EEB
European
Environmental
Bureau

JUNE 2023

EEB updated position on the EU Economic Governance Framework

Introduction

We are living in an era of poly crisis: the macroeconomic consequences of the covid and energy crisis have progressively exposed the deeply flawed economic system on which we have relied on in the past decades. Measures of austerity, of excessive fiscal consolidation and of liberalization have for long been the quick-fix solution for decades of sluggish economic growth. The Stability & Growth Pact (SGP), with its history of amendments and integrations, fuelled the rationale behind this period of economic liberalization and sharp fiscal discipline. Its arbitrary and one-size-fits-all constraints prevented most vulnerable Member States from pursuing fair and sustainable reforms. SGP suspension during the Covid crisis was a necessary action to promptly tackle the health crisis, which fully showcased the structural flaws embedded in the SGP and accelerated the conversation on potential alternative frameworks, which had already started before 2020.

In light of the ambitious climate, environmental, and social objectives the European Union has set out (i.e., European Green Deal (EGD), the European Pillar of Social Rights etc.) a paramount effort in public investments will be needed to guarantee a socially-fair, gender-just, and environmentally sustainable transition; as well as to channel private finance into sustainable and truly environmental investments. The SGP's potential role is then evident and of high importance. Its main function must be that of an enabler of a just transition and catalyser of proper national spending: rightly incentivizing and supporting national governments in their investment agendas, and entirely geared towards reaching EGD and other EU agreed social objectives.

On April 26 the European Commission issued the legislative proposal concerning the reform of the EU economic governance (the SGP). The European Parliament now has the opportunity to present its amendments to the legislative text by the second half of 2023. These will form the basis for trialogues at the end of 2023, with the ambitious expectation to approve the proposal by the end of the year.

We believe the proposal of the European Commission introduced some welcomed novelties, such as the removal of the 'structural budget rule' and the introduction of country-specific debt reduction pathways (offering some leeway to Member States to reduce their debt/GDP and deficit/GDP ratio over a longer period of time). However, these small improvements do not begin to address the transformation that the economy will have to endure: the proposed reforms do not guarantee Member States with sufficient fiscal space to tackle systemic social and environmental challenges. The EEB has already put forward its vision for a renewed SGP in its 2022 position paper. The following presents nine key demands as an update of the position paper in light of the recently issued legislative proposal.

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Policy Demands for a new Economic Governance Framework focused on Wellbeing.

Long term demands

Sustainability and wellbeing pact

The EU must break free from the long-gone days of sustained economic growth, or pursuits of unrealistic green growth, and shape a new sustainable path that secures an economically, environmentally, socially, and intergenerationally sustainable future for all. For this to become a reality, the whole framework and economic thinking underpinning the SGP must be revised, and a new *Sustainability and Wellbeing Pact* developed to advance a green and just society, ingraining in EU legislation the pursuit of *qualitative growth* over GDP growth.

This will necessarily imply the amendment of Union Treaties, whose arbitrary rules are no longer fit for purpose and do not reflect the needs of the current macroeconomic realities. Large consensus is building to carry out this ambitious but necessary step: EU Commission President Ursula von der Leyen expressed support for treaty change in her state of the Union last year. Similarly, French president Macron and former German chancellor Angela Merkel already declared themselves in favour of treaty changes following proposals from a citizens panel to reform the European Union as part of the Future of Europe process. Treaty change should not be an obstacle to carrying out important reforms. We must be bold and continue our efforts to amending Union Treaties, striving for comprehensive system change geared towards creating a sustainable economy of wellbeing.

From rules to standards

The reference values of the SGP are not grounded in any economic criteria, they are strict arbitrary rules, which have failed to be respected by almost all Member States[1]. Their one-size-fits-all economical underpinning fails to consider the differences across countries in terms of economic activity, historical debt burden, ability to raise capital and so on. Furthermore, these arbitrary reference values fail to acknowledge that the investment gap faced to tackle the green transition varies greatly across countries, as such, while it is important to have a common fiscal framework, some Member States will require greater flexibility and differentiated paths to bridge their spending gaps and be in line with the EGD.

A new legislative approach in the SGP, shifting from strict *rules* to more general *standards*, would guarantee a system that properly accounts for country and context specificities. Rather than relying on ex ante rules which are unable to predict new macroeconomic circumstances and unforeseen crises, a system based on standards would allow more country-specific fiscal manoeuvres and considerations. Fiscal standards must still pre-empt MS to avoid excessive government deficits; however, they would only consider debt as excessive when unsustainable for the individual MS with high probability. Unsustainability would be assessed on an ongoing basis through a thorough debt

[1] *Rethinking EU economic governance: The stability and growth pact*. Available at: https://www.epc.eu/content/PDF/2021/Stability_and_Growth_Pact_PB_v4.pdf

sustainability analysis (DSA), and it would allow the single MS together with the Commission to adjust fiscal trajectories considering both debt viability and investment requirements.[2]

This system would be an important way forward: releasing MSs of the burden of strictly (trying to) comply with absolute criteria would leave them with the individually required fiscal space to advance a green and just transition.

