FROM MAASTRICHT TO PARIS

Why climate change should be considered in a reformed EU fiscal framework

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CONTENTS

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INTRODUCTION

Adopted 30 years ago, the Maastricht Treaty placed limits on EU Member States debt and deficit levels to 60% and 3% of a country's GDP. Historically, debt servicing costs were a significant part of Member States budgets.[1] Binding numerical fiscal limits were therefore perceived as a necessity to ensure that Member States could continue to service their debt – hence limiting contagion risks inside the euro area – without assistance by other members or by the European Central Bank.[2] The Treaty arbitrarily limits the debt and deficit levels to, respectively, 60% and 3% of a country's GDP.[3] How to implement those rules has been further detailed in the Stability and Growth Pact.[4]

Concerns about debt sustainability risks appear today inflated compared to climate, environmental, and socio-economic challenges Europe is facing. Whilst servicing public debt has never cost so little to European governments[5], the existential threat from climate change and its impacts on the economy and public finance is becoming clearer every day – from agricultural productivity to energy production, health impacts from water, air and soil pollution, to the destruction of infrastructure due to extreme weather events.

In 2015, with the Paris Agreement on climate change, governments committed to limit the increase in global average temperature to well below 2°C degrees, and to pursue efforts to limit global temperature rise to an even more ambitious 1.5°C target. The Paris Agreement indicates that private and public financial flows need to be made "consistent with a pathway towards low greenhouse gas emissions and climate-resilient development."

Connections between climate change, debt sustainability, and the reform of the EU economic governance are often overlooked. This briefing seeks to unpack these connections, and formulates key recommendations which can shape the reform of the EU fiscal rules in order to limit the vast economic, social and environmental damages threatening our future.

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1 Accounting for 3,5-11% of GDP, as governments struggled with high long-term sovereign interest rates (7-25%).

2 In addition to the EU fiscal rules, policymakers originally engineered market discipline as a force for fiscal prudence in the euro area. This was achieved by barring the way to a lender of last resort for sovereign issuers in the European Treaties – the monetary financing prohibition (art 123 TFEU) and the 'no bailout clause' (art 125 TFEU). The financial and recent health crises have shown that a different approach is needed.

3 Currently defined in the protocol n°12 annexed to the TFUE, the quantitative limits of the Maastricht Treaty were defined 30 years ago taking into account, approximately, the average of the EU Member States debt levels and the average economic situation at the end of the 1990s. Assuming potential growth of 2% and an inflation target of 2%, a budget deficit limit of 3% of GDP would stabilise the ratio of government debt to GDP at 60%.

4 For more information on these maze of rules, see: SUTTOR-SOREL, L., "*Navigating The Maze*", Finance Watch, 2021.

5 European countries have experienced a continuous fall in long-term interest rates to a historically low level of 0-3%. This has resulted in debt servicing costs as low as 0-3% of GDP despite higher stocks of public debt. Recent surges in interest rates are far from reversing this trend – e.g. Italian's interest rates in April 2022 are still far below the German interest rates in 1992.

RECOMMENDATIONS

1 Task IFIs with country-specific debt sustainability analysis

Acknowledging that the sustainable level of government debt hinges on each sovereign's macroeconomic fundamentals, the national independent fiscal institutions (IFIs) should be tasked with conducting **country-specific debt sustainability analyses** that would receive a more prominent role in the European fiscal framework. **Crucially, climate-related fiscal risks** need to be better understood and monitored.

2 Develop a methodology to assess climate-related fiscal risks

We call upon Member States to urge the European Commission, in partnership with the European Fiscal Board and IFIs, to propose **a common EU methodology to measure climate-related fiscal risks** (physical and transition risks). More generally, we call upon Member States to support the efforts of the European Commission and EU IFIs in this field, by **providing them with the needed political and financial resources**.

3 Task IFIs with estimating green funding gaps

As part of a future review of the minimum standards for national fiscal frameworks, the national independent fiscal institutions should be tasked with estimating **national funding gaps to achieve EU's climate and environmental objectives** (i.e. green funding gaps).

4 Develop an EU methodology to assess green funding gaps

Member States should call upon the European Commission to elaborate **a consistent methodology** that could be used across Member States to measure the **national green funding gaps** (public and private). The public green funding gap, as well as a mapping of environmentally-harmful subsidies, should be integrated in revised National Energy and Climate Plans (NECPs) and guide fiscal decisions under the European Semester.

5 Move to conditionalised country-specific debt pathways

Acknowledging that the sustainable level of government debt hinges on each sovereign's macroeconomic fundamentals, **country-specific debt sustainability analyses** should become the basis of **country-specific debt pathways**. To disincentivize the misuse of taxpayers' money, country-specific debt pathway should be linked to the respect of **minimum standards** such as:

- **Full implementation of the anti-corruption recommendations** of the European Commission (Country-Specific Recommendations and Rule of Law Report), the Group of States against Corruption (GRECO), the OECD, and the United Nations.
- **Binding commitments to phase out environmentally-harmful subsidies**, in a socially just way.

