Reforming EU budget rules :

Identifying green spending

and promoting a transition-friendly public finance management

0) Introduction

On 26 April 2023, the European Commission submitted its proposals for a reform of the budgetary framework of the Stability Pact. The restrictions that would be placed on public spending under this new framework inevitably raise the question of the exemption of certain types of expenditure from the common rule.

The current rules provide for a flexibility clause for investments likely to increase "production potential", provided that they are co-financed by programmes from the Community budget. However, the conditions for using this flexibility are so restrictive that the clause has remained ineffective, with only 2 or 3 exceptions. The German government took a first position on the reform of the budgetary framework in the spring of 2022. Concerning the flexibility clause, its proposal is to facilitate its activation in the long term for the benefit of investments "with a substantial positive impact on potential growth and debt sustainability". While more flexible conditions for the implementation of fiscal rules are welcome, there are two arguments against the German proposal as it is formulated.

- Firstly, the proposal opts to favour growth-oriented investments without necessarily taking into account their environmental impact. The belief on which the German position is based is that "green growth" is possible, i.e. that there is no contradiction possible between a policy that prioritises economic growth versus the transition to carbon neutrality and the circular economy[1].

- Secondly, the method for operationalising the rule will inevitably be extremely weak, if not mission impossible. It involves assessing the impact of an investment on "productive potential" as well as on a dimension of public debt, its "sustainability".

[1] On the terms and uncertainties of this belief and the alternative option, as well as on the reasons why mainstream economists make this choice, see the note by G. Wolff & alia, The global quest for green growth. On a diverging position, see K. Raworth, Doughnut economics, especially chapter 7

> Production potential is a variable that is unobservable and is a contested theoretical construct[2]. There is therefor no proper, empirical method to validate the measure of an impact on this variable. The assessment of debt sustainability is also subject to many uncertainties[3].

The German government's proposal, based on the theoretical reference framework inherited from the 1980s, ignores the change in priority assigned to economic policy to combat climate change and the methodological difficulties that have been well identified in recent years. The difficulties associated with estimating production potential are recognised by the German government's note itself: it asks a technical group to develop an n-th version of the method for estimating the potential output[4]. However, the choice of method is not only technical, but also political[5] [6]. Contrary to the declared intention, the German proposal does not univocally lead to an improvement in the quality of public finances in a way that is favourable to the transition objective.

In a recent special report, the German Court of Audit (P. 40) noted that it was "essential to link fiscal policies with climate policy (climate budget)". In the first part of this paper we will show that such a link, which is necessary for the Community budget as well as for national budgets, must also find a counterpart in the European budgetary frame. This counterpart can logically find its place in a reform of the flexibility clause for investments. This note only deals with the quality of public expenditure supporting transition and its eligibility for a flexibility clause. It does not deal with the general macroeconomic conditions for the activation of such a clause. These conditions should be broad, but their exact definition can only be done in conjunction with the reform of the principles steering the deficit and debt levels[7]. It also does not address the issue of redistribution through taxation of income, an issue that is exacerbated for the most vulnerable populations by the rising price of carbon energy in the provisional absence of an energy source alternative.

In a second part, we report that public finance management methods in Europe are not yet up to the challenges of climate change. In the following two sections we propose first a specific condition for the activation of the flexibility clause and two cumulative eligibility criteria. The specific (non-macroeconomic) condition for the activation of the flexibility clause consists in the implementation of a programme to reduce budgetary expenditure that is harmful to the environment and the climate. We then propose a first eligibility criterion for public

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[2] In particular, it presupposes a regularity between macroeconomic aggregates which were profoundly disrupted by the COVID crisis and the energy crisis and whose evolution is uncertain due to the transformations caused by the energy transition.

[3] See O ; Blanchard & al. , Redesigning European fiscal rules, P. 10: “That debt forecasts and thus debt sustainability assessments are made under substantial uncertainty is obvious.”

[4] See paragraph 3 of the German position paper

[5] On the methodological weakness of the calculation of the potential output see https://theothereconomy.com/fr/fiches/solde-structurel-et-pib-potentiel/. See also the contribution of Dezernatszukunft : https://www.dezernatzukunft.org/do-the-mtos-cyclically-adjusted-budget-balances-serve-their-purpose-an-analysis-and-a-reform-proposal/.

[6] The methodological remarks in this paragraph also puts into question the German government's proposals on deficit levels. However, this is not the subject of this note.

