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Legal options for a green golden rule in the European Union's fiscal framework

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Executive summary

ACHIEVING THE EUROPEAN Union's climate goals and decoupling from Russian energy will require a massive increase in green public spending, which will be difficult when EU fiscal rules requiring fiscal consolidation are reinstated.

THE TWO MAJOR proposals to address the conflicting goals of fiscal consolidation and increased green public investment needs are a possible new European climate investment fund and a green golden rule. The latter would exclude any increase in net green public investment from the fiscal indicators used to measure compliance with fiscal rules, for countries with sound public finances.

AN EU CLIMATE fund and a well-designed green golden rule would be equivalent in terms of project selection, implementation and control procedures.

IF THE CLIMATE fund does not involve redistribution across member states, then the treatment of related spending and consequent borrowing in national fiscal indicators and in the EU's fiscal framework would be the same. New regulations would be needed to set up both the climate fund and the green golden rule. Special legislation would be needed to exempt the subsequent climate expenditures from EU fiscal rules in both cases.

A CLIMATE FUND financed by EU borrowing with redistributive effects across countries would likely result in the exclusion of the fund's activities from national fiscal indicators and EU fiscal rules without any legislative changes. There are question marks about the desirability and political feasibility of redistribution across the EU for climate purposes.

AN EU CLIMATE fund, irrespective of whether or not it involves redistribution, would mainly benefit southern and eastern EU countries. An instrument is needed to foster green public investment in western and northern EU countries as well. The green golden rule would be such an instrument.

WHILE THERE ARE some pragmatic options to mimic a green golden rule in the current EU fiscal framework, such as amending the so-called 'investment clause' and adjusting the medium-term objective for the structural balance, ultimately, elements of the 2011 Six-Pack legislation and the 2012 Treaty on Stability, Coordination and Governance should be revised to include a green golden rule.

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1 Introduction

The European Union aims to reduce greenhouse gas emissions by 55 percent by 2030 relative to 1990 with its 'Fit for 55' package, and then achieve carbon neutrality by 2050 with the European Green Deal. Achieving these targets will require substantial additional investment and major regulatory and tax measures. Available estimates suggest the additional green investment to meet the goals will amount to 2 percent of GDP[1]. Meanwhile, REPowerEU, the EU's energy policy response to Russia's invasion of Ukraine, foresees either additional or frontloaded measures to foster the green transition[2]. These investments will have to be funded.

A substantial portion of the funding for green investment will have to be provided by the public sector either directly in the form of public investment, or indirectly in the form of subsidies or guarantees to encourage private investment. By analysing the funding composition of national climate and energy plans, Darvas and Wolff (2022) concluded that the public share could be around 30 percent of total green investment needs. Private sector investment could be fostered by appropriate government regulation, taxation policy and, in particular, a higher carbon price, which should make green investment more profitable for the private sector (Kempa and Moslener, 2017). However, each of these instruments has limitations. For example, a significant increase in gas and electricity prices related to the Ukrainian war should be welcomed from the perspective of the green transition, because it creates strong incentives for the private sector to move away from fossil-fuel consumption. But governments throughout the EU have rushed to dampen the impact of higher energy prices[3]. There are political limitations to energy price increases, and the same applies to tighter regulations and subsidy elimination.

This implies that the green transition will require a substantial increase in public funding for green investment. But when the EU fiscal rules, suspended in the context of COVID-19, are re-introduced (most likely in 2024), all EU countries except Denmark, Luxembourg and Sweden will have to implement fiscal consolidation[4]. Past fiscal consolidation episodes resulted in cuts to public investment. This time, investment needs to be increased while consolidating budget deficits, which is unlikely to happen.

Two major proposals have been made to address the conflicting goals of fiscal consolidation and increased green public investment needs. Garicano (2022) proposed a new European climate investment fund akin to the loan component of the EU Recovery and Resilience Facility (RRF)[5]. Darvas and Wolff (2022) proposed a green golden rule to exclude any increase in net green public investment from the fiscal indicators used to measure compliance with fiscal rules.