6 Create unique National Reforms & Investment Plans (NRIPs)

These multiannual plans would integrate and streamline economic reform and fiscal plans that Member States submit as part of the European Semester – respectively National Reform Plans and Stability or Convergence Programmes. These NRIPs would have to align with country-specific debt pathways, **country-specific recommendations (CSRs), and commonly-defined EU priorities** (e.g. Green Deal, REPowerEU). This could improve the interplay between economic and fiscal policies while simplifying the European Semester and facilitating the delivery of EU social and climate goals.

8 Improve the European Semester

The European Semester should be used to assess countries' progress towards the achievement of EU objectives (e.g. EU Green Deal, European pillar of social rights, European Industrial Policy). **Country-Specific Recommendations (CSRs)** should be tailored according to countries' distance to the target. To improve relevance and compliance, CSRs should (i) better account for EU objectives and European Monetary Union (EMU) dimensions (e.g. euro area fiscal stance, spillovers, externalities), (ii) be associated with specific indicators, (iii) be formulated in a way that makes progress measurable, and (iv) be prioritised according to their significance.

Whilst national parliaments and the European Parliament need to play a central role in the future architecture, social partners and Civil Society Organisations (CSOs) should also be involved. **A dedicated regulation** organising the European Semester should integrate consultation mechanisms with civil society organisations and workers' unions in a formal way.

The adequate implementation of robust NECPs and the shift towards green, gender-just and progressive taxation should be encouraged under the European Semester.

7 Treat future-oriented expenditures differently

Allow newly-formed governments to submit, as part of their NRIPs, **a list of future-oriented expenditures** to be excluded from their deficit (and/or expenditure) limits.

To address concerns that any mechanism excluding automatically some categories of spending could create negative incentives to circumvent the rules, we suggest the following: The decision to exclude some spending from a Member State's expenditure ceiling should be part of a broader process of **ex-ante technical assessment** by the European Commission (e.g. respect of the Do-No-Significant-Harm principle, quality, EU objectives), **dialogue** between the Commission and Member States, and **political validation** by the Council. Ex-post, the Member State would have to report on pre-agreed result indicators.

In order to get preferential treatment, the list of future-oriented expenditures proposed by the Member State as part of its NRIP should demonstrably:

(1) Abide by the Do-No-Significant-Harm principle (DNSH)

(2) Be inclusive (taking into account the expected distributional impact, including gender dimension)

(3) Contribute to the implementation of EU climate and nature protection laws or the European Pillar of Social Rights

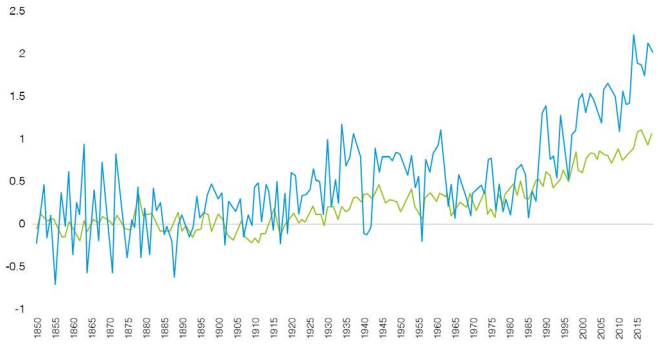
(4) Contribute to closing the national green funding gaps

I. WHAT ARE THE EXPECTED CLIMATE CHANGE TRENDS IN EUROPE?

Warming in Europe will continue to rise faster than the global average, widening risk disparities across the region in the 21st century. According to the most recent report by the United Nations Intergovernmental Panel on Climate Change (IPCC), southern regions tend to be more negatively affected, while some benefits have been observed, alongside negative impacts, in northern and central regions.[1]

Warming will decrease suitable habitat space for terrestrial and marine ecosystems and irreversibly change their composition, with increasing severity above a 2°C global warming level. Fire-prone areas are projected to expand across Europe, threatening biodiversity and carbon sinks.

Figure 1 - Global and European temperature anomalies, 1850-2019



Source: European Commission, 2022 - based on EEA, colours modified

Due to a combination of heat and drought, **substantive agricultural production losses are projected for most European areas over the 21st century**, which will not be offset by gains in Northern Europe.[2] While irrigation is an effective adaptation option for agriculture, this will be increasingly limited by water availability. Adaptation actions, e.g. habitat restoration and protection, fire and forest management and agroecology, can increase the resilience of ecosystems and their services.

Adaptation is not currently implemented at the scale, depth and speed needed to avoid the risks. According to the IPCC, key barriers are limited resources, lack of private sector and citizens engagement, insufficient mobilisation of finance, lack of political leadership, and a low sense of urgency.[3]

While climate change is not the main driver of social inequality in Europe, **poor households and marginalised groups in Europe are affected more severely than other social groups** by flooding, heat and drought and risks of spreading diseases.