[7] On this topic, see https://greentervention.org/2022/07/04/eng-fr-regles-budgetaires-europeennes-et-si-la-derogation-devenait-la-norme/ and https://greentervention.org/2022/02/24/eng-towards-a-realistic-and-result-oriented-european-economic-governance/

expenditure based on the appartenance to a medium/long term budgetary program supporting a sectoral transition policy or strategy. We add a second eligibility criterion based on the European taxonomy of "green" economic activities, taking into account the specificity of public expenditure and specific needs not covered by this taxonomy. The fifth part contains a short proposal for the governance of the reformed flexibility clause.

This approach to the flexibility clause is not only likely to provide sufficient safeguards to select expenditure that effectively contributes to environmental objectives. It would also provide an incentive for Member States to reorient public finance management patterns in a transition-friendly direction.

1) The need to link fiscal policies with climate policy

According to a strict interpretation of the subsidiarity principle, European budgetary rules have traditionally avoided interfering in a prescriptive way with the details of budgetary choices and their impact on resource allocation or distribution. The only exception was the flexibility clause mentioned above. However, there has been an evolution in the interpretation of this principle of subsidiarity in recent years. With the suspension of the budgetary rules following the COVID crisis, this trend has accelerated and some flexibility has been granted to Member States with regard to the size of the deficit. At the same time, the objectives and modalities of the 'allowed' additional expenditure have been clarified, taking into account the circumstantial needs to deal with the consequences of the health crisis and then the war in Ukraine[8].

Nor should climate protection be considered a subsidiary issue by the European budgetary framework. Climate is a common issue for several reasons:

- Saving a tonne of greenhouse gases (GHG) or reducing the risk of damage from climate change benefits everyone, not just the policy implementing country.
- Lack of progress in combating global warming and protecting the environment increases the risk of economic and financial destabilisation for all, as well as its cost;
- Each Member State is committed to making a well-defined quantitative contribution to the decarbonisation of the European economy by 2050, with an intermediate step in 2030, and its fiscal policies will be crucial in this respect.
- More solidarity and cost-sharing mechanisms between Member States will be needed to cope with the increasing damage caused by climate change events[9]. However, these mechanisms will only be politically sustainable if each Member State takes its share of investment in adaptation and mitigation.

Because of the transnational benefits, it is in everyone's interest that the European fiscal framework encourages a mix of public expenditure and revenue that accelerates the energy transition. Transparency on the contribution of budgetary choices to climate objectives will build trust between Member States. This is in any case a matter of good democratic practice.

[8] See https://greentervention.org/2022/07/04/eng-fr-regles-budgetaires-europeennes-et-si-la-derogation-devenait-la-norme/ (also in English on the site of Greentervention)
[9] Such mechanisms already exist: https://civil-protection-humanitarian-aid.ec.europa.eu/what/civil-protection/eu-civil-protection-mechanism_en

Every government and public body, every political force, every member of civil society should ask the question: is the management of my country's public finances organised in such a way as to support a sustainable and just transition?

The proposal to create additional budgetary space for "green" spending, i.e. spending that has a positive impact on the environmental sustainability of economic activities, is widely opposed. A first argument is that giving a privilege to certain expenditures will be at the expense of others that are also priorities, such as education, health, or investment in the digital transition.

However, the transnational impact and spill-over effects of underinvestment in climate protection and adaptation to global warming are substantially different in nature and scale from those of underinvestment in other policy areas. Moreover, climate protection protects the ability to develop economic activities, whether growing or not, in the short and long term. Not providing additional space ex ante to finance climate spending will ex post burden other spending.

A second argument against a flexibility clause prioritising 'green' expenditure is the difficulty of agreeing transparent and verifiable eligibility criteria. For this reason, some Member States and climate activists argue that it would open the door to 'creative accounting' and counterproductive investments. There is some truth in this. A third party verifier such as the European Commission may suffer from a lack of information and/or assessment capacity.

However, these difficulties should not be seen as an insurmountable obstacle. On the contrary, they should be an incentive to use the European fiscal frame to promote transparent and effective methods for assessing the environmental impact of national budgetary choices. Indeed, there is a long way to go and it is urgent to move in this direction. The corollary will be the identification of expenditure that can be described as climate and environmental friendly without the risk of the picture being blurred by "creative accounting".

Undoubtedly, the transition strategies to be implemented, the monitoring of progress and the adaptation of programmes in light of experience gained are matters for the overall mechanisms of climate and energy governance at European and national level. They do not fall within the scope of budgetary governance. But identifying the expenditure required for such programmes in a way that ensures sustained financing, promotes more effective public financial management in relation to environmental objectives and minimises the risks of "creative accounting" is part of the solution and commits public finance managers and political decision-makers.

