June 2023

European Commission's proposals to reform the EU economic governance framework:

A Climate and Environment Perspective

Introduction

The proposals issued by the European Commission on 27 April 2023 concerning the reform of the EU economic governance include:

- A regulation to reform the preventive arm of the stability and growth pact (*Proposal for a regulation on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97*), together with seven annexes.
- Amendments to the regulation concerning the excessive deficit procedure (*A proposal for amending Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure*)
- Amendments to the Directive concerning the requirements for member states' budgets (*Proposal for a Council Directive amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States*)

This analysis will focus on the climate aspects of the proposals, focusing on the proposed regulation on the preventive arm and its annexes, as well as the amendments to the directive on requirements for Member States′ budgetary frameworks.

The proposals on the table offer some leeway to Member States with a debt or deficit above the Treaty reference values to reduce their debt to GDP and deficit to GDP ratio over a longer period of time than under current rules, which is welcome. However, the proposed reforms do not go far enough to effectively generate the fiscal space needed for Member States to be able to make their economies more resilient to upcoming shocks, including climate change impacts. It is also uncertain at this stage whether the provisions on the table will be sufficient to avoid a return of austerity and cuts in public spending for environmental and social issues in several Member States.

Concerns from a climate perspective

1. The set of reforms and investments committed by Member States to obtain a longer debt reduction pathway "***shall be growth enhancing"*** (*Art 13* of the proposed Regulation, *Annex 7 Art 2.1, and Annex 2 L & M*). This reference to growth without any environmental criteria (the Do No Significant Harm (DNSH) science-based criteria is not included in the proposal) means that the fiscal space created could end up being detrimental to climate and environment. In addition, in their March Council Conclusions, the EU finance ministers had suggested adding "resilience-enhancing" as an assessment criterion, but this has not been included in the Commission's proposal. That would notably have allowed to value investments for climate adaptation, which make public finances more stable and resilient but may not generate GDP growth.

We call for the inclusion in *Art 13* of the proposed Regulation, in *Annex 2* and in *Annex 7* of the wording "resilience-enhancing investments and reforms" to replace "growth-enhancing", and for the inclusion of DNSH as an assessment criterion for investments and reforms promised by Member States. It will be important to dedicate a part of the Technical Support Instrument to helping member States' administrations monitor the respect of the DNSH principle.

2. The proposals on the table include no reference to fossil fuel and other **environmental harmful subsidies**, which jeopardise EU climate goals and slow down the green transition incentivising pollution, inefficient use of resources and the erosion of natural capital. By failing to align public expenditures with environmental goals, these subsidies also represent a waste of precious public resources that could be earmarked for the just transition.

The proposed Regulation, as well as *Annex 2 (Information to be provided in the national medium-term fiscal-structural plans) and Annex 7 (Assessment framework for the set of reform and investment commitments underpinning an extension of the adjustment period)* need to include an obligation for Member States to integrate a socially just and time-bound reduction of fossil fuel and other environmentally harmful subsidies in their national fiscal-structural plans.

3. The proposals will not generate sufficient fiscal space for Member States to be able to mitigate and adapt to climate change and ensure a just transition. We therefore believe that preferential treatment for **future-oriented expenditures** is needed.

We propose to allow newly formed governments to submit, as part of their national fiscal-structural plans, a list of future-oriented expenditures (which includes investments made to deliver the NECPs) to be excluded from their deficit and expenditure limits. 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 DNSH principle, quality, EU objectives and progress by the Member State concerned towards the achievement of its national climate and energy targets determined for each year, as well as its environmental targets), 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. This would require adding a new provision in the Regulation.

4. The amendments to the Directive on Member States' budgets includes a **reference to green budgeting** in ***Recital 5***, which concludes by saying: *"The European Semester provides an additional framework to support such efforts and the Technical Support Instrument offers practical assistance for their implementation"*. ***Recital 19*** continues, saying that *"green budgeting tools can help redirect public revenue and expenditure to green priorities (…) This means reporting data on how revenues reflect the need to ensure that the "polluter-pays" principle is reflected, and in turn on how expenditure reflects both favourably and unfavourably green priorities. Member States should publish information on how the relevant elements of their budgets contribute to achieving climate and environmental national and international commitments and the methodology used. Member States should publish data and descriptive information separately for expenditure, tax expenditure and revenue items. Member States are invited to publish information on the distributional impact of budgetary policies and take into account employment, social and distributional aspects in the development of green budgeting"*.