1 IPCC WGII, "*Sixth Assessment Report. Chapter 13 on Europe*", 2022.
2 Ibid.
3 Ibid., p.5.

II. WHY IS CLIMATE RELEVANT TO THE ECONOMY AND PUBLIC BUDGETS?

Climate change affects the economy and public finances in a number of ways: First, climate-related weather events directly affect the economy (i.e. **physical risks**) and public budgets through increased public spending to replace damaged assets and infrastructure, and to support affected households or firms.[4] Second, **mitigation and adaptation measures** needed to contain climate-related impacts also generate a cost – while benefits are not immediately visible. Thirdly, public budgets are impacted by **transition risks**, i.e. the economic risks that result from a transition (impact of carbon pricing, consumption changes, etc.) which can be reduced by early action or exacerbated by inaction and disorderly transition (e.g. lock-in and stranded assets). Last but not least, there are risks due to **feedback from global trends** – for example, climate change, ecosystem degradation and water scarcity contribute to higher and more volatile food prices, which will impact national economies. If these impacts are significant enough, they may affect the sustainability of public debt, the risk exposure of sovereign bondholders, and sovereign credit ratings.[5]

A. PHYSICAL RISKS

Climate-related damage in the EU could result in annual loss of at least €170 billion under a 3°C global warming scenario, significantly impacting public budgets. Climate-related natural disasters affected nearly 50 million people in the European Union between 1980 and 2020,[6] and the total economic loss amounted to at least €419 billion – or €12 billion per year.[7] Conservative estimates show that the current trend in global warming could result in an annual loss of at least €170 billion (1.36% of EU GDP).[8] For floods alone the expected annual damage is €2.5 billion for Germany, followed by Italy, France, Austria and Poland (around 2 billion a year each) from 2021 till mid-century.[9] Risks for critical infrastructure are assessed at €10 billion per year in Europe for the current period, while energy supply is expected to decrease in most cases – with worse effects under a 3°C scenario.[10] The benefits of investing in measures to manage the risks of floods, earthquakes, heatwaves, and wildfires substantially outweigh the costs by a factor of two to ten.[11]

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4 E.g. As noted in the EU Climate adaptation strategy, "Relief and reconstruction after extreme weather and slow-onset events will increase government expenditure, including via compensation for uninsured losses. The effects on production capacity may have a negative impact on economic growth [...]"

5 UNEP FI, "*ERISC phase ii: How food prices link environmental constraints to sovereign credit risk*", 2016.

6 EEA, "*Economic losses from climate-related extremes in Europe*", 3 Feb 2022.

7 EC, "*Closing the climate protection gap - Scoping policy and data gaps*", EC SWD(2021) 123, May 2021, p.8.

8 EC, "*Forging a climate-resilient Europe - the new EU Strategy on Adaptation to Climate Change*", COM(2021) 82

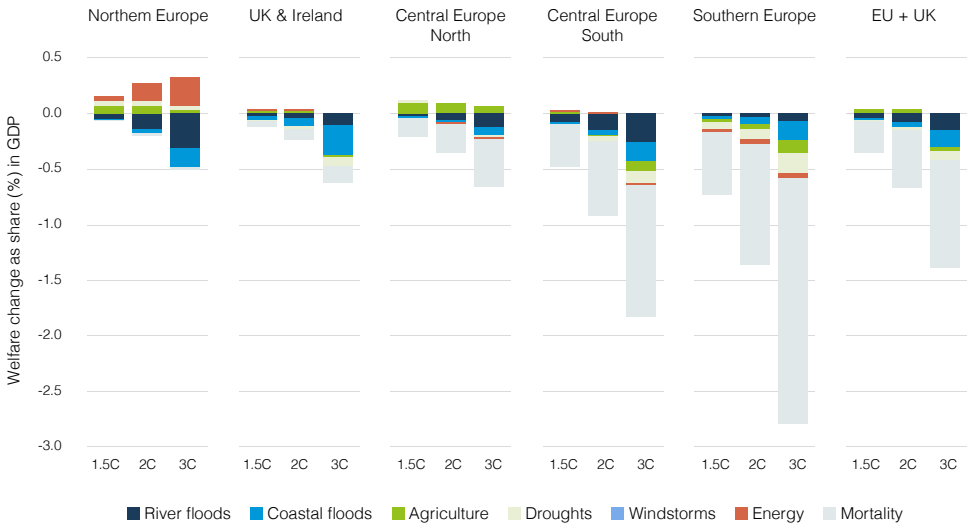
9 EC, *Joint Research Centre* (2018), page 28.

10 The most exposed energy supply sources are hydropower because of flooding risks for dams, and thermoelectric power including nuclear because of heat waves and water cooling constraints, see IPCC, op.cit., p.41-43.

