New Challenges at the Level of the EU: Green Deal and Economic Governance after Pandemic

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Abstract:

Public policies of each country are modeling economic growth based on resources, economic conditions and, especially, aspirations. In some countries, economic growth is just happing, while other countries are pursuing clear objectives. For the last couple of centuries, economic growth followed a quantitative objective and ignored the qualitative features of growth, ignoring environment and social policies. As a consequence, growth models departed from the nowadays long-term objectives of building sustainable, green, inclusive and smart economic activity.

The new millennium arrived with an ambitious agenda regarding the sustainability of growth model, while the new Commission provoked the EU Member States to a new economic paradigm, where the green economy and digitalization are taking the driving seats of the European growth models. The health crisis caused by the new Coronavirus pandemic revealed the shortcomings of the current economic model – long production chains and, in many cases, weak economic governance. For many EU member states, the requirements of the green economy – the Green Deal - the digitalization and the need of strengthening economic governance are a big challenge that should be solved together, over medium and long term.

Key words: *Green Deal, health crisis, economic governance, European Union*

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I. Approach to economic growth: from classic to modern

Economic growth was born and have become a preoccupation of economists after the industrial revolution. Angus Magnus[1] shows that over the last millennium, from the year 1000 to 1820 the advance in per capita income was a slow crawl — the world average rose about 50 per cent. Most of the growth went to accommodate a fourfold increase in population. Since 1820, world development has been much more dynamic. Per capita income rose more than eightfold, population more than fivefold. But not all countries advanced in the same pace and regional gaps have deepened.

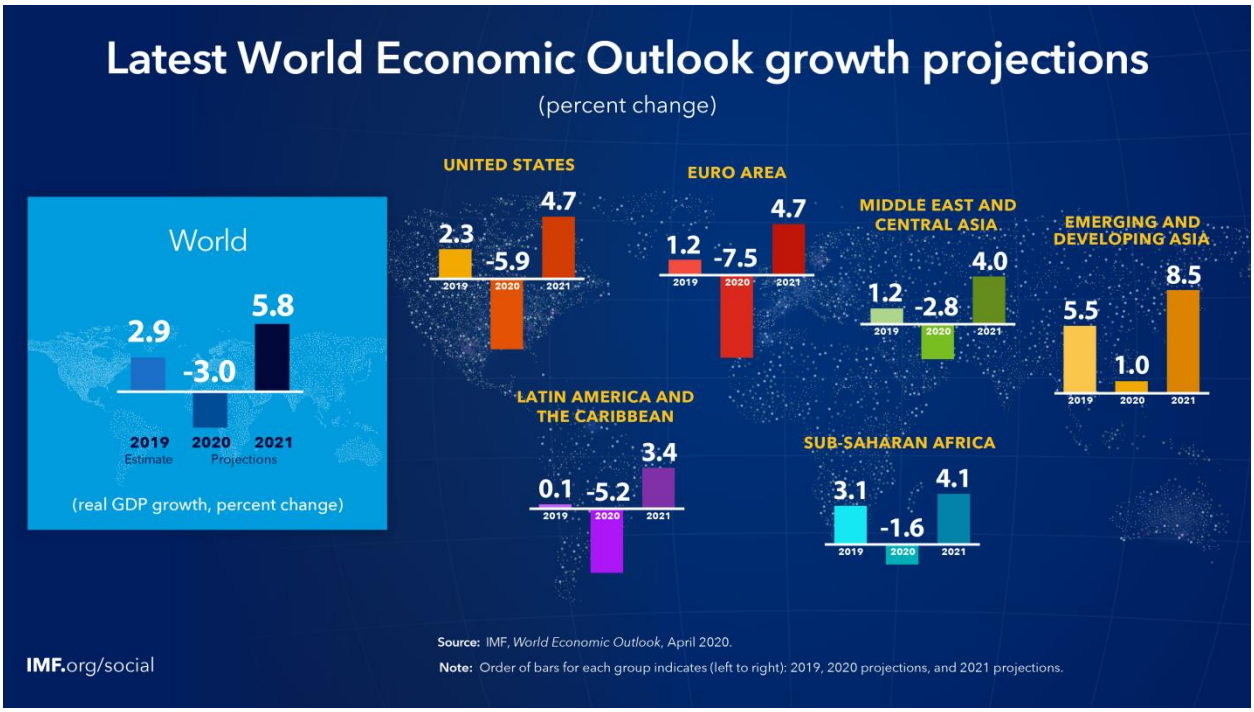
Countries that invested in new technologies saw immediate results in terms of rapid growth and higher competitiveness, becoming regional and world economic leaders. They set up institutions able to handle and to stimulate the development and the use of new technologies, also to internalize in the daily activity for increasing exponentially productivity. These countries won the gamble of the steam engine and they are leading the platoon.

