European budgetary rules
What if the derogation became the norm?

Summary:

2023 will be the fourth consecutive year of suspension of the fiscal rules under the European Stability and Growth Pact. This suspension allows for the coverage of budgetary needs resulting from the pandemic, and now the war in Ukraine. What lessons can be drawn from this four-year experience, unprecedented since the agreement of the Stability and Growth Pact in 1997? Does it signal the definitive failure of fiscal policy coordination focused on debt and deficit targets without considering the complexity of the interactions between this policy and the economy, society as well as the environment?

The suspension of the fiscal rules of the SGP does not mean that the fiscal policies of EU countries are no longer coordinated or that there is no need to do so. But this suspension went hand in hand with a reorientation in two directions. On the one hand, numerical rules have given way to judgement to guide the coordination of fiscal policies according to the macroeconomic stabilisation needs of the Union and of each country; on the other hand, a consensus was also reached on the specific budgetary measures to be taken in response to the disruptions caused by the pandemic and the war in Ukraine. The result is a reinterpretation of the principle of subsidiarity, which strongly limited until then the co-ordination of national fiscal policies to macroeconomic aspects and the level of public debt and deficit.

This shift should inspire the forthcoming reform of the budgetary framework. The new framework should lead to recommendations based on a shared diagnosis but not be constrained by numerical rules. It should guide fiscal policies in a two-dimensional space:

the correction of macroeconomic imbalances in the Union, on the one hand, and, on the other, objectives of common European interest, notably the objectives of the Green Pact for Europe and the European pillar of social rights. The Recovery and Resilience Facility, by easing the financial constraint of some countries, is an additional contribution to the mitigation of macroeconomic imbalances between countries and helps to keep the focus on medium and long-term priorities. Such an instrument will continue to be needed.

Building a consensus year after year since 2020 has been facilitated by the urgency. National democratic processes will inevitably lead to differences in assessment or of interests between countries. But experience has shown that such tensions can also arise when coordination is governed by what are now inadequate numerical rules. And dialogue between mature democracies is certainly more likely to lead to compromise and less damaging to European cohesion in the long term than forcing the application of opaque and unsuitable rules. The new approach would embed fiscal policies in their monetary, economic and environmental context. To make it sustainable, three conditions must be met: increased efficiency, notably through medium/long-term programming in support of sectoral transition policies; impact assessments and "green budgeting" methods that guarantee the effectiveness of spending and are not "greenwashing"; deliberative procedures that make it possible for national and European short, medium and long term priorities to converge year after year.

Four years of derogation from the European numerical budgetary rules

2023 will be the fourth consecutive year of suspension of the fiscal rules of the Stability and Growth Pact (SGP). Does this suspension signal the definitive failure of fiscal policy coordination focused on debt and deficit targets without taking into account the complexity of the interactions between fiscal policy, the economy, society, the environment and the biosphere? The rise of these complexities was evident before the pandemic: qualitatively and quantitatively insufficient support of monetary and fiscal policies to economic activity, erosion of the fiscal base, rising social inequalities and inequalities between European countries, deterioration of public services, weakening of public infrastructures, global warming, collapse of biodiversity and depletion of natural resources. But the responses provided by successive reforms of the budgetary rules, instead of broadening the focus and taking into account the substance of these complexities, have only added complication and opacity to the interpretative calculations of the two aggregates, public deficit and debt. This disembedded coordination of fiscal policies referring only to financial indicators has collapsed with the pandemic, and now the war in Ukraine. In both cases, the politically-motivated limitation of activities in certain sectors, called non-essential in the case of COVID or linked to trade with Russia at present, was at the origin of this collapse. What lessons can be drawn from this four-year experience, unprecedented since the agreement of the Stability and Growth Pact in 1997?

