6. A RETURN TO WHAT FISCAL RULES?

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6.1. ABSTRACT

The temporary suspension of the fiscal rules during the pandemic crisis offers a unique opportunity to revisit their effectiveness, and importantly review how suitable they are to meet the crucial challenges of the future. As fiscal policy is expected to play a more active role in the future, we must correct for at least the main faults of the current rules, namely their procyclical nature as well as their effective disincentivising of investments. We discuss how moving away from unobservable variables is the first step to improving the systems. We end by arguing that beyond fiscal rules we must rethink the whole fiscal framework in order to ensure that fiscal policy is effective and debt sustainability is not compromised.

6.2. INTRODUCTION

A rather broad consensus exists now in academic and policy circles\(^1\) – that the current fiscal framework is flawed and in need of change. The main reasons are that over the years, the rules have become too complex to be implementable as they target multiple metrics and lack a proper enforcement mechanism. This makes them unpredictable and ultimately non-credible.

It is also agreed that the way the unexpected technical flaws in the design of the rules made fiscal policy procyclical both in good times and in bad, leading to an

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\(^1\) This includes also the European Fiscal Board advising the European Commission on these matters. See Thygesen et al. 2020.
altogether ineffective fiscal policy both from a debt sustainability and stabilisation perspective. Also, by failing to discriminate between expenditure components, these rules have penalised investments leading to the existence of significant investment gaps.

In addition, a new debate has emerged on the future objectives of the fiscal framework: on top of ensuring debt sustainability and macro stabilisation, fiscal rules could also try to influence the composition of fiscal policies in EU countries, which in turn affects debt sustainability as well. This debate is very much driven by the large investments needs for the green and digital transitions. There exist various ways on how to do that, both on the expenditure side, e.g. by incentivizing green public investment, and on the revenue side, e.g. through carbon taxes to boost private investments.

More generally, the role of “good debt” has been recently highlighted by Italy’s prime minister Mario Draghi in order to finance expenditures that increase potential growth such as public investment, but also R&D, education, health expenditures, etc., (Draghi, 2021) but also to improve the stabilisation function fiscal policy (as different spending can have different multipliers). These arguments are supported by empirical evidence (with large cuts in public investment during consolidation episodes) and theoretical justifications to do this (negative externalities, free riding in achieving common priorities).

The suspension of the Stability and Growth Pact (SGP) until 2023 thus represents a unique opportunity to reform the rules in these directions, before they are reactivated. However, the limited timeframe available means reforms cannot involve Treaty changes. Only a detailed proposal of changes in secondary legislation made by the Commission in early 2022 could be discussed by member states and adopted before 2023. Even if a long-term discussion on the future of the fiscal and political union is warranted, the current discussion should focus on changes in fiscal rules that are both desirable based on first principles and that can realistically be achieved before the probable reinstatement of the SGP in 2023.

But before that, as rightly pointed out by the European Commission, European countries need to “build a broad-based consensus on the way forward well in time for 2023” (European Commission, 2021) on the objectives of the fiscal framework: they need to make sure that after 2023 the fiscal framework should ensure both sustainability and stabilisation, but also decide whether they also want the EU fiscal framework to influence the composition of fiscal policies and in which way.

Going forward the European fiscal framework will have to reflect a set of new circumstances:

- we face now historically high levels of debt levels, especially after COVID-19, but we also face historically low interest rates, which, at least for the moment, allows to use fiscal policy at a low cost.
- In the meantime, monetary policy is stuck at the effective zero lower bound and there is a need for fiscal policy to play a more important role to reach output potential and full employment.
There is a window of opportunity to use r-g<0 to invest in order to green our economies, and deal with the digital transformation.

In what follows we first review how the role of fiscal policy might be changing but also how the current fiscal framework has failed to provide help in macroeconomic management.

### 6.3. WHAT WILL THE ROLE OF FISCAL POLICY BE?

When it was first built, the EU framework was intended to prevent fiscal indiscipline by member states and to stop it spreading across the eurozone. Its design reflected the prevailing economic orthodoxy in the 1990s on the role of fiscal policy. This emphasised automatic adjustments in tax revenues and spending to stabilise income, consumption and business activity over the business cycle.