Short term demands

Demand 1. Exclude future-oriented expenditure from debt and deficit rules

The current proposal of the SGP does not separately account for climate, environment and social investments (hereafter *future-oriented expenditure*), *de facto* failing to differentiate them from socially harmful ones. By so doing, the proposal misses the chance to steer Member States towards a fiscal behavior in line with the Transition and away from past harmful practices (e.g., fossil fuel subsidies). Additionally, by overlooking *future-oriented expenditure* needs, the proposal raises the question whether it will even allow Member States to have the fiscal leeway to properly invest in the just transition.

Overall, the shortcoming of not differentiating and quantifying *future-oriented expenditure* proves that the Commission does not recognize the urgency of the Just Transition. As such, first and foremost we deem necessary for the Commission to draft an EU-wide regulatory framework to define *future-oriented expenditure*, in order to support Member States with a sound foundation to properly differentiate their fiscal activities and link their fiscal policy to climate targets (the European Taxonomy for sustainable economic activities can be used as a starting point[3]). Following a clear classification, Member States will be able to identify and include national *future-oriented expenditure* needs in their National Fiscal-Structural Plans (and in possible extensions), alongside their respective climate and environmental targets.

Future-oriented expenditure needs must be reviewed ex-ante by the European Commission, against the underlying regulatory framework and finally granted a preferential treatment, excluding them from the deficit and expenditure limits. Ex-post, the Member State would have to report on the pre-agreed climate and environmental targets and potentially face an excessive debt procedure (EDP) in case of breach[4].

In this process, the role of CSOs should be recognized and leveraged. As important points of contact with civil society, Member States' NGOs and trade unions must be ensured access to the drafting of National Fiscal-Structural Plans, developing alongside the government the investment program excluded from the deficit rule.

Demand 2. Integrate beyond GDP indicators

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[2] Olivier Blanchard, Alvaro Leandro, Jeromin Zettelmeyer, Redesigning EU fiscal rules: from rules to standards, *Economic Policy*, Volume 36, Issue 106, April 2021, Pages 195–236, https://doi.org/10.1093/epolic/eiab003

[3] Vincent, M. (2022) [Eng/fr] fiscal rules: Identifier Les Dépenses Vertes et promouvoir la transition, GREENTERVENTION. Available at: https://greentervention.org/2022/09/06/eng-fr-fiscal-rules-identifier-les-depenses-vertes-et-promouvoir-la-transition/

[4] More information on viable and pragmatic solution to prioritize green fiscal expenditures can be found in the following proposal by ZOE Institute and in a note by Greentervention

The new expenditure rule proposed by the Commission allows for a growth rate in investments which is linked to the country's *potential output growth* i.e., GDP. This approach goes in the right direction by scraping the previous 'structural balance budget' rule; however, we believe exclusive reliance on GDP as a benchmark is a limited approach and neglects other important aspects necessary for a *wellbeing and just society*.

GDP must not be the sole measure to assess a country's fiscal leeway. As it overlooks countries' green performance, GDP cannot exclusively assess the fiscal space required to promote the just and green transition and would risk underestimating the actual amount of fiscal space that is needed.

We believe that the current legislative proposal should be amended by complementing expenditure calculations based on GDP with other important indicators which portray a more comprehensive picture of countries' green, gender and socially just transition needs. A practical example would be to introduce GHG indicators. Member States with higher GHG emissions would be granted more expenditure capacity to tackle the significant investments required to bring down their emissions. The greater fiscal space would be conditional to reaching pre-determined targets in a pre-defined timeframe.

Today, the biggest polluting Member States are also the ones with the lowest GDP per capita[5]. Under the proposed expenditure rule, their sluggish growth would undermine their ability to adequately spend to reduce their emissions – although being the ones with the strongest need for green expenditure.

A preliminary combination of economic (e.g., GDP) and environmental (e.g., GHG) indicators would help develop an expenditure rule more mindful of necessary fiscal spaces, while at the same time represent fertile ground for moving past the limited idea of equating GDP growth with social prosperity.