However, growth models have ignored two dimensions: **environment and people**. In this process of higher and higher growth, protecting environment was only marginally considered until the beginning of the new millennium, while economic and social inclusion was labeled as leftish political ideology. But over the last 20-30 years, the concept of economic growth by all costs was replaced by the concept of green, smart, inclusive and sustainable growth. Otherwise, individuals and societies cannot develop nor become better.

Some countries considered research and education important factors in their equation of growth, stimulating quality supply side and equity; other countries, pursued quick (political) wins and focused on demand side, stimulating consumption based on debt. There is a strong correlation between innovation and R&D and environment and long-term sustainable growth[2]. Therefore, in 2018, The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel was shared between William D. Nordhaus "for integrating climate change into long-run macroeconomic analysis" and Paul M. Romer "for integrating technological innovations into long-run macroeconomic analysis."

[1] Angus Maddison, The World Economy: a millennial perspective, 2001, OECD;
[2] See JRC (2019): 2035 – Paths towards a sustainable EU economy. Sustainable transition and the potential of eco-innovation for jobs and economic development in EU eco-industries 2035

Irrespective of the growth model, the beginning of the year 2020 shut down the world economy. A new pandemic forced numerous companies world-wide to shut down, shrinking the global growth for 2020 to -3% (forecast)[1]. For Romania, the growth is projected to fall to -5% this year, while next year economic activity may recover to over 4%. For the first time since the Great Depression in the 30's of last century, both advanced and emerging economies will be in recession. In 2021, the global economy is projected to grow by 5.8%, under the assumption that the economic activity normalizes, and policy support will have been offered. The risks to this scenario remain high and uncontrollable, depending on the success in controlling the virus spread, the identification of the right cure, the discovery, testing and production of a new vaccine, the properly equipped hospitals and the availability of financial resources for all these.



Globalization is questioned. The Great Lockdown revealed the limitations of the long supply chains, the paradigm of the modern economy and the underlying factor of higher productivity and higher margins. Most European goods producers relocated partially or entirely their production in Asia, mainly in China. Therefore, over the last 10 years, also helped by the devaluating exchange rate policy, the Chinese exports doubled to 2.5 trillion USD, 10 times more

[1] IMF, World Economic Outlook, April 2020

than exports of Australia or Saudi Arabia. "Made in China" label became part of our lives, when talking about cloths but increasingly on equipment and high-tech. In case of Europe, shortening production chains would mean relocating polluting industry from China to Europe, while observing all rules related to taxes, labor force and social security. This would translate into an increase of prices for products relocated from China to the EU or accession countries. However, the need to observe the EU rules, especially on pollution, for example, should boost up research for greener technologies, just in line with the new EU objectives on a smarter and digital economy. Overall, a coherent economic policy would result in smart and clean economy on long term, which could offset the immediate negative impact of the price increase.

The Great Lockdown and the negative economic shock determined the European Commission to design new policies and instruments. In May 2020, a new recovery plan and a development package, together with financial resources were presented by the Commission. The EU budget was boosted by **Next Generation EU**[1], an emergency temporary recovery instrument, to help repair the immediate economic and social damage brought by the coronavirus pandemic, kickstart the recovery and prepare for a better future for the next generation. This proposal builds on the 2018 Commission's proposal and on the considerable progress that has already been made in the European Parliament and the Council. To ensure an effective implementation of the **Recovery Plan,** which reaches out to everybody in the EU and to our global partners, the Commission is mobilizing a variety of instruments, consisting in grants, loans and guarantees.

