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CLIMATE ACTION & EUROPE'S FISCAL DEBATE

POLITICS AND POSSIBILITIES

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With the launch of the European Commission's review of its fiscal rules on October 19th, the debate over Europe's fiscal future will pick up speed.

This briefing introduces readers to the Stability and Growth Pact (the cornerstone of the EU's fiscal framework), outlines its limitations and how climate action might offer an avenue for reform, before exploring the politics of the debate to come.

Reform of the Stability and Growth Pact is critical if Europe is to achieve the goals of the European Green Deal in an ambitious and socially just manner.

Success depends on the political sphere. A monumental effort of coalition-building between Member States supportive of reform is required. The resulting alliance will have to speak directly to the concerns and past experiences of Frugal nations to build a new fiscal consensus for Europe, one that is fit to face the challenges of the climate crisis.

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What is at stake in the fiscal reform debate?

The European fiscal framework is now considered, by many in both the Brussels institutions and European capitals, outdated and unsuited to help Europe overcome the challenges it faces. Elements within the European Commission, and Commissioner Paolo Gentiloni in particular, recognise this[1]. The Stability and Growth Pact (SGP) was suspended through activation of the General Escape Clause in March 2020 in response to the coronavirus pandemic, to give governments the leeway necessary to support their economies. The suspension is due to continue until at least the end of 2022[2]. This window provides an opportunity for Europe's leaders to rethink and reform the framework, to allow Member States increased fiscal space to adequately recover from the effects of the pandemic and fund the transition to a clean economy.

However, the form that such a reform should take remains unclear, with no consensus on the ideal proposal[3]. Furthermore, any attempt at progressive reform faces serious roadblocks, not least in the form of European governments themselves. The battle lines are being drawn for the year ahead[4], with the Frugal coalition growing and actively working to shape the public debate[5]. Support for reform has been expressed by France, Italy and Spain, while Germany's still-forming governing coalition faces both internal and domestic battles[6] before it will even consider throwing its weight behind either side.

With the outbreak of the pandemic in Europe in the spring of 2020, Member State governments deployed near-unprecedented levels of fiscal support[7], in order to protect companies, employment and households as lockdowns hit and aggregate demand contracted. All this spending, which has seen Europe overcome the dramatic shock of the pandemic and put it on the road to recovery[8], has led to fiscal conservatives across the bloc becoming increasingly vocal[9] as budget deficits and government debt grew. In a continent which has never fully recovered from the shock of the 2008 financial crisis[10], the 2010 Sovereign Debt Crisis[11] and the fiscal tightening[12] which followed, Europe's hawks are worried that Europe is continuing to spend beyond its means (leaning on disputed narratives which liken

[1] Gentiloni, Paolo (2021), **Speech at the European Fiscal Board Annual Conference.**

[2] Financial Times, The (2021), **EU set to extend suspension of budget rules.**

[3] Finance Watch (2021), **Navigating the Maze.**

[4] Economist, The (2021), **The Dull Man theory of history.**

[5] Telegraaf, De (2021), **The Netherlands prepared to discuss European fiscal rules.**

[6] Bloomberg (2021), **Scholz Faces Multiple Hurdles to Forge Working German Government**.

[7] Bruegel (2020), **The fiscal response to the economic fallout from the coronavirus.**

[8] European Commission (2021), **Summer 2021 Economic Forecast: Reopening fuels recovery.**

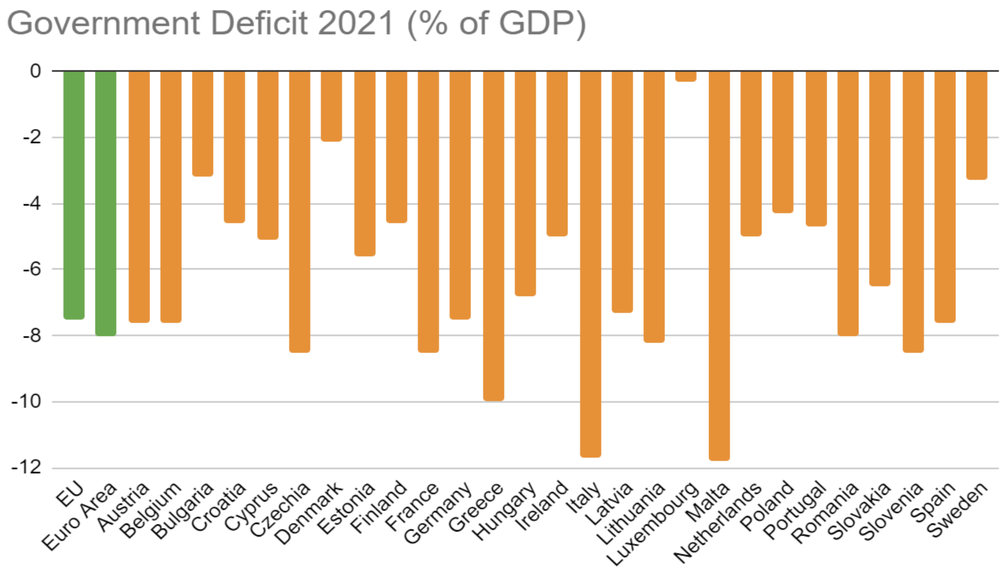
[9] Tooze, Adam (2021), **The debt hawks are flapping their wings.**

