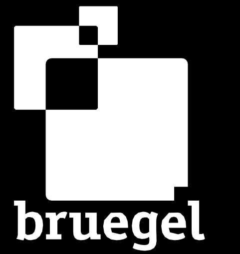
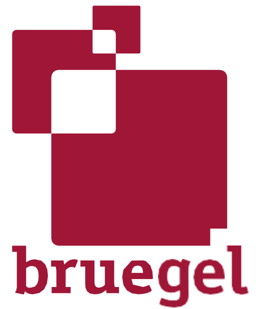


Greening EU Fiscal Rules

Zsolt Darvas
Based on joint work with Lennard Welslau and Jeromin Zettelmeyer

Seminar at the Joint Vienna Institute, 21 February 2024

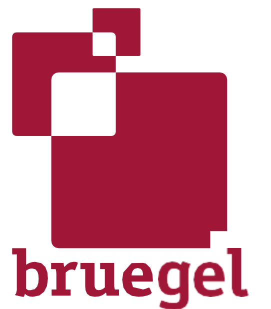
Motivation



- The Council and the European Parliament reached an agreement on reforming EU fiscal rules on 9 February 2024
- The reform is radical: the new fiscal framework is centred on country-specific debt sustainability analysis (DSA), augmented with some "*safeguards*", and scraps the earlier system of complex rules
- EU faces major public investment needs

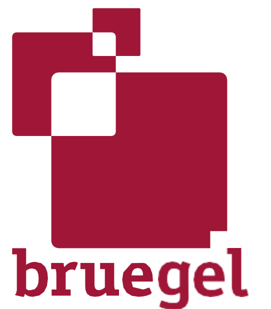
➢ How does the new EU fiscal framework incentivise investments?
➢ Was there a missed opportunity in fostering investments?

Outline



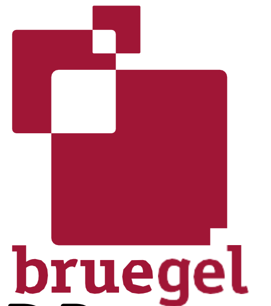
1. The main characteristics of the EU’s new fiscal framework
2. Incentives for reforms and investments in the new fiscal framework
3. The EU’s green investment needs
4. Theory: Public investment and disincentives/fiscal sustainability
5. The missed opportunity: fostering green investments with a *fiscally sustainable public investment rule*

1. The main characteristics of the EU's new fiscal framework



- Country-specific debt sustainability analysis (DSA)
- 3% treaty-based deficit reference value
- Four "*safeguards*":
  - Debt sustainability safeguard
  - Deficit resilience safeguard
  - No backloading safeguard
  - Minimum annual adjustment under the deficit-based excessive deficit procedure
- A net expenditure path as the single operational rule
- Countries have to prepare comprehensive medium-term fiscal-structural plans for a period of 4 years, which can be extended to 7 years if new reforms and investments are proposed

The safeguards



- ***Debt sustainability safeguard*** (for countries with more than 60% of GDP public debt): at least one percentage point of GDP per year decline in the debt ratio for countries with a larger than 90% of GDP debt ratio, and half a percentage point of GDP per year for countries with a debt ratio between 60% and 90% of GDP), from either the beginning of the adjustment period or from the correction of excessive deficit (whichever is later) by the end of the adjustment period.
- ***Deficit resilience safeguard*** (for countries with more than 60% of GDP public debt or more than 3% of GDP budget deficit): the structural overall budget deficit should not be higher than 1.5% of GDP, and when it is higher, the annual improvement in the structural primary balance should be 0.4% of GDP when the adjustment period lasts for four years and 0.25% of GDP when the adjustment period lasts for seven years.
- ***No backloading safeguard*** (for countries with more than 60% of GDP public debt or more than 3% of GDP budget deficit): the annual fiscal adjustment cannot increase during the adjustment period.
- ***Minimum annual adjustment under the deficit-based excessive deficit procedure*** (for countries with more than 3% of GDP budget deficit): 0.5% of GDP annual adjustment, which is measured in terms of the structural primary balance in 2025-2027 and in terms of the overall structural balance from 2028.