In this Policy Contribution, we compare these two proposals in terms of their treatment under the current EU fiscal rules, and analyse the legal options for their introduction in the EU fiscal framework. We start with a brief review of the rationale for a green golden rule and then discuss legal options.

1 See IEA (2020), IRENA (2021) and Bloomberg NEF (2021) for the world, and D'Aprile *et al* (2020) and European Commission (2020) for the EU.

2 See https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1511.

3 See Bruegel's dataset on national policies to shield consumers from rising energy prices: https://www.bruegel.org/publications/datasets/national-policies-to-shield-consumers-from-rising-energy-prices/.

4 In the cases of Denmark, Luxembourg and Sweden, the May 2022 European Commission forecast for the structural balance in 2023 exceeded the medium-term objective by a large margin. The forecast structural balance is well below the objective for all other EU countries.

5 While Garicano (2022) initially spoke about "grants and loans", his detailed proposal clarified that "*there would be no direct transfers to the benefit of certain member states. Redistribution would only exist through lower borrowing costs – an implicit subsidy from the more creditworthy members to the less creditworthy ones.*"

2 The rationale for a green golden rule

There is a clear conceptual rationale for a general green golden rule (ie excluding all public investment from fiscal surveillance indicators). But the practical implementation challenges of a golden rule often result in such proposals being dismissed (Bundesbank, 2019; Bénassy-Quéré, 2022). However, Darvas and Wolff (2022) argued that the case for a limited golden rule excluding only climate investment is even stronger than for a general golden rule, and that a narrow focus on climate investment would avoid the practical difficulties raised in the literature.

Arguments supporting a general golden rule include the (unintentional) characteristic of fiscal frameworks to encourage fiscal procyclicality on capital spending budgets (Alesina and Bayouni, 1996) and large cuts in public investment (Blanchard and Giavazzi, 2004). There are important reasons why politicians prefer cutting investment over cutting current spending. First, in ageing societies, the interests of future generations have less electoral support. Vote-maximising politicians are likely to decide against the future, as seen in previous fiscal consolidation episodes. Second, fiscal rules create disadvantages for investments by treating them fully as current expenses, even though the benefits of investments accrue over long periods (Beetsma and Debrun, 2007; Peletier *et al*, 1999). This biases the political economy further against investment. Breuning and Busemeyer (2012) showed that public investment is hit harder by austerity than entitlement spending. Basic accounting logic would allow net investment to be funded by deficits as they increase the stock of assets (Blanchard and Giavazzi, 2004). Corporate accounting rules treat current and investment spending differently: the cost of an investment is not charged for a single year when the investment is implemented, but is distributed over the service life of the capital good. The same principle should apply to public investment.

Green investments are by their nature long term, with a political payoff that may take a long time to materialise

The rationale for a narrow green golden rule is even stronger. Green investments are by their nature long term, with a political payoff that may take a long time to materialise. First, stronger national climate action does not, by itself, solve global climate change, and countries have an incentive to free-ride on the climate efforts of other countries. Second, even at national level, the climate transformation will take many years and noticeable changes may only be observed after long periods. Therefore, it is even more likely that fiscal consolidation will lead to cuts to green public investment than to other types of public investment.

Excluding public green investment (and public subsidies to incentivise private green investment) from both deficit and debt indicators used for assessing compliance with fiscal rules would incentivise green investment, because it would be excluded from fiscal consolidation requirements. Without such a golden rule, politicians must find other expenditure to cut or increase taxation, in order to increase green investment. With the golden rule, such expenditure cuts or tax increases are not necessary to increase green investment (Darvas and Wolff, 2022).

The main criticisms of any golden rule proposal relate to practical implementation, such as the definition of investment, and possible distortions whereby favoured investments are preferred over other forms of capital or current spending that might also be beneficial over the long run, such as education and healthcare. The risk of 'greenwashing' – governments trying to reclassify non-green spending as green to exempt it from fiscal rules – is another major concern. But such misbehaviour would be a characteristic of an uncontrolled version of the rule that nobody proposes.