Any fiscal policy that attempted to go beyond these automatic stabilisers was likely to cause inflation. Consequently politicians, who could have an incentive to overspend, ought to be institutionally constrained. Today, however, after a global financial crisis and now a global pandemic, two once-in-a-lifetime shocks in the space of just over a decade, the economic context is very different. Both these episodes show that fiscal policy is about more than just automatic stabilisation, although at first policymakers in Europe were slow to recognise this — partly because of the grip exerted by the old orthodoxies, but mostly because of the fear of fiscal spillovers across borders. In each case the policy response, at the macro level, had to be sufficient to cushion the severity of an economic shock. This was not the case during the euro crisis, but during the pandemic, fiscal policy protected companies, as well as employment and households. The response to the crisis was both timely and on a sufficiently large scale, aided by the newly created European Central Bank’s Pandemic Emergency Purchase Programme (PEPP), which helped keep the cost of borrowing low by avoiding liquidity crises in the sovereign bond markets such as the ones we witnessed during the euro crisis.

Any new framework will have to reflect this reality of the future role of fiscal policy, but it also needs to correct for a number of flaws. Looking back, we observe that fiscal policy has been largely procyclical in the past 20 years when it ought to be countercyclical and the immediate victim to any attempt to fiscally consolidate has been investment. We discuss this next.

### 6.3.1. EMU AND PROCYCLICAL FISCAL POLICY

Even if the use of these measures is sometimes questionable (especially in real time, as we will discuss later), confronting the historical yearly change in structural balance against the yearly change in output gap since the Maastricht criteria were established in 1992, the procyclicality of fiscal policy becomes quite evident in euro area countries, as shown in Figure 1.
Figure 1: Yearly change in structural balance and output gap, percentage points. 
(Selected years).

Source: Bruegel based on IMF World Economic Outlook.

Note: Current euro area members are included prior to their adoption of the euro, meeting the Maastricht criteria in the years prior to adoption was a necessary step.
There are two main observations to make. First, each country’s position within the four quadrants is relevant. A traditional Keynesian view of fiscal policy would place countries in one of two quadrants: the first (++ or the third (−). In times of increase in the output gap (i.e., times of economic growth) an increase in the structural balance is associated with less accommodative discretionary fiscal measures. Similarly, in the third quadrant, when the output gap decreases and becomes negative, the structural balance should decrease as a result of the corresponding discretionary measures to stimulate demand. This was the case in 2020, with every single country in the third quadrant. However, this is not often the case. Since 1992, only around half of the euro area countries were in one of those two quadrants in any given year, and in 2012 (at the height of the sovereign debt crisis) only three were: Estonia, Finland and Malta. As we discuss later this was in part due to flawed recommendations by the European Commission at the time.

Second, the correlation between the change in the output gap and the change in the structural balance is also informative. We would expect this correlation to be positive, or in other words the greater the fall (rise) in the output gap, the greater the change in the structural balance. Figure 1 plots this relation for a selected number of years. This relation is weak and ambiguous before the introduction of the euro, but after 2002, the relation between those two changes is positive only in 2007 and 2008. That is, only in those two years did countries with the greatest deterioration in their output gap on average also reduce their structural balance more (indicating an increase in discretionary fiscal measures). In all other years between 2003 and 2020, countries with a greater annual fall in their output gap on average undertook less discretionary fiscal policy than those with an increase (or smaller decrease) in their output gap. The counter-cyclical measures adopted in 2008 were encouraging and unsurprising given the dire economic context, yet the situation reverted quickly and by 2010 the relationship was strongly inverted again.

Even in 2020, when every single euro area country saw a negative change in their structural balance in response to the COVID-19-induced economic downturn and a shift in attitudes on the need for expansive fiscal policy was evident throughout the EU, we observe a negative correlation. This means that countries where the economic impact of COVID-19 was comparatively lower (with a smaller decrease in their output gap vis-à-vis 2019) also generally implemented larger discretionary fiscal measures, evident in the deterioration of their structural balance. This also suggests that fiscal policy was not counter-cyclical enough during good times and that countries with higher debt-to-GDP ratios feared initially they didn’t have enough buffer to implement strong discretionary measures.

