CLIMATE ACTION NETWORK
Europe

JANUARY 2023

Reform of the EU economic governance
Missing the mark on climate is not an option

Climate Action Network (CAN) Europe is Europe's leading NGO coalition fighting dangerous climate change. With over 185 member organisations active in 38 European countries, representing over 1,700 NGOs and more than 40 million citizens, CAN Europe promotes sustainable climate, energy and development policies throughout Europe.

The Orientations proposed by the European Commission in November 2022 to reform the EU economic governance, if not improved, risk deepening the climate crisis. While they make austerity less brutal and give more leeway for Member States to invest, they do not propose anything to ensure that this fiscal leeway will be used to tackle climate change and implement a just transition. They also miss linking the European Semester with green budgeting processes at national level, which means that fossil fuel and other environmentally harmful subsidies could continue to thrive, and even expand.

Human-induced climate change is the largest, most pervasive threat to the natural environment and human societies the world has ever experienced.[1] Climate change is relevant to the EU economic governance:

- **By encouraging indiscriminate GDP growth to reduce the debt to GDP ratio, the European economic governance framework is promoting an economic model which is not aligned with a 1.5°C trajectory and EU climate commitments**. A vague requirement that Member States align their fiscal-structural plans with their future National Energy and Climate Plans (NECPs) is utterly insufficient to ensure this will effectively drive the European economy away from fossil fuels, endless natural resources extraction and environmentally harmful technologies.
- **Climate change threatens the sustainability of public finances, as such it is a source of systemic risk for the sustainability of public deficit and private and public debt**.[2] Public and private investments now in the just and green transition at scale would reduce future climate risks and their cost for the public purse.

---

[1] Promotion and protection of human rights in the context of climate change mitigation, loss and damage and participation, United Nations Special Rapporteur on the promotion and protection of human rights in the context of climate change, A/77/226, 2022, available at https://documents-dds-ny.un.org/doc/UNDOC/GEN/N22/438/51/PDF/N2243851.pdf?OpenElement

[2] From Maastricht to Paris - Why climate change should be considered in a reformed EU fiscal framework, CAN Europe and Finance Watch, 2022, https://caneurope.org/content/uploads/2022/06/Policy_Brief_From_Maastricht_to_Paris_FW_CAN_FINAL.pdf; see also EC, "Forging a climate-resilient Europe - the new EU Strategy on Adaptation to Climate Change", COM(2021) 82.

- Because **the existing EU fiscal framework constraints public investments.** While private finance has a major role to play to fill the green funding gap, public spending in climate action is needed too, especially if the green transition has to be just. A reformed framework needs to incentivize public spending in the just transition and climate action, as well as relevant reforms needed to make these investments impactful.

In addition, austerity is not over. Citizens in Europe continue to face a progressive erosion of their rights to health, housing, education, and a clean environment against a background of rising inequality and a cost of living crisis. We welcome the reference to the need to strengthen social resilience and that investments justifying an extension of the debt reduction pathway should contribute to the implementation of the European Pillar of Social Rights. But this is not sufficient to ensure that the reformed framework will support a just transition, uphold public services and investments that are future-oriented.

Several elements in the proposed Orientations go in the right direction:

- **The debt sustainability analysis (DSA) will play a key role** to determine the reference adjustment path of each country, and to design the country plans. This is important as the sustainability of a debt cannot reasonably be assessed mainly on the basis of the proportion of the GDP it represents. Giving more weight to DSAs reduces the negative effects of the arbitrary 60% debt-to-GDP ratio. The 1/20 debt reduction rule[3] is removed to avoid austerity when the general escape clause will be lifted.
- **Having a single indicator to guide debt and deficit adjustment paths** – the nationally-financed net primary expenditure – is a very important improvement as this indicator excludes interest payments and cyclical unemployment costs (so-called automatic stabilisers) from the calculation of the expenditure ceiling.
- **A medium-term approach replaces an annual approach**. Today's challenges require medium-term planning, which will give a more stable and predictable economic outlook to people, governments and private sector/investors. Having as a principle four-year plans, with a possible three years extension under certain conditions is a reasonable move.
- **Proposing a legislative reform of the Stability and Growth Pact is welcome** as it will involve the European Parliament and greater civic participation, rather than tweaking the edge of non-legislative documents like the Code of conduct.

However**, none of these positive elements are directly addressing the interlinkages between climate and fiscal policy.** Altogether, the Orientations on the table are not up to the mark. Our recommendations are grouped under three objectives: Avoiding that the fiscal space translates into spending harming climate; Generating sufficient fiscal space to invest in the just and green transition; and Ensuring greater ownership and adherence to national fiscal-structural plans.

[3] I.e. Member States with a debt above 60% of their GDP need to reduce the debt in excess by 5% every year.