The narrower goal of carbon-emission reductions would reduce worries about defining what constitutes green investment. Darvas and Wolff (2022) proposed that the Council of the EU define a list of top green priorities that would result in the greatest emissions reductions. The increase in net public spending on these priorities would not count as deficit and debt under the fiscal rules. Based on the priority list, each country should integrate a climate public investment plan into its annual Stability or Convergence Programme, which is assessed by the European Commission and approved by the Council of the EU. National fiscal councils and audit offices, the European Commission, the European Court of Auditors and possibly other institutions should play roles in assessing compliance with the green golden rule. Therefore, this governance

system, similar to the governance system of the Recovery and Resilience Facility, would address the definitional ambiguity and reduce the risk of 'greenwashing' to a minimal level.

Our proposed governance system would also be rather similar to the governance system of a new EU climate fund, as proposed by Garicano (2022). But the main advantage of a green golden rule over such an EU climate fund would be that the green golden rule would benefit every country, including western/northern European countries. The main beneficiaries of a new EU climate fund would be southern and eastern European countries irrespective of whether or not the fund involves redistribution across member states. Redistribution is only conceivable from the richer northern/western countries to poorer southern/easter countries, as with RRF grants and the regular EU budget. If the new EU climate fund did not involve redistribution, but only offered loans like the loan component of the RRF, then at best southern and eastern European countries could borrow from the climate fund. Western and northern EU countries can borrow at a similar or even lower rate than the EU, and thus, for example, Germany borrowing from the EU would lead to a financial loss (in the form of higher interest) to Germany. It is not surprising that the demand for RRF loans has been moderate, and no western/northern EU country has borrowed from that facility.

Another criticism of a green golden rule is that by allowing green spending to be financed by borrowing, it could undermine public debt sustainability (Bénassy-Quéré, 2022). For this reason, Darvas and Wolff (2022) proposed that the green golden rule should only apply to countries with sound public finances. In fact, the RRF helps green investment in the more indebted southern European countries, since at least 37 percent of RRF spending should be used for mitigating climate change and the RRF heavily redistributes funds toward southern European countries[6]. Therefore, Darvas and Wolff (2022) proposed that the question of a green golden rule can become relevant for these countries only after the RRF expires in 2026.

3 The treatment of Recovery and Resilience Fund spending in statistical indicators[7]

The two main proposals to address the conflicting needs of fiscal consolidation and more green public investment – a new EU climate fund and a green golden rule – would be rather similar in terms of their treatment under EU fiscal rules. To show this, we start our analysis by looking at the treatment of Recovery and Resilience Fund (RRF) spending in EU fiscal indicators, which is a precedent for the treatment of a new EU climate fund.

Eurostat's statistical treatment of the spending financed by the RRF differs depending on whether the fund includes direct redistribution or not. In terms of clarifying what no direct redistribution across EU countries means, there are two main options:

- The potential EU climate fund could be financed by annual contributions without EU borrowing (like the regular EU budget): countries get back from the fund the exact amount they pay in. For example, in 2025, Germany could borrow €10 billion on capital markets, pay €10 billion into the fund, receive €10 billion from the fund and spend this money on green projects.
- The EU climate fund would borrow on capital markets, lend to an EU country, and later this country would repay the loan to the EU climate fund, which is used by the fund to repay borrowing from the market (as with RRF loans).

6 The RRF also redistributes towards central and eastern European countries, which have lower GDP *per capita* and relatively low public debt-to-GDP ratios.

7 This section is based on Darvas (2022).

Because the first option appears somewhat odd, existing proposals focus on the second option. As with RRF loans, EU countries jointly guarantee the repayment of EU debt so the EU can borrow at a lower interest rate than more than half of its member states. Since the EU lends to its members at its actual borrowing cost, some countries could cut interest payments by borrowing from the EU instead of borrowing from the market. By underwriting EU borrowing, more creditworthy EU countries implicitly subsidise those countries that borrow from the EU, by running the risk that they default on their liability to the EU. This risk is probably not high, not least because no EU country has ever defaulted on an EU liability, and the share of EU climate fund-related debt would be small compared with the total national debt. But there is a risk.

Both options for a no-direct-redistribution fund would result in the same treatment of the resulting climate spending in deficit and debt indicators and for the purposes of the fiscal rules.