6.3.2. PUBLIC INVESTMENT AND EUROPEAN FISCAL RULES

Public investment in many European countries remains very low compared to other developed economies, especially since the great financial crisis of 2008.
The popularity of balanced-budget rules in the 1980s and 1990s spawned a series of academic studies on the effects of fiscal consolidation on government fixed capital formation. This research consistently shows such consolidation programmes have a particularly strong negative effect on the level of public investments, which falls consistently more than other types of public expenditure. Roubini and Sachs (1989) find that capital expenditures are the first to be reduced, often drastically, during periods of restrictive fiscal policy given as they are the least rigid component of the budget. Similarly, de Haan et al. (1996) explain the decline of government capital formation by its disproportionate decline in times of fiscal tightening. Peletier et al. (1999) introduce a model that indicates that a balanced-budget rule induces below-optimal levels of investment, even as they concede exceptions for public investment are hard to introduce, primarily given difficulties classifying investment and the government propensity to exploit such exceptions.

Data on fiscal adjustment programmes between 1960-94 exposes a similar pattern: Alesina and Ardagna (1998) show public investment as a share of GDP to be 16 percent lower in the two years following a successful adjustment programme. This was found to be even higher in countries which had high debt levels at the time: public investment fell by 40 percent in Belgium (1986-87) and 29 percent in Ireland (1985-86), and did not recover in the years following the adjustment. More generally, Blanchard and Leigh (2013) find not only that is fiscal consolidation associated with lower investment growth, but this decline is three times the size of the fall in consumption. Similarly, Romer and Romer (2010) show investment growth declines four times faster than consumption following a tax increase.

That said, some disagreement remains on the desirability of fiscal laxity or simply exceptions to budgetary prudence when it comes to public investment. For example, Kellermann (2007) found the social opportunity cost of debt-finance public investment was higher than that financed by taxes, indicating a benevolent government would raise the latter to fund investment.

In light of this literature, EU fiscal rules have received attention for their possible role stifling public investment. Turrini (2004) finds some evidence of this especially in the early days of the Maastricht criteria (although his results leave room for ambiguity). Most EU countries are characterised by low levels of public investment, in particular those with larger public debt. To take an example (but this is true over many years), Figure 2 exhibits an evident negative relation between levels of public debt and net public investment (gross investment minus the depreciation of capital stock) in 2019. Not only did investment not recover after the GFC, but in 2019 net public investment was still negative in Italy, Spain, Greece and Portugal, four member states that experienced substantial fiscal constraints during the sovereign debt crisis. More generally, large EU countries, like Germany, France, Italy and Spain, have much lower investment levels than other large economies such as the US or the UK.

As a result, numerous proposals have emerged in the aftermath of the sovereign debt crisis and even more so following the COVID-19 pandemic in order to increase member state capacity to undertake investments.
A RETURN TO WHAT FISCAL RULES?

Figure 2: Net public investment and public debt in 2019. % of GDP.

Source: Bruegel based on European Commission AMECO database, Eurostat, IMF World Economic Outlook, April 2021.

The sovereign debt crisis and the poor recovery of European public investment, in the periphery especially, but generally throughout the continent, resulted in several of these proposals. Truger (2015) call for a golden rule that allows for deficit-financed public investment to be included in the EU’s fiscal rules, both for growth and intergenerational fairness purposes. He proposes a simple calculation that subtracts military expenditure and adds investment grants for the private sector to current net public investment calculations. Barbiero and Darvas (2014) similarly examine how net public investment recovered elsewhere but not in the EU following the 2008 crisis, and was particularly poor in fiscally constrained countries. They similarly lay out a set of proposals for an asymmetric golden rule to protect and incentivise public investment, to come hand in hand with improvements in budgeting, transparency and project assessment. Bogaert (2016) proposes a change in accounting within the SGP so that public investment becomes a core aspect of structural policy (and not a cyclical instrument) while maintaining much of the remaining current structure. It should be noted that other papers have also emerged arguing against a golden rule, including Bundesbank (2019) which examines Germany’s unsuccessful experience in that regard (as a result the German golden rule was scrapped in 2011).