11 World Bank, "*Economics for Disaster Prevention and Preparedness in Europe*", 2021.

Climate-related welfare damages[12] are expected to vary across Member States and climate scenarios (see figure 2). EU countries will be affected to different degrees – Southern European countries worse, followed by Central European countries, the Nordic countries, and the Baltic States. Loss in labour productivity and from mortality due to heat are expected to have a very high impact on GDP in Southern European countries.[13]

Figure 2 - Climate-related welfare damages vary across Member States



Source: EC, Joint Research Centre (2020), colours modified

B. TRANSITION RISKS

Transitioning to a low-carbon economy requires the conversion of large parts of the EU's productive capital stock, such as built infrastructure, industrial plants, and machinery, which will imply stranding of certain assets. This applies not only to the stock of extracting infrastructure (i.e. pipelines and other forms of capital linked to fossil fuels) but also to a large number of industrial plants whose output requires fossil fuels as material inputs or for heat processes (e.g. metals, coke, chemicals, steel). The consequent asset stranding (in the form of idle productive capacity) would in turn affect the physical stock that supports the rest of the economic activity (e.g. warehousing, transport infrastructure, etc.).[14]

An early and orderly transition is more manageable and less costly than a disorderly one. Currently, the productive capital stock at risk of stranding under a rapid low-carbon transition in Europe is substantial, but manageable (see figure 3). However, in case of an abrupt and unplanned transition, the drop in capital utilisation might have systemic effects with far-reaching consequences.

12 I.e. percentage of GDP loss compared to how GDP would evolve without climate change.

13 IPCC WGII, "*Sixth Assessment Report. Chapter 13 on Europe*", 2022.

14 CAHEN-FOUROT, L., CAMPIGLIO, E., et al., "*Capital stranding cascades: The impact of decarbonisation on productive asset utilisation*", Vienna University of Economics and Business, WP Series 18/2019

Figure 3 - Productive capital stock at risk of stranding

(million € at 2010 current prices and share of total/sectoral capital stocks)

	Total capital	Mining (B)	Manufacturing (C)	Electricity/gas (D)
Austria	5,689 (0.8%)	431 (16.0%)	1,706 (2.4%)	3,315 (12.5%)
Belgium	3,181 (0.6%)	1 (0.1%)	2,692 (3.0%)	285 (1.2%)
Czechia	17,536 (3.7%)	4,075 (60.9%)	2,772 (3.3%)	6,718 (25.7%)
Germany	40,752 (1.0%)	3,629 (29.6%)	12,702 (2.8%)	21,627 (12.2%)
Greece	8,774 (2.7%)	1,313 (48.7%)	1,800 (8.1%)	2,683 (17.1%)
France	35,514 (1.4%)	3,644 (21.4%)	3,877 (2.1%)	21,913 (23.3%)
Italy	58,589 (2.1%)	2,252 (10.7%)	19,776 (4.9%)	30,565 (14.0%)
Sweden	3,970 (0.8%)	55 (1.4%)	1,762 (2.2%)	1,856 (3.1%)
Slovakia	18,749 (8.2%)	473 (15.1%)	3,220 (7.7%)	13,548 (35.1%)
UK	84,678 (3.6%)	45,900 (69.3%)	7,385 (2.9%)	28,384 (35.7%)

Source: CAHEN-FOUROT, CAMPIGLIO, et al. (2019), colours modified

Climate-related risks will entail adverse economic, financial and fiscal impacts. The European Central Bank's climate stress test reveals the significant exposure of both financial and non-financial corporations to climate-related risks across the EU (figure 4) and the feedback loops between the real economy and the financial sector (figure 5).[15] Whilst these results are subject to limitations due to the known methodological challenges and limited scope of climate-related physical risk coverage[16], they are sufficient for the ECB to recognise climate change as a source of **"systemic risk"** for the financial and corporate sectors. In the absence of further mitigation policies, the cost to companies and banks most exposed to climate risks would significantly rise, with strong consequences for financial stability. It is further evidenced that financial instability could negatively affect broader economic activity, which in turn would affect public and private finances through various channels such as non-performing loans, reduced credit to the real economy, or possible decisions to bail out financial institutions.

15 ECB, "*ECB economy-wide climate stress test*", Occasional Paper Series, No 281, September 2021

16 The ECB economy-wide climate stress test did incorporate physical risk factors, albeit only a limited amount of risk categories were included, whereas inclusion of further ones was left to future work. Significant challenges remain among which data gaps and limitations of the models that simulate economic effects of climate change. More discussion in: Alogoskoufis, S., Dunz, N., et al, "*ECB economy-wide climate stress test: Methodology and results*", ECB Occasional Paper Series, No 281, September 2021.