In line with the European System of Accounts (European Union, 2013) and a Council legal option, Eurostat (2021) concluded that national spending financed by RRF grants will not be included in national deficit and debt indicators, but spending financed by RRF loans will.

The justification for excluding RRF grants is that EU borrowing to finance these grants should not be counted as member-state debt because "*there is no match between the grants received from the RRF by the individual Member States and the amounts that potentially will have to be repaid by each individual Member State, as the two elements are calculated on the basis of different criteria*" and "*there is great uncertainty on what amount each Member State will be liable for*" (paragraph 38 of the Eurostat guidance). Thus, since there is redistribution ("*different criteria*") and it is impossible to calculate the expected value of the national liability to the repayment of EU debt in 2028-2058 ("*uncertainty*")[8], EU debt used to finance the grants constitutes only "*a contingent liability for the Union budgetary planning*", but not a national debt (paragraph 42). The national budget deficit is defined as the net borrowing of the government and thus spending from RRF grants does not matter for deficits: countries record a revenue item (payment received from RRF) and an expenditure item (national expenditure financed by the RRF), which is called "*the principle of the EU flows neutrality on the general government net lending/net borrowing*" in the statistical jargon (paragraph 28 of Eurostat, 2021).

Thus, by blurring the liability that EU countries have for repaying the EU debt, the financing of RRF grants does not appear in national debt and deficit statistics and is thus exempt from EU fiscal rules.

This is different for spending financed by RRF loans: Eurostat concluded that these loans should be recorded as national debt and thus expenditure financed by that debt increases national budget deficits (paragraphs 43-45 of the Eurostat guidance). So, spending financed by RRF loans is not exempt from fiscal rules.

An EU climate fund would be recorded in the same way as the RRF.

8 See Darvas (2021) on the nonsense of Next Generation EU net balance calculations.

4 The 2015 treatment of the European Fund for Strategic Investments in statistical indicators

An important question is whether the statistical treatment of the 2015 European Fund for Strategic Investments (EFSI)[9], often called 'The Juncker plan'[10], would be a precedent for the statistical treatment of a possible new EU climate fund. EFSI involved two types of contributions from EU countries: an initial capital transfer to EFSI and regular national co-financing of projects also co-financed by EFSI. The initial national contributions to EFSI were excluded from the structural deficit calculation. Based on this precedent, Garicano (2022) suggested that a Commission decision would be sufficient to exclude spending financed by a possible new EU climate fund from the deficit and debt calculation without changing the fiscal rules. Unfortunately, this is not the case, for the following reasons.

European Commission (2015) noted that "*Two aspects need to be distinguished here: i) whether these contributions are recorded statistically as deficit and/or debt, in line with the established definitions of the European System of Account (ESA); and ii) the way in which the Commission will take account of such contributions in its assessment of compliance with the Pact.*"

How contributions are recorded is left to the independent Eurostat, though the Commission suggested that if a country borrows to fund the contribution, this will increase government debt. This in turn increases the budget deficit. For the compliance assessment, the Commission decided that the initial contributions to EFSI are one-off measures, and thus they will not be accounted for in the structural balance (because, by definition, the structural balance does not include exceptional one-off measures). But even in this case, the initial contributions to EFSI boosted the budget deficit. The Commission also noted that an excessive deficit procedure would not be launched if non-compliance with the 3 percent deficit criterion resulted only from EFSI contributions, if the excess over the 3 percent reference value is small and is expected to be temporary, in line with Treaty provisions. A similar conclusion was reached for non-respect of the debt criterion.

A European climate fund would be in place for decades and EU countries would have to contribute to it over long periods

A European climate fund would be in place for decades and EU countries would have to contribute to it over long periods, either by financing the fund's annual expenses if the fund has no borrowing capacity, or repaying the fund's debt and its interest if the fund borrows on the market. Therefore, national contributions to it cannot be considered exceptional one-off measures. In the same vein, breaching the 3 percent deficit threshold would not be temporary if it results from expenditures that lasts for decades. Therefore, the treatment of the initial capital transfer to EFSI in EU fiscal rules does not provide a relevant precedent for a possible new EU climate fund.