The COVID-19 pandemic has laid bare the need for a reform in the EU fiscal rules, before their current suspension ends. In light of the accelerated shift in the consensus over the merits of fiscal policy, it is unsurprising that calls for a bigger role for public investment have also grown. Darvas and Anderson (2020) present many of the arguments in favour of changing how public investment is treated in EU fiscal rules: intergenerational fairness, avoiding strategic underinvestment due to deficit limits, improved medium-term fiscal sustainability with higher potential growth, the spread of the cost...
of public investment across years of use (as is done in corporate accounting). The authors also acknowledge some of the issues around a golden rule (difficulties classifying expenditure, possible spending distortions, protracted deficits), yet they firmly propose for a multi-year ahead expenditure rule, augmented with an asymmetric golden rule in times of recession. Thygesen et al (2020) call for growth-enhancing expenditure to be protected, after decades of declining growth-enhancing public expenditure necessary for improving the resilience of our economies. Bofinger (2020) similarly proposes the introduction of a golden rule in EU fiscal norms that excludes public investment from deficit targets and thus eases “the EU fiscal straitjacket.” Finally, even if Martin et al. (2021) do not support a golden rule given the possible distortions in the mix of investment expenditure and other growth enhancing expenditure, they consider that Independent Fiscal Institutions (IFIs) and the European Commission should take into account the different impact of different kinds of expenditure on potential output and ensure that climate investments are not postponed.

### 6.4. GETTING TO BETTER FISCAL RULES

Generally, a reformed fiscal framework should be guided by a number of first principles, that will help make fiscal policy an effective macroeconomic management tool and ensure debt sustainability:

- The rules should be simpler, so that they are easier to communicate by policy makers and legislators so that they are understood by all stakeholders and by consequence assume ownership.
- The rules should move away from unobservable variables with high measurement errors in real time: this is particularly true of the structural deficit and the output gap. We will discuss this later in greater details.
- The rules should focus on large, unwarranted potentially dangerous deviations as required by Article 126(2) of the Treaty on the Functioning of the European Union (TFEU), and should not try to micromanage national fiscal policy on a yearly basis with adjustment requirements that are often below measurement errors.
- The medium-term targets of the framework should remain country-specific (like the current medium-term objective is country specific), while the long-term target, the 60% of GDP limit for the public debt ratio, could remain universal as it is stipulated by the TFEU (even if this number is not justified by economic theory or empirical research). Debt sustainability depends on country-specific parameters (r, g, politically acceptable primary surpluses in the future if needed), so medium-term targets should remain country specific too and take these variables into account. We appreciate that this could complicate the nature of the rules but there is no reason fiscal adjustments should be similar in very different countries.
- The rules should take a medium-term perspective to incentivize countries to
improve medium-term planning (for the moment medium term plans that are part of current framework are often a box-ticking exercise, as shown by the EU IFI network, 2021). The implementation of the rules should focus on medium-term debt target and not on yearly changes (see for instance Darvas et al. 2018).

- The rules should get rid of some of its most complex exceptions and make escape clauses easier to trigger (also at country level) and possibly more frequent.
- The rules should take the monetary policy situation into consideration: when monetary policy is constrained by the zero-lower bound, fiscal policy not only needs to stabilise the economy (and help bring inflation towards the target) but is also able do it cheaply thanks to low long-term rates. Such an attempt would really make better use of fiscal-monetary cooperation, necessary for effective macroeconomic management.
- The fiscal framework should make clear that it is not aiming at being symmetric (to deal with negative demand externalities resulting from a country running a tighter fiscal policy than what would be desirable from the euro area perspective as a whole). This has proved to be impossible in practice (as it is difficult to ask a country to do more at the expenses of its own taxpayers to help its partners abroad). Instead, a central instrument could be agreed on to play that role, as a complement to the reform of the fiscal rules.

As we think about reforming the rules, two specific issues that could make an important difference, to improve the countercyclicality of the rules and to take into account the large investment needs of the future.

6.4.1. REDUCE THE USE OF MISMEASURED UNOBSERVABLE VARIABLES AND SIMPLIFY

In theory, the current fiscal rules, which have been adjusted over the years to take into account the business cycle, could do a good job, but in practice they face major hurdles (Claeys et al. 2016). A key indicator used in the current rules is the structural budget balance. This is the government budget balance corrected for the effects of the business cycle and one-off payments (such as bank bailouts).