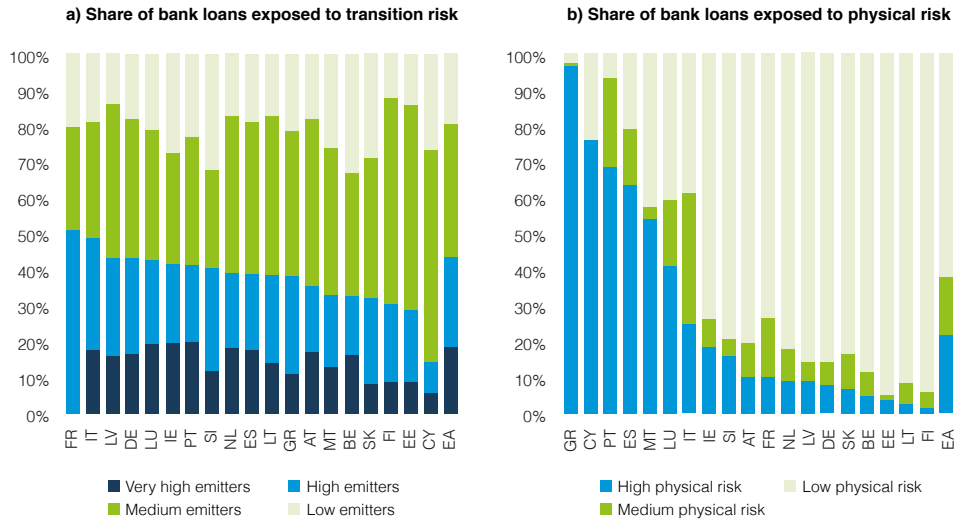
Figure 4 - Share of firms exposed to physical versus transition risk by country

(percentages)

Source: ECB (2021), colours modified

Figure 5 - Share of banks exposures to climate risk per country

(percentages)



Source: ECB (2021), colours modified

C. INTEGRATING CLIMATE CHANGE IN EUROPEAN FISCAL FRAMEWORKS

It is fundamental to plan and execute the transition as early as possible. Whilst significant climate-related risks exist for the economy, the financial system, and the sustainability of public finances, they increase under more severe global warming scenarios. Meanwhile, climate change is still insufficiently accounted for in fiscal frameworks and budgetary planning.[17]

Climate-related risks call for reforms of the EU prudential and fiscal frameworks. Whilst protecting society against the build up of these climate-related financial risks in the private financial sector requires reforming prudential rules[18], transitioning to a low-carbon economy and enhancing fiscal resilience to climate-related disasters[19] requires a reform of the EU and national fiscal frameworks. The reformed frameworks should be better equipped to fulfil the following objectives:

- ➔ **Identify the fiscal impact of climate change** (i.e. climate-related fiscal risks - section III),
- ➔ **Identify climate mitigation and adaptation funding gaps** (i.e. the green funding gap - section IV) and
- ➔ **Mobilise private and public funding to bridge these gaps** (see sections V & VI).

17 EC, "Forging a climate-resilient Europe - the new EU Strategy on Adaptation to Climate Change", COM(2021) 82

18 See: PHILIPPONNAT, T., "*Breaking the climate-finance doom loop*", Finance Watch, 2020; SYMON, J., "*A 'silver bullet' against Green Swans*", Finance Watch 2021; NORWOOD, P., "*Insuring the uninsurable*", Finance Watch, 2021

19 RADU, D., "*Disaster Risk Financing: Main Concepts & Evidence from EU Member States*", EC, DG ECFIN, 2021.

III. IDENTIFYING THE FISCAL IMPACT OF CLIMATE CHANGE

The largest socio-economic impacts are expected in southern regions in Europe, through the effects of extreme heat, water scarcity, drought, forest fires and agriculture losses.[20] As recently highlighted by the IPCC[21], even under the most optimistic scenario, extreme weather events will intensify until mid-century. All of these events will trigger a need for public spending, from responding to wildfires or floods, rebuilding of public infrastructure, to supporting farmers or people who will lose their homes and livelihoods.[22] Several of these countries already have significant levels of public debt, and these expected socio-economic impacts will therefore exacerbate existing macroeconomic and fiscal divergences among Member States.

Despite these risks, the EU fiscal framework is still blind to the fiscal impact of climate change. By overly relying on an arbitrary 60% debt-to-GDP threshold to gauge debt sustainability, the EU framework tends to overlook country-specific drivers of unsustainable debt such as the building up of climate-related fiscal risks.[23] Whilst the EU has made it an official objective of its climate adaptation strategy[24], climate-related fiscal risks are so far hardly considered when determining Member States' medium to long-term debt sustainability.