A shift towards argument-based coordination

The suspension of the fiscal rules of the SGP does not mean that the fiscal policies of the EU countries, and more particularly of the Eurozone, are no longer coordinated or that there is no need to do so. But the practice that has become established since 2020 makes a return to context-blind rules neither likely nor desirable. From spring 2020 onwards, the derogation from the budgetary rules has allowed for a finer calibration of the deficit and debt recommendations than had previously been the case. Year after year, the agreement on the policies to be implemented is based not only on a shared diagnosis of the macroeconomic situation but also on the priority fiscal measures. In 2020, the consensus was obviously on health spending, but also on non-conventional measures to preserve salaried employment, the liquidity and solvency of companies and the economic fabric[i]. Similarly, in 2021, the fiscal policies recommendations for 2022 specified as a priority objective an acceleration of the energy and digital transition through investment[ii]. The extension of the derogation clause until at least the end of 2023 is also accompanied by fairly specific recommendations[iii]. These aim to support the incomes of households and businesses most affected by the rise in energy and food prices and to limit the impact of energy import price rises on consumer prices. They also include the financing of the strategy to free the country from Russian gas imports.

These developments mark an important shift in the modes of coordination.

On the one hand, the recommended and continued orientation of policies in terms of public deficit and budgetary support for macroeconomic activity is based on a well-founded diagnosis that is not constrained by numerical rules. This diagnosis is drawn up by the commission and shared with and by the Member States. Since 2020, there has hardly been any question of the sterile application of numerical rules. This makes it possible to replace the arguments about compliance with the rules with a substantive debate on the desirable development of public deficits and debts. The approach also makes it possible to take into account the interactions between monetary policy and fiscal policies and to think in terms of the policy mix. In the current context of rising import prices and structural disruptions in energy supplies, this last aspect has become crucial. The management of fiscal policies cannot follow rules that are at best operational in calm times.

On the other hand, the increased flexibility granted goes hand in hand with a requirement to align certain measures under national budgets with objectives of common European interest. This second point is far from trivial. It calls into question a principle of the monetary Union well established since the Delors report[iv] of 1989. Because of the principle of subsidiarity[v], the European level should not interfere with specific national budgetary choices, except in the case of debt and deficit, which potentially have a macroeconomic impact on all European partners. This principle of subsidiarity is still often invoked to oppose, for example, a "golden rule for investment" which would allow some expenditure to be subtracted from the relevant deficit to apply the rule. However, by linking recommendations of a macroeconomic nature on the deficit to recommendations on the composition of expenditure and revenue, the Commission and the Council have changed the interpretation of subsidiarity. The practice since 2020 has taken into account in a much more differentiated way the contribution of particular budgetary measures to short, medium and long-term European priorities and their synergies[vi].

Another innovation has accompanied and reinforced this paradigm shift, the Recovery and Resilience Facility (RRF). This is a European financing mechanism for expenditure that is programmed and implemented through national budgets. This expenditure must contribute to a common interest validated by the European authorities, such as the energy transition, the digital transition or social cohesion. The contribution to a common interest is validated by the European authorities. The primary purpose of the RRF is to reduce macroeconomic imbalances between countries that are likely to worsen under the impact of the pandemic. At the same time, it promotes vertical coordination of national and EU fiscal policies.

A model for the future?

Is the emergence of new modes of coordination of fiscal policies and a new instrument purely circumstantial or does it correspond to a lasting necessity? And what, if anything, is missing to complete it?

The use of the derogation clause from the budgetary rules of the Stability Pact was justified by the necessary increase in public deficits and the priority to be given to certain national budgetary expenditures in order to avoid a collapse of the European economy. It was also justified by the need for flexibility in a very uncertain macroeconomic context.

These three factors persist and will intensify in the short, medium and long term. The coordination of national fiscal policies with monetary policy is becoming more complex due to the risks of recession and increases in energy and food prices beyond the control of monetary policy. In this context, unconventional budgetary measures, such as the reduction of indirect taxes on certain products, aid at the pump and exceptional social transfers have been taken. The energy transition and the priority given to freeing ourselves from Russian hydrocarbons, particularly Russian gas, requires the deployment of renewable energies and the improvement of energy efficiency at a pace unprecedented to date. This pace will have to be maintained for decades (see Annex 1). In addition, there is a need for greater sobriety in the use of energy.