According to the structural deficit rule, if the structural deficit is too high compared to the country’s medium-term objective, then countries must adjust their budgets. In theory, when a recession hits, the actual budget deficit automatically deteriorates because of falling tax revenues and increased unemployment benefit payments. But if legislations do not change, the structural balance does not change and therefore the rule should not trigger austerity policies.

But in practice the structural budget balance is hard to estimate in real time. The estimate relies on uncertain assessments of the economic cycle (the output gap) and its impact on government revenues and spending. Estimated changes in the structural balance are typically revised by more than half a percent of GDP (Claeys et al. 2016,
Anderson and Darvas, 2020), which is more than the adjustment that the rules require. It seems inconceivable that recommendations for fiscal policies should be based on such an unreliable indicator, especially because during crises, measurement problems worsen at the moment when clear indicators are most needed. Unsurprisingly, academics and even finance ministers of several euro-area countries have expressed doubts in recent years about EU methods for estimating the cyclical position of the economy and its implications for analysing budgets.

Economic forecasts are also a major source of errors. Current fiscal rules rely on European Commission forecasts on growth and inflation, which often turn out to be wrong. During and in the aftermath of the euro crisis, the European Commission repeatedly forecast that the economy would return to growth and inflation quickly towards 2%, a fact that did not happen. As a consequence, policy recommendations based on these estimates and forecasts actually made the economic situation worse during the period 2010-15. Forecasting accurately is certainly very difficult, especially in uncertain times, and other forecasters, such as the IMF, the OECD or private institutions, did not do better than the European Commission. But it would be better to have fiscal rules which are less dependent on economic forecasts and mismeasurement-prone output gap estimates.

Another important issue is that even though countries can provide additional stimulus for one year by entering an excessive deficit procedure (EDP), when a recession lingers for several years, current fiscal rules at best allow for a deceleration of fiscal consolidation, when a sustained stimulus may instead be needed. Based on such rules, policy recommendations were largely mistaken already before the crisis and eventually worsened the economic situation in Europe during the crisis, as most euro area countries started to consolidate their public finances as soon as 2010, instead of waiting for the best time to do it. This is indeed what Figure 1 showed.

Another key problem with the current EU fiscal framework is the opaque web of “flexibility” clauses. This leads to never-ending bargaining between member states and the European Commission about the implementation of the rules, which undermines trust in them. Several politicians in countries that do not fully respect the rules regard the rules as inappropriate and openly disregard the rules, while politicians in countries that tend to comply with the rules worry that the rules are not enforced on their partners. In these circumstances, preserving the fiscal framework as it is today would be harmful.

One way of removing this procyclicality as we think about revising the Stability and Growth Pact and the Fiscal Compact is the following. First, the 3 percent deficit and the badly measured structural deficit should not be used anymore as operational targets for fiscal policy. Second, the fiscal framework should focus on a rule limiting the growth of nominal public expenditure, excluding unemployment insurance expenditure and one-off expenditures. According to this rule (explained in detail in Claeys et al., 2016), the annual growth of nominal public expenditure should not exceed the sum of the country’s potential real GDP growth plus the central bank’s inflation target (2 per-
A RETURN TO WHAT FISCAL RULES?

cent per year). This last element would increase its countercyclicality and help the ECB reach its target (as also pointed out recently by Lane, 2021). In bad times, this would reduce the incentive of governments to cut expenditures. Even if tax revenues fall and spending on unemployment increases, governments would still be allowed to support growth through deficits. In good times, this would dampen excessive booms, such as those in Ireland and Spain before the crisis, because governments would not be allowed to spend the extra tax revenues generated by bubbles. This limitation of expenditure would also take account of the level of public debt. Countries with high debt would have lower spending growth than those with low debt, in order to ensure long-term fiscal sustainability. Third, the opaque web of flexibility clauses in current fiscal rules should also be radically reduced. One way of doing that is by tasking the Commission with the help of the European Fiscal Board and EU Independent Fiscal Institutions (IFI) Network to assess when countries or the whole region can deviate from the rules in exceptional times, as it was done during the COVID-19 crisis.