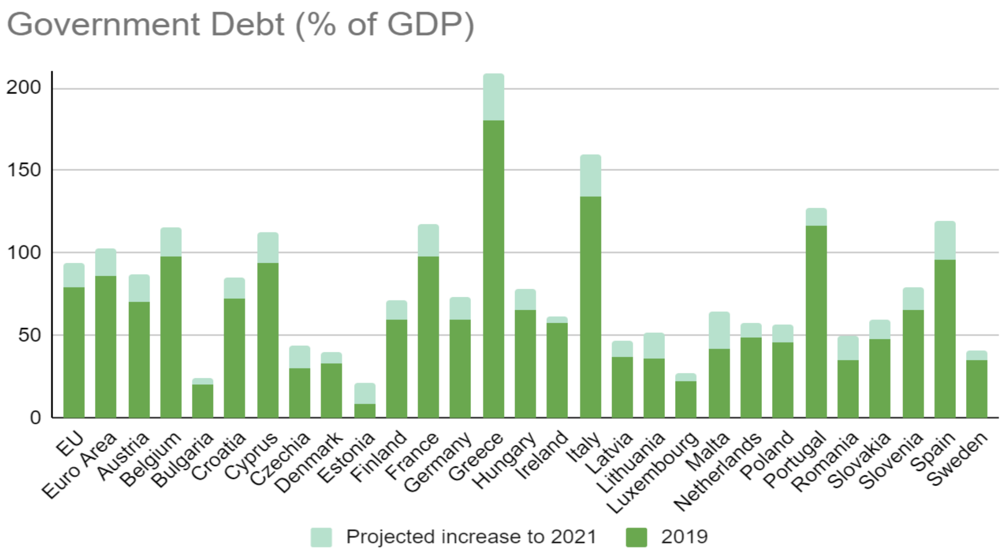
[10] Washington Post (2018), **A guide to the financial crisis — 10 years later.**

[11] CEPR (2015), **The Eurozone Crisis**.

[12] Business Insider (2018), **Austerity has measurably damaged Europe: here is the statistical evidence.**

public finances to personal budgeting [13]) and urging a reactivation of the EU's fiscal framework[14].





Source: European Commission Spring 2021 Forecast

However, a range of expert voices have called this approach into question[15] [16], as the world slowly emerges from one crisis while facing another head-on. Catastrophic climate change will affect us all[17], and is already impacting many[18].

[13] Farmer, R & Zabczyk, P (2018), **The Household Fallacy.**

[14] Financial Times, The (2021), **EU hawks set tough terms for talks on reform of fiscal rules.**

[15] VoxEu (2021), **Fiscal rules in the European Monetary Union.**

[16] European Fiscal Board (2021), **Assessment of the fiscal stance appropriate for the euro area in 2022.**

[17] Intergovernmental Panel on Climate Change (IPCC) (2021), **Climate Change 2021**.

[18] Guardian, The (2021), **Climate crisis made deadly German floods 'up to nine times more likely'.**

Confronting the climate crisis increases scrutiny on fiscal policy, as governments are taking concrete action and aligning policies and tools to put Europe on the path to be the first climate neutral continent by 2050[19]. The additional public investment need (including funding from institutions such as the European Investment Bank) necessary to meet the bloc's ambitious climate goals is between 0.5% and 1% of GDP annually until 2030 (€360bn on average), with an even greater increase needed beyond that[20]. As the private sector mobilises to embrace the clean transition, government spending will be needed to support businesses and citizens as the decarbonisation of the economy continues apace[21].