II. The EU Green Deal – a project for the next 30 years

Scientists have warned over the risk of climate change if pollution is not contained and reduced. More economic activity, more employment, higher trade and salaries with more pollution is an unsustainable economic model that is leading to self-destruction over the long term. Green political parties have emerged in Northern Europe, reflecting a higher level of understanding of economic and social challenges, as well as better standards of living. It is unrealistic to believe that individuals facing poverty are preoccupied by luxury and untouchable goods, such as quality of air, heritage of our children etc.

[1] European Commission (2020): Europe's moment – repair and prepare for the next generation, avilable at https://ec.europa.eu/commission/presscorner/detail/en/ip_20_940

The ambition of the Green Deal is that until 2050, human activity does not hurt nature and environment. In other words, the trace of carbon dioxide left by humans should not exceed the capability of environment to absorb it, conducting an environmentally neutral activity. It means that current economic sectors which are polluting – transport, energy, construction building, agriculture, chemical industry etc. – should significantly increase investments for reshaping towards an environment neutral activity.

> *The main goals for 2030 are: reducing greenhouse gas emissions by at least 40% (compared to 1990 levels); at least 32% share of renewable energy and improving energy efficiency by at least 32.5%.*

Financing the Green Deal will combine EU grants, national co-financing, private money and additional financing schemes for the private sector. The Deal requires at least 1,000 billion EUR over the next decade in investments, in a combination of EU budget funds, plus additional public and private investments engaged by these funds. The EU budget for climate and environment expenditure in the period of 2021-2030 will reach over 500 billion EUR, meaning 25% of the 2021-2027 multi-annual financial framework (MFF). This amount will be top up by an additional 114 billion EUR national co-financing for climate and environment in that period. The **InvestEU** fund is a more sophisticated financial instrument that will engage private and public climate and environment-related investments amounting to about 279 billion EUR during 2021-2030, by supplying a guarantee from the EU budget in order to reduce the risk of the financing and investment operations. This instrument would be less feasible for emerging EU economies, including Romania, whose financial sectors and mechanisms are less sophisticated.

In order to contain negative shocks for business and individuals in the process towards a greener economy, **The Just Transition Mechanism** will include financing from the EU budget, co-financing from the Member States, and contributions from InvestEU and the European Investment Bank (EIB) to get to 100 billion EUR investments engaged in the period of 2021-2027, which, extrapolated over a 10-year period, will get to 143 billion EUR, thus ensuring a just transition.

Current system of taxing polluters through the carbon dioxide emission certificates, introduced by the Emission Certificate Trading System (ECTS) will also contribute to financing

the transition. Thus, the Innovation Fund and the Modernisation Fund, which are not part of the EU budget, but are funded from part of the revenues obtained from carbon dioxide emission certificate auctioning within the Emission Certificate Trading System, will provide at least 25 billion EUR for the EU's transition to climate neutrality.

Romania must focus intensively on the consequences of the Green Deal by the European Commission. There are risks, but there are opportunities as well. Romania needs to solve the issue of outdated, polluting generation capacities that must be revamped or replaced with clean generation sources. A large percent of about 25-30% of Romania's energy mix is still based on coal. Furthermore, we see stagnation of investments in the area of wind-based generation, and prosumers - the new players on the market - are still at an early phase. Investments in grids are highly needed but they require a new wave of smart rules and regulations.

At the same time, the EC invited Member States to identify challenged regions that need money and practical support, and work with the Commission to produce a practical change plan. The European Commission has included a European Just Transition Mechanism, particularly dedicated to coal-producing regions such as Valea Jiului or the Oltenia region. The Mechanism intends to generate investments amounting to 100 billion EUR in the next 7 years and 143 billion EUR in the next 10 years through non-reimbursable European funds, but also through special crediting lines. Romania is among the main beneficiaries of the Just Transition Mechanism, which is meant to help Europe reach climate neutrality by 2050 according to the Commission's estimations presented to the EU Member States. According to some preliminary estimations, Poland would be the main beneficiary of the Mechanism, as it would benefit from investments amounting to approximately 27 billion EUR. Poland is followed by Germany, with investments of 13.4 billion EUR; Romania with 10.1 billion EUR, and the Czech Republic with 7.8 billion EUR.