The other types of national contributions to EFSI, the regular national co-financing of projects also co-financed by EFSI, were included in the structural balance already in 2015, as well as in budget deficit and public debt indicators. To foster such national co-financing, European Commission (2015) suggested that it could be considered for the so-called 'investment clause', which allows temporary deviations from the medium-term objective (MTO) for the structural balance, or from the adjustment path toward it, for a temporary period under rather strict conditions. In Section 7.1 we discuss the investment clause and conclude that it would not be a proper instrument to foster green investment.

9 See https://www.consilium.europa.eu/en/policies/investment-plan/strategic-investments-fund/.
10 See https://ec.europa.eu/commission/presscorner/detail/en/IP_19_6119.

5 An new EU climate fund with direct redistribution

An EU climate fund with direct redistribution could be similar to the grant component of RRF: the EU borrows on the capital markets and pays out grants, for which the cross-country allocation of pay-outs differs from the cross-country allocation of repayment of EU debt.

Direct redistribution via an EU climate fund would lead to different statistical treatment, especially if the fund is financed by long-term borrowing. Like RRF grants, the different criteria used for allocating the cross-country grants from the fund and cross-country contributions to the fund, and the uncertainty about how much each country should pay into the fund in the future, would likely lead Eurostat to conclude that expenditures financed by the fund would not constitute national deficits and debts.

However, it is not clear-cut whether there is a rationale for redistribution and whether there would be political will for that. The climate is global and the marginal benefit of additional climate spending by a net-payer country could be higher in low-income countries outside of the EU than in other EU countries. On the other hand, fostering the achievement of EU climate goals, which could also strengthen EU climate leadership, and making fiscally weaker EU countries more fiscally sustainable would be positives for the EU. Highly-indebted EU countries might not be able to finance the necessary public climate investment. Furthermore, Zenios (2021) argued that climate is a systemic risk that has asymmetric effects on EU countries and thus joint action would be an expression of EU solidarity.

Nevertheless, if the three goals are to (1) limit redistribution, (2) exclude climate spending from fiscal rules and (3) avoid changing fiscal-rule legislation, a trick would be to design a climate fund so it involves only 'little' redistribution. For example, the criteria for allocating the grants from the fund would primarily depend on gross national income, but would include other indicators as well. The future repayment of the resulting EU debt would depend only on GNI. Thus, there would not be a direct match between the grants received from the climate fund by individual countries and the amounts that potentially will have to be repaid by each individual member state. Eurostat might then conclude that the consequent EU borrowing should not be counted in national debts and deficits.

6 A new EU climate fund financed by own resources

The issue of exempting green public spending from fiscal rules would be irrelevant if a new EU climate fund was financed by new own resources (ie revenues). In this case, the fund would collect revenues and distribute these revenues to EU countries for green spending, but EU governments would not have to pay any direct contribution to the fund.

However, collecting enough own resources to cover a significant portion of the needed increase in public green investment is extremely unlikely. Moreover, a new own resource for the EU budget implies that the same revenue does not accrue to national budgets, thus increasing national budget deficits (Wolff, 2020). For example, if the revenues come from the European Commission's plan to redirect to the EU some of the reallocated taxes from the world's largest companies and some of the revenues from the EU emissions trading system[11] (European Commission, 2021), then member states will not receive these tax revenues. Thus,

11 See press release of 22 December 2021: https://ec.europa.eu/commission/presscorner/detail/en/ip_21_7025.

national budget deficits are going to be larger, all else being equal. The only exceptions are resources countries cannot levy, like the proposed carbon border adjustment, but it's unlikely that such a source would provide a sizeable contribution to an EU climate fund.

7 The scope for promoting green public investment in the current EU fiscal framework

In the current EU fiscal framework, there are only limited options for promoting green public investment (either in the form of a green golden rule or a new EU climate fund without redistribution), and these exist only in the preventive arm of the Stability and Growth Pact (SGP) but not in the corrective arm. This requires revisions to:

- The existing 'investment clause'[12] to alter the adjustment path in the next years, and
- The medium-term objective (MTO) to change the long-run anchor for the structural balance.