Such an overhauled framework would be simpler, more transparent, and easier to monitor than the current system and would avoid relying on an unpredictable indicator. It would thus be more conducive to the two desirable objectives of sustainability and stabilisation. Incentive compatible rules will mean that countries will follow them, not because of fear of sanctions, but because they agree that the rule represents the best guidance for their fiscal policies to be supportive of growth and without jeopardising sustainability.

6.4.2. INCENTIVISE GREEN INVESTMENTS

Another important point to consider is how the European fiscal framework should try to influence the composition of fiscal policies of member states. In particular, how it could be adjusted to incentivise EU countries to green their economies and allow them to invest massively in green public investments that will be needed for the ecological transition.

Darvas and Wolff (2021a) estimate that additional public investment of the order of between 0.5 percent and 1 percent of GDP will be required annually during this decade to meet EU climate goals. They advocate for a green golden rule that excludes net green investment from the EU fiscal indicators used to measure fiscal rule compliance, and thus avoid underinvestment due to deficit constraints. Other global estimates of investment needs are summarised in Lenaerts et al. (2021) and include the those recently developed by the International Energy Agency which estimates annual investments globally stand at $2 trillion per year or 2.5 percent of global GDP and should rise to $5 trillion by 2030 (and remain so at least until 2050). The International Renewable Energy Agency frontloads these investments, considering $5.7 trillion is required annually until 2030, while Bloomberg New Energy Finance estimates yearly investment requirements of between $3.1-5.8 trillion up to 2050. Finally, the European Commission estimates, only in the EU, meeting 2030 targets will require €360 billion in additional investment annually.
Corporations and households will be responsible for the majority of green investments, but public investment will also be needed because of the public-good nature of some of the investments (e.g., to deploy a sustainable transportation system, or to renovate public buildings and social housing to make them energy efficient). Given the relatively small size of the EU budget (despite the welcome addition of the Next Generation EU programme in the next 5 years), most of these public investments will still have to be carried out at the national level. But this means that decisions, and the allocation of funds will be in the hands of national governments and not under the control of the EU. So, if the European Commission wants to foster investment to accelerate the transition, it must find a way to encourage green public investment in member states. The main tool for the EU Commission to do this is the European fiscal framework (Claeys, 2019).

As discussed earlier, the European fiscal rules should be reformed to deter countries from slashing public investment when they consolidate their public finances and to ensure that they are able to take advantage of favourable interest rates to invest in public goods. One way to do that would be to include some form of golden rule in the European fiscal framework to allow the financing of investments through the issuing of debt or at least to change the way public investments are treated in budgets. This could be done by treating them in the same way that corporate investment is accounted for by smoothing investment expenditure over the whole service life of the investment (as in the expenditure rule proposed in Claeys et al., 2016 and discuss in the previous section).

And yet, if an agreement cannot be found to reform thoroughly the European fiscal rules to make them more investment-friendly in general, a useful reform would be to authorise deficit-financed green investment during the transition. One way to put in place a form of “green golden rule” would be to revise the investment clause of the European fiscal framework by exempting public investments that help mitigate or adapt to climate change.

In fact, the current clause already allows for deviation from the structural balance medium-term objective (MTO) to finance investments “with positive, direct and verifiable long-term effects on growth and on the sustainability of public finances” (European Commission, 2019). Given the potentially high risk in the long run of climate change for public finances, it would not be a stretch to apply the clause to green investments.

However, other refinements would be necessary to transform the clause from a small and temporary exemption that can only be used in bad times to a more significant and permanent exemption for green investment from the rules, also in good times. Indeed, the current version of the investment clause is subject to the following conditions:

- The member state’s 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 and an appropriate safety margin with respect to the 3 percent of GDP deficit reference value is preserved.
The projects should be co-financed by EU funds, including through EFSI.
The deviation should not exceed 0.5 percent of GDP, and in cumulative with the structural reform clause it should not exceed 0.75 percent of GDP.
Co-financed expenditures should not substitute for national investments.
The MTO should be reached during the 4-years of the Stability or Convergence programme.
The exemption is granted for one-time only during the adjustment path towards the MTO.