Adjustment requirements under the new EU fiscal framework (SPB in % of GDP, countries with debt to GDP ratio above 60%)

	European Commission forecasts for 2024			Min. SPB required by DSA criteria		Min. SPB required by 3% deficit cap		Min. SPB required by EDP and the debt safeguard		Min. SPB required by EDP, the debt safeguard and the deficit resilience		Minimum SPB satisfying all criteria		Average annual fiscal adjustment need	
	Debt	Fiscal balance	SPB	4-year adj.	7-year adj.	4-year adj.	7-year adj.	4-year adj.	7-year adj.	4-year adj.	7-year adj.	4-year adj.	7-year adj.	4-year adj.	7-year adj.
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)=max(4,6,8,10)	(13)=max(5,7,9,11)	(14)={(12)-(3)}/4	(19)={(14)-(3)}/7
Greece	152	-0.9	2.0	1.3	1.2	1.2	1.3			2.3	2.5	2.3	2.5	0.07	0.07
Italy	141	-4.4	-0.9	3.3	2.9	3.2	2.8					3.3	2.9	1.05	0.55
France	109	-4.4	-2.4	0.8	0.6	0.3	0.4		2.1			0.8	2.1	0.81	0.65
Spain	106	-3.2	-1.0	1.9	2.2	1.2	1.6	2.3	2.7			2.3	2.7	0.82	0.52
Belgium	106	-4.9	-2.4	2.2	2.3	1.7	1.8					2.2	2.3	1.14	0.68
Portugal	100	0.1	2.1	2.8	2.6	1.5	0.9					2.8	2.6	0.16	0.07
Finland	77	-3.2	-1.0	0.5	0.3	-0.7	-0.8	2.1				2.1	0.3	0.77	0.19
Austria	76	-2.4	-0.7	1.0	1.1	0.0	-0.4					1.0	1.1	0.42	0.25
Hungary	72	-4.3	1.0	2.4	2.6	1.6	2.1					2.4	2.6	0.36	0.22
Cyprus	71	2.1	3.4	-0.1	-0.5	-0.5	-0.6				-0.1	-0.1	-0.1	-0.89	-0.51
Slovenia	68	-3.3	-1.1	1.5	1.4	1.7	1.9					1.7	1.9	0.69	0.43
Germany	64	-1.6	-0.2	0.5	0.2	-0.3	-0.6					0.5	0.2	0.19	0.05

- SPB required by the 3% deficit cap (6,7) exceeds the SPB required by the DSA criteria (4,5)
- SPB required by the debt safeguard (8,9) exceeds the SPB required by the DSA criteria and the deficit cap
- Deficit resilience safeguard (10,11) affects the net-expenditure path without changing the SPB target
- SPB required by the deficit resilience safeguard exceeds the SPB required by the DSA criteria, the deficit cap, and the debt safeguard

Source: Bruegel. Note: Methodology based on European Commission (2023) and adjusted with the new requirements of the approved fiscal framework.
Data: November 2023 Commission forecast for macro variables, January-February 2024 market expectations for interest rate and inflation.

Adjustment requirements under the new EU fiscal framework (SPB in % of GDP, countries with debt to GDP ratio below 60%)

