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EU Economic Governance and the Climate Crisis

The Covid-19 pandemic crisis, which partly resulted from the decline in biodiversity, was the first episode in a likely long series of major disturbances calling for massive government support. In fact, IPCC scientists anticipate a higher frequency of shocks driven by climate change in the next three decades (IPCC 2021). In this context, it is important to acknowledge that climate shocks will likely disturb both supply and demand in the future, a fact that will likely fuel more inflation episodes as well as more volatility and uncertainty in general over the coming decades. These new macroeconomic conditions emphasize the key role of governments in protecting citizens and navigating a transition toward a sustainable economic system. And indeed, the European Commission has set the objective of cutting carbon emissions by at least 55 percent by 2030 to become climate neutral by 2050. The missions of protecting citizens and becoming a climate-neutral economy pose a historical challenge to government budgets and, more generally, raise the issue of articulating the EU's ambitions within domestic economic and political contexts. Is the EU's current economic governance well equipped to face these challenges? What can the EU do within the current economic and political governance framework? What feasible changes in economic governance can be thought of to foster a game-changer role for the EU in the climate crisis? The institutional setup of the European Union makes the answer to this question tricky.

In fact, current political governance involves a non-standard policy mix characterized by a common currency for most Eurozone member countries but not for the rest, country-specific budget and tax policies, and fiscal transfers from the EU that are not intended to be permanent. In sum, monetary policy runs at the federal level for Eurozone member countries, while tax policies are still mostly a national government responsibility. This is not optimal from an economic point of view, but it is the political status quo and derives from historical circumstances. Finally, there is an extra layer of institutional complexity, since euro area treasuries are to follow common rules under the Stability and Growth Pact and their budget position is under the surveillance of the European Semester. The political process is rarely smooth, and enforcement is obviously never guaranteed. In this context, the EU is currently revising its economic governance framework[1] in accordance with guidelines agreed by the European Council in March 2023. However, there is still room for debate.

[1] https://ec.europa.eu/commission/presscorner/detail/en/ip_23_2393.

KEY MESSAGES

- **Government support for firms and households accounts for a substantial part of national budgets**
- **Traditional support measures for the corporate sector mostly benefit carbon-intensive sectors and dwarf new green support measures**
- **Untargeted, across-the-board income support measures to households are not efficient because they benefit high-income households, which tend to have a larger carbon footprint**
- **Non-standard monetary policy has taken the form of an unprecedented economic stimulus, which has mostly benefited carbon-intensive sectors**
- **The EU must use institutional leverage to change the allocation of fiscal and monetary support**

I will try to emphasize the incentivizing role that the EU's economic governance can play on national tax policies and on federal monetary policy to make them compatible with the 2030 Climate Target Plan. In my first point, I focus on two categories of government support: traditional government support to firms on the one hand, and new support to households to compensate for the impact of climate change on the other. I emphasize the limits of both current schemes and argue that EU institutions could use leverage to adapt the framework to the objective of cutting carbon emissions. My second point concerns the greening of monetary policy and discusses how EU institutions may encourage the tilting of its corporate bond portfolio toward low-carbon-intensive activity.

THE TALE OF TWO GOVERNMENT SUPPORTS

Extreme climate events will continue to put pressure on government budgets over the coming decades. While Eurozone members still largely benefit from the massive acquisition of government bonds by the ECB and abundant global savings, it is unquestionably essential to pursue virtuous budgetary and taxation policies, and to fight against the waste of government resources. In

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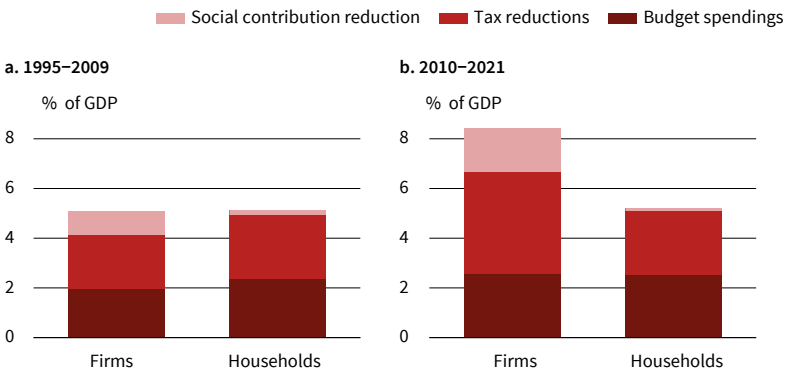
Figure 1

Government Support to Firms and Households in France 1995–2021



Source: INSEE, budget laws and social security laws; Delatte (2023). © ifo Institute

this context, two domestic government support forms deserve the EU institutions' attention.