This monumental challenge demands a re-evaluation of the EU's fiscal framework, as embodied by the SGP. Adopted in 1997, the framework was designed to prevent fiscal indiscipline by Member States through the enforcement of maximum debt and deficit levels, emphasising automatic adjustments to tax revenues and public spending to avoid inflation. Certain politicians were perceived as over-spenders and the SGP was to act as their institutional leash. This leash has proven a threadbare one, however, as Member State compliance with the SGP has been limited since the Pact's entry into force[22].

This briefing will first examine the Stability and Growth Pact itself, before outlining the case for reform and the potential options. It will then move towards the politics of the reform debate, before concluding by looking forward to the negotiations to come.

What is the Stability and Growth Pact and why does it need reform?

Conceived of as part of the Maastricht Treaty negotiations in 1992 and officially adopted in 1997, the Stability and Growth Pact (SGP) was considered an essential element of the effective governance of the nascent Eurozone, in line with the contemporary neoliberal economic consensus informed by recent memories of high inflation[23]. Members of the new monetary union were to keep their annual deficit under 3% of GDP while national debt could not exceed 60% of GDP. Such rules were put into place to ensure the fiscal coordination of the Eurozone, by limiting the window of fiscal action open to Member States. Policymakers, unable to achieve political agreement on greater fiscal coordination[24], imposed such a fiscal straitjacket in an attempt to avoid the potential negative spill-over effects of a sovereign debt crisis (such a crisis would nonetheless erupt 13 years later). The

[19] European Council (2021), **Fit for 55.**

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

[21] Pisani-Ferry, Jean (2021), **Climate Policy is Macroeconomic Policy, and the Implications Will Be Significant.**

[22] European Commission (2021), **Compliance Tracker.**

[23] Transforming Society (2019), **Explaining the Neoliberal turn.**

[24] VoxEu (2021), **Fiscal rules in the European Monetary Union.**

SGP was entrusted with corrective[25] and preventative[26] powers, as a means of bringing undisciplined Member States to heel.

Box 1 - How the SGP fits into the European fiscal framework

- **The Maastricht Treaty debt and deficit rules:** the 1992 treaty established the numerical values for the debt ceiling (60% of GDP) and the annual deficit cap (3% of GDP).
- **The Stability and Growth Pact:** Built on Article 126 of the Treaty on the Functioning of the EU, and established in 1997, the SGP contains the preventative arm, dealing with the surveillance and coordination of national fiscal policies, and the corrective arm, incorporating the Excessive Deficit Procedure.
- **The European Semester:** As part of this coordination cycle introduced in 2010, Eurozone Member States must submit draft budget statements to check their compliance with fiscal rules.
- **National Fiscal Frameworks:** Domestic budgets must be submitted to the Commission, approved, and then executed. As part of the 2012 Fiscal Compact[27], Eurozone states must also implement a structural deficit rule.

The SGP was soon considered too restrictive by some Eurozone finance ministries, and compliance remained inconsistent while enforcement was effectively non-existent[28]. During the first years of its implementation, favourable economic conditions had eased compliance, but with smaller recessions between 2001 and 2003, Member State governments were already feeling the strain[29]. Under pressure from France and Germany, the Commission amended the instrument in 2005 so that it more explicitly considered national economic circumstances, rather than a blunt appraisal of deficit and debt[30].

The SGP was then further expanded in 2011 and 2013 (in response to the Eurozone sovereign debt crisis), when the Six Pack[31], Two Pack[32] [33] and Fiscal Compact introduced much more comprehensive surveillance, enforcement, and

[25] Eur-Lex (2021), **Council Regulation (EC) No 1467/97 of 7 July 1997.**

[26] Eur-Lex (2021), **Council Regulation (EC) No 1466/97 of 7 July 1997.**

[27] ECB (2012), **Main elements of the Fiscal Compact.**

[28] VoxEU (2020), **Tracking compliance with EU fiscal rules: A new database of the Secretariat of the European Fiscal Board.**

[29] ECB (2020), **Fiscal Rules, Policy and Macroeconomic Stabilization in the Euro Area.**

[30] José Manuel González-Páramo (2005), **Speech at ECB Conference.**

[31] Eur-Lex (2021). **Requirements for Euro area countries' budgets.**

[32] Eur-Lex (2021), **Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013.**

[33] Eur-Lex (2021), **Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013.**

preventative powers in an effort to impose sustainable finances on the bloc. However, these successive reforms did little to resolve the fundamental problems of the SGP[34].