Demand 3. Focus on the quality of investments

For too long the prerequisite for investments and spending has been exclusively their ability to generate growth. This approach proved short-sighted as it overlooked that indiscriminate growth does not necessarily lead to improved conditions for everyone and for the environment. The current proposal again references growth without any environmental and social criteria. To avoid that fiscal space created becomes detrimental to climate and environment, we demand that:

1) Greater fiscal leeway does not nationally translate into further investments in sectors of the economy which are environmentally and/or socially harmful. Each member state should abide by the ***'Do no significant harm' principle*** [6]as an assessment criterion for national investments and reforms.

2) All fossil fuel subsidies come to an end, as they jeopardise EU climate goals and slow down the green transition. Each Member State must include in its National Plan a socially-just and time-bound ***fossil fuel phase out strategy***, in line with European objectives.

[5] A targeted golden rule for public investments? - europarl.europa.eu. Available at https://www.europarl.europa.eu/RegData/etudes/STUD/2023/733740/IPOL_STU(2023)733740_EN.pdf

[6] Reform of the EU economic governance: Missing the mark on climate is not an option. Available at https://caneurope.org/reform-of-the-eu-economic-governance-missing-the-mark-on-climate-is-not-an-option/

3) ***Resilience-enhancing*** should be the basis of the justification for slower debt-reduction pathways – and not exclusively growth-enhancing reforms as suggested by the European Commission. This would allow to value investments for climate adaptation and other socially enhancing targets, overall strengthening public finances, although not necessarily generating GDP growth.

4) Member States implement **green budgeting tools** in drafting their National Fiscal-Structural Plans. These tools must help guide fiscal policy decisions by informing how fiscal expenditures relate and shape (either favorably or unfavourably) green priorities. Member States must provide insights into how their budgeting programmes contribute to achieving climate and environmental national and international commitments.

Demand 4. Greening the Macroeconomic Imbalance Procedure (MIP)

The MIP framework currently in place relies exclusively on financial, social and macroeconomic risks to identify and correct national imbalances and potential spillovers. Unfortunately, in the new legislative proposal nothing points to an improvement of the MIP procedure in factoring in economic and social imbalances and risks linked to climate and environmental degradation. We believe that for Member States to seriously commit to their EGD objectives, a more holistic MIP framework, inclusive of also climate and environmental indicators, is necessary.

As such we demand for the Commission's proposal to broaden MIP's risk indicators based on categories of risks that are increasingly likely to create imbalances, such as[7]:

- Unequal Member States progress towards the reduction of dependence on fossil fuels. An unbalanced or insufficient transition effort from one Member States can increase economic costs for the EU as a whole.
- Unequal Member States vulnerability to climatic and environmental disaster, with consequent unequal risks on national households, businesses, and productivity.
- Vulnerability of financial institutions (which, according to a 2022 supervisory stress test conducted by the ECB, currently lack the measurement and management tools to properly account for climate risks in their stress tests frameworks)

Providing a legal basis for climate and environmental risks would contribute to pinning down Member States efforts in the just transition, comply more strongly with their CSRs and to better coordinate the climate agenda across countries[8].

Just as for the current MIP, whenever a Member State diverges from its emission reduction path an "Excessive Emissions Procedure" would be triggered with the objective of bringing the country back on track, through for example technical advice in shaping reforms and/or targeted investments[9].

[7] https://greentervention.org/2023/04/28/eng-fr-bulletin-meteo-et-reforme-des-regles-budgetaires-weather-report-and-reform-of-the-budgetary-rules/
[8] Reform of the EU economic governance: Missing the mark on climate is not an option. Available at https://caneurope.org/reform-of-the-eu-economic-governance-missing-the-mark-on-climate-is-not-an-option/
[9] Fiscal policy - youthforum.org. Available at https://www.youthforum.org/files/220420-Fiscal-Policy-Position-Paper.pdf

Demand 5. A European Just Transition Capacity:

The reinstatement of the arbitrary reference criteria is irreconcilable with the massive investments that will need to take place and required by the EGD. Studies[10] show that with the current rules only three EU Member States (Denmark, Sweden, and Luxembourg) would be able to finance their required green expenditure without breaching the 3% deficit. As cutting expenditure in other sectors of the economy to finance climate and environmental objective is not an option, the only feasible solution is for the EU to support Member States through a permanent green fiscal capacity.