However, Romania should pay attention to how appealing the business environment is (taxation regime; regulations; stability; predictability) and be aware all the time that it is competing with other countries in attracting and keeping investors here. Investing in revamping the existing production capacities is key, in parallel with investing in new, efficient, environment-friendly production capacities.

The energy transition will obviously have a considerable impact on some coal-based producers and industries and on some coal-producing regions. The restructuring of the energy sector and the change of the energy mix have already driven job losses in such regions of Europe

and in Romania as well, and this is a trend that cannot be avoided in the future. It is very important that we anticipate the structural changes of the energy sector early, and approach such changes through clear, lasting policies, in order to reduce and mitigate the economic and social impact as much as possible.

The investment plan under the Green Pact envisages a review of the relevant **state aid norms** by 2021. Thus, the intent is to encourage innovation and implementation of new, environment-friendly technologies on a commercial scale.

The use of **green taxation as a tool to change behavior and generate revenue remains modest**. Environmental taxes, as well as different forms of carbon pricing, are important policy instruments to achieve the required transition. A significant price on carbon dioxide emissions has been a key feature of Swedish climate policy since 2015 and now covers about 40% of Swedish greenhouse gas emission, helping Sweden to reduce greenhouse gas emissions in sectors not covered by the EU Emissions Trading System, while keeping the economy growing. Other Member States, including Ireland, Denmark, France, Finland, Slovenia, Estonia, Latvia, Poland and Portugal also apply a carbon tax. In Ireland all revenues from a recent price increase in the carbon tax (around 90 million EUR in 2020) will be fully allocated to climate-related spending. Part of them (6 million EUR) will be used to establishing an Irish 'Just Transition Fund' for the Midlands – covering investment in retraining and reskilling and helping local communities and businesses to adjust to the low carbon transition.

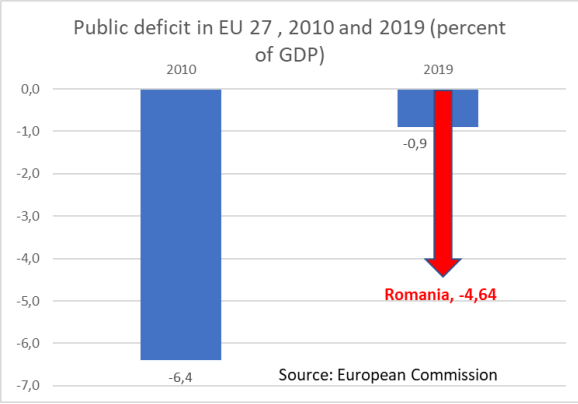
III. What about economic governance?

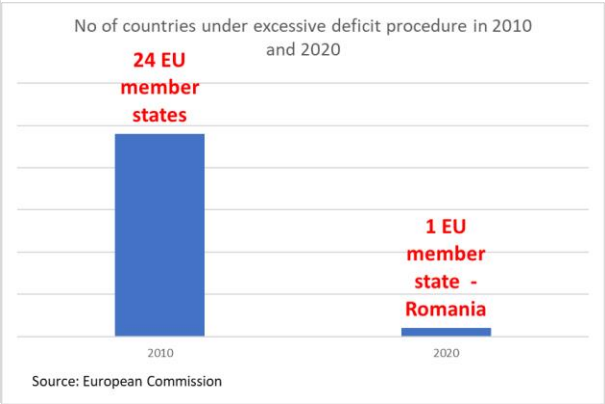
Since 1992, the European Union introduced stricter rules for economic governance through the Maastricht Treaty. It established that the deficit of the general government should be below 3% of GDP, and the public debt should stay below 60% of GDP. Five years later, in 1997, rules of the Maastricht Treaty are strengthened through the Stability and Growth Pact. It also provides a clearer and enforced framework for monitoring and coordination of national fiscal and economic policies to ensure sustainable growth and economic convergence of all member states. The severe crisis of 2008-2009 reveled macroeconomic weaknesses of the economic governance in many EU countries. The situation called for stronger and more refined rules of economic governance, enforced through the so-called Six-pack and two-pack legislation. The new rules

targeted fiscal surveillance and broadened the scope of the surveillance to include macroeconomic imbalances and their adjustment.