What, then, is the problem with the SGP?

The issues are manifold and have been attested to by a range of academics[35], as well as the European Fiscal Board (the Commission-appointed independent body which monitors the European fiscal framework) itself[36]. Some significant problems include:

> **Drivers of deficits and debt:** by mandating that governments restrict spending and investment in order to meet the deficit and debt targets, regardless of the underlying economic conditions, the SGP as originally designed forced governments facing downturns into a choice between damaging austerity and non-compliance. Furthermore, by mandating tightening measures as an automatic response to downturns, the SGP has served to amplify negative impacts across the bloc, since demand has been suppressed across the Eurozone as a whole, slowing the pace of recovery.

> **60% and 3% are limits with a weak theoretical basis:** The 60% debt limit and 3% deficit cap lack a sound basis in economic theory or empirical evidence[37]. The debt cap, the first of these 'reference values' to be agreed, was arrived at by simply averaging the government debts of the 12 countries negotiating the Maastricht treaty. Meanwhile, the 3% deficit cap was decided upon by extrapolating the growth trends and interest rate levels of the 90s forward. With this structure, the SGP assesses fiscal sustainability primarily on backward-looking variables rather than forward-looking ones, where historic deficits and debt/GDP figures are given more weight than future growth and interest rates in assessing fiscal sustainability.

> **Little consideration of spending quality (environmental/social concerns):** By focusing on numerical indicators, the SGP fails to adequately consider the quality and impact of government spending, or whether said spending is necessary to achieve the EU's wider environmental and social goals. Non-compliant Member States may be investing in improved infrastructure and an ambitious climate transition, while compliant Member States may have large, inefficient civil bureaucracies and threadbare public services – yet the SGP as designed does little to recognise the qualitative difference. Although a 2015

[34] Increased surveillance and enforcement powers had little impact in an economic context where Member States had been battered by the Eurozone Crisis, the Great Recession, Troika-imposed fiscal tightening and in some cases, such as Italy, had still not emerged from the impact of the high interest rates of the 1980s and the recessions of the early 90s.

[35] VoxEu (2021), **Fiscal rules in the European Monetary Union.**

[36] European Fiscal Board (2021), **Assessment of the fiscal stance appropriate for the euro area in 2022.**

[37] VoxEU (2021), **Maastricht values.**

reinterpretation of the rulebook[38] included a provision covering EU-funded "major structural reforms" that did not put Member States far beyond the 3% deficit cap, social and environmental factors are yet to be considered adequately.

What are the options?

Given the myriad issues associated with the SGP, it is unsurprising that scholars of the Eurozone and its governance are almost unanimous in their calls for the Pact to be reformed[39]. These experts are joined by voices from various institutions, from the OECD[40] to the European Commission[41] (although the latter is currently facing internal debates over the topic). However, the reform proposals are as numerous as the SGP is complex. The table below outlines some of the principal options.

Proposal	Legislative Process	Impact
Increase of reference values (60% debt & 3% deficit limits).	Changing the limits requires treaty change, unanimous approval from Member States and referenda in multiple countries (which can backfire[42]) – all of which would require a seismic political shift.	Member States would have more fiscal space, which they could use to pursue environmental and social goals. However, changing the reference values would not address the other weaknesses of the SGP.
Green Golden Rule: public investments considered green would be exempted from debt and deficit calculations.	The reform would pass through the Ordinary Legislative Procedure [43] (known as codecision), requiring adoption by the Council and the Parliament.	The proposal would free up fiscal space explicitly for the pursuit of climate goals, allowing governments to decarbonise without cuts elsewhere in their budgets.

[38] European Commission (2015), **Making the best use of the flexibility within the existing rules of the stability and growth pact.**

[39] VoxEu (2021), **Fiscal rules in the European Monetary Union.**

[40] OECD (2021), **Economic Surveys of the European Union and the Euro Area.**

[41] Paolo Gentiloni (2021), **Speech at EFB Annual Conference.**

[42] Siune K., Svensson P., Tonsgaard O. (2002), **The European union: The Danes said 'no' in 1992 but 'yes' in 1995: How and why?**