Establishing a *European Just Transition Capacity* would help coordinate, implement, and supervise national green and social investment plans. The fiscal capacity system must be designed as to allow that resource disbursement at the supranational level will:

1. **Avoid the risk of MS underinvesting and missing their climate targets**. Member States individually pursuing climate objectives can create cross-border externalities which will necessarily run down spending efforts and outcomes.[11]
2. **Allow for better borrowing conditions**. Highly indebted Member States would benefit from a reduction in their cost of funding, avoiding the risk of aggravating their already fragile balance sheets and jeopardising their debt sustainability and just transition[12].
3. **Ensure that budget allocation rules align with green and social investment needs and objectives.** Allocation criteria must reflect countries' investment needs to build an economy resilient to future shocks, without compromising the green transition. While the RRF distribution of funds was mostly based on GDP considerations, we believe that disbursements from a new Investment Capacity must consider wellbeing and sustainability metrics as well, such as differences across national Economic Resilience Indexes (ERI)[13], as well as considerations on national carbon emission levels[14], in order to assess which Member States have the greatest financial needs to promote the green and just transition.
4. **Ensure conditionalities for disbursements**. The investment capacity must serve the Just Transition and contribute to building a wellbeing society. In order to guarantee this, *disbursement of funds must be conditional* on Member States commitment to:
    - a socially-just and time-bound fossil fuel phase out strategy;
    - active investments in socially and gender-just public policies. With the ultimate aim to promote;

[10] A targeted golden rule for public investments? - europarl.europa.eu. Available at https://www.europarl.europa.eu/RegData/etudes/STUD/2023/733740/IPOL_STU(2023)733740_EN.pdf

[11] A targeted golden rule for public investments? - europarl.europa.eu. Available at https://www.europarl.europa.eu/RegData/etudes/STUD/2023/733740/IPOL_STU(2023)733740_EN.pdf

[12] A European Climate Fund or a green golden rule: Not as different as they seem. Available at https://www.bruegel.org/blog-post/european-climate-fund-or-green-golden-rule-not-different-they-seem

[13] The ERI was developed by ZOE Institute as a tool to rank countries based on their economic resilience. The ERI is calculated from six different dimensions (i.e., Economic Independence, Education & Skills, Financial Resilience, Governance, Production Capacity, Social Progress & Cohesion)

[14] A targeted golden rule for public investments? - europarl.europa.eu. Available at https://www.europarl.europa.eu/RegData/etudes/STUD/2023/733740/IPOL_STU(2023)733740_EN.pdf

- identify and reach satisfactory and quantifiable targets for the above-mentioned points.

Once again, the involvement of civil society organizations can be leveraged to comprehensively identify the country-specific investment needs that must be covered by the *Just Transition Capacity*.

Demand 6: Increase National Ownership and Democracy

Ensuring a higher degree of democratic ownership must be a priority. Guaranteeing and strengthening civic participation in the fiscal and economic reforms that will be necessary to tackle the climate crisis will also ensure greater acceptance and support for the transition. This will necessarily require the active involvement of national Parliaments and other civil society organizations in the drafting of new medium-term fiscal-structural plans.

Demand 7. Progressive and sustainable taxation

The rethinking of EU macroeconomic governance rules must be coupled with a concrete commitment towards fair and green tax reforms. In response to the current environmental crises and socio-economic transformations, governments need to look for new sources of revenue to ensure sustainability of public accounts, finance investments on climate mitigation, adaptation and just transition, all the while ensuring continuity of public services. In this context, credible and just tax policies will be key to enable Member States to sustainably generate the revenues to prevent future crises, austerity, and welfare cuts.

However, while taxation could be a key enabler of a just transition towards a wellbeing economy, current tax policies across the EU are widely unfit for purpose, this slows down the green transition and exacerbates social exclusion. For example, while Member States derive the majority (52%) of their tax revenue from labour, resource use goes relatively tax free, if not subsidised *(*e.g. *Member States subsidise fossil fuels with €50 billion per year and 15 Member States allocate more subsidies to fossil fuels than to renewable energy*[15]*)*. Also, all environmental taxes combined only account for less than 6% of total taxes EU-wide[16].

As part of the wider processing of rethinking Europe's fiscal framework, EU institutions and national governments must finally move from words to action and embark in ambitious fair and green tax reforms. Important components of such tax reforms are a combination of environmental taxes on emissions, pollution and resource use, and the removal of environmentally harmful subsidies, coupled with progressive/redistributive taxes on wealth, inheritance, and speculative financial products. Adequate planning for the use of the revenues is also crucial to design effective and just measures that address environmental issues while leaving no one behind.

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[15] European Commission, Directorate-General for Energy, Rademaekers, K., Smith, M., Gorenstein Dedecca, J. (2020). *Energy costs, taxes and the impact of government interventions on investments – Final report, summary*, Publications Office. https://data.europa.eu/doi/10.2833/827631

[16] "The Role of (Environmental) Taxation in Supporting Sustainability Transitions." European Environment Agency, January 30, 2023. https://www.eea.europa.eu/publications/the-role-of-environmental-taxation.

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