Fiscal measures in support of "green" jobs or investments will be all the more necessary to keep the transition on course as the tightening of monetary policy is likely to affect activities and investments without differentiating a priori their impact on the energy transition.

More generally, the hypothesis that it will be possible to achieve sufficiently green, inclusive and fair positive growth over the next thirty years still needs to be validated, as does the possibility of an absolute decoupling of growth from planetary limits[vii]. And it is known that it is not possible to rely solely on price adjustments to bring about the necessary transformations. New fiscal policies and new sectoral measures could therefore be required without it being possible to anticipate their nature: the occurrence of events that cannot be anticipated because they are unprecedented in nature and scope is very likely, if not certain.

The European Union is collectively committed to the climate objectives of the Paris Agreement as well as to the other objectives of the Green Deal for Europe, notably biodiversity and the preservation of natural resources. However, many of the policies to achieve these goals are subject to national programming and implementation: energy efficiency in buildings, urban and regional transport, agro-ecological transformation strategy, deployment of decentralised renewable energy production, circular economy and waste management, among others. The European level has a role to play in monitoring results and coordinating regulation or guidance, as well as in financing trans-European networks. Furthermore, as is the case with the Recovery and Resilience Facility, it will be essential that the financial constraints that could weigh on national expenditure necessary to achieve objectives of common interest are alleviated by a European instrument financed by a sustainable European own resource

The methods of horizontal and vertical coordination of national and European fiscal policies that have emerged since 2000 could therefore usefully inspire the reform of the Stability and Growth Pact. Member States must have the necessary margins to conduct the policies required for a just transition and be encouraged to calibrate the composition of their expenditure and revenue accordingly. The uncertainties inherent in this transition mean that no rule can be a lasting substitute for a detailed and shared judgement

Four conditions for legitimacy and effectiveness.

The legitimacy and therefore the sustainability of the new governance will, however, depend on the fulfilment of four conditions that are still insufficiently met:

Preferring founded judgement over numerical rules

The necessary reform of the Stability Pact cannot mean a return to the past, i.e. the reintroduction of even simplified rules for public deficits and debts that are blind to the context. The coordination of fiscal policies will have to be guided in a two-dimensional space: on one axis the needs of macroeconomic stabilisation and on the other the fiscal measures that will allow the achievement of objectives of common interest, in particular when they contribute to the social and environmental sustainability of the European economy[viii]. It must be possible to arbitrate between such measures and the level of the deficit as has been the case since 2020. It must also articulate the European and national levels of decision and financing. We must resolutely abandon an interpretation of the principle of subsidiarity that confines the coordination of national fiscal policies to a macroeconomic exercise and must rely on a holistic vision of the articulation of national and European budgets.

Clarifying the objectives and democratising the coordination process

European coordination of national fiscal policies is inevitably a source of tension. National parliaments remain in charge of national budgets, while each country must be able to assess whether the fiscal policies of its partners contribute to shared objectives and, at the very least, do not harm them. Creating the conditions year after year for a convergence of views between the European and national levels on the objectives is essential for effective coordination. The reference to numerical rules supposed to guarantee macroeconomic stability or to an objective as general and imprecise as "sustainable growth" does not provide lasting legitimacý for a European coordination of national fiscal policies. Retaining objectives of common interest, such as those associated with the decarbonisation of the European economy and the protection of biodiversitý as well as the realisation of the European floor of social rights can. Of course, the operational objectives will have to be adapted year after year to the circumstances of the moment, as has been the case since 2020. Enhanced exchanges between national parliamentarians, including European parliamentarians, can strengthen mutual understanding between the latter, who are the ultimate decision-makers. Furthermore, the

European social dialogue should be transformed into a social and environmental dialogue by including environmental organisations. Finally, where expenditure clearly contributes to the production of European public or common goods, tensions will be more easily absorbed by sustainable European financing instruments along the lines of the FRR or the Community budget. The legitimacy of such instruments can be granted at European level.