A Council decision would be sufficient for these changes.

7.1 The 'investment clause'

Since 2015, the EU fiscal framework has included a limited golden rule, called the 'investment clause' . The conditions and the scope of the investment clause are not specified in any EU legislation, but are based on a Council decision, informed by a Commission proposal (European Commission, 2015), a Council legal service option and an Economic and Financial Committee[13] compromise agreement (Council of the European Union, 2015).

For certain EU-funded projects, the investment clause allows for temporary deviations from the MTO, or from the adjustment path towards it, amounting to at most 0.5percent of GDP[14], for a period of maximum of three years, under the following (rather strict) conditions[15]:

- GDP growth is forecast to be negative or to remain well below its potential (resulting in negative output gap greater than 1.5 percent of potential GDP);
- The member state remains in the preventive arm at the time of the assessment of the application for use of the clause;
- An appropriate safety margin with respect to the 3 percent of GDP deficit reference value is preserved;
- Only national co-financing of projects co-funded by the EU under the Structural and Investment Funds, Trans-European-Network, Connecting Europe Facility and the European Fund for Strategic Investments (EFSI) are allowed;
- The projects financed must have positive, direct and verifiable long-term budgetary effects;
- Co-financed expenditure should not substitute for nationally-financed investments, so that total public investment does not decrease;

12 See: https://www.consilium.europa.eu/en/policies/stability-growth-pact-flexibility/.

13 A policy coordination committee; see https://europa.eu/efc/index_en.

14 In case the member state also benefits from the so-called 'structural reform clause', then the total cumulative temporary deviation allowed under the two clauses cannot exceed 0.75 percent of GDP.

15 See the detailed specification on pages 22-25 of the *Vade Mecum* (European Commission, 2019).

- The maximum initial distance of the structural balance from the MTO is 1.5 percent of GDP, so that in the benchmark case of an annual adjustment of 0.5 percent of GDP, the member state can achieve its MTO within the four years;
- In the period of adjustment towards the MTO, the clause can be applied only once.

As a result of these restrictive conditions, only two countries, Italy[16] and Finland[17], have so far applied for the investment clause. Anderson and Darvas (2021) concluded that the extra room for manoeuvre offered by the investment clause was minuscule for the two countries that applied for it, which, along with the very strict criteria for application, brings into question the usefulness of this clause.

The current investment clause would not provide a good legal basis for excluding spending financed by an EU climate fund or a green golden rule from fiscal rule indicators, because the allowed maximum initial 0.5 percent of GDP temporary deviation, which should be corrected in three years, would be too tiny and for a too-limited period to make a difference. Moreover, the European Commission's May 2022 forecast suggested that only two countries, Denmark and Lithuania, would meet its very strict conditions in 2023[18].

The investment clause could theoretically be revised by a Council agreement following a Commission Communication, yet the Commission already struggled to find a legal basis for this narrow investment clause in 2015: the Stability and Growth Pact does not allow exceptions for investments, but allows for structural reforms. Article 5(1) of Regulation (EC) No 1466/77 was used to justify the investment clause:

> *"When defining the adjustment path to the medium-term budgetary objective for Member States that have not yet reached this objective, and in allowing a temporary deviation from this objective for Member States that have already reached it, provided that an appropriate safety margin with respect to the deficit reference value is preserved and that the budgetary position is expected to return to the medium-term budgetary objective within the programme period, the Council and the Commission shall take into account the implementation of major structural reforms which have direct long-term positive budgetary effects, including by raising potential sustainable growth, and therefore a verifiable impact on the long-term sustainability of public finances."*

This article does not mention public investment. Thus, when using this legal provision for a temporary deviation from the structural balance targets in case of investments, the member state has to demonstrate that the particular investments are economically equivalent to structural reforms, because they have a direct, positive and verifiable effect on fiscal sustainability. The member state's request for such a temporary deviation is subject to a plausibility assessment by the Commission and the Council.