[43] European Council (2021), **The ordinary legislative procedure.**

Reform of the Debt Reduction Benchmark[44]: decreasing the required annual rate at which Member States need to return their debt & deficit to the reference values.	The reform would pass through the Ordinary Legislative Procedure.	This would allow Member States more leeway for medium-term expansive fiscal policy, such that increased investment in climate and social goals would be more feasible within the fiscal framework.
Reform of the Stability & Convergence Program[45] (in which governments report their fiscal planning for the coming years to the Commission) to explicitly examine climate & social criteria.	The reform would pass through the Ordinary Legislative Procedure.	This would mandate Eurozone Member States to show that their spending contributes, overall, to the EU's environmental and social goals.
Creation of an independent body to monitor the implementation of the SGP and alignment with climate & social goals – known as the "no change" proposal.	The reform would pass through the Ordinary Legislative Procedure.	The Juncker Commission already put forward such a proposal in 2015[46] [47]. Such a framework is considered suboptimal, not addressing, and reinforcing the existing issues with the SGP[48].
Not reforming the SGP at all in favour of making the Recovery & Resilience Facility (RRF) a permanent joint EU debt mechanism.	The reform would pass through the Ordinary Legislative Procedure.	As suggested by French finance minister Lemaire[49] and supported by likely future chancellor Scholz [50], Europe's leaders would avoid the question of SGP reform by instead

[44] Hauptmeier S., Kamps C. (2020), Debt rule design in theory and practice – the SGP's debt benchmark revisited.

[45] European Commission (2021), Stability and convergence programmes.

[46] European Commission (2015), Completing Europe's Economic and Monetary Union.

[47] Which resulted in the creation of the European Fiscal Board.

[48] Bruegel (2016), A proposal to revive the European Fiscal Framework.

[49] Bloomberg (2021), France Calls for Permanent EU Debt Mechanism to Boost Investment.

[50] Politico (2021), Germans ponder 'sea change' on tax, spending policies ahead of election.

		making the RRF permanent, with the funds used for the green & digital transitions.
Reinterpretation of elements of the Code of Conduct[51] (such as the investment clause).	The Code of Conduct falls under the Commission's sole remit, so they could do this unilaterally.	This 'quick fix' solution would create fiscal space but would be unlikely to resolve any issues with the SGP in the long-term.

Changing the reference values will require treaty change, unanimity and referenda, all of which are not politically feasible. On the other hand, it is expected that the Commission will look to publish a reinterpretation of the rules in response to the need for reform[52]. Such a "quick fix" will not, however, go far enough in creating the necessary fiscal space for Europe to face the challenges to come. Those solutions which can be effective and fall within the realm of credibility, then, are those which lie between these two poles, and it is in this space (as is so often the case with European legislative battles) that the forthcoming negotiations will take place.

How can SGP reform support the transition to a clean economy?

One of the most promising vectors for SGP reform lies in tying any proposal to Europe's goal of continent-wide decarbonisation by 2050[53]. Multiple reform proposals are centred on better incorporating climate concerns into European fiscal governance and freeing up more fiscal space for the increased investment need of between 0.5% and 1% of GDP annually until 2030. Some possible reforms to existing aspects of the SGP include turning the investment clause into a 'sustainable investment clause' which favours sustainable spending, or a reform of the Stability and Convergence Program to track the sustainability of public investment. These measures, enacted either alone or in combination, would go some way towards reducing the dissonance between Europe's climate and debt sustainability goals, without being too politically divisive.

Another policy option, which would allow for greater fiscal flexibility, is that of a *green golden rule*. Such an option was recently proposed by Bruegel in a paper[54] presented at the September 2021 informal ECOFIN Council[55], which arguably

[51] European Council (2017), **Specifications on the implementation of the Stability and Growth Pact.**

[52] Euractiv (2021), **Commission hints at quick fix of fiscal rules in 2022.**

[53] European Council (2021), **Fit For 55.**

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

[55] Slovenian Presidency (2021), **Finance ministers discuss boosting the development of sustainable financial markets and fiscal policy in Brdo.**

marked the starting gun for the fiscal debate which will consume the years to come.

The paper puts forward a strategy for a functional green golden rule, which would allow governments fiscal space to pursue green spending while not entirely abandoning the fiscal discipline of the SGP. According to the proposal, fiscal consolidation would continue at the pace set out by the debt reduction benchmark, and deficits would still need to be kept around the 3% mark. However, any investments considered 'green' (i.e., in line with the EU's decarbonisation goals) would be exempt from debt and deficit calculations, leaving more room for necessary government spending on the clean transition.