CAN Europe outlines ten recommendations, building on the European Commission's Orientations for the reform of the EU economic governance, to green the EU fiscal rules and ensure that a reformed economic governance framework is conducive to a just ecological transition. Among those ten demands, we highlight in particular:

1. The **Do No Significant Harm science-based criteria** should be used to screen investments and reforms that a government proposes to benefit from a longer debt reduction pathway
2. Member States should **apply green budgeting tools** to their national fiscal-structural plans to reflect the EU climate and environmental objectives in national public spending
3. Criteria to assess whether investments and reforms justify a slower debt reduction pathway should not include "growth-enhancing" but rather "**resilience-enhancing**" - i.e. they should make public finances more sustainable while never promoting indiscriminate GDP growth
4. Governments should have the possibility to submit, as part of their national fiscal-structural plan, a list of **future-oriented expenditures to be excluded from their deficit** and/or expenditure limit
5. Develop an EU methodology to **assess the green funding gap** and task IFIs to estimate it
6. Greening the **macroeconomic imbalance procedure**
7. **Preserving** EU funds for mitigation
8. No cuts in **social spending**
9. Strengthen **civic participation** for greater national ownership
10. A newly elected government should be able to **propose an amended plan**

A. Avoiding that the fiscal space translates into spending harming climate

1. Do no significant harm (DNSH) criteria

All investments and reforms included in the national fiscal-structural plans, whether the country has a low, medium or high-risk debt, should comply with an uncompromised DNSH criteria (encompassing all Delegated Acts except the complementary Delegated Act in order to make sure nuclear and fossil gas investments are not included in the plans). It would be unacceptable to encourage or even tolerate investments and reforms that do significant damage to climate or the environment. The European Semester is the natural space in the EU architecture to coordinate national investments and reforms and the European economic governance reform should give more space to climate and environmental considerations in that regard.

As a minimum, this criteria should be used to screen additional investments and reforms that a government can propose to benefit from a longer adjustment period.

2. Role of green budgeting and green and progressive taxation in the EU economic governance

A reformed EU economic governance framework should apply green budgeting tools on national budgets to encourage upholding the common climate and environmental objectives in national public spending, and to ensure that environmentally harmful subsidies, in particular fossil fuel subsidies, are terminated in a socially just manner. If this is not the case, additional fiscal space may translate in a continuation or even an increase of environmentally harmful spending in national budgets.

In addition, reforms included in the national fiscal-structural plans should systematically include a mandatory phase out of fossil fuel subsidies, as well as progress towards green and progressive taxation which would contribute to the reduction of climate-damaging emissions. This should also be reflected systematically in the country-specific recommendations and in the upcoming NECPs. Green and progressive taxation is indispensable to reduce the deficit and the debt, as well as inequality.

Taxing pollution could generate substantial income that could be used to support citizens to shift to renewable energy or insulate their homes for example.[4] A small tax of 0.1% on financial transactions could generate up to 57 billion euros per year, without hurting the finances of the overwhelming majority of people.[5] The European Semester should pay due attention to this agenda.

Strong anti-corruption safeguards are needed, and respect of anti-corruption requirements and recommendations should be a prerequisite for the approval of a Member State's national fiscal-structural plan. Current practices are not sufficient to avoid corruption and misuse of public funds, including EU funds.[6]

3. Resilience-enhancing reforms and investments - not growth-enhancing

The Orientations propose to look at whether the investments and reforms justifying a slower debt reduction pathway are "growth-enhancing". This is highly problematic for two reasons: a) This criteria is extremely difficult to measure. b) An investment can generate GDP growth but destroy the environment and jeopardise climate action. It can also increase inequality. The orientations garner the references to GDP growth with the adjectives "inclusive" and "sustainable", but nothing is foreseen to ensure that the growth generated will effectively contribute to reduce inequality and make our planet livable.

There is a huge risk that the growth-enhancing criterion may beat all the others when assessing investments and reforms proposed by Member States to justify a slower reduction pathway for their debt. Criteria for investments and reforms should not include growth-enhancing but rather resilience-enhancing investments. Our debt and public finance will be more sustainable if investments and reforms contribute to lowering fiscal risks, regardless of whether they generate GDP growth. Investments and reforms for climate action definitely lower fiscal risks; reforms that increase government revenue (such as progressive environmental-friendly taxation) also contribute to debt

---

[4] See for example Climate Dividend in the Environment of Emissions Trading in the Slovak Republic, Renew Europe & Progresivne Slovensko, 2021, https://d3n8a8pro7vhmx.cloudfront.net/progressiveslovakia/pages/371/attachments/original/1637749231/Progres%C3%ADvne_Slovensko_-_Climate_dividend.pdf?1637749231 and Austria's ecological tax reform: a model for other EU Member States?, Robin Damberger, 2021, http://kluwertaxblog.com/2022/02/03/austrias-ecological-tax-reform-a-model-for-other-eu-member-states/.

[5] https://ec.europa.eu/commission/presscorner/detail/lt/MEMO_12_799

[6] The misuse of the activation of the General
Escape Clause by the Hungarian government, Levego Munkacsoport, 2022, https://www.levego.hu/sites/default/files/Misuse_of_General_Escape_Clause_by_Hungarian_government.pdf

sustainability. Adequate social protection systems are also indispensable in any just transition scenario. Therefore, the criteria should be “resilience-enhancing” and not “growth-enhancing”.