The new Commission is also looking at economic governance rules. Not because it is not needed, anymore, but because some objectives have been reached while for other objectives there is need of more ownership from each government. Economic governance has not become obsolete, a stranded asset but it needs to be reinforced and truly believed. Faking economic governance is not an option. Moreover, the pandemic induced new internal and external macroeconomic imbalances in most of the Member States, exacerbating those already existing prior the health crisis.

The Great Lockdown worsened the macroeconomic conditions more than the previous economic crisis (2008-2009). The economic crisis deteriorated the fiscal stance in most of the EU member states, where an average budget deficit reached 6.9% of GDP, well beyond the 3% deficit threshold. Therefore, an Excessive Deficit Procedure was opened for 24 countries out of 27, but Estonia, Luxemburg and UK. Fiscal consolidation measures and economic recovery resulted in a significant improvement of fiscal stance in all countries, in 2019 the average public deficit dropped to 0.9% of GDP and no country under fiscal corrective measure. However, Romania departed from the trend and increased its 2019 budget deficit to 4.64% of GDP, which triggered the opening of the excessive deficit procedure in 2020. This procedure implies a number of measures to reduce the deficit of the general consolidated budget, most likely through a combination of revenue increase and expenditure reduction.





Regarding internal and external **macroeconomic imbalances** at the EU level, monitored through the Macroeconomic Imbalance Procedure, the European Commission reports published at the end of February, 2020[1] indicates that eight countries are still facing macro imbalances – (Germany, Ireland, Spain, France, Croatia, Netherlands, Portugal and Romania) and three countries have accumulated excessive imbalances – Cyprus, Greece and Italy. In Germany and the Netherlands large current account surpluses persist, Spain, Portugal, Ireland and Croatia have showed a combination of vulnerabilities linked to high private, government and foreign debt. Croatia and Spain slowed down measures to close imbalances, while economic recovery has helped the adjustment in Ireland. In France, government debt is not declining productivity growth remains subdued, while in Sweden, household debt and house prices remain high. In Romania, external imbalances have been growing stimulated by a procyclical and expansionary fiscal policy, while competitiveness has been affected. In Cyprus, financial sector vulnerabilities remain, while in Greece there are still challenges related to government debt, NPLs and the external sector, in a context of still low growth potential and high unemployment. In Italy, government debt to GDP ratio is still on the rise, and potential growth remains insufficient.

While many macroeconomic and fiscal challenges have been pointed out and, in many cases, tackled, the **Green Deal and the digital transformation** are requesting credible policies and significant public and private investments, based on coherent and sustainable economic programs. Strengthening economic framework is a prerequisite and implies the correction of excessive deficits, the correction of macroeconomic imbalances, reduction of vulnerabilities to shocks and coordination of economic policies. There are still areas of improvement, but the current momentum is focused on the recovery phase.

Procyclical fiscal policies in good economic times are the recipe for fiscal pressure and very low investments during recession. Unexpected events – such as the COVID-19 health crisis came in top of other already known risks to global economic growth, such as trade war, migration and political instability.

[1] Communication from the Commission to the European Parliament, The European Council, The Council, The European Central Bank and The Eurogroup; 2020 European Semester: Assessment of progress on structural reforms, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176(2011),https://ec.europa.eu/info/sites/info/files/2020-european_semester_communicationcountry_reports_en.pdf

Economic stability is shaken by the health crisis and the subsequent economic lockdown. All member states of the European Union are facing negative growth in 2020, according to the Spring Forecast of the European Commission. Most affected countries are Italy, Greece and Spain, where economic contraction in 2020 is foreseen above 9% of GDP. The less affected country seems to be Poland, where the forecasted economic growth for this year go to only -4.3%, followed by Luxemburg and Austria, Netherlands, Denmark and Romania[1] with a contraction of 5-6 percentage points.