All proposals involve trade-offs, however: if no other reforms are made, then many of the more damaging aspects of the SGP will remain in place, and no extra fiscal space will be created to pursue social goals, not to mention the difficulty of agreeing what is considered 'green' (an issue highlighted by the current EU taxonomy battle[56]). However, a green golden rule does present a politically feasible opportunity for reform. It not only offers a clear path to financing the green investment for the coming clean transition through debt, but also, in focusing on the Stability and Growth Pact itself, could be achieved through the Ordinary Legislative Procedure, therefore avoiding the prospect of treaty change. It offers a credible avenue for a re-evaluation of the quality of Member State spending while moving the debate away from wrangling over deficit and debt limits, opening up political space for a less polarised, more constructive fiscal discussion.

The politics of the Fiscal Debate

As the link between aligning Europe's fiscal and climate policy grows clearer and a chorus of voices from across civil society support a change[57], the debate on reforming Europe's fiscal rules is heating up. While a loose grouping of Member States is pushing publicly for reform, the so-called Frugal Four (Austria, Denmark, the Netherlands and Sweden)[58], who so strongly pushed against the introduction of the Recovery and Resilience Facility[59], have expanded their coalition so as to limit the parameters of the fiscal debate. Can Europe make the necessary changes to its fiscal governance? The outcome depends on whether those pushing for reform can succeed in forging a new fiscal consensus, which agrees that Europe's fiscal rules should align with its environmental and social goals.

[56] Linklaters (2021), **Inclusion of nuclear and natural gas in EU taxonomy? Next steps.**

[57] Financial Watch (2021), **Open Letter: Reshaping the European Fiscal Framework.**

[58] Financial Times, The (2020), **'Frugal four' fight to protect EU budget rebates.**

[59] Kurz S., (2020), **The 'frugal four' advocate a responsible EU budget.**

Box 2 - Timeline of the current reform debate

- **October 2019** – European Fiscal Board proposes reform of SGP[60]
- **February 2020** - Commission launches Economic Governance Review[61]
- **March 2020** – COVID-19 hits Europe, General Escape Clause (GEC) activated[62]
- **March 2021** - Commission commits to GEC extension until 2022 at least[63]
- **11-12 September 2021** - Informal ECOFIN. The debate starts heating up as Frugal 8 release non-paper[64]
- **26 September 2021** - German Elections leave SPD/Green/FDP coalition as likely government[65]
- **19 October 2021** - Commission to re-launch Economic Governance Review. The debate will begin in earnest.[66]
- **January 2022** – French presidency of the Council of the EU begins
- **End 2022** – Expected end of Commission Review[67]

The Frugals

Emerging from the New Hanseatic League[68] (a grouping of eight conservative Member States seeking to compensate for the loss of the liberal UK post-Brexit) in the wake of the coronavirus pandemic, the alliteratively named 'Frugal Four' of Austria, Denmark, the Netherlands and Sweden were originally formed in response to the proposed debt mutualisation of the Recovery and Resilience Facility[69].

One of the strengths of the Frugals is that their united front and repeated appeals to sustainable finances and the European treaties make them a significant blocking force for any potential reform. This is already becoming clear in the SGP debate, in which the previously established Frugal Four has doubled in size, to include Finland, Latvia, Slovakia and Czechia[70].

[60] European Commission (2019), **Assessment of EU fiscal rules with a focus on the six and two-pack legislation.**
[61] European Commission (2020), **Economic governance review: Questions and answers.**
[62] Euronews (2021), **Brussels wants member states to keep spending to maintain recovery.**
[63] Euractiv (2021), **Commission wants to keep fiscal rules suspended in 2022.**
[64] Twitter, Vallée S. (2021), **Frugal 4 now turned Frugal 8 Non paper on the reforms of the SGP.**
[65] DW (2021), **Germany's election results: Facts and figures.**
[66] Reuters (2021), **EU Commission to launch EU budget rules review on Oct 19.**
[67] Euractiv (2021), **Commission hints at quick fix of fiscal rules in 2022.**
[68] Schulz D., Henökl T. (2020), **New Alliances in Post-Brexit Europe: Does the New Hanseatic League Revive Nordic Political Cooperation?**
[69] Kurz S., (2020), **The 'frugal four' advocate a responsible EU budget.**
[70] Twitter, Vallée S. (2021), **Frugal 4 now turned Frugal 8 Non paper on the reforms of the SGP.**

Where does this hardened stance originate from? It is, for most of these nations, entrenched in society, beyond ideology or short-term political aims. Dutch fiscal policy, for example, established balanced budgets as its core principle as early as 1814[71]. In the specific case of Latvia, Slovakia and Czechia, this is combined with memories of their own recent fiscal past. With their economies battered by the 2008 crisis (Latvian GDP shrunk 17.7%, for example), governments in these states, loath to use monetary policy to ease conditions (so as not to jeopardise their future entry into the Euro), imposed wide-ranging austerity measures, causing a range of negative outcomes[72]. This experience has coloured the European-level fiscal stance of these nations. From their perspective, if they were able to make tough fiscal decisions in times of crisis, the same should apply across the bloc[73].