Getting Member States up and working through medium-term programming and performance indicators

The coordination of fiscal policies must be based on medium-term fiscal programming in support of the various sector policies structuring the transition. Specific and measurable quantitative outcome indicators shall guide and monitor the choice of the volume and allocation of public funding and the policies that accompany it[ix]. As shown in Annex 2, the macro-economic approach that indiscriminately focuses on a model-based estimate of investment needs is not helpful, including because it does not differentiate between investments that are likely to be privately financed and those that are not. The next version of the National Energy and Climate Plans foreseen by the European regulation could be the right instrument for budgetary programming. But much remains to be done: the Commission noted in its evaluation of their latest draft that "... these plans are not always sufficiently detailed and precise concerning the actions and measures planned for important dimensions such as the identification of the necessary investments, the mobilisation of financing,..."[x].

Strengthening the environmental effectiveness of budget programmes

Confidence in the effectiveness of budgetary spending is also a condition for the sustainability of outcome-driven budgetary coordination. In any case, the success of the Green Pact for Europe depends on the ability of fiscal policies to bring about the required transformations. Much remains to be done here too, both in the Member States and at European level. The methods used at this stage to assess the contribution of public spending to the EU's climate objectives are satisfactory in only a few countries. With regard to expenditure under the EU budget, the European Court of Auditors[xi] severely criticises the method used: it notes that "the methodology used does not require quantification of the impact of expenditure on GHG emissions nor does it set specific indicators for adaptation". In response, the Commission acknowledges that monitoring the achievement of results is essential to ensure the effectiveness of the mainstreaming effort, but that it has not put in place a system for monitoring climate outcomes. The German Court of Auditors concludes that the impact assessments are totally unsatisfactory[xii]. In its 2021 report, the French Environmental Authority notes 'a worrying gap between the medium and long-term objectives set, the ambitions stated for achieving them and the actions that are supposed to translate them'[xiii].
Furthermore, the method used to evaluate "green investments" under the Recovery and Resilience Facility is based on a list of expenditures. Like the method used for the EU budget, it is an a priori exercise, which does not assess the final contribution to the EU's climate objectives. A survey of green budgeting practices conducted by the European Commission highlights that only five Member States carry out environmental impact assessments[xiv]. In addition, only six Member States label expenditure with an environmental objective, which is a condition for minimal transparency.

Conclusion

The ways of coordinating national fiscal policies adopted in response to the pandemic, and now the war in Ukraine, should inspire future reform of the fiscal framework. They must move away from rigid numerical rules that are now inadequate in the light of deficit and debt levels. They must allow recommendations to be drawn up based on a shared diagnosis. The aim is to take into account both the macroeconomic situation of the Union and the particularities of each country and to orient national budgets towards well-specified objectives of common European interest. The Recovery and Resilience Facility, by alleviating the financial constraint of certain countries, is an additional contribution to the rebalancing of macroeconomic imbalances between countries and makes it possible to maintain the focus on medium and long-term priorities. Such an instrument will continue to be needed.

The development of a consensus year after year since 2020 has been facilitated by the urgency of the situations. It cannot be expected that the alignment of national priorities will always be so easy. National democratic processes will inevitably lead to conflicts between countries on how to align national and European priorities. But experience has shown that such tensions also arise when coordination is governed by rules. And dialogue between mature democracies is certainly more likely to lead to compromise and less damaging to European cohesion in the long term than forcing the application of rules that do not take into account the complexity of situations. In order to make the new approach, which embeds fiscal policies in their fiscal, monetary, economic and environmental context, sustainable, three conditions must be met: to put in place medium/long-term budgetary programming, to adopt methods of "green budgeting" and impact assessment that are not "greenwashing", and to promote deliberative procedures that make it possible for national and European priorities to converge year after year in the short and long term.