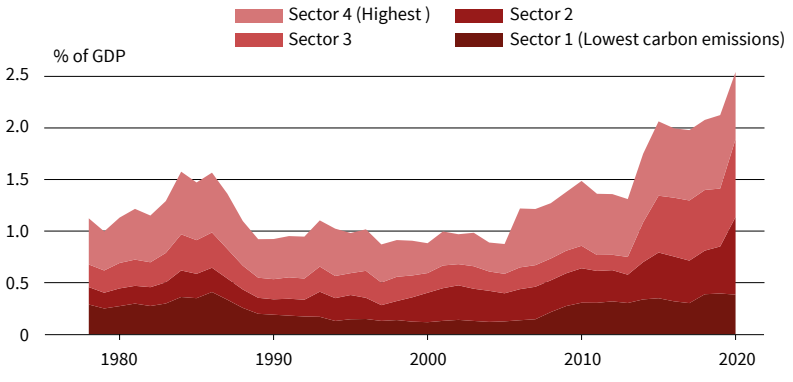
GOVERNMENT SUPPORT TO FIRMS AND THE CLIMATE CRISIS

Tax policy can assist in the transition toward a carbon-neutral production system. To this end, economists generally recommend providing strong government support to the development of low-carbon technologies. According to recent patent data, a combination of subsidies and a sufficiently high carbon tax would steer firms toward clean technologies (Acemoglu et al. 2012).

However, this reasoning does not account for the fact that the existing stock of government support to firms is primarily targeted at carbon-intensive sectors. In fact, government support has in general been neutral to the sectoral structure of the economy, which, in carbon-intensive economies such as ours, means that tax subsidies primarily benefit carbon-intensive sectors. This is not surprising from a pre-climate-crisis perspective, but the objective of cutting carbon emissions by 55 percent by 2030 calls for dramatically changing the allocation of support. In other words, tax policy during this transition does not need to start from scratch, but should simply depart from the status quo, which is likely to trigger strong resistance from vested interests.

Figure 2

Sectoral Composition of French Government Support



Source: Eurostat; INSEE; Delatte (2023). © ifo Institute

For example, in France, the amount of money that the government has allotted to supporting the corporate sector has doubled over the last 45 years (as a percentage of GDP), averaging 8.5 percent of GDP since 2010, equivalent to EUR 190 billion per year (Figure 1). Interestingly, half of government subsidies have benefited the most carbon-intensive sectors (including all manufacturing industries; see Figure 2). In the French scheme, only one-quarter of total government support is budgetary in the form of government subsidies, the rest being tax and social security exemptions. For example, the largest French corporate tax credit, with a volume of EUR 20 billion (0.7 percent of GDP), is distributed regardless of the sector but on payroll criteria.[2] Relying on exemptions instead of subsidies implies a lack of data transparency, because only budget support is recorded in the national accounts while tax and social security exemptions count as losses and are hence not recorded as spending. This lack of visibility diminishes the attention they receive in the public spending debate.

In total, the French government distributes annually the equivalent of 8.5 percent of GDP in aid to companies, with only one-quarter of it going to low-carbon-intensive sectors.[3] At the same time, the green budget, i.e., government support for the ecological transition, amounts to just EUR 37 billion. In other words, the existing stock of government support, which is mostly directed to brown activity, massively dwarfs the new green budget.