The expanded Frugal Eight announced themselves in a non-paper at the September 2021 informal ECOFIN council[74]. They called for a return to fiscal sustainability, reforms which simplify the regulations while strengthening enforcement powers against non-compliant states and appealed to a concern for future generations (an appeal which loses its impact when future generations face catastrophic climate change[75]).

> "To put it bluntly, it is like a speed limit in front of a school. If it is not adhered to, the solution is 'more controls and tougher penalties'. And not simply lifting the speed limit."
> **Gernot Blümel, Austrian Finance Minister**

The coalition has already established its initial stance in the negotiations by opposing a green golden rule and emphasising the need for fiscal discipline, suspecting that any push for green exceptions is being used as cover by more fiscally liberal Member States[76] [77].

The Reformers

In comparison to the united voice of the Frugal Eight in this debate, Member States which advocate reform are less cohesive. With calls for reform being led by some of the largest economies of the Eurozone (France, Spain and Italy, the latter of which has implicitly backed expansive European fiscal policy in their recent

[71] Bos, F. (2008), **The Dutch Fiscal Framework: History, Current Practice and the Role of the Central Planning Bureau.**

[72] Dovladbekova, I. (2012), **Austerity Policy in Latvia and Its Consequences.**

[73] Kattel, R. (2010), **Financial and economic crisis in Eastern Europe.**

[74] Twitter, Vallée S. (2021), **Frugal 4 now turned Frugal 8 Non paper on the reforms of the SGP.**

[75] Finance Watch (2021), **Fiscal Mythology unmasked.**

[76] Sueddeutsche Zeitung (2021), **Are Green debts better?**

[77] Telegraaf, De (2021), **The Netherlands prepared to discuss European fiscal rules.**

budget[78]) and supported by others such as Portugal[79], it would appear that the makings of a convincing reform bloc were already in place. What is more, these Member States are explicitly supported by Economy Commissioner Paolo Gentiloni, who has been leading the push within Brussels for rules which prioritise growth over the deflationary pressures of debt and deficit limits[80].

However, the reformers must overcome two significant hurdles before they are able to convincingly push for changes to the SGP in the debate to come.

1. **There is currently no consensus on the preferred reform proposal.** While these governments have publicly acknowledged the need for reform, with Spain's Nadia Calviño calling the SGP "not fit for purpose"[81] and France's Bruno Le Maire advocating for "rules adapted to this new reality [of the post-pandemic world]"[82], no clear consensus has emerged over which of the reform proposals these Member States would advocate for in the debate.

2. **In stark contrast to the Frugals, the reformers have so far failed to present a united front in the debate**. Paris, Madrid, Rome, Lisbon and others have so far lacked any coordination in their public engagement on the issue. This partly stems from the lack of consensus, but also from the differing political priorities of the Member State governments.

   France, for example, has not yet completely backed SGP reform as the desired means of unlocking increased fiscal space and is still seriously floating the idea of making the European Recovery and Resilience Facility (RRF) a permanent mechanism[83] (a move which likely future German chancellor Scholz has also supported[84]). While a successful drive towards a permanent RRF would indeed unlock more fiscal space for environmental and social goals, the current uncertainty over which mechanism to reform creates a conflicted dynamic, which, if it continues into the debate proper, will leave reformers struggling to wield their combined influence to successfully push for a new fiscal consensus.

What about Germany?