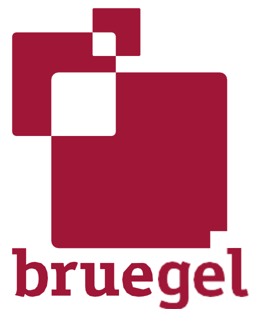
	European Commission forecasts for 2024			Min. SPB required by DSA criteria		Min. SPB required by 3% deficit cap		Min. SPB required by EDP and the debt safeguard		Min. SPB required by EDP, the debt safeguard and the deficit resilience		Minimum SPB satisfying all criteria		Average annual fiscal adjustment need	
	Debt	Fiscal balance	SPB	4-year adj.	7-year adj.	4-year adj.	7-year adj.	4-year adj.	7-year adj.	4-year adj.	7-year adj.	4-year adj.	7-year adj.	4-year adj.	7-year adj.
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)=max(4,6,8,10)	(13)=max(5,7,9,11)	(14)={(12)-(3)}/4	(19)={(14)-(3)}/7
Slovakia	60	-6.5	-5.1	1.2	1.6	1.0	1.3					1.2	1.6	1.57	0.96
Croatia	59	-1.8	-1.2	0.4	0.5	-0.5	-0.5					0.4	0.5	0.38	0.24
Malta	56	-4.6	-2.7	-0.3	0.0	-0.6	-0.2					-0.3	0.0	0.60	0.39
Poland	54	-4.6	-1.8	0.0	0.3	-0.2	0.0			0.1	0.7	0.1	0.7	0.48	0.36
Romania	49	-5.3	-3.0	1.3	2.1	1.2	1.6					1.3	2.1	1.08	0.73
Netherlands	47	-1.8	-0.5	1.2	1.2	1.6	1.4					1.6	1.4	0.53	0.27
Czech Republic	45	-2.4	-0.1	-0.2	0.0	0.4	0.7					0.4	0.7	0.13	0.12
Latvia	42	-3.1	-1.7	-1.4	-1.1	-1.6	-1.5			-0.3	-0.1	-0.3	-0.1	0.35	0.22
Ireland	41	0.6	0.8	-2.8	-2.9	-1.4	-1.4					-1.4	-1.4	-0.55	-0.32
Lithuania	38	-2.3	-0.5	-1.4	-1.3	-0.7	-0.9					-0.7	-0.9	-0.05	-0.05
Sweden	30	-0.7	1.5	-2.3	-2.1	-1.2	-1.1					-1.2	-1.1	-0.67	-0.37
Luxembourg	29	-2.1	-0.6	-2.0	-1.8	-0.2	-0.2					-0.2	-0.2	0.09	0.05
Denmark	28	1.8	2.9	-3.1	-3.2	-1.5	-1.7					-1.5	-1.7	-1.10	-0.65
Bulgaria	24	-3.0	-2.7	-2.1	-1.5	-1.1	-0.7					-1.1	-0.7	0.40	0.28
Estonia	21	-2.4	0.0	-3.7	-3.5	-2.5	-2.4					-2.5	-2.4	-0.64	-0.35

SPB required by the 3% deficit cap (6,7) exceeds the SPB required by the DSA criteria (4,5)

SPB required by the deficit resilience safeguard exceeds the SPB required by the DSA criteria, the deficit cap, and the debt safeguard

Source: Bruegel. Note: Methodology based on European Commission (2023) and adjusted with the new requirements of the approved fiscal framework.
Data: November 2023 Commission forecast for macro variables, January-February 2024 market expectations for interest rate and inflation.

Annual average fiscal adjustment requirements under the new fiscal framework



2
1.5
1
0.5
0
-0.5
-1
-1.5

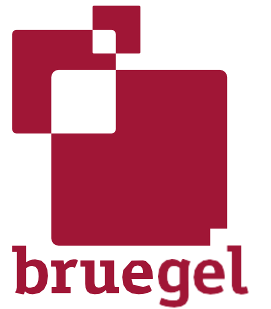
Slovakia, Finland, Italy, Belgium, Romania, Spain, Netherlands, Slovenia, Malta, Austria, France, Croatia, Hungary, Germany, Latvia, Bulgaria, Poland, Portugal, Luxembourg, Czechia, Lithuania, Greece, Ireland, Estonia, Sweden, Cyprus, Denmark

4-year adjustment | 7-year adjustment | difference

For some countries, the 7-year adjustment period requires about 0.5% of GDP less average annual adjustment than the 4-year adjustment period

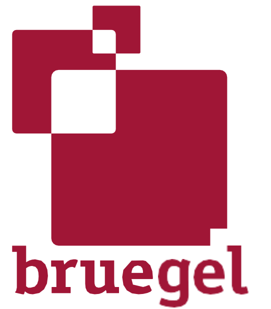
Source: Bruegel. Note: Methodology based on European Commission (2023) and adjusted with the new requirements of the approved fiscal framework.
Data: November 2023 Commission forecast for macro variables, January-February 2024 market expectations for interest rate and inflation.