The understanding of the fiscal impacts of climate change is in its infancy. Some institutions have taken the first steps to integrate climate change into their debt sustainability and fiscal impact analysis – e.g. the UK Office for Budget Responsibility, the Swiss Federal Finance Administration, or the European Commission.[25] In 2019, an independent fiscal institution in the Netherlands, the CPB Netherlands Bureau for Economic Policy Analysis (CPB), estimated the effects of the Netherlands' Climate Agreement[26] measures on the public budget – among other distributional impacts on households, businesses and other countries.[27] The CPB also explored the relationship between sustainable public finances and climate costs.[28]

Interest in the fiscal impact of climate change is growing, but hurdles remain. A growing number of national independent fiscal institutions (IFIs) intend to assess climate transition

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20 EC, "*Climate change impacts and adaptation in Europe*", JRC PESETA IV final report, 2021.

21 IPCC, "*Climate Change 2021. The physical science basis. Summary for policymakers*", 2021.

22 EC, "*Climate change impacts and adaptation in Europe*", JRC PESETA IV final report, 2021.

23 Other drivers include the evolution of interest payment-to-GDP, interest growth (r/g) differential, share of short-term debt and foreign-held debt on total debt stock, or the average maturity of the debt stock. For more discussion: SUTTOR-SOREL, L., "*Fiscal Mythology Unmasked*", Finance Watch, 2021.

24 "Robust assessments of the main economic impacts stemming from natural risks should be made available and estimates of their fiscal impacts reflected in the budgetary planning process." in: EC "*Forging a climate-resilient Europe - the new EU Strategy on Adaptation to Climate Change*", 2021.

25 E.g. Office for Budget Responsibility, "*Fiscal risks report*", July 2021; European Commission, "*Debt Sustainability Monitor 2019*", 2020, p.116-124; European Commission, "*Fiscal Sustainability Report 2021 - Vol 2*", 2022, p.138-163

26 Concluded in June 2019, the Netherlands' National Climate Agreement contains agreements with representatives of high GHG emitting economic sectors on what they will do to help achieve the climate goals. The participating sectors are: electricity, industry, built environment, traffic and transport, and agriculture. This agreement is an essential part of the Netherlands' NECP.

27 CPB, "*Evaluation draft Climate Agreement and Cabinet Variants*", 2019;

28 CPB, "*Zorgen om morgen*", December 2019.

measures in the near future. However, IFIs face many challenges in their assessment, including a lack of internal expertise, a lack of reliable data and economic models, and general uncertainty about feedback effects of climate risks.[29]

Country-specific debt sustainability analysis needs to account for medium to long-term climate-related fiscal risks. Failing to decisively invest in mitigation and adaptation today will inevitably hamper future debt sustainability: the fiscal costs of additional investments today pale in comparison to the economic and fiscal losses that would arise in a scenario of runaway climate change. The EU fiscal framework consequently needs to encourage Member States to precautionarily invest in mitigating those risks. It should also discourage fiscal positions that exacerbate future costs by aggravating climate-related risks (see 6. & 7.).

We welcome the efforts by the European Commission and Member States to measure climate-related fiscal risks and integrate them into debt sustainability analyses. We are aware of the methodological challenges, including the need to improve data collection – e.g. through harmonised definitions and reporting requirements, methodologies and tools such as "green budgeting", and datasets on past natural events.

➜ RECOMMENDATIONS

1

Task IFIs with country-specific debt sustainability analysis

Acknowledging that the sustainable level of government debt hinges on each sovereign's macroeconomic fundamentals, the national independent fiscal institutions (IFIs)[30] should be tasked with conducting **country-specific debt sustainability analyses**[31] that would receive a more prominent role in the European fiscal framework. **Crucially, climate-related fiscal risks** need to be better understood and monitored.

2

Develop a methodology to assess climate-related fiscal risks

We call upon Member States to urge the European Commission, in partnership with the European Fiscal Board and IFIs, to propose **a common EU methodology to measure climate-related fiscal risks** (physical and transition risks). More generally, we call upon Member States to support the efforts of the European Commission and EU IFIs in this field, by **providing them with the needed political and financial resources**.[32]

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29 National independent fiscal institutions, "*Assessing the fiscal policy impact of the climate transition*", 2022.

30 According to the *Council Directive 2011/85/EU* that institutes national fiscal frameworks, EU Member States have to prepare and execute their budget according to a set of minimum requirements. This directive also outlines the role IFIs play in monitoring Member States compliance with fiscal rules and providing economic and budgetary forecasts.

31 These analyses would account for country-specific drivers of unsustainable debt such as the evolution of interest payment-to-GDP, interest growth (r/g) differential, share of short-term debt and foreign-held debt on total debt stock, average maturity of the debt stock, and the building up of fiscal risks.

32 In particular, the effective functioning of IFIs should be supported by enhanced minimum national framework standards in EU Member States. Building on best practices, these minimum standards should ensure e.g. functional autonomy, access to information, safeguards from political pressures, etc. Crucially, these standards should ensure governance arrangements that shield IFIs from being captured by any school of thought. More in: SUTTOR-SOREL, L., "*Breaking the Stalemate*", Finance Watch, 2022, p.19.