Public finances are the most affected, due to a combined simultaneous and negative effects of lower public revenues and higher expenditures for health sector and social security. As a result, budget deficit of Italy is foreseen at above -11% of GDP in 2020, while for Spain at -10.1% of GDP. The budget deficit of Romania and Poland are also at very high levels of -9.2% of GDP and -9.5% of GDP, respectively. These high deficits are not only adding more pressure on financing the public gap but are also reducing the financial intermediation from banks to private companies. Shrinking economic activity has negative influence on employment, while some current account deficits are reducing in the context of lower consumption (Hungary, Croatia and Romania).

[1] The forecast economic growth for 2020 for Romania is -6% by the EC and -5% by the IMF.

Overview - the spring 2020 forecast

	Real GDP			Inflation			Unemployment rate			Current account			Budget balance		
	2019	2020	2021	2019	2020	2021	2019	2020	2021	2019	2020	2021	2019	2020	2021
Belgium	1.4	-7.2	6.7	1.2	0.2	1.3	5.4	7.0	6.6	-0.7	-0.1	-0.3	-1.9	-8.9	-4.2
Germany	0.6	-6.5	5.9	1.4	0.3	1.4	3.2	4.0	3.5	7.6	6.1	7.4	1.4	-7.0	-1.5
Estonia	4.3	-6.9	5.9	2.3	0.7	1.7	4.4	9.2	6.5	2.3	1.1	2.2	-0.3	-8.3	-3.4
Ireland	5.5	-7.9	6.1	0.9	-0.3	0.9	5.0	7.4	7.0	-9.4	4.6	4.4	0.4	-5.6	-2.9
Greece	1.9	-9.7	7.9	0.5	-0.6	0.5	17.3	19.9	16.8	-0.3	0.1	-1.2	1.5	-6.4	-2.1
Spain	2.0	-9.4	7.0	0.8	0.0	1.0	14.1	18.9	17.0	2.0	3.2	2.7	-2.8	-10.1	-6.7
France	1.3	-8.2	7.4	1.3	0.4	0.9	8.5	10.1	9.7	-0.1	-0.1	-0.4	-3.0	-9.9	-4.0
Italy	0.3	-9.5	6.5	0.6	-0.3	0.7	10.0	11.8	10.7	3.0	3.4	3.3	-1.6	-11.1	-5.6
Cyprus	3.2	-7.4	6.1	0.5	-0.2	1.0	7.1	8.6	7.5	-5.7	-10.9	-10.1	1.7	-7.0	-1.8
Latvia	2.2	-7.0	6.4	2.7	0.2	1.9	6.3	8.6	8.3	0.6	1.1	1.2	-0.2	-7.3	-4.5
Lithuania	3.9	-7.9	7.4	2.2	0.8	1.5	6.3	9.7	7.9	3.5	2.2	2.9	0.3	-6.9	-2.7
Luxembourg	2.3	-5.4	5.7	1.6	0.7	1.6	5.6	6.4	6.1	4.5	4.5	4.5	2.2	-4.8	0.1
Malta	4.4	-5.8	6.0	1.5	0.7	1.1	3.4	5.9	4.4	10.7	7.6	9.7	0.5	-6.7	-2.5
Netherlands	1.8	-6.8	5.0	2.7	0.8	1.3	3.4	5.9	5.3	10.2	9.0	8.4	1.7	-6.3	-3.5
Austria	1.6	-5.5	5.0	1.5	1.1	1.5	4.5	5.8	4.9	2.3	0.9	1.6	0.7	-6.1	-1.9
Portugal	2.2	-6.8	5.8	0.3	-0.2	1.2	6.5	9.7	7.4	0.0	-0.6	-0.2	0.2	-6.5	-1.8
Slovenia	2.4	-7.0	6.7	1.7	0.5	1.2	4.5	7.0	5.1	6.8	6.8	6.8	0.5	-7.2	-2.1
Slovakia	2.3	-6.7	6.6	2.8	1.9	1.1	5.8	8.8	7.1	-2.6	-2.9	-2.4	-1.3	-8.5	-4.2
Finland	1.0	-6.3	3.7	1.1	0.5	1.4	6.7	8.3	7.7	-0.8	-1.3	-1.5	-1.1	-7.4	-3.4
Euro area	**1.2**	**-7.7**	**6.3**	**1.2**	**0.2**	**1.1**	**7.5**	**9.6**	**8.6**	**3.3**	**3.4**	**3.6**	**-0.6**	**-8.5**	**-3.5**
Bulgaria	3.4	-7.2	6.0	2.5	1.1	1.1	4.2	7.0	5.8	5.2	3.3	5.4	2.1	-2.8	-1.8
Czechia	2.6	-6.2	5.0	2.6	2.3	1.9	2.0	5.0	4.2	0.7	-1.5	-1.0	0.3	-6.7	-4.0
Denmark	2.4	-5.9	5.1	0.7	0.3	1.3	5.0	6.4	5.7	7.9	6.2	6.7	3.7	-7.2	-2.3
Croatia	2.9	-9.1	7.5	0.8	0.4	0.9	6.6	10.2	7.4	2.4	-1.7	0.5	0.4	-7.1	-2.2
Hungary	4.9	-7.0	6.0	3.4	3.0	2.7	3.4	7.0	6.1	-0.9	1.3	1.5	-2.0	-5.2	-4.0
Poland	4.1	-4.3	4.1	2.1	2.5	2.8	3.3	7.5	5.3	0.4	0.6	0.9	-0.7	-9.5	-3.8
Romania	4.1	-6.0	4.2	3.9	2.5	3.1	3.9	6.5	5.4	-4.6	-3.3	-3.4	-4.3	-9.2	-11.4
Sweden	1.2	-6.1	4.3	1.7	0.4	1.1	6.8	9.7	9.3	4.4	3.7	4.0	0.5	-5.6	-2.2
EU	**1.5**	**-7.4**	**6.1**	**1.4**	**0.6**	**1.3**	**6.7**	**9.0**	**7.9**	**3.2**	**3.1**	**3.4**	**-0.6**	**-8.3**	**-3.6**
United Kingdom	1.4	-8.3	6.0	1.8	1.2	2.1	3.8	6.7	6.0	-3.8	-4.1	-4.3	-2.1	-10.5	-6.7
China	6.1	1.0	7.8	:	:	:	:	:	:	1.0	0.6	0.8	:	:	:
Japan	0.7	-5.0	2.7	0.5	0.0	0.2	2.3	4.3	4.5	3.5	3.6	3.2	-2.3	-4.9	-5.3
United States	2.3	-6.5	4.9	1.8	0.5	1.5	3.7	9.2	7.6	-2.3	-3.0	-3.0	-7.2	-17.8	-8.5
World	2.9	-3.5	5.2	:	:	:	:	:	:	:	:	:	:	:	:

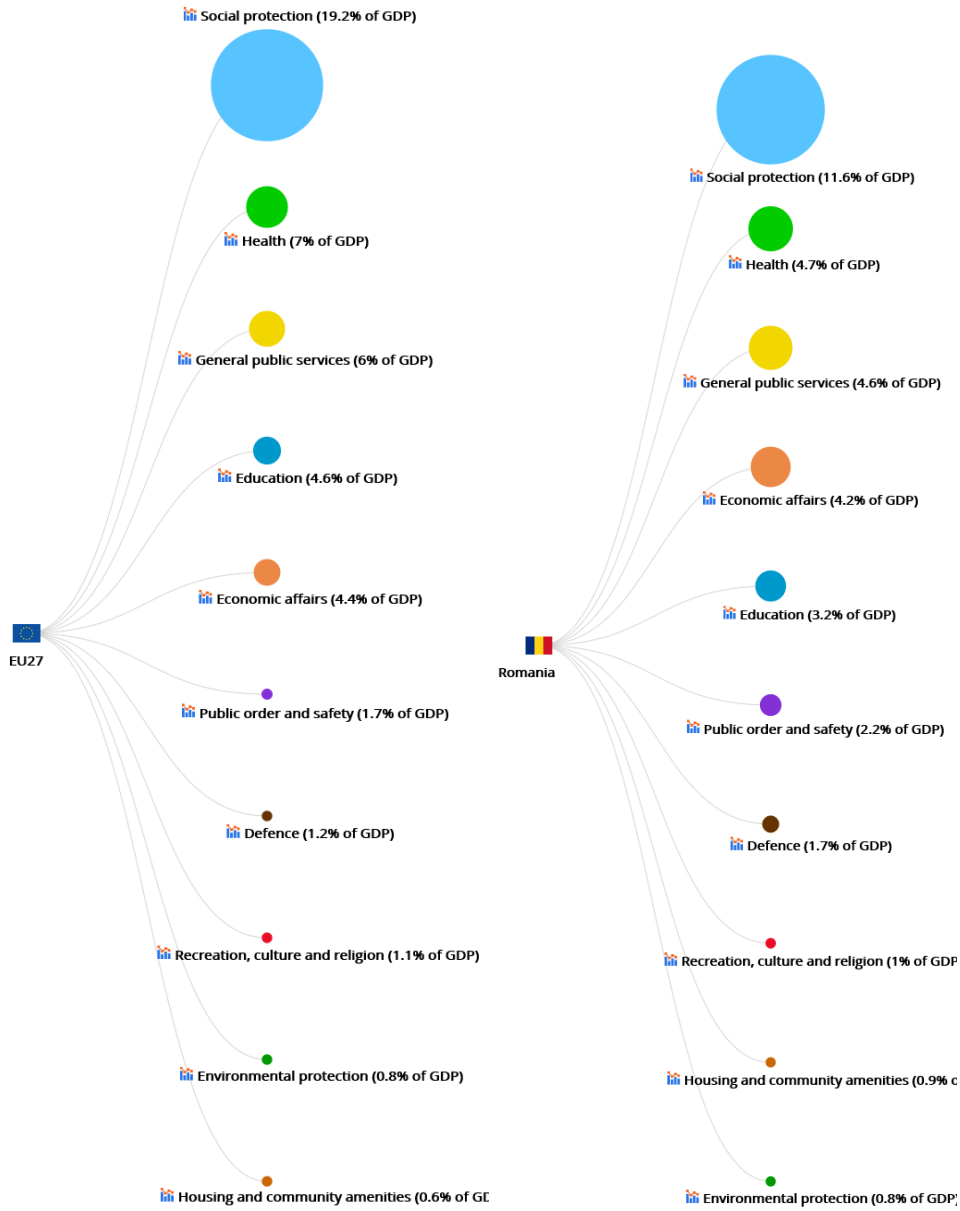
Source: European Commission, Spring Forecast, May 2020