2.1 Incentives for reforms and investments in the new fiscal framework



- Main incentive: the possibility of extending the four-year-long adjustment period to seven years, thereby lowering the annual fiscal adjustment requirement
- Various requirements, including an increase in nationally-financed public investments
- However, to increase public investment at a time of fiscal consolidation, EU countries would need to undertake more fiscal consolidation in non-investment components of the budget to make room for extra investment

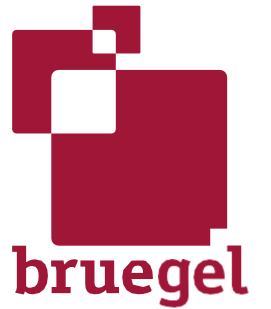
2.2 Two provisions related to certain investments



First:

- Article 2 (Definitions): "*(2) 'net expenditure' means government expenditure net of interest expenditure, discretionary revenue measures, expenditure on programmes of the Union fully matched by Union funds revenue, national expenditure on co-financing of programmes funded by the Union, cyclical elements of unemployment benefit expenditure, and one-offs and other temporary measures;*"
- However, the net expenditure indicator is the operational target in the new fiscal framework, but it does not influence any of the fiscal adjustment requirements

2.3 Two provisions related to certain investments



Second:

- Article 38bis (Transitory provisions) "*(c) Projects related to Recovery and Resilience Facility loans as well as national co-financing of EU funds in 2025 and 2026 shall be taken into account whenever a Member State requests an exception to the no-backloading safeguard referred to in Article 6 point c, provided that this does not endanger fiscal sustainability in the medium term;*"
- However, when RRF-loan financed expenditures decline in 2026 = fiscal consolidation → excluding it would require more fiscal consolidation in other budget items
- Exclusion helps if such spending goes up in 2026 → incentive to delay such spending to 2026, or not to request an exception

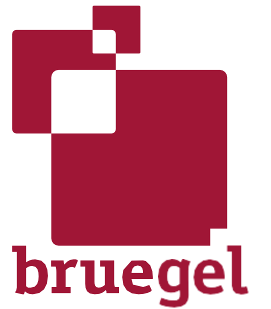
3.1 The EU's total (public+private) green investment needs

European Union		France	
Power grid	34.2	Energy	9
Power plants	25.6	Agriculture	2
Industry	11.3	Industry	4
Residential	106.3	Residential	21
Tertiary	46	Tertiary	27
Transport	129.6	Transport	3
Other	3.4		
Total	356.4	Total	66
% GDP	2	% GDP	2.3

Source: European Commission (2020a) and Pisani-Ferry and Mahfouz (2023). Note: numbers for the EU refer to investment needs to achieve a 55% emissions reduction by 2030 (MIX scenario); numbers for France refer to investment needs to reach the 2030 target for France, compared to a business-as-usual scenario without greening of the economy. The transport component of the Commission estimate is broadly in line with another Commission recovery-related estimate for the transport sector (European Commission, 2020b).

Estimated green total investment needs are large: about 2% of GDP per year to achieve a 55% emissions reduction by 2030

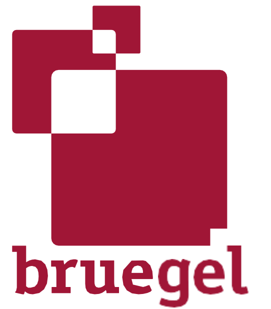
3.2 Public green investment needs



- Darvas and Wolff (2022): public share around 30%
- Pisani-Ferry and Mahfouz (2023): public share 50% for France
- These two estimates additional public sector investment needs of 0.6%-1.0%
- However, the bottom-up approach of Baccianti (2022) suggests 1.8% GDP per year for the public sector alone

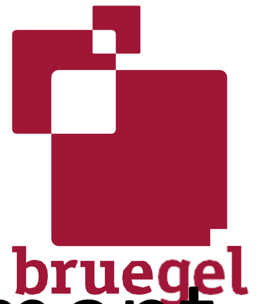
➢ The new EU fiscal framework severely constraints an increase in green investment in high-debt EU countries