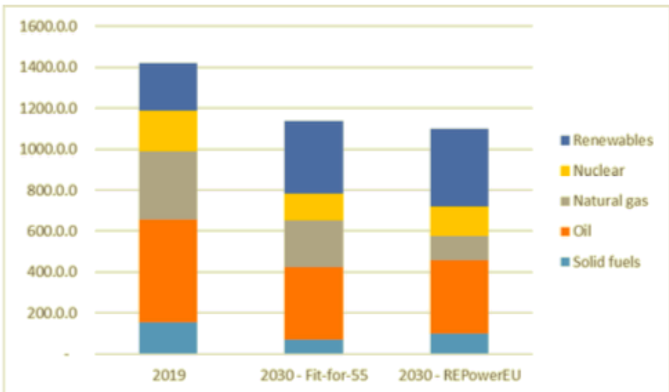
Annex 1: Changing energy priorities as a result of the war in Ukraine

Making Europe independent of Russian oil, gas and coal imports has become a European priority. To this end, the European Commission proposed in May 2022 a strategy called RePowerEU. This new strategy adapts the strategy adopted in July 2021 "Fit for 55", which aims to reduce greenhouse gas emissions by 55% between 1990 and 2030 in accordance with the Green Pact for Europe.

According to RePOwerEU, the expected reduction of Russian fossil fuel imports (solids, gas and oil) depends on three main parameters. The first is to replace Russian gas with gas from other sources: however, this is limited by the lack of transport and supply infrastructure; the second is to replace gas with other 'easy' fossil fuels (coal and oil); the third is to replace gas with renewables and to increase energy efficiency.

The REPowerEU strategy does not include significant alternatives. Changes in consumer behaviour are part of the package proposed by the Commission, but would only have a limited effect. However, some observers question whether we should not rely much more on energy sobriety[xv]. The development of the hydrogen industry should help save gas, but not before 2027 at the earliest. The postponement of the nuclear phase-out announced by Belgium and France will only have a marginal impact. Moreover, for the very short term (2022 and 2023), the French electricity company has announced that it has to reduce nuclear power production for safety reasons. And the new French nuclear power plants, if any, are not expected to be operational before 2035.

Figure 1: Gross inland consumption by fuel in 2019 and in 2030 in the Fit-for-55 and REPowerEU scenarios (Mtoe)



Source: Eurostat (2019) and Primes (2030)

Source : European Commisison; SWD (2022) 230 , P.13

As can be seen from the graph above, the Commission considers that an increase in the consumption of oil and solid fuels compared to the previous "Adjustment to target 55" scenario is inevitable with its negative impact on the carbon budget. Furthermore, stopping gas imports from Russia without disrupting the short- or medium-term non-substitutable energy supply in some parts of Europe (Eastern and Central Europe, Northern Germany) requires additional investments in gas transport, processing and storage infrastructure (LNG), which is however relatively high in GHG content and/or whose extraction may cause serious environmental damage (shale gas). The consequence is that a success in reducing dependence on Russian gas may well result in a failure to meet GHG emission targets. This will also result in "stranded assets" in Europe and possibly in exporting countries, due to the rapid obsolescence of investments in gas infrastructure that are necessary in the short and medium term, but which are destined to become useless by the time the decarbonisation of the European economy is finalised (unless they are built in a way that is compatible with hydrogen transport).

Thus, the EU's ability to meet its 2030 climate targets without Russian gas will depend mainly on its ability to deploy renewables at an unprecedented rate while diversifying its gas import sources in the short term. However, CAN, the European Climate Action Network, believes that it is possible to fully replace Russian gas imports without resorting to carbon-based alternatives within four years, provided that the development of renewable energy and investments in energy efficiency are accelerated,

Annex 2: Investment, fiscal needs and public policies

The Commission's work on energy transition presents estimates of the investment needed to achieve the objectives of the European Green Deal. For the program "Fit for 55" the estimated needs amount 340 billion per year[xvi] [xvii]. To reach the RePowerEU target, which adds the constraint of a freeing from hydrocarbon imports from Russia, it would be necessary to add about 40 billion euros per year. 380 billion represents 2.8% of 2020 GDP.