IV. IDENTIFYING GREEN FUNDING GAPS

There is a lack of robust country-specific green funding gap[33] estimates which would support efficient budget allocation decisions. Estimates only exist so far on aggregate green funding needs at the EU level.[34] At the national level, the data included in National Energy and Climate Plans (NECPs) has been considered by the European Court of Auditors as "incomplete, inconsistent and showing large disparities", with each country using its own methodology.[35] For investment needs concerning the circular economy and biodiversity, the calculation is even more difficult. "Although the Commission provided some support to Member States, it did not develop a common framework for Member States to apply when assessing their needs and identifying flagship sustainable projects".[36]

National green funding gaps should be estimated by independent fiscal institutions (IFIs)[37], based on a common European methodology to be proposed by the European Commission and/or by a dedicated working group led by the European Fiscal Board.

➜ RECOMMENDATIONS

3 **Task IFIs with estimating green funding gaps**

As part of a future review of the minimum standards for national fiscal frameworks[38], the national independent fiscal institutions should be tasked with estimating **national funding gaps to achieve EU's climate and environmental objectives** (i.e. green funding gaps).

4 **Develop an EU methodology to assess green funding gaps**

Member States should call upon the European Commission to elaborate **a consistent methodology** that could be used across Member States to measure the **national green funding gaps** (public and private). The public green funding gap, as well as a mapping of environmentally-harmful subsidies, should be integrated in revised National Energy and Climate Plans (NECPs) and guide fiscal decisions under the European Semester.

33 i.e. the climate mitigation and adaptation funding gaps

34 i.e. an aggregated additional €520bn per year until 2030 is needed for the EU to reach its environmental objectives

35 *European Court of Auditors (2021)*, p.41

36 *European Court of Auditors (2021)*, p.41

37 As recently done by Fiskalni Svet, Slovenia's Independent Fiscal Institution (IFI). See: *Brložnik (2022)*

38 I.e. The *Council Directive 2011/85/EU* institutes minimum standards for national fiscal frameworks and specifies the role that Independent Fiscal Institutions (IFIs) should play, such as monitoring Member States compliance with fiscal rules and providing economic and budgetary forecasts.

V. COUNTRY-SPECIFIC DEBT PATHWAYS & PUBLIC SPENDING QUALITY

Debt rules are the cornerstone of current EU fiscal rules, but they have considerable limits. First, there is a large consensus that the 60% debt-to-GDP limit is not evidence-based and not adapted to current macroeconomic realities.[39] Second, the EU fiscal framework overly relies on this arbitrary debt-to-GDP threshold to gauge debt sustainability, overlooking other drivers of unsustainable debt.[40] Third, the 'debt-to-GDP' ratio suffers from important conceptual flaws.[41] Fourth, the debt-reduction benchmark that requires countries to reach the 60% debt-to-GDP value over twenty years is heavily criticised for being one-size-fits-all and impracticable.

Today, complying with these arbitrary debt rules risks doing more harm than good. To comply with the debt-reduction rule introduced in 2011, the euro area would need to maintain an annual fiscal surplus of 1.1% of GDP over 20 years – a level that would break the recovery and lower many countries' GDP over the long run therefore increasing their debt-to-GDP ratio. Compliance with debt rules in societies already deeply affected by the pandemic risks translating into cuts in social spending and in financing of climate action.

There is a need to move to country-specific debt pathways, but also to ensure the respect of minimum standards for the quality of public finance. In particular, the waste of public resources via corruption or environmentally harmful subsidies must end.

➜ RECOMMENDATIONS

5 **Move to conditionalised country-specific debt pathways**

Acknowledging that the sustainable level of government debt hinges on each sovereign's macroeconomic fundamentals, **country-specific debt sustainability analyses** should become the basis of **country-specific debt pathways**. To disincentivize the misuse of taxpayers' money, country-specific debt pathway should be linked to the respect of **minimum standards** such as:

- **Full implementation of the anti-corruption recommendations** of the European Commission (Country-Specific Recommendations and Rule of Law Report), the Group of States against Corruption (GRECO), the OECD, and the United Nations.
- **Binding commitments to phase out environmentally-harmful subsidies**, in a socially just way.

39 The quantitative limits of the Maastricht Treaty were defined 30 years ago taking into account, approximately, the average of the EU Member States debt levels and the average economic situation at the end of the 1990s. Assuming potential growth of 2% and an inflation target of 2%, a budget deficit limit of 3% of GDP would stabilise the ratio of government debt to GDP at 60%.

40 Those drivers include the evolution of interest payment-to-GDP, interest growth (r/g) differential, share of short-term debt and foreign-held debt on total debt stock, average maturity of the debt stock, and the building up of fiscal risks

41 Such as non-commensurability and time-inconsistency. See more in: SUTTOR-SOREL, L., "*Fiscal Mythology Unmasked*", Finance Watch, 2021, p.22.

