period.”*
Minimum debt reduction (i)	*Debt at the end of the adjustment period should be lower than before its start*
Minimum debt reduction (ii)	*Debt must “decrease by a minimum annual average of [AA pp of GDP] over 4 years after the adjustment period”*
Excessive deficit	*Minimum fiscal effort of 0.5% of GDP per year while deficit is excessive*
Deficit resilience	*Fiscal adjustment should “guarantee a common safety margin below the 3% of GDP deficit threshold”*

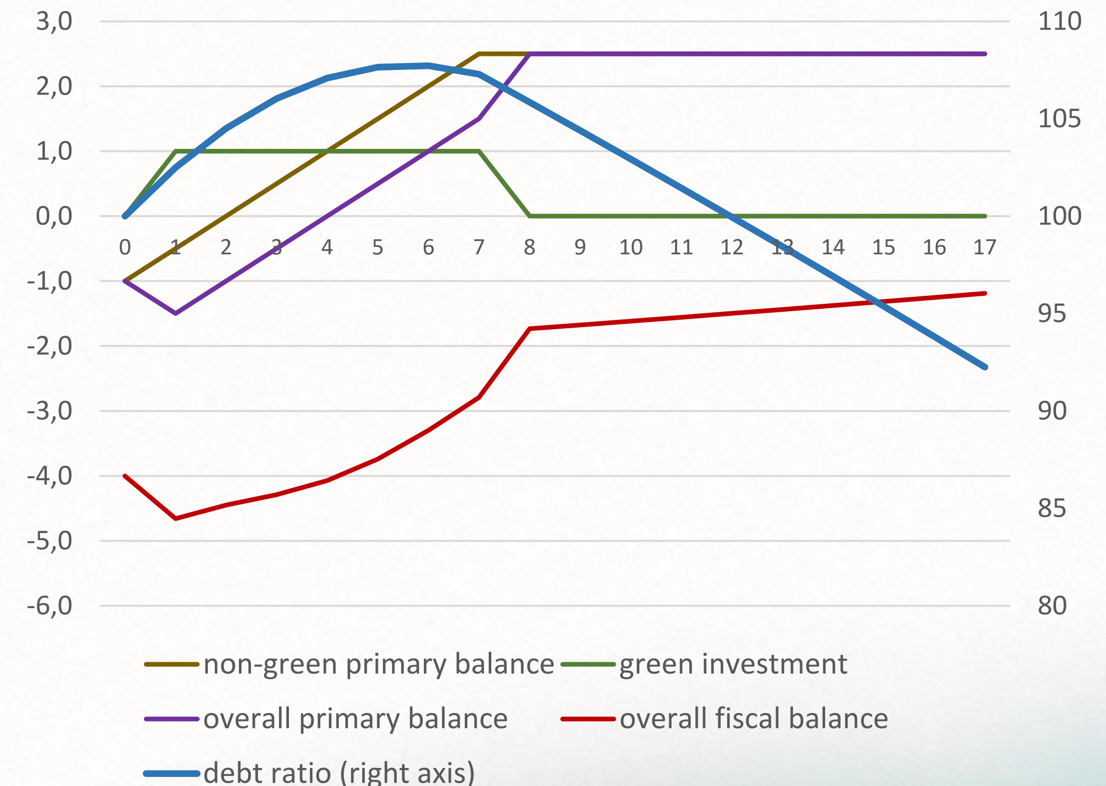
The proposed framework is bit green, but not green enough

1. Lowers required *annual* (not necessarily total) fiscal adjustment for countries with EU-endorsed public investment plans.
2. EU-endorsed public investment can justify a limited exception to the no-backloading safeguard
   - "Projects related to Recovery and Resilience Fund loans in 2025 and 2026 as well as national co-financing of EU funds will be taken into account whenever a Member State requests an exception to the no-backloading safeguard, provided that this does not endanger fiscal sustainability in the medium term."

<u>Main problem</u>: Green public investment constrained by various other safeguards, even when it is EU-endorsed, and even if it is structured consistent with debt sustainability and the 3% deficit benchmark.

A green investment programme combined with fiscal adjustment could easily conflict with the proposal (example)

- Starting debt: 100, starting deficit 4, starting interest bill 3, debt stock rolls over in 7 years. Nominal interest rate = 4%, inflation = 2%, real growth = 1%
- During years 1 through 7, country spends 1% of GDP in additional annual green investment. *At the same time, fiscal adjustment raises primary balance from -1% of GDP to 2.5 over 7 years, in steps of 0.5% of GDP.*
- Both DSA and 3% benchmark are satisfied.
- *<u>But problem</u>: debt safeguard (i), excessive deficit safeguard, and no-backloading safeguard are all violated.*



Notes: "non-green primary balance" = primary balance minus additional green investment spending
"green investment" = *additional* green investment due to the temporary investment push. All units in percent of GDP.

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(Green) investment and fiscal sustainability: “theory”

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From the perspective of fiscal sustainability, it is ok for public investment to result in a rise in the net debt ratio if:

1. It pays for itself (by generating fees, or raising future output and taxes), or
2. Even if the investment does not pay for itself, if:
   - The investment programme is temporary (leading to a “level” increase in debt, rather than permanent increase in the deficit)
   - After the end of the investment programme, the primary balance is high enough to rule out explosive debt paths with high probability (which implies declining debt under baseline assumptions).

Problems:

i. Not all green public investment satisfies (1)
ii. The ’safeguards’ can make make strategy (2) impossible (as shown in example)

The small solution

(Darvas, Welslau and Zettelmeyer 2023)

1. In applying the no-backloading safeguard, define “fiscal effort” in terms of non-green primary balance rather than overall primary balance.
2. Either drop the remaining safeguards altogether or modify them:
   - In applying the *excessive deficit safeguard*, define “fiscal effort” in terms of non-green primary balance rather than overall primary balance.
   - Exclude debt issued to finance a (council-endorsed) green investment programme from the application of the *debt safeguard* (it would remain included in the DSA requirements that need to apply after 4-7 years).

Main problem: horizon of green investment programme would be limited to 7 years.

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The bigger solution: a "fiscally responsible green golden rule"

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1. Separate debt and deficits after the beginning of the adjustment period into a portion attributable to an EU-endorsed green investment programme and the "non-green" rest.

- *"Non-green" debt and deficit*: must satisfy DSA, 3%, no backloading and potentially additional safeguards after (or with respect to) 7-year adjustment period.
- *EU-endorsed green investment programme*: can be of arbitrary length and cost so long as it is accompanied by fiscal adjustment such that after the end of the programme, the primary balance is high enough to ensure the decline of *overall* debt with high probability and an *overall* deficit of less than 3% of GDP.

2. Adapt the excessive deficit procedure (EDP) such that countries that do not deliver the promised non-green fiscal adjustment trigger the procedure (requiring a corrective adjustment path that ensures debt sustainability).

Conclusion

The proposed fiscal framework could be augmented by a "fiscally responsible green golden rule" that allows increases in the debt ratio to finance green investment, *conditional on simultaneous fiscal adjustment*.

- This works *conceptually*, because the investment push is temporary while the underlying fiscal adjustment is permanent (a flow adjustment).
  - Hence, can pay for a time-limited increase in investment by 1% of GDP per year with fiscal adjustment that is much lower than 1% of GDP per year.
- It would also work *practically*, because
  1. The green golden rule would apply only to investment programmes that are individually endorsed at the EU level – no free-for-all.
  2. If the promised simultaneous fiscal adjustment does not happen, the authorisation to raise debt to finance the programme would be withdrawn, triggering an EDP.

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