These figures require two qualifications: the link with public budgets and the coordination of investment decisions.

- *An ambiguous link with public funding needs*

The estimates do not provide clear guidance on the public expenditure needed to achieve the transition for two reasons:

- they do not distinguish between what needs to be financed or co-financed by the public and what can and will be financed by the private sector;
- and they do not include all the public expenditure needed to achieve the transition.

Indeed, the cost estimates are based on a model [xviii]that can estimate the investments needed to move from the current energy system to one that emits no more GHGs than the target set by the European Green Deal. The main underlying assumptions include that the equalisation of energy supply and demand is the result of smooth price adjustments ("perfect markets") and that representative agents make investment decisions based on a cost-optimisation calculation. However, in reality, several obstacles may prevent investors or households from undertaking the investments deemed "optimal" and many cases require at least some public co-financing. The investor, whether an entrepreneur or a household, may face liquidity or credit constraints to invest; the expected return may need to consider a period beyond the investor's time horizon or be too uncertain. The financing of network infrastructure also usually requires at least some public co-financing. On the other hand, there are several expenditures that are not considered in the model but are necessary to support the transition. These include social transfers to households affected by energy price increases, expenditure on upgrading and renewing professional skills, and capacity building for administrative implementation. On the net revenue side, the transitional increase in the carbon tax and the reduction in carbon subsidies should also be taken into account.

- *Missing links to the articulation of the European and national level of sector policies*

It is widely recognised that public policies, and thus fiscal choices for transition, need to be organised at the sectoral level and at different levels of decision-making, European, national, local. For example, strategic investments to complete the trans-European transport network and the energy network, as well as their financing, must be coordinated at European level. The same is largely true for support for innovation and the development of new industrial production, such as batteries. However, most of the investment needs identified to achieve the climate objectives are in the building sector as well as in investments in renewable energies, and in the urban and interurban transport sector[xix]. In these sectors, the need for European coordination rem

---

[i] European Commission, 2020 European Semester, country specific recommendations

[ii] European Commission, 2021, One year since the outbreak of COVID-19: fiscal policy response

[iii] See for the adaptation of the energy strategy European Commission, 2022, RePowerEU Plan, and the complementary public finance strategy EC, 2022, European Semester - Spring Package.

[iv] See the Delors report, point 30

[v] The principle of subsidiarity protects the Member States' ability to decide and act in areas which do not fall within the exclusive competence of the Union. It only legitimises Union intervention if the objectives of an action cannot be sufficiently achieved by the Member States but can be better achieved at Union level, by reason of the scale or effects of the proposed action. Its application to the coordination of national fiscal policies is all the more sensitive as these are at the heart of national democratic debates and are perceived as an important dimension of sovereignty. See for example the explanation on the site of the European Parliament

[vi] This note does not assess how far this was successful in the various countries. Its focus is the shift in the governance experienced with the suspension of the fiscal rules.

[vii] To learn more on the GDP problematic and the "decoupling" issue see for example this contribution (in French)

[viii] See for example the proposal by Greentervention

[ix] See for example the box in the proposal by Greentervention and the 2022 report by the French High Climate Council, Par. 3.3.2.

[x] See EC, 2020, An EU-wide assessment of National Energy and Climate Plans

[xi] See the special report by he European Court of Auditors

[xii] Special report by the German Court of Auditors

[xiii] Report by the French Environmental Authority

[xiv] See the webpage of the European Commission on Green budgeting

[xv] See for example the publication by the French Think tank Carbone 4

[xvi] The "Fit for 55 » strategy aims to reduce the EU greenhouse gas emissions by 55% between 1990 and 2030.

[xvii] See paragraph 3.2.3 of the Staff working document (2020) 98 of the European Commission

[xviii] See the description of the PRIMES model

[xix] See table 1 of the Staff working document (2020) 98 of the European Commission and annex 1 of the communication RePowerEU Plan