We call for the inclusion of these recitals in the body of the proposed Directive as these are fundamental to avoid that the fiscal space generated translates into fossil fuel and other environmentally harmful subsidies.

5. For Member States having a government deficit below the 3% of GDP reference value and public debt below the 60% of GDP reference value, the only objective mentioned is to ensure that the headline deficit is maintained below the 3% of GDP reference value (*Art 7 para 2 of the Regulation*). However, it may well be, as has been the case so far, that governments with a low debt and deficit are not spending enough for the just transformation of their economy and society and would be well inspired to invest more in climate mitigation and adaptation in order to strengthen the resilience and stability of the economy of the EU as a whole.

We suggest amending *Art 7 para 2* of the proposed Regulation to add that ensuring that the headline deficit is maintained below the 3% of GDP reference value is balanced with the need for the Member State concerned to fill the green spending gap to meet the EU climate targets and environmental goals, and to implement its NECP.

Climate-related positive elements in the European Commission's proposals that need to be preserved and strengthened

1. The national plans shall explain how they address the common priorities of the Union which include the **European Green Deal** and will have to be consistent with the updated **National Energy and Climate Plans** (*Art 12 and Annex 2 J*).

This needs being preserved because the provision covers all national fiscal-structural plans, so all Member States and not only those with a risky debt or deficit. We suggest, however, to add the obligation for Member States to integrate in their national plans a programme of gradual and sustained reduction of fossil fuel subsidies in a socially just manner. It is crucial to ensure consistency between Member States' climate and energy ambitions and public finances policies - as without the latter, the former will remain empty promises.

2. *Annex 2* regarding the Information to be provided in the national medium-term fiscal-structural plans includes (*para d*) to the extent possible, **information on disaster and climate contingent liabilities -** which is welcome. *Annex 2 j* requires to provide the total public investment expenditure, as well as reforms and public investment expenditure addressing the common priorities of the Union referred to in *Annex 6*.

For the latter, it would be important to add a request to specify what is for climate and environment as a share of the total public expenditure.

3. The set of reforms and investments promised to obtain a longer debt reduction pathway will address the EU priorities, which include the **European Green Deal** including the transition to climate neutrality by 2050 and the translation at national level through the **National Energy and Climate Plans**; as well as the European Pillar of Social Rights including the related targets on employment, skills and poverty reduction by 2030 (*Art 12 and Annex 6 of the proposed Regulation*).

Preserving the references to these climate and social common objectives in the Regulation is crucial, as well as the fact that each of the reform and investment commitments underpinning an extension of the adjustment period shall be sufficiently detailed, front-loaded, time-bound and verifiable (*Art 13.3*).

4. The proposed amendments to the Directive setting the requirements when member states submit their budget to the Commission asks them to **include climate-related fiscal risks**: *Article 9(2)*, point d would now require assessing the risks deriving from climate change and the implications of climate policies on public finances. Similarly, *Article 14(3)* requires Member States to publish data to the extent possible on disaster and climate related contingent liabilities as well as on economic losses incurred from natural disasters and climate related shocks. For these shocks, the fiscal costs borne by the public sector and the instruments used to mitigate or cover the shocks would also be reported. It is fundamental and the only reasonable course of action to start measuring and integrating climate-related fiscal risks in macro-economic and public finance decisions.

These references are welcome, and need being preserved in the final text of the Directive.

5. Regarding **participation**, *Annex 2 Q* requires Member States to provide information on the consultations of social partners, civil society organisations and other relevant stakeholders in view of the preparation of the national fiscal-structural plan. This is welcome. *Art 26* of the preventive arm Regulation regards the European Semester dialogue.

We would suggest adding the Working Party on the Environment among the bodies to be consulted.

CONTACTS

Katy Wiese: Policy Coordinator at EEB (katharina.wiese@eeb.org)

Isabelle Brachet: Senior Fiscal Reform Policy Coordinator at CAN Europe (isabelle.brachet@caneurope.org)