2) A public finance management that does not meet the needs of transition

At the European level, attempts have been made to highlight the link between public expenditure and environmental objectives, in particular greenhouse gas emissions. However, two Courts of Auditors have criticised the method used to assess the 'colour' of the expenditure items financed by the EU budget as well as by the recent Recovery and Resilience Facility (RRF). The European Court criticised the fact that "the current monitoring method is an a priori exercise, which does not assess the final contribution towards EU climate goals.

The method does not require quantification of the impact of spending on GHG emissions or set any specific indicators regarding adaptation"[10]. The German Court notes that "the classification system (...) is less effective for climate change mitigation and also less transparent than the taxonomy" [11] (read: the European Taxonomy of Sustainable Activities). Both criticisms are legitimate. In light of this, it cannot be expected that the method used for the RRF becomes the basis for identifying 'green' expenditure that would be eligible for flexibility under EU budgetary rules.

Transition impact assessment of budgetary choices is a nascent practice in almost all Member States[12]. Several institutions or agencies have recently alerted to the weakness of the methods used in this respect at national level. In a recent special report, the German Court of Auditors criticised the methods used by the German administration to evaluate German projects and programmes[13]: "Most climate protection programmes do not provide for targets regarding greenhouse gas abatement. The concertation of policy initiatives between the various ministries still does not run smoothly. What is more, the climate impact of budget inflows and outflows remains largely opaque". In France, the High Climate Council expressed concern in its latest annual report about the lack of indicators to assess progress towards the transition[14]. The French Environmental Authority also expressed in its last annual report strong concerns about the distance between the degree of ambition and the reality of the implementation of programmes and projects[15] [16].

3) Identifying brown and green spending

3.1 Contextualising the impact of public spending on climate

The impact of public policies and spending on the climate results from a combination - intentional or not, coherent or not - of budgetary interventions with non-budgetary policy instruments such as regulation, norms and standards, including financial regulation, as well as with financing by public banks. The articulation of the different levels of decision-making - European, national, sub-national - also has an impact on the outcome.

The range of relevant budgetary interventions is rich. Spending includes funding for infrastructure (from cycle paths to railways, rolling stock, hydrogen pipelines, investments to adapt to climate change), various kinds of subsidies for households and businesses, insulation for public buildings, support for research and development and economic activities designed to speed up the transition, forest rehabilitation, support for ecological

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[10] See point 39 of the report 9/22 of the ECA. See also the reports 22/2021 et 01/2020
[11] See the Summary of the June 2022 report in English; main report in German
[12] See the reports by the European Commission on the page dedicated to Green budgeting as well as the European Commission/OECD/IMF report.
[13] Special report (March 2022), "Federal government needs to control climate protection in a targeted manner."
[14] See le rapport annuel du Haut Conseil Climat, 2022 and the special report on ministerial plans « climate ».
[15] See the rapport annuel 2021 de l'Autorité environnementale
[16] France and Germany are mentioned as examples. The fact that other countries are not mentioned does not mean that the management of public finances by these other countries is exemplary.

agriculture, training for workers, social transfers for those most affected by energy price rises.

3.2 Programming the elimination of fossil fuel subsidies

The European Court of Auditors has noted the existence of numerous budgetary expenditures or tax exemptions that are similar to fossil fuel subsidies and that are slowing down the transition. The elimination of these subsidies must be programmed taking into account the economic and social consequences. This suggests a first condition for the activation of a flexibility clause for green spending :

Condition for activating a flexibility clause

- **A government can only activate a flexibility clause if it implements a programme of gradual and sustained reduction in patent and hiden fossil fuel subsidies.**

3.3 Identifying green spending items: building on national mitigation and adaptation strategies.

Climate policy is conceived, planned, and programmed at the level of sectors, including transport, energy, industry, agriculture, forest management, buildings. To be effective, public policy for each sector or sub-sector must be defined by regulatory measures, by organisational and coordination methods for implementation[17] and by medium/long-term budgetary programming based on a prospective identification of needs. Furthermore, it can be shown that progress can be measured by performance indicators that can have a direct impact on GHG emissions or other environmental goals[18].

The above considerations suggest a first criterion of eligibility of public expenditure to this clause.

Eligibility criterion 1 of "green" spending items to the flexibility clause

- **An expenditure will be eligible for the safeguard clause if it is part of a medium to long term budgetary programme supporting a transition strategy (mitigation or adaptation) associated with relevant and verifiable performance indicators.**

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[17] At the level of a sector, a sub-sector (rail freight), a territorial entity (metropolis, tourist resort) or a branch (automotive industry, tourism)

[18] As an (incomplete) example, such performance indicators have been identified for three French sectors, transport, construction and agriculture. The indicators are: growth in rail traffic, modal share of cycling, share of low-emission vehicles, number of passengers per vehicle, number of dwellings insulated over 2015-2030, number of dwellings heated with gas, number of dwellings heated with oil, size of cattle herd, % of manure methanised, % of organic farming, % of legumes. See the Carbon 4 study. The choice of indicators to guide climate policies reflects the state of technological knowledge as well as political choices. It will also depend on the preference of citizens as consumers as well as on implementation capacities. Over time, regulations, budget programmes and indicators may need to be adapted and fine tuned in the light of experience. However, as we are (unfortunately) still at the beginning of the process, there is no doubt that it is now possible to identify a set of measures and performances that will necessarily be part of the solution.