VI. FAVOURING FUTURE-ORIENTED EXPENDITURES

An excessive focus on numerical fiscal limits incentivises undifferentiated reductions in public spending without regard for their quality or the investment needs. This proves problematic in the presence of daunting annual EU funding gaps – such as €520 billion a year until 2030 to meet EU environmental objectives, €142 billion a year for social infrastructures such as hospitals or schools, along with €190 billion a year to stabilise the stock of public capital.[42] In addition, the European Commission assessed that delivering the REPowerEU objectives, in particular reducing our dependence on Russian fossil fuels and accelerating the energy transition, requires an additional investment of €210 billion between now and 2027, on top of what is needed to realise the objectives of the Fit for 55 proposals.[43] Failing to bridge these funding gaps could lead to significant fiscal risks, threatening long-term debt sustainability and leaving future generations worse off.

The European Semester is not yet sufficiently focused on incentivising Member States to reach the EU's objectives (e.g. European Green Deal, European Pillar of Social Rights, EU industrial policy), global commitments such as the UN 2030 Agenda for Sustainable Development as well as overarching goals given by the treaties (e.g. convergence within the EU and well-being of its people). Fixing these two intertwined issues calls for a number of targeted changes.

➜ RECOMMENDATIONS

6

Create unique National Reforms & Investment Plans (NRIPs)

These multiannual plans would integrate and streamline economic reform and fiscal plans that Member States submit as part of the European Semester – respectively National Reform Plans and Stability or Convergence Programmes. These NRIPs would have to align with country-specific debt pathways, **country-specific recommendations (CSRs), and commonly-defined EU priorities** (e.g. Green Deal, REPowerEU). This could improve the interplay between economic and fiscal policies while simplifying the European Semester and facilitating the delivery of EU social and climate goals.

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42 Source: European Commission, "*COM(2021) 662 final - The EU economy after COVID-19: implications for economic governance*", 19.10.2021, p.17. ; FRANSEN, L., BUFALO, G., REVIGLIO, E., "*Boosting Investment in Social Infrastructure in Europe - Report of the High-Level Task Force on Financing Social Infrastructure in Europe*", 2018, 116p.; European Commission, "*SWD(2020) 98 final - Identifying Europe's recovery needs*", 27.5.2020, p. 16-18

43 EC, "*REPowerEU Plan*", Communication COM(2022) 230 final, 18 May 2022.

7 Treat future-oriented expenditures differently

Allow newly-formed governments to submit, as part of their NRIPs, **a list of future-oriented expenditures**[44] to be excluded from their deficit (and/or expenditure) limits.

To address concerns that any mechanism excluding automatically some categories of spending could create negative incentives to circumvent the rules, we suggest the following: The decision to exclude some spending from a Member State's expenditure ceiling should be part of a broader process of **ex-ante technical assessment** by the European Commission (e.g. respect of the Do-No-Significant-Harm principle, quality, EU objectives), **dialogue** between the Commission and Member States, and **political validation** by the Council. Ex-post, the Member State would have to report on pre-agreed result indicators.

In order to get preferential treatment, the list of future-oriented expenditures proposed by the Member State as part of its NRIP should demonstrably:

(1) Abide by the Do-No-Significant-Harm principle (DNSH)

(2) Be inclusive (taking into account the expected distributional impact, including gender dimension)

(3) Contribute to the implementation of EU climate and nature protection laws or the European Pillar of Social Rights

(4) Contribute to closing the national green funding gaps

8 Improve the European Semester

The European Semester should be used to assess countries' progress towards the achievement of EU objectives (e.g. EU Green Deal, European pillar of social rights, European Industrial Policy). **Country-Specific Recommendations (CSRs)** should be tailored according to countries' distance to the target. To improve relevance and compliance, CSRs should (i) better account for EU objectives and European Monetary Union (EMU) dimensions (e.g. euro area fiscal stance, spillovers, externalities), (ii) be associated with specific indicators, (iii) be formulated in a way that makes progress measurable, and (iv) be prioritised according to their significance.

Whilst national parliaments and the European Parliament need to play a central role in the future architecture, social partners and Civil Society Organisations (CSOs) should also be involved. **A dedicated regulation** organising the European Semester should integrate consultation mechanisms with civil society organisations and workers' unions in a formal way.

The adequate implementation of robust NECPs and the shift towards green, gender-just and progressive taxation should be encouraged under the European Semester.

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44 Future-oriented expenditures cover categories such as public investment, green expenditures, and productive social expenditures such as spending on education (i.e. investment in human capital) and healthcare – both associated with a positive impact on GDP growth.

➜ CONTACT

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Making finance serve society

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About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org

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About Climate Action Network (CAN) Europe

Climate Action Network (CAN) Europe is Europe's leading NGO coalition fighting dangerous climate change. With over 170 member organisations from 38 European countries, representing over 1.500 NGOs and more than 47 million citizens, CAN Europe promotes sustainable climate, energy and development policies throughout Europe.