Nevertheless, possible revisions of the investment clause could include changing the scope from specific EU-financed investments to any green public investment, the removal of the GDP condition, the removal of (or an increase in) the maximum 1.5 percent of GDP initial structural balance distance condition, increasing the allowed 0.5 percent maximum temporary devia-

16 Italy requested a 0.3 percent of GDP deviation in 2015 for the 2016 budget, of which 0.25 percent was granted under conditions, but this flexibility for 2016 was retroactively reduced to 0.21 percent of GDP in 2017, in light of the investments actually made in 2016, which were lower than planned.

17 Finland requested a 0.1 percent of GDP deviation in 2016 for the 2017 budget, which was granted, but it was retroactively withdrawn in 2018 because outturn data for 2017 showed a decline in public investment in 2017 compared to the previous year, while investments linked to Union funds were estimated to have remained stable. The 0.1 percent of GDP deviation for Finland and the 0.21 percent of GDP deviation for Italy were dwarfed by the revision of the 2017 structural balance estimates.

18 Among the three countries for which the European Commission forecasts a negative output gap greater than 1.5 percent of potential GDP in 2023 (Lithuania -2.1 percent, Denmark -1.9 percent, Romania -2.7 percent), Romania is expected to have a 6.3 percent of GDP budget deficit.

tion, and allowing more time to correct the temporary deviation by extending the length of the programme period. Yet such revisions are limited by the above-cited provisions of Article 5(1) of Regulation (EC) No 1466/77, in particular, by the requirements that there should be an appropriate safety margin with respect to the 3 percent deficit criterion, and that the MTO has be reached within the programme period.

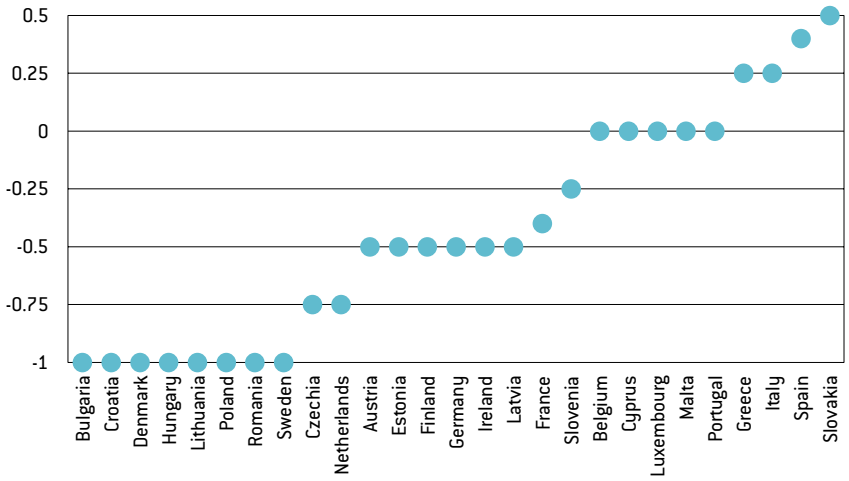
7.2 The medium-term objective

The determination of the MTO as codified in Article 2a of Regulation 1466/97, includes[19]:
"The medium-term budgetary objectives shall ensure the sustainability of public finances or a rapid progress towards such sustainability while allowing room for budgetary manoeuvre, considering in particular the need for public investment."

Thus, public investment is explicitly mentioned as a consideration for the MTO. We propose that a first calculation of the MTOs should be done according to the procedure described in the latest (2017) version of the Code of Conduct of the SGP (Council of the European Union, 2017), and then in a second step, these MTOs should be reduced by the increase in the net green investment the country aims to implement. Fiscal surveillance should ensure that the extra fiscal space provided by a lowered MTO is solely used for net green investment.

A limitation of the proposed MTO correction is that the floor of the MTO is minus 1 percent for euro-area and Exchange Rate Mechanism (ERM II) members with public debt below 60 percent, and minus 0.5 percent when debt is over 60 percent of GDP. For 2023, four euro-area or ERM II countries (Bulgaria, Croatia[20], Denmark, Lithuania) have an MTO of minus 1 percent and three euro-area countries (Austria, Finland, Germany) with debt over 60 percent have an MTO of minus 0.5 percent (Figure 1). For these seven countries, the current legislation would not allow any reduction of the MTO. For three additional countries the scope for reduction is minimal: 0.1 percentage points of GDP for France and 0.25 percentage points of GDP for the Netherlands and Slovenia.