3.4 Reducing the risk of "creative accounting": using the European taxonomy

In the context of European budgetary rules, the mere fact that an expenditure is part of a national medium- to long-term budgetary programme in support of transition will not be sufficient to make it eligible for the flexibility clause with a satisfactory degree of certainty about its effectiveness.

It is necessary to add a second criterion of European scope which would allow to judge - all other things being equal - the intrinsic impact of the expenditure on the environmental objectives, in particular the carbon balance. As a starting point, the European taxonomy for sustainable economic activities would have many advantages. It would lead to a high degree of coherence between public finances at European and national levels, as well as with the activities of the European Investment Bank. It can and should be expected that, following the criticism of the two Courts of Auditors, the Commission, the Council and the Parliament will reflect on the application of this taxonomy to public expenditure financed by the European budget. It could also be used in the context of a possible successor to the FRR. In addition, the EIB has announced that it is adopting this taxonomy for its own evaluation of projects and programmes.

Beyond providing a consistent approach across the different European institutions, the taxonomy has other advantages. Despite some weaknesses and highly contested decisions on the inclusion of nuclear power and gas as a transitional activity, it remains largely based on scientific and accurate data. It therefore severely limits the scope for "creative" circumvention. It provides good guidance for applying the principle of "do not significantly harm" (DNSH) to other environmental objectives. It covers the most relevant sectors, with the notable and unfortunate exception of the agricultural sector. It should be extended beyond climate change (mitigation and adaptation) to four other environmental areas, namely sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and protection and restoration of biodiversity and ecosystems. It is firmly anchored in institutional and legal terms.

However, the taxonomy was conceived to classify isolated economic activities and not fiscal expenditures in support of public policy. Adjustments are still needed to select public expenditures that can reasonably be expected to have a lasting positive impact on climate change mitigation or adaptation, while limiting the scope for "creative accounting".

With regard to climate, the taxonomy defines the conditions under which an economic activity can be qualified as a substantial contribution to mitigation or adaptation while respecting the DNSH principle. The taxonomy distinguishes three categories of activities: those that contribute directly to the mitigation or adaptation objective, enabling activities and transitional activities.

Based on the taxonomy, a second eligibility criterion can be defined:

Eligibility criterion 2 of “green” spending items:

- **Eligible budgetary expenditure shall finance or co-finance (loans, grants, guarantees) activities that meet the criteria of the European taxonomy of sustainable activities and respect moreover the conditions below:**

    - **Activities contributing by their own performance to climate change mitigation and adaptation will be eligible without further conditions.**

    - **Expenditure on enabling activities will be eligible if combined with expenditure on activities that contribute by their own performance to climate change mitigation or adaptation. They will also be eligible if an impact assessment concludes that they are necessary and most likely sufficient for the development of private activities contributing by their own performance in a substantial way to climate change mitigation or adaptation.**

    - **Transitional activities are not eligible, unless they can be shown to contribute to the 2030 climate objectives and are part of a strategy to ensure that they are replaced by 2045 at the latest by activities compatible with a zero-emission economy.**

The list of eligible expenditure in the 'taxonomy' should be complemented by expenditure financing enabling activities not included in the taxonomy of economic activities. This list would include :

- **Social transfers to absorb the short and medium term distributional impact of energy price increases if combined with a programme to progressively reduce the carbon dependency of beneficiaries.**
- **Support for vocational training and retraining in the industries most affected by the transformation of consumption and production patterns as well as training programmes in environmental public administration.**
- **To the extent not covered by the taxonomy of economic activities, support to households to improve the energy efficiency and carbon neutrality of their housing and mobility facilities.**

5) Governance

Member States will present the list of eligible expenditure and associated sectoral policies as part of the fiscal programme submitted under its Stability Pact obligation to the European institutions. The list will be approved by the Council on a proposal by the Commission together with the fiscal programme. Compliance with climate and environmental objectives and the National Energy and Climate Strategy will have been verified by an independent national institution specialised in environmental and climate issues and different from the Independent Fiscal Institution. Expenditure on other environmental objectives not yet covered should be included as soon as the relevant delegated acts have been adopted.