One of the most significant unknowns in the SGP debate is which position the traditionally ordoliberal Germany will take. A champion of fiscal rectitude since the end of the Second World War (based, in part, on a since-debunked association

[78] Euractiv (2021), **Draghi on quest to challenge EU rules and grow out of public debt.**

[79] Reuters (2021), **EU fiscal rules must remain flexible until 2022 -Portugal finance minister.**

[80] Politico (2021), **Gentiloni: Unchanged deficit rules will deepen North-South divide.**

[81] Politico (2021), **POLITICO Brussels Playbook.**

[82] Politico (2021), **France's Le Maire: EU should 'reflect' on new budget rules.**

[83] Bloomberg (2021), **France Calls for Permanent EU Debt Mechanism to Boost Investment.**

[84] Politico (2021), **Germans ponder 'sea change' on tax, spending policies ahead of election.**

between inflation and the rise of Nazism[85]), German establishment hawks reacted to the coronavirus debt burden and prospect of more flexible fiscal rules with predictable panic[86]. Although Angela Merkel's support of the debt mutualisation of the Recovery and Resilience Facility seemed to signal a change in the nation's fiscal stance, her succession by professed ordoliberal Armin Laschet[87] made the chances of German-backed reform seem slim indeed.

The results of the German election on September 26th changed that calculation, however. With the likeliest coalition being a 'traffic light' between the centre-left SPD, Greens and Liberal FDP, the chance that German government policy will tend towards reform has somewhat increased, although the result is far from signalling a decisive shift away from fiscal conservatism (especially considering the FDP's traditional hawkishness on the issue).

The German positioning on European fiscal rules will most likely emerge out of internal debates over domestic fiscal policy, in particular around the reform of the country's *Schuldenbremse* (debt brake), which currently limits annual government borrowing to no more than 0.35% of GDP[88]. If reform of the debt brake can be agreed, it will perhaps open the door to Germany backing amendments to the SGP (although it is far from certain that the German political class would be willing to extend the fiscal space of its European neighbours). While the Greens have advocated for such reforms (and have explicitly considered SGP reform)[89], both the SDP's Scholz[90] (the likely next Chancellor) and the FDP have come out clearly against any changes to the domestic framework.

This, however, does not mean that reform of both the debt brake and SGP is out of the question. Recent reports suggest that a consensus may be building around creating exceptions for investments in green and digital infrastructure[91] (indeed Scholz's own comments at the September informal ECOFIN left the door open to such a proposal[92]), without modifying the level of the debt brake itself. If this were to be agreed at German level, it would put momentum behind calls for a green golden rule at European level.

The German stance on SGP reform will have significant consequences for the European debate. Germany, in many ways the proto-frugal of Europe, has in the past supported (if, at times, only implicitly) the fiscally conservative coalition. This

[85] Redeker N. et al. (2019), **Misremembering Weimar: Unpacking the historic roots of Germany's monetary policy discourse.**

[86] Schäuble W. (2021), **Are We Risking a Debt Pandemic?**

[88] Economist, The (2021), **Why German politicians are fighting over the debt brake.**

[89] Financial Times, The (2021), **Greens argue case for reforming Germany's strict fiscal rules.**

[90] Irish Times, The (2021), **German finance minister Olaf Scholz rejects calls to reform EU fiscal rules.**

[91] Handelsblatt (2021), **Golden bridge for the FDP: The traffic light coalition is the only option.**

[92] European Commission (2021), **Informal Economic and Finance Ministers Council.**

pattern was broken in 2020, as Germany joined France in support of the Recovery and Resilience Facility, marking a turning point in the debate over the measure and leading to the Frugal Four backing down. If Germany were to similarly support a progressive reform of the SGP, it could wield its influence to forge a consensus which is both politically acceptable to the Frugals while allowing Europe to pursue its environmental and social goals.

On your marks…

October 19th, 2021 sees the launch of the EU's revamped Economic Governance Review, the starting gun for what is sure to be a long debate over the bloc's fiscal rules. Whether or not Europe's leaders can come to a new, more expansive agreement will set the economic path of the continent for the decades to come and will be critical in deciding if the aims of the European Green Deal are to be achieved in an ambitious and socially just manner.

Member States in favour of reform remain divided and uncoordinated, while the Frugals opposing them speak with one voice. A monumental effort of progressive coalition-building is required, while the resulting alliance will have to speak directly to the concerns and past experiences of Frugal nations in order to build a new fiscal consensus.

The window for action is closing rapidly, with the Commission aiming to come to some agreement by the end of 2022[93]. A concerted, coordinated drive towards reform is, therefore, urgently needed.

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About E3G

E3G is an independent climate change think tank accelerating the transition to a climate-safe world. E3G builds cross-sectoral coalitions to achieve carefully defined outcomes, chosen for their capacity to leverage change. E3G works closely with like-minded partners in government, politics, business, civil society, science, the media, public interest foundations and elsewhere. More information is available at **www.e3g.org**

[93] Euractiv (2021), **Commission hints at quick fix of fiscal rules in 2022.**