Figure 1: The 2023 medium-term objectives (MTOs), percent of GDP



Source: Bruegel based on the 2022 national stability or convergence programmes. Note: The 2022 stability or convergence programmes include the MTO for 19 countries, of which the MTO has not been changed from its previous value in the cases of 12 countries. We could not find information about the MTO in the stability or convergence programmes of seven countries (Belgium, Croatia, Greece, Ireland, Portugal, Romania and Slovenia), while France is the only country for which the 2022 stability or convergence programme was not available on 11 July 2022 (https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester/european-semester-timeline/national-reform-programmes-and-stability-or-convergence-programmes/2022-european_en). For the seven countries with missing MTO information and for France, we use the MTO values which were set for 2020-2022 in 2019.

19 See https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:01997R1466-20111213.

20 Since Croatia entered the ERM II in 2020 and is set to enter the euro area in 2023, and Croatia's gross public debt is expected to exceed 60 percent of GDP in 2023, Croatia's minimum MTO will increase to at least -0.5 percent of GDP.

8 Conclusions

EU countries must increase green public investment significantly to meet EU climate goals. This will be challenging when EU fiscal rules are reactivated because fiscal consolidation episodes usually coincide with cuts in public investment, for political-economy reasons. The two main proposals to address this challenge are the establishment of a new EU climate fund and the introduction of a green golden rule. The latter would exempt the increase in net green public investment from the statistical indicators considered for fiscal rules for countries with sound public finances.

An EU climate fund and a well-designed green golden rule would be equivalent in terms of project selection, implementation and control procedures. If the climate fund does not involve redistribution across member states, then the treatment of related spending and consequent borrowing in national fiscal indicators and in the EU's fiscal framework would be the same. New regulations would be needed to set up both the climate fund and the green golden rule. Special legislation would be needed to exempt the subsequent climate expenditures from EU fiscal rules in both cases.

The main difference between a non-redistributive EU climate fund offering only loans and a well-designed green golden rule is that the former could potentially benefit only southern and eastern EU countries facing higher-than-EU borrowing costs, while the latter would incentivise green public investment in all EU countries, including in western and northern EU countries.

An EU climate fund offering only loans might not incur significant demand for two reasons. First, some EU countries can borrow at a cheaper rate than the EU, so borrowing from the EU would lead to a financial loss. Second, demand for RRF loans has been moderate: only seven countries have decided to borrow from the RRF, and of these seven, only three have borrowed the full available amounts. The other four have borrowed only about one-third or less of what was available. It is therefore rather uncertain whether EU countries would want to borrow from a new EU climate fund.

Another difference between a non-redistributive EU climate fund offering only loans and a well-designed green golden rule is that an EU climate fund financed by EU borrowing would create an indirect subsidy, going from more creditworthy to less creditworthy countries in the form of reduced interest costs, because of the joint guarantee of EU borrowing.

A further difference is that an EU climate fund could result in positive reputational effects (demonstrating the EU's determination to act together) and beneficial financial market development resulting from more EU debt (Christie *et al*, 2021), which would not be the case with a green golden rule.

A climate fund financed by EU borrowing with redistributive effects across countries would likely result in the exclusion of the fund's activities from national fiscal indicators and EU fiscal rules. But there are question marks about the desirability and political feasibility of redistribution across the EU for climate purposes, and redistribution is only conceivable from richer western and northern EU countries toward poorer southern and eastern EU countries. An instrument is needed to foster green public investment in western and northern EU countries as well. Our proposed green golden rule would be such an instrument.

The options to mimic a green golden rule in the current EU fiscal framework are rather limited: the investment clause could be revised and the medium-term objective for the structural balance could be adjusted, but both options have severe limitations. Ultimately, certain elements of the 2011 Six-Pack legislation[21] and the 2012 Treaty on Stability, Coordination and Governance (TSCG)[22] should be revised to include a green golden rule in the EU fiscal framework.

21 See https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/legal-basis-stability-and-growth-pact_en.

22 See https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:42012A0302(01).

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