B. Generating sufficient fiscal space to invest in the just and green transition

1. Preferential treatment for future-oriented expenditures

The unique operational target proposed in the Orientations (nationally-financed net primary expenditure) excludes unemployment costs (so-called automatic stabilisers) from the calculation of the budget deficit as well as debt interest payments, which is welcome.

In order to generate the fiscal leeway needed to bridge the green funding gap, governments (or newly formed governments) should have the possibility to submit, as part of their (revised) national fiscal-structural plan, a list of future-oriented expenditures to be excluded from their deficit and/or expenditure limit up to a certain proportion of the GDP. 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, dialogue between the Commission and Member States, and political validation by the Council.[7] 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 should demonstrably:

(1) Abide by the Do-No-Significant-Harm principle (DNSH)
(2) Be inclusive (taking into account the expected distributional impact, including the 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

2. Develop an EU methodology to assess the green funding gap and task IFIs to estimate it

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.

As part of a future review of the minimum standards for national fiscal frameworks announced in the Commission’s Orientations, the national independent fiscal institutions (IFIs) should be tasked with estimating national funding gaps to achieve EU’s climate and environmental objectives (i.e. green funding gaps). This estimate would be very useful to inform Member States budgetary choices. In addition, the European Commission, in partnership with the European Fiscal Board and IFIs, should

[7] "Breaking the Stalemate", Finance Watch, 2022, https://www.finance-watch.org/wp-content/uploads/2022/02/V2-breaking-the-stalemate-final.pdf

propose a common EU methodology to measure climate-related fiscal risks (physical and transition risks). These should be part of any sound Debt Sustainability Analysis.

3. Greening the macroeconomic imbalance procedure

The Orientations acknowledge that the increasingly apparent climate crisis with growing severity and frequency of extreme weather events poses *"a significant challenge for the sustainability of public finances".* It also states that "*Systemic challenges, notably related to climate change, environment and the energy transition, will be covered in the context of the European Semester, and referred to in the Alert Mechanism Report (AMR) and In-depth Country Review (IDR) when they have a clear link to macroeconomic imbalances."*

It is on the basis of these reports that the excessive macroeconomic imbalance procedure can be triggered. The scoreboard comprises a small number of macroeconomic and macro-financial indicators for Member States that allow for the early identification of macroeconomic imbalances. The European Commission should integrate national climate indicators in the scoreboard used to assess macroeconomic imbalances. If a Member State is not on track to achieve its climate/environmental goals, it generates a macro-imbalance risk.

4. Preserving EU funds for mitigation

In case EU funds are frozen because a Member State does not comply with the agreed fiscal-structural plan (the country-specific debt reduction pathway), funds for climate change mitigation investments should be exempted . The benefits of such investments go beyond that single country and the urgency of the climate crisis does not allow for further delays.

C. Ensuring greater ownership and adherence to national fiscal-structural plans

1. No cuts in social spending

The fourth criterion proposed by the European Commission to assess whether the country-specific investment priorities can justify a slower debt reduction pathway should explicitly exclude cuts in social spending in any future legislative proposal: "ensure that country-specific investment priorities can be addressed without leading to investment cuts elsewhere over the planning horizon" should be complemented by adding "*and in particular that there will be no cuts in social spending".* Another option to consider is to allow governments to ask that future-oriented spending be excluded from the calculation of the net expenditure path/deficit, up to a certain proportion of the GDP (see above).

Several Member States are developing a proposal for a social imbalance procedure under the European Semester. These efforts should be encouraged to ensure the European Semester pays more attention to social (and environmental) issues.

2. Strengthen civic participation for greater national ownership

Civic participation under the European Semester should be strengthened. We welcome the proposal to give independent national fiscal institutions a greater role and to improve their set-up and performance. However, this is not enough to ensure national ownership, which is a precondition for compliance. A stronger involvement of national Parliaments and other national stakeholders (civil society organisations, social partners, advisory bodies on gender equality, etc) should be a requirement for the elaboration of the national fiscal-structural plans.

3. A newly elected government should be able to propose an amended plan

The Orientations propose that the 4 year national fiscal-structural plans would not be amended, except "*in case of objective circumstances making the implementation of the plan infeasible*". The fact that there is a newly elected government is not explicitly envisaged as opening the possibility to revise the plan before its end date. This is particularly problematic when the plan includes a longer pathway (up to seven years) with milestones/targets for reforms and investments, as it would deprive a national election from any possibility to have an influence on these policies. We believe that the future legislative proposal should expressly include a possibility to revise the national plan, undergoing the same validation process, when there is a newly elected government.

***

CONTACTS

Isabelle Brachet, Fiscal Reform Policy Coordinator,

isabelle.brachet@caneurope.org

info@caneurope.org

www.caneurope.org

Facebook LinkedIn Twitter