IV. Some are fine tuning while some are closing large gaps

Wise and responsible governments are building now the eco-system of excellence to compensate for higher energy and transport prices reflecting a friendly approach to the environment and a more responsible attitude towards next generations. It requires a certain level and quality of institutions, high standards in health, education and infrastructure, solid social policies and a friendly and predictable business environment. "Old" Europe has accumulated many years of investments and has developed strong institutions. For "New" Europe that has been through brutal shifts of economic and political regimes, the stock of investments and the quality of institutions are weaker.

Persisting weaknesses have been identified in most Central and Eastern Europe in terms of quality of public services. The most severe situation is signaled in Romania, where the lower

level of public revenues is triggering low levels of resources for health, education and social assistance. For example, in 2019, the cost of social assistance was 19.2% of GDP for average EU, while Romania was allocating only 11.6% of GDP, reflecting the huge gap in public revenues – 45% of GDP average EU against 32% of GDP in Romania. With available public resources at two thirds of the EU average, Romania has accumulated significant gaps compared to average and old Europe. Therefore, the health crisis and the new requirements for a greener economy is complicating the economic policy and is adding additional constraints on the convergence process.



Source: Eurostat

V. Next steps

Fixing the economy of the European Union is a priority, which should be based on relocating some production from outside EU. Requirements of greener energy, agriculture, transportation would boost up investments in research and digitalization, contributing to a smart, sustainable and green economy. State aid policies and smart regulations for smart energy production and distribution should be revised immediately for allowing such investments to be implemented in a couple of years. On short term, the new recovery plan designed by the European Commission is ensuring heeling and a quick restart of the EU economy. Good quality education and health remain a prerequisite for this new economic paradigm proposed by the Green Deal and compelled by the pandemic.

At the end of the day, the health crisis is helping Europe to find its sustainable way.

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