4.1 Theory: Public investment disincentives



- Political economy tends to favour current spending over investment spending
  - Government incentives are aligned with 4-5-year electoral horizons
  - Public investments tend to have longer-term benefits
  - Future beneficiaries are insufficiently represented at the polls → governments underinvest (relative to a social planner with a moderate discount rate)
- This distortion could be massive for green public investment
  - Public investment in the next 5-10 years will determine the welfare of all future generations but could require sacrifices by the current generation
- Past practice: in times of fiscal consolidation, public investments tend to suffer disproportionately

4.2 Theory: Public investment and fiscal sustainability

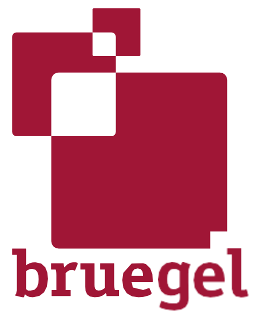


- From the perspective of fiscal sustainability, it is ok for public investment to result in a rise in the debt ratio if:

1. It pays for itself (by generating fees, or raising future output and taxes), or
2. Even if the investment does not pay for itself, if:
    - The investment programme is temporary (leading to a “level” increase in debt, rather than permanent increase in the deficit)
    - After the end of the investment programme, the primary balance is high enough to rule out explosive debt paths with high probability (which implies declining debt under baseline assumptions).

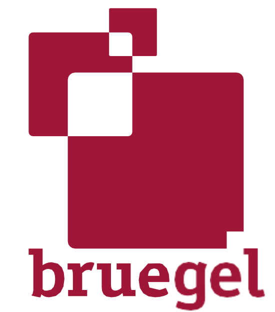
- Problems:
    - Not all green public investment satisfies (1), but even if they do, the current DSA practice does not incorporate the impact of planned measures, only adopted measures
    - The safeguards make strategy (2) impossible

5.1 The missed opportunity: fostering green investments with a fiscally sustainable public investment rule



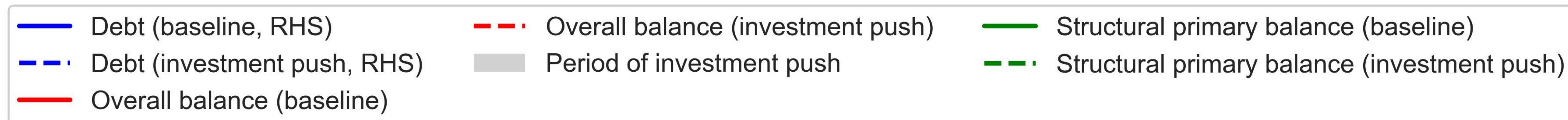
- A temporary green public investment programme:
  - For one year less than the length of the adjustment period (e.g. for 6 years if the adjustment lasts for 7 years)
  - Exempt the temporary investment programme from safeguards
  - While applying all safeguards to the rest of the budget
  - By the last year of the adjustment period, all conditions must hold
  - Only investments endorsed by the Council and monitored by the Commission can be excluded
- A long-lasting green public investment programme
  - Same as above, except that the investment programme can last beyond the end of the adjustment period

5.2 Illustration of a temporary investment programme of 0.5% of GDP per year for 6 years



- Little delay in debt decline
- Long-run structural primary balance (SPB) is hardly higher

- (note: deficit resilience safeguard is in terms of the structural balance which is met in the post-10-year period)is



Conclusions

- New fiscal framework requires ambitious fiscal adjustments from high-debt countries
- Extending the adjustment period from 4 to 7 years reduces the annual average adjustment need by about 0.5% for some countries
- But the extension requires tough conditions, including an increase in nationally financed investments – which is a difficult task for a vote-maximizing politician at the time of fiscal consolidation
- The opportunity to introduce a fiscally responsible public investment rule has been missed
- Such a rule would have ensured fiscal sustainability, while allowing an investment progamme

Thank you!

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