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EU FISCAL REFORM MUST UNLOCK CLIMATE INVESTMENT

THE TIME IS NOW TO REMOVE THE LIMITS ON GREEN SPENDING

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The Commission released its proposal for reforming the EU's economic governance framework last November, and member states will soon attempt to forge a new fiscal consensus. The March European Council will be the crucial venue to build this consensus. Governments have committed tens of billions of euros to supporting citizens facing crisis and must mobilise hundreds of billions more to reach their climate goals and remain competitive on the international stage. To do this, they need rules which do not limit public spending, but rather accelerate investment in the EU's decarbonisation.

Amid crisis, the EU must reform its fiscal rules[2]

Europe faces inflation, looming recession, and a worsening climate crisis. Responding to these overlapping crises has required tens of billions of euros of government support,[3] and will require far more in future. Public finances were

[1] This is an updated version (3 March 2023) of the original briefing paper published in December 2022, considering recent political developments.

[2] The need to reform the fiscal rules has recently been amplified on the international stage. The current fiscal rules are not only insufficient to answer to the effects of the polycrisis, but also in terms of the EU's international competitiveness.

[3] Bruegel, 2022, **National fiscal policy responses to the energy crisis.**

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already strained following the COVID pandemic and remain so amid high gas prices.[4] **Such a complex situation makes responding to future crises much more difficult** – as some governments might simply not have the national fiscal space to spend the money they need to.

In response, **member states and the Commission are accelerating the debate on reforming the EU's fiscal rules,[5] particularly the Stability and Growth Pact (SGP).** The current rules constrain government spending and encourage austerity. The rules were deactivated during the pandemic but are due to be reactivated in 2024 according to the Commission's timeline. If they are not reformed, they will exacerbate the bloc's economic hardship by limiting the crisis response capacity of the EU and its member states.

With the cost-of-living soaring, recession on the horizon and climate impacts worsening, the Commission and member states must address the fiscal question. A crucial part of the solution is allowing governments to unlock the necessary investments and spending to face the current challenges.

Reforming the fiscal rules is crucial to EU decarbonisation and competitiveness

Responding to the climate crisis, and meeting the EU's 2030 and 2050 climate commitments, requires far greater public investment[6] than governments' spending to face the gas crunch. **To meet the investment needs of the green transition, public investment in Europe will need to increase by at least €100bn every year** – starting now. Governments are already falling well short of this investment target, making clear the necessity of a fiscal framework which empowers them to do it.

The Commission's "Orientation"[7] (or proposal) on reforming the SGP does not give states the fiscal freedom to remain competitive on the international stage and make the European Green Deal a reality. While the change to a medium-term, country-specific debt reduction pathway should be welcomed by member states unduly penalised by the current one-size-fits all economic governance, there is little in the proposed reform which incentivises green spending or gives

[4] European Commission, 2022, **Autumn 2022 Economic Forecast: The EU economy at a turning point.**

[5] Finance Watch, 2021, **Navigating the Maze.**

[6] Bruegel, 2021, **A green fiscal pact: climate investment in times of budget consolidation.**

[7] European Commission, 2022, **Building an economic governance framework fit for the challenges ahead.**

green investment a privileged status. Such elements are however crucial for member states to bridge the green investment gap.

For the reformed SGP to accelerate, rather than limit, the EU's progress towards its 2030 and 2050 targets, politically feasible green amendments must make it into the final deal.

The Commission's "Orientation" and climate investment

One element of the reform that could unlock some green spending is adjustment periods during which member states are allowed to raise their debts. Highly indebted member states can apply to extend their four-year adjustment period by up to three more years. The criteria for extending the adjustment period, and therefore slowing the pace with which member states need to reduce their debt, is a commitment to structural reforms and investments. This includes – but is not limited to - investments in the green transition.

However, it is doubtful that this alone would unlock the necessary green investment. It would only apply to highly indebted countries, so would not incentivise green spending from other member states that are also crucial to reach the bloc's decarbonisation goals. Furthermore, the exact figures will need to be clarified. How much investment could member states commit to before they start to see diminishing returns on making the pace of debt reduction more gradual? Would that investment level be enough to bridge the green investment gap?

Member states should demand that the reform focuses more on incentivising investment, to better support the green transition. A first step would be to expand this provision extending the adjustment period to cover all countries, not only the most highly-indebted – thereby incentivising all member states to increase green investment.

Time to reach consensus is short

With the fiscal rules set to be reactivated in 2024, and the Commission aiming to fast-track the legislative process in 2023, **member states have only a few short**

months to come to a consensus on fiscal reform. If governments can agree on a reform which explicitly supports green investments, then they can accelerate progress towards the 2030 and 2050 climate goals. They can also ramp up energy savings and renewables deployment to strengthen Europe's energy security. If, however, they fail to reach an adequately ambitious deal, the SGP will be a fiscal straitjacket, constraining member states' crisis response and transition pathways.

The Commission hopes that member states reach a common position by the conclusion of the 2023 March European Council. Therefore, member states are in the driving seat now. There is a clear opportunity to design a fiscal regime fit for Europe's future. National governments should take that opportunity to support citizens, strengthen Europe's resilience, and unlock vital investment in the green transition.

About E3G

E3G is an independent climate change think tank with a global outlook. We work on the frontier of the climate landscape, tackling the barriers and advancing the solutions to a safe climate. Our goal is to translate climate politics, economics and policies into action.

E3G builds broad-based coalitions to deliver a safe climate, working closely with like-minded partners in government, politics, civil society, science, the media, public interest foundations and elsewhere to leverage change.

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