As a result of these very restrictive conditions, only two countries, Italy and Finland, have ever used the investment clause (European Commission, 2018). The current investment clause is established in the Code of Conduct of the Stability and Growth Pact (SGP), modified for the last time in 2017 (Economic and Financial Committee, 2017). The clause actually provides guidance on the application of Articles 5.1 and 9.1 of Regulation (EC) 1466/97, which is the legislation (amended in 2005 and 2011) authorising “temporary deviations” from the adjustment path towards the MTO in case of actions that have long-term positive budgetary effects. Given the more permanent nature of the current reason to invest (to accelerate the transition in the next 10 years), the revision of the SGP Code of Conduct will probably not be enough this time, and a revision of the Regulation will also have to be pursued to increase the flexibility.

However, to avoid any abuse of such a green investment clause by countries that might be tempted to apply the exemption to their current expenditures, two safeguards could be introduced in the new legislation:

• First, the maximum amount of green investment exempted could be related to the level of the ‘green investment gap’ in each country, which would be discussed and determined each year as part of the European Semester.
• Second, clear accounting rules would be needed to separate investment in the low-carbon transition from other expenditures. This should be facilitated by the introduction of an ambitious taxonomy for sustainable finance (which was introduced in July 2020).

Hence, well-defined green investments (to avoid greenwashing), which could be financed through the issuance of green bonds which currently sought-after in financial market, could be clearly separated from the rest of the budget and exempted from the rules.

This reform, limited to the investment clause, would not put an end to the debate about the European fiscal framework and would not solve its other flaws (in particular its harmful reliance on unobservable variables), but it would be a good first step, as it could help encourage EU countries to invest in decarbonisation.

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Beyond the discussion on fiscal rules, the broader picture will require careful thinking of what the new role of fiscal policy is as we aim to meet two very important and long transitions, that of climate change and the digital transformation. But as we do not start with a clean slate, namely with high levels of debt that could weigh in on some countries’ ability to invest, we must think of a framework that will ensure debt sustainability, but also will make sure we meet our common targets.

The COVID-19 pandemic crisis led to a more decisive policy action at the national level, in comparison to the policy response after the financial crisis. But importantly, the pandemic crisis gave rise to a crucial innovation in the context of the EU fiscal architecture, with the creation of the Next Generation EU (NGEU) programme and the Recovery and Resilience Facility (RRF). This was innovative both in terms of the volume of funds (up to €800 billion between 2021 and 2026) but, most importantly, because it allowed for the first time a significant issuance of common debt to finance investments through grants.

The RRF, in its current form, is designed to be financed with long-term debt, to be repaid in the next 3 decades. The actual way of repaying it is not decided quite yet but the July 2020 agreement contained a provision to potentially introduce new “own resources,” in other words a tax base at the European level to repay the debt, even if, as of now, the RRF and NEGU program are a temporary one-off instrument.

However, we believe that the NGEU programme can be useful template for the future (as also argued in Demertzis et al., 2022). An investment-focused centralised instrument with a borrowing capacity modelled on NGEU could indeed be used to reach the adequate level of expenditures geared towards common priorities such as the green transition.

In particular, if its size were to be significant enough, this could be a more effective way of making sure that all countries achieve common goals, compared to an incentivizing green golden rule that would exclude national climate investments from deficit calculations. The current governance structure of NGEU, with a tight control of the European Commission and the Council on spending plans, could guarantee that expenditures effectively target common objectives and would provide a more incentive compatible approach to identifying what is green, thus preventing greenwashing.

Indeed, the process put in place for NGEU and in particular for the assessment of the national Recovery and Resilience plans by the Commission has led to intense discussions between the Commission and EU countries about the content of the plans and on the investments financed thanks to EU borrowing to be sure that the plans fulfilled the objectives of the EU recovery programme (Darvas, 2021). It remains to be seen how the implementation of the plans will be carried out by countries in practice, but if the NGEU experiment is positive, such a governance system could be a good template to carry out investments to fulfil common objectives in the near future.

It is true that given its focus on investment and its slow disbursement, the NGEU is not the right tool for helping in the acute phase of any crisis, as the latter requires spend-
ing on protecting employment and providing unemployment benefits, short-term work scheme, support to companies, etc. Such spending is mostly done at the national level, given the current fiscal structures. But it could still be helpful in obtaining the adequate fiscal stance during the recovery phase and would in fact be complementary with the rules as it would reduce their stringency and potential negative impact on growth and public investment (Darvas and Wolff, 2021b).

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182