What the EU Can Do about This Issue

EU competition policy offers the most straightforward leverage in EU economic governance because, while state aid is decided and funded domestically, it must follow specific rules set by the EU (TFEU Article 107). It is striking therefore that state aid has significantly increased in France despite its general prohibition in the EU. As it turns out, the Treaty leaves room for several policy objectives with which state aid can be considered compatible. These exemptions unambiguously explain the expansion of public aid in the EU. It is worth noting that the "Block Exemption" qualification was extended on March 9, 2023, following the US Inflation Reduction Act, suggesting that a "public aid race" could well develop in the context of shocks with global impact. Despite the reporting obligations, it is not feasible to monitor the scope of public aid because of the numerous exceptions.[4] As a consequence, it would be useful to overhaul the public aid framework and discuss linking it to *green condition-*

[2] Note that this tax credit was turned into a social contribution reduction in 2019.
[3] Here I make the (somehow realistic) assumption that tax subsidies and exemptions follow the same distribution across economic sectors.
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ality, such as carbon emissions, the proportion of investment in fossil fuels, and the like.

GOVERNMENT SUPPORT TO HOUSEHOLDS

The richest 10 percent of the global population accounted for nearly 48 percent of global emissions in 2019, while 63 percent of the global inequality in individual emissions is now due to the gap between low and high emitters within countries (Chancel 2021). In turn, climate risks disproportionately affect the poorest households, who are more exposed and more vulnerable. In the context of the EU's objective of reducing carbon emissions, governments should allocate enough budget resources to offset the climate impact on low-income households. Given the potential cost of this new category of government support, one efficient way to proceed would be to avoid compensation measures across the board, instead tightly targeting low-income households. In this vein, it is important to remember that progressive taxation, which taxes the richest more heavily than the poorest, reduces the purchasing power of the richest and hence their carbon emissions. It also provides the resources to provide transfers to compensate for the effect of climate change on low-income households.

The recent package of measures implemented by governments to address the impact of inflation is an interesting case study. According to the ECB, real wages have fallen by almost 4 percent since 2019 and are expected to fall further in the coming months (Bodnár et al. 2022). The effect of inflation is certainly not homogeneous across all income levels: for example, in France, the bottom 50 percent of the population consumes 100 percent of its income, whereas the top 10 percent consumes 60 percent and saves 40 percent. This implies that in their daily life, the bottom 50 percent suffers 1/0.6 = 1.67 times more from consumer goods inflation than the top 10 percent. The gap is particularly pronounced when food prices increase faster than those for other goods, as has been the case in the current inflation episode (in France, y-o-y inflation on food still stood at 14 percent in May 2023). This calls for targeted tax responses. The hardest-hit income levels should get the greatest tax support. This is a matter of government spending efficiency. Yet, various governments have implemented across-the-board income tax support such as subsidizing the price of gas for every citizen. In France, the government's contribution to motorists' fuel costs began on April 1, 2022, with a total of EUR 7.6 billion (0.2 percent of GDP) budgeted in 2022 to finance such a rebate.

This is not efficient, since the demand for energy of high-income households is less elastic to prices than that of low-income households. It means that for the better-earning, absorbing a higher price did not pose much of a burden, so subsidizing fuel costs not only was unnecessary, but runs against the general interest of reducing the consumption of fossil fuels. In this sense, a subsidy for public transportation may have been more efficient and would have been compatible with carbon emission reduction goals.[5] More generally, any tax support to absorb the effects of climate change on households should meet the following criteria: 1) targeted toward the bottom of the income distribution, and 2) compatible with the long-run climate change mitigation objectives.

What the EU Can Do about This Issue

While tax policy is almost exclusively under domestic governance, the recent developments offer an opportunity to create leverage at the EU level. The unanimous-decision rule should be replaced by a qualified-majority rule for tax decisions, so that tax harmonization takes place on a best-case basis and not the other way around. Among other harmonization possibilities, a minimum corporate tax rate could be considered at the EU level (e.g., 25 percent) as well as a common minimum tax on top wealth and top income in order to end tax competition in the EU. In this new context, with more leeway, EU member states could transfer part of the tax revenue they collect to the EU to contribute to EU resources as well as to compensation measures.

GREENING MONETARY POLICY

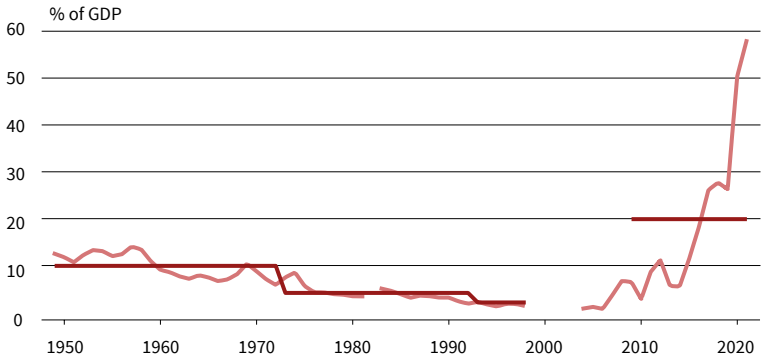
Monetary policy returned in force in 2008 on an unprecedented scale. In addition to managing short-term liquidity, central banks began lending directly to governments, banks, and corporates to an extraordinary degree. Figure 3 shows all operations carried out by the Banque de France to finance businesses, banks, and the government since 1949.[6] The J-shaped curve indicates that the Banque de France has never been so present in financing the economy than after 2008. In fact, the objective since then has been to act directly on the cost of long-term borrowing to make it cheaper and thus stimulate investment. It implies that the Banque de France has acted directly on quantities, as it did during the post-WWII period and the *Trente Glorieuses* (the thirty-year period of economic growth in France between 1945 and 1975). However, the conditions were radically different then, since contemporary monetary action is neutral; the principle in place in the aftermath of World War II was to deliberately interfere with the structure of the economy. In sum, central banks are more active today than even during the *Planification* period in the 1960s.

[5] Subsidizing public transportation is more efficient conditional on the distribution of public transportation users being biased towards middle- and low-income households.

[6] Category "Loans to the economy" 1949–1999 and then 2004–2021 with the addition of "Refinancing operations," "Bonds denominated in euros issued by eurozone residents," and "Bonds held under monetary policy operations."

Figure 3

Banque de France Financing Operations



Source: Baubeau (2018); Monnet (2018); Banque de France annual reports 2004–2020. © ifo Institute

In this context, in July 2022 the ECB's Governing Council decided to start greening its stock of corporate bond holdings, with a view to removing the existing bias toward emission-intensive firms. This so-called "tilting" of the Corporate Sector Purchase Programme (CSPP) reinvestments will start on October 1, 2022, aiming not only to mitigate climate-related financial risks on the Eurosystem's balance sheet, but also to send a signal to financial markets, encouraging them to switch their investment decisions from carbon-intensive to low-carbon assets. This decision, together with the fact that the ECB is a very active public actor today, underlines that greening the existing stock represents an outstanding opportunity to bring about a fast and efficient transition.

While the principle of tilting is an extraordinary step, given the market neutrality constraints under which the ECB has been operating so far, the speed is still very slow. In a recent speech, Isabel Schnabel, a permanent member of the ECB's Governing Council, pointed out that, at the current rate of tilting of the ECB corporate bond portfolio, polluting companies would continue to dominate the portfolio until at least the end of the 2020s, all other things being equal. That is a very long time, given the pace at which temperatures are rising (Schnabel 2023).

What the EU Can Do about This Issue

The EU governance should unambiguously play a part in speeding up this tilting. The most obvious institutional channel is the European Parliament, to which the ECB is accountable (Article 284 (3) of the Treaty on the Functioning of the European Union). However, despite the "Monetary Dialogue" and the annual report of the EP on Monetary Policy, the leverage of the European Parliament is still very limited. It would be key for the EP to gain an effective control on monetary policy.

POLICY CONCLUSION

It is crucial to link government support for the corporate sector to carbon emissions, an area where EU political governance could help. To be efficient in budgetary terms, government support to protect citizens against climate shocks should target low incomes instead of doling out across-the-board income support measures. The allocation of the ECB's corporate bond portfolio is largely biased toward carbon-intensive firms; therefore, the European Parliament should gain more control to actively promote the reorienting of this portfolio toward low-carbon-intensive firms.

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